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August 16, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Foreign Account Tax Compliance Offset Provisions of the HIRE Act

Dear Commissioner Shulman:

Enclosed are comments on foreign tax compliance offset provisions of the HIRE Act. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
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**ABA SECTION OF TAXATION
COMMENTS ON FOREIGN ACCOUNT TAX COMPLIANCE
OFFSET PROVISIONS OF THE HIRE ACT, P.L. 111-147**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Michael Hirschfeld of the U.S. Activities of Foreigners and Tax Treaties Committee of the Section of Taxation. Substantive contributions were made by Alan Appel, Dyke Arboneaux, Paul Carman, Michael Donovan, Alan Granwell, Anne Jacobs, Andrew Jensen, Rachel Kleinberg, Dean Marsan, James McPherson, Michael Miller, Susan Nevas, Stanley Ruchelman, David Shapiro, William Sherman, Jordan Tamchin, Christopher Van Blarcum, Sarah Wang, and John Young. The Comments were reviewed by Alan I. Appel, Committee Chair. The Comments were further reviewed by Fred F. Murray of the Section’s Committee of Government Submissions and Joan Arnold, Council Director for the U.S Activities of Foreigners and Tax Treaties Committee.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who may be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: August 16, 2010

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EXECUTIVE SUMMARY

These Comments address certain issues raised by the Hiring Incentives to Restore Employment Act of 2010¹ (the “HIRE Act”), and are in response to a request for comments made by the Internal Revenue Service (the “Service”) on April 19, 2010.²

Section 501 of the HIRE Act, by adding sections 1471 through 1474 of the Code,³ imposes new information reporting regimes for certain payments made to foreign entities, which is enforced by a new withholding tax regime on payments made to those entities.⁴ The reporting and concomitant withholding are effective as of January 1, 2013. The law applies to withholdable payments made to a foreign entity that is either a foreign financial institution (“FFI”) or a non-financial foreign entity (“NFFE”).

Section 501 of the HIRE Act was previously introduced as part of the Foreign Account Tax Compliance Act of 2009⁵ (“FATCA”), which was not enacted. These Comments provide recommendations and suggestions for the implementation of section 501 of the HIRE Act.⁶

The legislation provides authority for the Service and the Department of the Treasury (“Treasury”) to provide guidance for the implementation of the statute, including regulations that would limit the scope of the application of the statute in situations in which the likelihood for abuse of the U.S. tax system is not significant.⁷ The Comments contain suggestions for consideration when promulgating such guidance.

¹ Pub. L. No. 111-147, § 501, 124 Stat. 71

² Announcement 2010-22, 2010 I.R.B. 602.

³ References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

⁴ Collectively, sections 1471 through 1474 comprise chapter four of subtitle A of the Code, entitled “Taxes to Enforce Reporting on Certain Foreign Accounts.” Hereinafter, the reporting and withholding regime imposed by this new chapter is referred to generally as the “Chapter 4 regime.” To distinguish the new withholding tax imposed by this new chapter from withholding taxes imposed by other sections of the Code, the new withholding tax is referred to as the “Chapter 4 withholding tax.”

⁵ H.R. 3933 and S. 1934, 111th Cong. (1st Sess., 2009).

⁶ ABA Section of Taxation Comments on Foreign Account Tax Compliance Act of 2009, H.R. 3933 and S. 1934 (December 3, 2009), *available at* <http://www.abanet.org/tax/pubpolicy/2009/091203commentsonhr3933ands1934.pdf>.

⁷ *See, e.g.*, I.R.C. §§ 1471(b)(2)(B), 1471(d)(5), 1471(f)(4), 1472(c)(2).

As explained in more detail below, our recommendations with respect to guidance that may be issued are:

1. We recommend that the guidance clarify the scope of the term “financial institution” and, as suggested in the legislative history, that it except certain “holding companies, research and development subsidiaries, and financing subsidiaries within an affiliated group of non-financial operating companies.” We also recommend that other entities that we believe pose a low risk of U.S. tax evasion, such as certain insurance companies, collective investment funds primarily targeted to foreign investors and U.S. tax-exempt entities, and certain investment vehicles established for certain exempt entities, be similarly excepted. Additionally, we recommend that certain entities be excluded from the Chapter 4 regime entirely, possibly pursuant to the authority granted in sections 1471(b)(2)(B) or 1471(f)(4), including wholly-owned agencies and instrumentalities of foreign central banks, widely-held investment vehicles, investment vehicles created pursuant to the Undertakings for Collective Investment in Transferable Securities (“UCITS”) directive, and foreign pension plans.

2. We recommend that the guidance clarify that certain FFIs will be deemed to meet the reporting requirements imposed by section 1471(b) pursuant to section 1471(b)(2)(A) provided the FFI (i) certifies that it has no United States accounts and (ii) agrees to implement internal procedures to monitor and maintain the absence of United States accounts. Due to the compliance costs and burdens associated with the reporting requirements imposed by section 1471(b), we also recommend that the Treasury exclude from the reporting requirements pursuant to section 1471(b)(2)(B) certain FFIs with *de minimis* United States accounts and consider whether an alternative form of less burdensome reporting is appropriate for other FFIs in lieu of either full reporting or complete exemption.

3. We recommend that the guidance clarify the scope of the term “withholdable payment” and that it exclude certain payments that we believe represent a low risk of tax evasion or tax abuse, such as certain routine payments made in the ordinary course of business and certain adjustments that may be treated as dividends under the Code.

4. An exemption from the reporting requirements exists for equity or debt interests in a financial institution that are regularly traded on an established securities market. We recommend that the guidance clarify the meaning and scope of an “established securities market” and provide that the term includes certain foreign exchanges and over-the-counter markets.

