AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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▶SUBJECT

TREASURY AND INTERNAL REVENUE SERVICE ISSUE ADDITIONAL GUIDANCE ON FATCA

On April 8, 2011, the Treasury Department and the Internal Revenue Service issued substantial additional guidance (Notice 2011-34) regarding the implementation of the Foreign Account Tax Compliance Act ("FATCA") as it applies to foreign financial institutions.

▶INTRODUCTION

FATCA, which was enacted as part of the Hiring Incentives to Restore Employment ("HIRE") Act, became law on March 18, 2010, and will be effective on January 1, 2013. Congress passed FATCA in order to help Treasury identify United States residents who invest offshore and thereby to enhance and enforce compliance with their tax obligations. To achieve this goal, FATCA created new Internal Revenue Code sections 1471 through 1474, which will require "foreign financial institutions" ("FFIs") to withhold 30% from certain payments and meet substantial disclosure obligations to avoid such withholding. The requirements that FATCA imposes will apply in addition to those already in place under the current withholding regime. For example, the FATCA requirements will apply even to FFIs that are treated as qualified intermediaries under section 1441.

The Service has not yet issued regulations implementing FATCA. However, on August 27, 2010, the Service issued Notice 2010-60, 2010-37 I.R.B. 329, in order to provide preliminary guidance on priority issues. Subsequently, on April 8, 2011, it issued Notice 2011-34, 2011-19 I.R.B. 765, in order to provide guidance in response to comments previously received and to request further comments with respect to specific issues. The 2011 notice supersedes the 2010 preliminary guidance.

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In addition to addressing FFIs (discussed in detail below), Notice 2011-34 states that additional guidance will be forthcoming regarding the application of FATCA to qualified intermediaries ("QIs"), foreign withholding partnerships ("FWPs"), and foreign withholding trusts ("FWTs"). As these entities have already entered into agreements with the Service to provide certain documentation and to undertake certain reporting procedures for their United States and foreign account holders, Treasury and the Service intend to coordinate the new Code section 1471 withholding and reporting requirements with existing obligations under the QI (or FWP/FWT) agreements. QIs, FWPs, and FWTs will be expected to include in their agreements with the Service the information necessary to become participating FFIs under FATCA unless they are deemed to be compliant FFIs under FATCA.

Notably, FATCA broadly defines the term FFI to include not only traditional institutions such as banks, but also hedge funds and private equity funds. Further, as stated, FATCA imposes significant information reporting requirements on those FFIs that, in order to avoid the 30% withholding rule, enter into an agreement with the Service to provide information about the FFI's United States accounts. Finally, FATCA makes other changes including: (i) establishing an extended statute of limitations for certain offshore income; (ii) expanding the passive foreign investment company reporting rules; (iii) repealing certain rules relating to bearer bonds; and (iv) implementing rules for dividend-equivalent payments under swaps that are treated as dividends for United States withholding tax purposes.

The following summarizes some of the key provisions of FATCA that govern the obligations of FFIs regarding withholdable payments.

▶FATCA'S GENERAL RULE

The general rule under FATCA applies when an FFI receives a "withholdable payment" and the FFI has not entered into an agreement with the Treasury (an "FFI Agreement") to provide information about its United States accounts. In this situation, the withholding agent must deduct and withhold 30% from the payment. The general rule thus turns on the respective definitions of the terms "FFI" and "withholdable payment."

FOREIGN FINANCIAL INSTITUTION

Included Entities

FATCA defines an FFI as any "financial institution" that is a foreign entity. It broadly defines the term financial institution to include any entity which is in the banking business or holds financial assets for the account of others as a substantial portion of its business, e.g., brokers, dealers and clearing organizations.

Additionally, a financial institution includes hedge funds and private equity funds. Specifically, the Service has defined a financial institution to include a foreign entity that:

> is engaged, or holds itself out as being engaged, primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a future, forward contract, or option) in the foregoing. This provision is meant to include hedge funds and private equity funds (among others).

The Notice further provides that this category of financial institutions:

> generally includes, but is not limited to, mutual funds (or their foreign equivalent), funds of funds (and other similar investments), exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools, and other investment vehicles.

The Service has also provided that the term "business" differs from the term "trade or business." Specifically, otherwise isolated transactions may cause an entity to be engaged primarily in the business of investing, reinvesting, or trading in securities, depending upon the facts.