5. An FFI is required to withhold tax on “passthru payments” that it makes to a “recalcitrant account holder” or another FFI (if such other FFI does not independently comply with the Chapter 4 regime), unless the FFI makes a valid election to be withheld upon. We recommend that the guidance specify that a valid election to be withheld upon requires the consent of the upstream payor. We also recommend that the guidance clarify the scope and application of the term “recalcitrant account holder” and indicate how

many requests for information must be disregarded before an FFI must treat an account holder as recalcitrant. Further, we recommend that the guidance clarify that, with respect to a recalcitrant account holder, the FFI will not be required to close the account in any case so long as the FFI agrees to withhold upon passthru payments made to such account (or makes a valid election to be withheld upon). For situations in which an FFI must withhold upon a passthru payment made to a recalcitrant account holder, we recommend the guidance provide specific methodologies for determining how much of a passthru payment is attributable to a withholdable payment, particularly for those situations where a withholdable payment received by the FFI may not be attributable to specific assets held by specific recalcitrant account holders.

6. The Chapter 4 regime does not apply to obligations outstanding as of March 18, 2012. We recommend that the guidance define an “obligation” for these purposes to include: (i) any requirement, actual or contingent, to make a payment to another party, including inchoate obligations under an executed agreement and, subject to anti-avoidance rules, fixed-term straight preferred stock; and (ii) a revolving credit agreement itself, and not just the drawdowns on such a revolver. We also recommend that the guidance provide that a significant modification of an obligation outstanding on or before March 18, 2012, will constitute a new obligation for purposes of section 501(d) of the HIRE Act only if the principal purpose of the modification was the avoidance or evasion of the Chapter 4 regime.

7. The Chapter 4 regime provides that where an FFI is the beneficial owner of a payment on which tax was withheld, no credit or refund of the tax is allowed unless the FFI is entitled to a reduced rate of tax on such payment under a U.S. income tax treaty. We recommend that for purposes of this provision, beneficial ownership be defined so as to restrict the impact of credit or refund denial to the FFI, its managers and influential investors.

8. A withholding agent is required to withhold tax on payments made to FFIs and NFFEs that do not comply with certain reporting obligations. To aid the withholding agent in determining whether withholding is required with respect to a particular payment, we recommend that the Treasury publish a list of those FFIs that: (i) have entered into an information-sharing agreement with the Treasury pursuant to section 1471(b) (a “Section 1471(b) Agreement”); (ii) are deemed to meet the reporting requirements of section 1471(b); and (iii) are otherwise excepted from the Chapter 4 regime. We also recommend that the guidance provide presumption rules to aid a withholding agent in determining whether a foreign entity is an FFI or an NFFE.

9. We recommend that safe harbors should be created to permit FFIs to determine whether an account is a “United States account.” In the absence of explicit safe harbors, we recommend that the guidance clarify which “know-your-customer” (“KYC”), anti-money-laundering (“AML”), or other verification and due diligence procedures are necessary and sufficient for making this determination.

10. An FFI is required to report the account balance or value of its United States accounts. We recommend that the guidance provide that, in the case of accounts where valuation information would not be readily available, an FFI is permitted to use such information as it would normally rely upon for purposes of valuation, such as net asset value.

11. We recommend that transition rules be developed for existing foreign funds that would be considered FFIs under the Chapter 4 regime where investments in such funds do not fall within the grandfathering provision of section 501(d) of the HIRE Act and the entity lacks the right to demand information from its account holders necessary to comply with the Chapter 4 regime. Such rules might provide that where an existing foreign fund is able to substantially comply with reporting requirements with respect to its United States accounts by the effective date of the Chapter 4 regime, the fund will be granted additional time to address certain situations that might prevent a fund from successfully entering into a Section 1471(b) Agreement.

12. We recommend that certain insurance policies and products not be brought within the scope of financial accounts which are subject to the Chapter 4 regime. Payments on a variety of insurance policies, ranging from property and casualty policies to reinsurance policies, depend upon the occurrence of a loss arising from a specified contingency and are not the type of accounts which can be effectively used to store wealth or evade U.S. taxation.

13. We recommend that guidance clarify that an election by an FFI to be withheld upon under section 1471(b)(3) is intended to require the FFI to obtain waivers of U.S. treaty rights from its recalcitrant account holders or non-compliant FFI account holders pursuant to section 1471(b)(3)(C)(ii), and not to require the FFI to provide its own waiver.

COMMENTS

I. Overview of the New Reporting and Withholding Regime

Sections 1471 through 1474 operate to impose a 30% withholding tax on “withholdable payments” made to FFIs and NFFEs after December 31, 2012, unless those entities enter into an agreement with the Service and comply with extensive information reporting requirements. These provisions would not apply to payments made after December 31, 2012, on “obligations” that are outstanding on March 18, 2012, or to the gross proceeds from any disposition of such an obligation.⁸

A “withholdable payment” is any U.S.-source payment of interest (including any original issue discount (“OID”)), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income (“FDAP”), and of any gross proceeds from the disposition of any property of a type which produces U.S.-source interest and dividends.⁹ A withholdable payment does not include any item of income that is considered effectively connected with the conduct of a trade or business within the United States under sections 871(b)(1) or 882(a)(1).¹⁰ For purposes of determining amounts that constitute withholdable payments, interest paid on deposits with a foreign branch of a domestic corporation or domestic partnership that is engaged in the commercial banking business is considered U.S.-source interest.¹¹ Interest paid by a foreign branch of a domestic corporation or a domestic partnership is also considered U.S.-source for purposes of determining a withholdable payment if it is paid on: (i) certain deposits or withdrawable accounts with savings institutions and supervised as savings and loan or similar associations under Federal or State law; or (ii) amounts held by an insurance company under an agreement to pay interest thereon.¹² All persons, whether U.S. or foreign, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment are considered “withholding agents” with respect to the 30% withholding tax on such payments.¹³ Withholding agents are considered liable for such tax and are indemnified against the claims and demands of any person for the amount of such withheld tax.¹⁴

⁸ This is the date which is two years after the date of the March 18, 2010, date of enactment. HIRE Act § 501(d)(2).

⁹ I.R.C. § 1473(1).

¹⁰ I.R.C. § 1473(1)(B).

¹¹ I.R.C. § 1473(1)(C).

¹² I.R.C. § 1473(1)(C). *See* I.R.C. §§ 861(a)(1)(B)(ii), 871(i)(3).

¹³ I.R.C. § 1473(4).

¹⁴ I.R.C. § 1474(a).

With certain significant exceptions, amounts withheld on withholdable payments made to FFIs or NFFEs are refundable to the beneficial owner of such payments to the extent that such amounts would otherwise be refundable under the standard chapter 3 nonresident withholding tax rules of sections 1441 through 1446.¹⁵ For example, if the beneficial owner is entitled under an income tax treaty to a reduced rate of withholding tax on the payment, or if the payment is not otherwise subject to U.S. tax (*e.g.*, the payment is eligible for the portfolio interest exemption,¹⁶ etc.), the beneficial owner would be entitled to a credit or refund of any excess tax withheld.¹⁷ However, no credit or refund will be allowed to a beneficial owner that is an NFFE unless the entity provides the Treasury with the information necessary to determine whether it is a “United States owned foreign entity” and identifies its “substantial United States owners.”¹⁸ Further, if the beneficial owner is an FFI, the FFI is only entitled to a credit or refund to the extent that the FFI is entitled to a reduced rate of withholding under an applicable bilateral U.S. income tax treaty, irrespective of whether the payment would not otherwise have been subject to U.S. withholding tax.¹⁹ Thus, withholding on portfolio interest, for example, would not be refundable, in whole or in part, unless the FFI could claim a reduced (or zero) rate of tax under an applicable tax treaty. An FFI that is entitled to a refund or credit is not entitled to any interest with respect to such refund or credit.²⁰

Certain classes of payments are exempted in their entirety from the Chapter 4 regime, including payments made to a foreign entity to the extent the beneficial owner of such payments is a foreign government, its political subdivisions or any wholly-owned agency or instrumentality thereof, an international organization or any wholly-owned agency or instrumentality thereof, a foreign central bank of issue, or any other class of persons identified by the Treasury as posing a low risk of tax evasion.²¹ Also exempted are payments made to NFFEs to the extent the payment is beneficially owned by (i) a corporation whose stock is regularly traded on an established securities market, or a

¹⁵ I.R.C. § 1474(b)(1).

¹⁶ I.R.C. §§ 871(h) and 882(c).

¹⁷ Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the “Hiring Incentives to Restore Employment Act,” Under Consideration by the Senate*, JCX-4-10 (Feb. 23, 2010)(hereinafter “Joint Committee on Taxation”), at 25, available at <http://www.jct.gov/publications.html?func=download&id=3648>. The Treasury also has a longer period--180 days instead of the standard 45 days--to make such refunds or credits before overpayment interest is allowed. I.R.C. § 6611(e)(4).

¹⁸ I.R.C. § 1474(b)(3). The terms “United States owned foreign entity” and “substantial United States owner” are separately defined in sections 1471(d)(3) and 1473(2), respectively, and are discussed in more detail below.

¹⁹ I.R.C. § 1474(b)(2)(A).

²⁰ I.R.C. § 1474(b)(2)(A)(i)(II).

²¹ I.R.C. §§ 1471(f), 1472(c)(1)(D)-(F), 1472(c)(2).

member of such a corporation's expanded affiliate group;²² (ii) any entity organized under the laws of a possession of the United States which is wholly owned by one or more *bona fide* residents of such possession; or (iii) any other class of persons identified by the Treasury as exempt from the Chapter 4 regime.²³

In order to avoid the Chapter 4 withholding tax on all other withholdable payments, a foreign entity must comply with an extensive information reporting regime. The information reporting requirements differ depending on whether a foreign entity is an FFI or an NFFE.

A. Foreign Financial Institutions

An entity that is not a United States person or organized under the laws of any possession of the United States is an FFI if it is an entity that: (i) accepts deposits in the ordinary course of a banking or similar business; (ii) holds financial assets for the account of others as a substantial portion of its business; or (iii) is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any derivatives therein.²⁴ This definition is broad enough to capture not only traditional banks, but also the vast majority of foreign investment vehicles, including offshore hedge funds, private equity funds, and securitization vehicles.²⁵

Withholdable payments made to an FFI will be subject to the Chapter 4 withholding tax unless the FFI enters into a "Section 1471(b) Agreement." Under a Section 1471(b) Agreement, the FFI must agree: (i) to obtain information on its account holders to determine which accounts are "United States accounts;" (ii) to comply with verification and due diligence procedures required by the Treasury with respect to the identification of such United States accounts; (iii) to report, on an annual basis, certain required information with respect to United States accounts; (iv) to deduct and withhold a tax equal to 30% on certain "passthru payments;"²⁶ (v) to comply with requests by the Treasury for additional information with respect to United States accounts; and (vi) in any case where foreign law would prevent the reporting of the required information on

²² An "expanded affiliate group" includes any member of an affiliated group applying the rules of affiliation through a common parent outlined in section 1504(a), but: (i) applying a more-than-50% stock ownership (by vote and value) threshold for affiliation instead of an 80%-or-more stock ownership threshold; (ii) including insurance companies and foreign corporations; and (iii) including partnerships and other non-corporate entities if 50% or more of the value of the beneficial interests in such entity is directly or indirectly owned by members of the expanded affiliated group. I.R.C. § 1471(e)(2).

²³ I.R.C. § 1472(c)(1)(A)-(C), (G).

²⁴ I.R.C. §§ 1471(d)(4)-(5), 1473(5).