Excluded Entities

Treasury and the Service intend to issue regulations that will exclude four types of entities from the definition of a financial institution that would otherwise qualify as FFIs because they primarily engage in investing, reinvesting, or trading in securities. The regulations will classify these entities as non-financial foreign entities ("NFFEs") and will exempt them from withholding from payments that they beneficially own. The first group of NFFEs is comprised of certain holding companies of a subsidiary or a group of subsidiaries that primarily engage in a trade or business other than that of a financial institution. This group of NFFEs, however, will not include investment funds, such as private equity funds, venture capital funds, leveraged buyout funds, or any investment vehicle having a purpose to acquire or to start up companies and then to hold these companies for an investment purpose for a limited time.

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The second group of NFFEs is comprised of certain start-up companies. These companies invest capital into assets with the intent to operate a business that is not a financial institution and that is not yet an operating business. Regulations will exclude these companies from the definition of an FFI for the first 24 months after their organization.

The third group of NFFEs is comprised of non-financial entities that are liquidating or emerging from reorganization or bankruptcy. The final group is comprised of hedging/financing centers of a non-financial group.

NFFEs

Although the regulations will exempt from withholding the NFFEs just discussed, as a general rule, FATCA requires NFFEs receiving withholdable payments that they beneficially own to disclose their substantial United States owners or to certify that they do not have any substantial United States owners. An NFFE that fails to do so will be subject to 30% United States withholding tax on all withholdable payments, *e.g.*, as if it were a non-compliant FFI.

Additional Points About FFIs

Treasury and the Service also intend to exclude from the definition of an FFI insurance companies that issue insurance contracts without a cash value. They do not, however, intend to exclude: (1) insurance companies that issue contracts that combine insurance protection and an investment component; (2) FFIs that receive withholdable payments solely through their United States branches; and (3) CFCs that qualify as FFIs.

WITHHOLDABLE PAYMENTS

If an entity is an FFI, FATCA's general rule requires the FFI to withhold 30% from any withholdable payment. Withholdable payments include the payment of interest, dividends, and other United States source payments traditionally subject to United States withholding tax. Withholdable payments also include the gross proceeds from the sale or other disposition of United States stocks, bonds, or other debt instruments. Withholdable payments do not include income effectively connected with the conduct of a United States trade or business.

To avoid having the general rule apply, an FFI must enter into an FFI Agreement. Because the consequence of not doing so will require the FFI to withhold, FATCA provides a strong incentive for FFIs to enter into FFI Agreements.

▶FFI AGREEMENTS

The Service has not yet released a draft FFI Agreement. FATCA, however, provides general provisions that govern what must be included in an FFI Agreement. The key point about FFI Agreements is that they require FFIs to discover and report information to the Service about accounts that United States persons have at the FFI, known as the FFI's "United States accounts." This rule thus requires a definition of the term "United States account" and specifies what information the FFI must provide to the Service about its United States accounts.

UNITED STATES ACCOUNT

FATCA defines a United States account as any "financial account" that is owned by "specified United States persons" or "United States owned foreign entities". A financial account includes depository accounts at the FFI, custodial accounts that the FFI maintains, and equity or debt interests in an FFI (other than interests that are regularly traded on an established securities market). There are exceptions to the definition of a United States account for accounts that natural persons hold and that are less than $50,000.

Specified United States Persons and United States Owned Foreign Entities

The term "specified United States persons" means any United States person. However, FATCA excludes certain persons from this definition and thus limits the definition of a United States account. Specifically, the term "specified United States persons" does not include: (i) corporations whose stock is regularly traded on an established market; (ii) corporations that are members of "expanded affiliated groups" (generally, affiliated groups defined by using 50% instead of 80% under the section 1504 definition); (iii) banks; (iv) exempt organizations; (v) real estate investment trusts; (vi) regulated investment companies (mutual funds); and (vii) certain trusts.

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The term "United States owned foreign entity" means any foreign entity that has at least one "substantial United States owner." Regarding corporations, a substantial United States owner is generally a United States person that owns more than ten percent of the stock of the corporation. Regarding partnerships, a substantial United States owner is generally a United States person that owns more than ten percent of the profits or capital interests of the partnership.

As noted above, the definition of a financial institution includes entities that are primarily engaged in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or other interests (which includes hedge funds and private equity funds). If any of these United States entities owns any amount of stock or any amount of a partnership interest in a United States owned foreign entity, the Service will consider its ownership to be substantial and it will therefore be treated as a substantial United States owner.