²⁵ Joint Committee on Taxation, *supra* note 17, at 44. Note that the Technical Explanation does not specifically refer to securitization vehicles, though the inclusion of such vehicles is consistent with the statutory language.

²⁶ Unless validly electing to be withheld upon, as described below.

United States accounts, to attempt to obtain a valid and effective waiver of such law from each holder of such account and, if the waiver cannot be obtained within a reasonable period of time, to close the account.²⁷ Any Section 1471(b) Agreement may be terminated by the Treasury if it determines that an FFI is not in compliance with the agreement.²⁸ Certain FFIs may be deemed to meet the above requirements by the Treasury if: (i) the FFI complies with procedures prescribed by the Treasury to ensure that the FFI does not maintain United States accounts and meets such other requirements as prescribed by the Treasury with respect to the accounts of other FFIs maintained by the institution; or (ii) the FFI is a member of a class of institutions with respect to which the Treasury has determined that the application of the Chapter 4 regime is not required.²⁹

A “United States account” is any financial account held by one or more “specified United States persons” or “United States owned foreign entities,” including depository and custodial accounts maintained by the FFI, and any equity or debt interest in the FFI that is not regularly traded on an established securities market.³⁰ A financial account would include, for example, a partnership interest held in a foreign hedge fund or foreign private equity fund and a non-publicly-traded bond issued by a foreign commercial bank. A United States account does not include, unless otherwise elected by the FFI, any depository account maintained by the FFI if each holder of the account is a natural person and, with respect to each such holder, the aggregate value of all depository accounts held by such holder and maintained by the same FFI does not exceed \$50,000.³¹ A United States account also does not include an account in a tiered FFI structure where the account is held by another FFI with a valid Section 1471(b) Agreement or where the Treasury determines that the reporting with respect to such account would be duplicative.³²

A “specified United States person” is any United States person other than a corporation the stock of which is regularly traded on an established securities market or a member of its expanded affiliate group; a tax-exempt organization or an individual retirement plan; the United States or any of its wholly-owned agencies or instrumentalities; any State, the District of Columbia, any possession of the United States, or any political subdivisions, wholly-owned agencies, or wholly-owned

²⁷ I.R.C. § 1471(b)(1).

²⁸ I.R.C. § 1471(b)(1).

²⁹ I.R.C. § 1471(b)(2).

³⁰ I.R.C. § 1471(d)(1)(A), (2).

³¹ I.R.C. § 1471(d)(1)(B). To the extent provided by the Treasury, the \$50,000 aggregate limit may also apply to depository accounts maintained by the same individual across an FFI and its expanded affiliated group.

³² I.R.C. § 1471(d)(1)(C).

instrumentalities thereof; a bank; a real estate investment trust; a regulated investment company; a common trust fund; or certain tax-exempt and charitable trusts.³³

A “United States owned foreign entity” is any foreign entity that has one or more “substantial United States owners.”³⁴ A “substantial United States owner” is a specified United States person that owns, directly or indirectly, more than 10% of the stock in a corporation (by vote or value), owns more than 10% of the profits or capital interests in a partnership, owns more than 10% of the beneficial interests in a trust, or is considered the owner of a trust or a portion of a trust under the grantor trust rules.³⁵ In the case of any foreign entity engaged in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any derivatives therein (such as a foreign hedge fund, private equity fund, etc.), a substantial United States owner is a specified United States person owning any percentage of the ownership interests (whether stock, partnership interests, membership units, etc.) therein.³⁶

Under a Section 1471(b) Agreement, an FFI is required to report to the Service with respect to each United States account: (i) the name, address, and tax identification number (“TIN”) of each account holder that is a specified United States person and, in the case of an account holder that is a United States owned foreign entity, the name, address and TIN of each substantial United States owner of such entity; (ii) the account number; (iii) the account balance or value; and (iv) except to the extent otherwise provided by the Treasury, the gross receipts and gross withdrawals or payments from the account determined for such period as provided by the Treasury.³⁷ Alternatively, in lieu of reporting the information described in clauses (iii) and (iv) to the Service, the FFI may elect to provide full Form 1099 reporting with respect to each account holder that is a specified United States person or a United States owned foreign entity as though such person or entity were a natural person and citizen of the United States.³⁸ In the event of

³³ I.R.C. § 1473(3). Section 1473(3) permits the Secretary to create exceptions to the definition of a “specified United States person.” This grant of authority presumably applies to exceptions that would both expand, or more importantly, further restrict the scope of the definition.

³⁴ I.R.C. § 1471(d)(3).

³⁵ I.R.C. § 1473(2)(A).

³⁶ I.R.C. § 1473(2)(A).

³⁷ I.R.C. § 1471(c)(1).

³⁸ I.R.C. § 1471(c)(2). This election can be made separately for each member of an expanded affiliated group. In addition, there are no explicit prohibitions on revocation of the election and therefore an FFI can presumably decide whether to make the election on an annual basis. Because the election does not involve the timing of income or deductions, we do not believe it should be viewed as a method of accounting that would require U.S. consent to change or revoke. We recommend that the Service consider adopting rules explicitly providing for the right to make and revoke the election on an annual basis.

such an election, the FFI's Section 1471(b) Agreement will be revised to reflect the different information reporting requirement.³⁹

To the extent an FFI is treated as a qualified intermediary ("QI") for purposes of chapter 3 withholding taxes imposed on nonresident aliens, the reporting requirements under a Section 1471(b) Agreement are in addition to any reporting requirements imposed under the QI regime.⁴⁰

Under a Section 1471(b) Agreement, an FFI must also agree to deduct and withhold a tax equal to 30% on: (i) any "passthru payment" which is made by the FFI to a "recalcitrant account holder" or another FFI which does not have a valid section 1471(b) agreement in place; and (ii) in the case of any passthru payment made to another FFI which has made a valid election to be withheld upon under section 1471(b)(3) (a "Section 1471(b)(3) Election"), so much of such payment as is allocable to accounts held by recalcitrant account holders or FFIs which do not have a valid Section 1471(b) Agreement in place.⁴¹ Alternatively, an FFI may make a Section 1471(b)(3) Election so that, in the case of any withholdable payments it receives that are attributable to recalcitrant account holders or FFIs that do not have a valid Section 1471(b) Agreement in place, the electing FFI can be withheld upon.⁴² If an FFI makes such an election, its Section 1471(b) Agreement will include provisions: (i) requiring that the FFI notify the withholding agent with respect to each payment to which the Section 1471(b)(3) Election applies of such information as may be necessary for the withholding agent to determine the appropriate amount to deduct and withhold from such payment; and (ii) waiving any right under any U.S. tax treaty with respect to any amount deducted and withheld pursuant to a Section 1471(b)(3) Election.⁴³

A "passthru payment" is any withholdable payment or other payment to the extent attributable to a withholdable payment.⁴⁴ A "recalcitrant account holder" is any account holder that: (i) fails to comply with reasonable requests for information necessary to determine whether the account is a United States account, (ii) fails to comply with reasonable requests for the name, address, and TIN of each account holder which is a specified United States person, or the name, address, and TIN of each substantial United

³⁹ I.R.C. § 1471(c)(2)(B). The FFI will still have to comply with all other requirements necessary to enter into a Section 1471(b) Agreement described previously; only the annual information reporting requirement referred to in section 1471(b)(1)(C) will be altered to designate the election of Form 1099 reporting.

⁴⁰ I.R.C. § 1471(c)(3).

⁴¹ I.R.C. § 1471(b)(1)(D).

⁴² I.R.C. § 1471(b)(3)(B).

⁴³ I.R.C. § 1471(b)(3)(C).

⁴⁴ I.R.C. § 1471(d)(7).

States owner of a United States owned foreign entity, or (iii) fails to provide a waiver of any foreign law which would prevent the reporting of such information upon request.⁴⁵

B. Non-Financial Foreign Entities

An NFFE is any foreign entity that is not a financial institution.⁴⁶ Any withholdable payment made to an NFFE is subject to the Chapter 4 withholding tax if (i) the beneficial owner of the payment is the NFFE or another NFFE; and (ii) the NFFE does not comply with certain information reporting requirements.⁴⁷

To avoid the Chapter 4 withholding tax, an NFFE must provide the withholding agent with either: (i) the name, address, and TIN of each substantial United States owner of the NFFE; or (ii) a certification that the NFFE does not have any substantial United States owners.⁴⁸ In addition, the withholding agent must not know, or have reason to know, that either the certification or any of the information provided is incorrect; and the withholding agent must report the information obtained to the Treasury.⁴⁹

II. General Observations on the Implementation of Section 501 of the HIRE Act

Implementation of sections 1471 through 1474 on a timely basis will be a monumental undertaking for the Treasury, the Service and the taxpayer community, particularly in view of the number of entities that may be classified as FFIs under the expanded statutory definition and the complex myriad transactions that may be undertaken among FFIs. We believe the following should be considered when drafting guidance under these provisions: (i) the guidance should elicit the necessary information; (ii) in a manner that is not overly burdensome on FFIs; and (iii) that will not disrupt global financial transactions or discourage investment in U.S. capital markets. To the extent possible, we recommend that the guidance build on prior guidance and protocols.

The Chapter 4 regime requires that FFIs and NFFEs identify and report information with respect to U.S. account holders and U.S. investors. We recommend that, in drafting guidance, Treasury and the Service be sensitive to concerns that the reporting requirements be implemented in a manner that is not violative of the local laws to which FFIs and NFFEs are subject. FFIs and NFFEs may be constrained in their ability to identify and report U.S. account holders and U.S. investors by their local regulatory, privacy, information disclosure or other legal restraints, some of which may impose criminal sanctions for the disclosure of information relating to persons that are investing in or doing business with the reporting entity. These various legal restrictions

⁴⁵ I.R.C. § 1471(d)(6).

⁴⁶ I.R.C. § 1472(d).

⁴⁷ I.R.C. § 1472(a).

⁴⁸ I.R.C. § 1472(b)(1).

⁴⁹ I.R.C. § 1472(b)(2)-(3).

will not necessarily be the same in all countries and jurisdictions. Thus, FFIs or NFFEs, even if part of the same expanded affiliate group, may be subject to differing legal restrictions and requirements.

The financial community will require sufficient time to establish systems to perform the required due diligence to be able to comply with the Chapter 4 regime.⁵⁰ Thus, these members of the financial community will need definitive guidance on required procedures well in advance of the time when the Chapter 4 regime becomes effective.

In view of the fact that some FFIs may not have significant U.S. investments or U.S. account holders, and therefore as a matter of business and cost/benefit principles will evaluate whether they should enter into a Section 1471(b) Agreement, we recommend that consideration be given to crafting a two-tier system under which larger institutions that have more U.S. account holders and greater resources are subject to the full Chapter 4 regime while other FFIs that may have fewer U.S. account holders and few resources are subject to a less burdensome regime. For example, an FFI with a low percentage of investments in U.S. property that would be the source of withholdable payments would be permitted to rely on certifications from its account holders as to whether they are specified United States persons without complying with the additional due diligence and verification procedures contemplated by section 1471(b)(1)(B) unless the FFI has knowledge that the information received from the account holder is incorrect. Such FFIs would also be required to report only the information required in section 1471(c)(1)(A) and (B) to satisfy the reporting requirement of section 1471(b)(1)(C).⁵¹ An FFI subject to the less burdensome regime would enter into a Section 1471(b) Agreement which reflects these less extensive requirements.