Information About United States accounts

Under an FFI Agreement, if an FFI holds United States accounts, it must report information to the Service about each such account. The information that the FFI must report generally includes: (i) the name, address, and taxpayer identification number of each account holder; (ii) the account number; (iii) the account balance; and (iv) the gross receipts and gross withdrawals from the account. Further, if foreign law prevents reporting this or other information that an FFI must report, the FFI must attempt to obtain a waiver from the holder of the account and, if a waiver is not obtained, the FFI must close the account.

IDENTIFICATION OF UNITED STATES ACCOUNTS

The guidance that the Service has issued specifies the procedures that an FFI must follow to identify its United States accounts, accounts of recalcitrant account holders, and accounts that are other than United States accounts. The guidance further discusses the documentation that an FFI may rely upon in implementing these procedures and the yearly certification that the FFI must provide to the Service regarding the FFI's completion of the procedures.

PASSTHRU PAYMENTS

An FFI Agreement may also require an FFI to deduct and withhold a tax equal to 30% of any "passthru payment" made to a "recalcitrant account holder" (an account holder that fails to produce required information) or to a non-particpating FFI (an FFI that does not comply with FATCA). A passthru payment is any withholdable payment or any payment to the extent that it is attributable to a withholdable payment. Alternatively, if certain conditions are met, an FFI may elect to allow counterparties to withhold the portion of any withholdable payments to it that are allocable to the recalcitrant account holder or to the non-compliant FFI.

The Service has responded to comments regarding the definition of a passthru payment and, specifically, how to determine whether a payment is attributable to a withholdable payment. Treasury and the Service intend to issue regulations that will define a passthru payment as a payment that an FFI makes to the extent that the payment is a withholdable payment plus the amount that is not a withholdable payment multiplied by a percentage that is generally based on the FFI's total assets and United States assets.

This definition rests on one of the purposes of the passthru payment rule. *i.e.*, to encourage FFIs to enter into FFI Agreements if the FFI holds investments that produce payments that are attributable to withholdable payments even if the FFI does not directly hold assets that produce withholdable payments. Otherwise, a participating FFI could be used as a "blocker" that would permit non-participating FFIs to invest indirectly in United States assets without entering into an FFI Agreement.

INVESTMENT VEHICLES

Treasury and the Service intend to issue guidance that would deem certain collective investment vehicles and other investment funds as presumptively meeting the FFI Agreement requirement. Generally, under this guidance: (i) all holders of the fund must be FFIs that have complied with the FFI Agreement requirement; (ii) the fund must prohibit persons who have not complied with the FFI Agreement requirement from obtaining an interest in the fund; and (iii) the fund must certify and publish its "passthru payment percentage" as required. Treasury and the Service are also considering whether to deem other entities as having met the FFI Agreement requirement, including foreign entities all of the interests of which are regularly traded on an established securities market, *e.g.*, exchange traded funds.

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ADDITIONAL COMMENTS ABOUT REPORTING

Generally, an FFI must report the required information to the Treasury annually. As an alternative, an FFI can elect to report as a United States financial institution (*e.g.*, under sections 6041, 6042, 6045, and 6049) to avoid the annual reporting requirement and the passthru payment withholding requirements. In addition, Treasury and the Service are considering a centralized compliance option for certain funds that are associated with a common asset manager or other agent.

▶NOTICE 2011-34

Treasury and the Service issued Notice 2011-34 to provide guidance in seven areas: (i) procedures that participating FFIs must follow to identify United States accounts from the preexisting individual accounts that the FFI holds; (ii) definition of the term "passthru payment" and the obligations of FFIs to withhold from passthru payments; (iii) defining categories of FFIs that will be deemed to be compliant; (iv) explaining the obligation of participating FFIs to report United States accounts; (v) the treatment of qualified intermediaries under section 1471; (vi) the application of section 1471 to expanded affiliated groups of FFIs; and (vii) the effective date of FFI Agreements.

Regarding the procedures that an FFI must follow to identify United States accounts from preexisting individual accounts that the FFI holds, Notice 2011-34 revised the procedures that were specified in Notice 2010-60. Notice 2011-34 establishes six steps that a participating FFI must follow to determine whether preexisting individual accounts should be treated as (i) United States accounts, (ii) accounts that belong to recalcitrant account holders, or (iii) non-United States accounts.

▶PREPARATION

FATCA does not become effective until January 1, 2013. However, FATCA imposes complex compliance obligations. For example, for its corporate and partnership account holders, an FFI will have to determine whether United States persons own more than ten percent of the stock of the corporation or more than ten percent of the interests in the partnership. As such, an FFI should now consider what compliance procedures and processes it will need to implement to make these and other determinations.