In the alternative, we recommend that Treasury consider whether it may be feasible to achieve convergence with the OECD's efforts in its Treaty Relief and Compliance Enhancement ("TRACE") project, formerly the collective investment project, with the requirements of the Chapter 4 regime. The OECD efforts are targeted on procedures for treaty relief for investors in collective investment undertakings with a focus of supplying information to source jurisdictions from which dividends, etc. are paid, while the Chapter 4 regime is focused on the supply of information about U.S. persons with foreign accounts wherever they may be situated. Even though each has a different focus, both have the overarching objective of developing workable procedures

⁵⁰ The required investment and time for processing system changes in both the government and the private sector may be significant. Treasury and the Service might convene working sessions with affected industry groups, as they have done in the past with other initiatives such as the Schedule M-3 for corporate tax returns, to determine the feasibility of proposed dates.

⁵¹ Section 1471(c)(1)(A) and (B) would require an FFI under the less burdensome regime to report only the name, address, TIN, and related account number of each account holder which is a specified United States person and, in the case of any account holder which is a United States owned foreign entity, the account number and the name, address, and TIN of each substantial United States owner of such entity. The Service could then use this basic information for initiating further inquiries where evasion of U.S. taxes is suspected.

for intermediaries to report beneficial owners in a relevant manner to taxing authorities. The OECD’s work with IT specialists from various governments and banks to develop “readable” information for government recipients of such information raises the question whether it would be possible to develop one general set of procedures for the Chapter 4 regime and TRACE as opposed to multiple requirements.

In complying with the Chapter 4 regime, FFIs, in effect, will be required to prove a negative proposition, *i.e.*, that an account holder is not a specified United States person or a United States-owned foreign entity. FFIs may not readily have the information available to prove this proposition. Information obtained under existing KYC and AML information reporting regimes may not be able to elicit the required information because these regimes were designed for other purposes and may not necessarily identify whether an account holder is a specified United States person; further, such regimes may not necessarily be consistent over different foreign jurisdictions. For example, U.S. citizens residing abroad, dual citizens, or individuals holding the right to lawful permanent residence in the U.S. while living abroad may not be known, and it is especially difficult to identify substantial United States owners of a U.S.-owned foreign entity with existing data.⁵²

In view of the various grants of authority given to Treasury and the numerous issues associated with the Chapter 4 regime that are presented, extensive guidance will be required. We recommend that this guidance be issued in tranches, so as to give stakeholders as much opportunity as possible to absorb and comment on how Treasury and the Service propose to implement the new regime. Further, it is likely that FFIs will not be able to design and implement IT systems to gather and report all required information prior to having a full understanding of the overall structure of the implementing guidance. Thus, the effective date for compliance with the Chapter 4 regime should be considered in this context. For example, we recommend that an FFI with an address-based KYC regime that is capable of identifying accounts with U.S. addresses and entities with 25% or more U.S. ownership be permitted to rely on that system for 12-24 months with respect to its account holders that existed on the date regulatory guidance implementing the Chapter 4 withholding regime is first promulgated.

III. Recommendations

A. Clarify the Scope of the Term “Financial Institution” and Provide Exceptions For Certain Entities Posing a Low Risk of Tax Evasion

The definition of a “financial institution” found in section 1471(d)(5) is very broad and encompasses: banks; broker/dealers; various types of investment vehicle including hedge funds, private equity funds, widely-held and private investment funds;

⁵² The technical explanation of the HIRE Act refers with apparent approval to the EU Third Money Laundering Directive, Directive 2005/60/EC of the European Parliament and of the Council, 26 October 2005, but articles 3(6)(a)-(b) of the Directive generally only require identification of 25% owners of entities. Joint Committee on Taxation, *supra* note 17, at 38-39. See comment at footnote 56.

and a myriad of other financial structures, including securitization vehicles, pension funds, and insurance company accounts.

The volume of entities encompassed within the definition of a financial institution presents numerous significant problems for tax administration. The administrative burden on the Service associated with having a direct, contractual relationship with so many entities (estimated in the hundreds of thousands) may prove overwhelming, at least in early stages of implementation. Further, the sheer volume of entities encompassed within the definition of a financial institution may prevent the Service from initially focusing its efforts on those institutions that pose the greatest risk for tax evasion.

A financial institution is defined in the Chapter 4 regime by a three-category approach which includes an entity that:

- (i) accepts deposits in the ordinary course of a banking or similar business;
- (ii) as a substantial portion of its business, holds financial assets for the account of others; or
- (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in various financial items.⁵³

While the first category is readily interpreted, what may or may not be included in the second and third categories is not nearly as clear.

As to the second category of institutions, we recommend that Treasury and the Service amplify and illustrate what the term “substantial” means in this context. We believe that a reasonable approach to arrive at a definition of “substantial” in this context would be to apply a series of presumptions to various thresholds based on the percentage of gross revenues an entity receives that are attributable to holding financial assets for the account of others.⁵⁴ For example, if less than 20% of an entity’s gross revenues were attributable to holding financial assets for the account of others, then such activity would be presumed to not be a substantial portion of the entity’s business; if 20% to one-third of the entity’s gross revenues were attributable to holding financial assets for the account of others, then such activity would be presumed to be a substantial portion of the entity’s business unless the entity rebuts the presumption; if more than one-third of the entity’s

⁵³ I.R.C. § 1471(d)(5).

⁵⁴ The term “substantial” generally carries very context-specific definitions in the numerous places it appears in the Code. For example, in the context of section 501(c)(3) charities and the related restriction that no substantial part of the organization’s activities may consist of attempting to influence legislation, spending as little as 16.5% to 20.5% of the organization’s time on lobbying has been considered “substantial.” *Haswell v. United States*, 500 F.2d 1133 (Ct. Cl. 1974). Such a low threshold for substantiality presumably exists since the intended goal is to prevent section 501(c)(3) charities from influencing legislation. Similarly, the “financial institution” definition outlined as part of the Chapter 4 regime above presumably is intended to prevent an entity from engaging in the business of holding financial assets for the account of others without being subject to the Chapter 4 regime; thus, we believe a correspondingly low threshold for substantiality is appropriate.

gross revenues were attributable to holding financial assets for the account of others, such activity would be conclusively presumed to be a substantial portion of the entity's business.

The third category of institutions potentially encompasses most funds and investment vehicles. We recommend that guidance be issued to clarify the term "financial institution" and provide exceptions for certain classes of institutions, identified below, that represent a low risk of tax evasion. As a result of being excepted from categorization as financial institutions, these entities will be treated as NFFEs under the Chapter 4 regime. In cases where a particular entity is also excepted from the reporting requirements applicable to NFFEs, such as in the case of a publicly-traded corporation,⁵⁵ the entity will not be subject to the Chapter 4 regime. In three of the instances described below, involving companies within affiliated groups, the legislative history to the Chapter 4 regime has already suggested such exceptions.⁵⁶ We believe that such exceptions are an appropriate exercise of the authority provided under the statute. We also recommend additional exceptions as provided below.

- (i) Foreign Holding Companies: The legislative history suggests that certain holding companies may be excepted from the term "financial institution."⁵⁷ We recommend that this exception apply to a foreign holding company: (A) that owns operating companies; or (B) that is a bank holding company; notwithstanding that such holding company by definition is primarily invested in securities.⁵⁸ We recommend that to qualify as a foreign holding company under this exception the entity should hold, as all or substantially all of its assets, interests constituting directly or indirectly an 80% or more ownership interest by value (and also possibly by vote) in underlying operating companies, and assets related to the management, supervision, and administration of those companies.⁵⁹ Companies that are within the recommended definition for a foreign holding company could be accorded non-FFI status such that withholdable payments made to such entities would be subject to the less burdensome NFFE regime. This would reflect the same treatment that would be applicable to the payments if

⁵⁵ I.R.C. § 1472(c)(1).

⁵⁶ The technical explanation of the revenue provisions in the HIRE Act states that exceptions from the term "financial institution" may include "entities such as certain holding companies, research and development subsidiaries, or financing subsidiaries within an affiliated group of non-financial operating companies." Joint Committee on Taxation, *supra* note 17, at 44.

⁵⁷ *Id.*

⁵⁸ At a recent seminar, a Service official noted that holding companies that hold only non-FFIs would not themselves be classified as FFIs. Randall Jackson, *IRS Looks to Process in Applying FATCA to Insurance Industry*, 2010 TNT 107-5 (June 4, 2010).

⁵⁹ These requirements are designed to ensure that a holding company is primarily invested only in other companies and is not likely involved in its own separate business. In other contexts, "substantially all" of the assets of a corporation has been identified as 70% of the gross assets of a corporation and 90% of the net assets of a corporation. See Rev. Proc. 77-37, 1977-2 C.B. 586.

they were received directly by the underlying operating companies of the specific holding corporation.

We recognize that many foreign holding companies may be required to have local ownership in operating businesses whose ownership may exceed 20%, thus preventing the holding company from holding at least an 80% interest in the operating company. Thus, some degree of flexibility in the 80% ownership threshold or the requirement that such 80% interests constitute a substantial majority of the holding company's assets may be appropriate.⁶⁰

- (ii) Research and Development (“R & D”) Subsidiaries: The legislative history suggests that an R & D subsidiary may not be treated as a financial institution.⁶¹ We believe this exception to be warranted, though we are unsure whether an exception from application of the term is necessary to accomplish the result. We doubt that an R & D subsidiary would meet any of the three requirements for qualification as a financial institution, even if the group to which it belonged included or was solely comprised of financial institutions, the R & D activity was financial in nature, and it included investing, reinvesting or trading in securities, partnership interests, commodities, or interests therein. Presumably, the subsidiary nevertheless would not be engaged *primarily* in the *business* of such investing, reinvesting or trading, as its activities would be for purposes such as testing and developing investment theories for the benefit of other group members. Therefore, an R & D subsidiary would not, we believe, qualify as a “financial institution” under section 1471(d)(5)(C). Accordingly, to the extent, if any, that R & D subsidiaries are owned by U.S. persons other than group members, we recommend that their ownership be disclosed within the NFFE regime under section 1472.
- (iii) Financing Subsidiaries: The legislative history suggests that financing subsidiaries within an expanded affiliated group of non-financial operating companies may be excepted from the term “financial institution.”⁶² We recommend that such entities be excepted to the extent that their transactions take place within the group. Presumably such subsidiaries would comprise: (A) companies solely engaged in borrowing money from, lending money to, and providing hedging and other Treasury functions for affiliated companies; (B) companies solely engaged in raising funds from related parties and transferring

⁶⁰ We further note that certain tax treaties impose additional requirements on certain foreign holding companies, sometimes referred to as “headquarter companies,” to qualify for tax benefits under the treaty. *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Fr., Aug. 31, 1994, art. 30(3), (6)(h). However, we believe that imposing such additional requirements in determining which foreign holding companies should be excepted from the Chapter 4 regime would result in an overly narrow exception.

⁶¹ Joint Committee on Taxation, *supra* note 17, at 44.

⁶² *Id.*

them to related companies; and (C) companies primarily engaged in providing financing for unrelated purchasers of goods and services from related parties in the ordinary course of business. We recommend that an exception be provided for these subsidiaries on the theory that the transactions with these entities generally do not result in payments and funds leaving the affiliated group, and that as long as the Chapter 4 regime applies when the funds leave the group there is little need to impose the full reporting requirements to which FFIs are subject on the intra-group transactions. Where funds do exit the affiliated group, as in the case of financing for unrelated purchasers of goods and services in the ordinary course of business, the exception is based on the theory that, as will be discussed in more detail below, such payments in the ordinary course are not payments to which the Chapter 4 regime should apply. These various intra-group funds transfers could not easily be used by U.S. investors to evade U.S. taxes.

- (iv) Insurance Companies: The legislative history provides that Treasury may prescribe rules addressing circumstances in which insurance companies are considered FFIs.⁶³ While Treasury has apparently broad authority to bring insurance companies within the scope of the Chapter 4 regime, we recommend that the following insurance companies not be brought within the scope of the regime, with due regard to concerns that insurance policies might be “wrapped” around investments. We recommend that guidance clarify that the following insurance companies will not be brought within the scope of the section 1471 reporting requirements:

(A) P&C Companies: We recommend that the activities of a property and casualty insurance company not be brought within the scope of the term “financial institution” where substantially all of the business of the company consists of underwriting property and casualty insurance products. The examples of insurance products that the Joint Committee on Taxation explained were of concern (*i.e.*, annuities and cash value life insurance) do not include property and casualty insurance products.⁶⁴ Property and casualty insurance products include, for example: homeowners insurance, auto insurance, workers’ compensation insurance, crop insurance, product liability insurance, medical malpractice insurance, commercial liability insurance, directors and officers insurance and excess casualty insurance. Property and casualty insurance does not include insurance products that an individual would purchase as a form of investment

⁶³ The legislative history provides that “[i]t is anticipated that [Treasury] may prescribe special rules addressing the circumstances in which certain categories of companies, such as certain insurance companies, are financial institutions.” Joint Committee on Taxation, *supra* note 17, at 44.

⁶⁴ Property and casualty insurance companies generally do not specialize in issuing annuity contracts or cash value life insurance contracts, recognized in the legislative history to the HIRE Act as potential concerns under the Chapter 4 regime. *Id.* Note that U.S. AML rules for insurance companies apply only to issuers of insurance products with cash value or investment features, such as non-group permanent life insurance policies and annuity contracts. 31 CFR § 103.37(a)(4), (9); 70 Fed. Reg. 66755. Similarly, under articles 3(2)(b) and (e) of the EU Third Money Laundering Directive, *supra* note 52, only life insurance companies are within the scope of the Directive.

product. Property and casualty insurers' potential liability to policyholders depends upon the occurrence of a loss arising from a certain contingency. It seems highly unlikely to us that a policy of this type could be used as a means to store wealth. Accordingly, property and casualty insurers do not present the risk of U.S. tax avoidance that the Chapter 4 regime is designed to prevent, so long as substantially all of the business of the company is concentrated in underwriting property and casualty insurance products. Further, foreign property and casualty insurers provide capacity for certain types of insurance that domestic insurers are unable or unwilling to write. Therefore, we recommend that guidance provide clarification that foreign property and casualty insurance companies will not be brought within the scope of the term "financial institution" under the circumstances described above.

(B) Reinsurance Companies: We recommend that the activities of a reinsurance company not be brought within the scope of the term "financial institution" where substantially all of the business of the company consists in underwriting reinsurance contracts. Reinsurance is often described as "insurance for insurance companies," a way for a primary insurer to protect against unforeseen or extraordinary losses. Reinsurance serves to limit liability on specific risks, to increase individual insurers' capacity, to share liability when losses overwhelm the primary insurer's resources, and to help insurers stabilize their business in the face of the wide swings in profit and loss margins inherent in the insurance business. For example, reinsurance plays a necessary, though behind-the-scenes, role in the financial management of natural disaster losses.

The relationship of reinsurer to ceding insurer is not that of an account holder to a depositor or investor. In a reinsurance contract one insurance company (the assuming insurer) charges a premium to indemnify another insurance company (the ceding insurer) against all or part of the loss it may sustain under its policies. Reinsurance companies hold reserves for payments to contract holders upon the occurrence of a specified contingency. Their potential liability to contract holders depends upon the occurrence of a loss arising from certain contingencies. Furthermore, because only insurance companies can purchase reinsurance, individuals (or shell corporations or other entities formed by individuals), which are the focus of the Chapter 4 regime, are not involved in reinsurance transactions. Accordingly, reinsurers do not present the risk of U.S. tax avoidance that the Chapter 4 regime is designed to prevent, so long as the reinsurer is not also engaged in underwriting insurance products that can be used to store wealth. However, foreign reinsurers provide capacity to domestic insurers and are essential to the stability of the domestic insurance marketplace. Therefore, we recommend that guidance clarify that foreign reinsurance companies will not be brought within the scope of the term "financial institution" so long as substantially all of the business of the company is concentrated in underwriting reinsurance contracts.

- (v) Collective Investment Funds Primarily Targeted to Foreign Investors and/or U.S. Tax-Exempt Investors: We recommend that an exception from the term “financial institution” be provided for collective investment funds that are limited to certain investors, namely foreign investors without substantial United States owners and/or U.S. tax-exempt investors, such as sovereign wealth funds (“SWFs”).⁶⁵ Provided that the fund has a mechanism in place to ensure that the initial investment in the fund is made by approved investors, *i.e.*, foreign investors without substantial United States owners and U.S. tax-exempt investors, and the fund restricts transfers of such interests to U.S. taxable investors and monitors its account holders on a periodic basis, the vehicle would not be able to be effectively used to evade U.S. taxes. While an absolute prohibition against any U.S. taxable investors in the fund, either directly or indirectly, might be applied, we believe that some latitude for U.S. taxable investors may be appropriate where such taxable investors form the fund and hold a related carried interest. In such a case, these taxable investors would be required to report necessary information to the Service but the fund generally would be exempt from reporting on its other account holders. As noted below in connection with widely-held investment vehicles, there may be a potential for abuse in the case of taxable investors responsible for initially forming the fund such that an appropriately drafted and narrowly-applicable anti-abuse mechanism may be appropriate.
- (vi) Certain Investment Vehicles: We recommend that investment vehicles established solely for non-financial publicly-traded corporations, U.S. charities, or other U.S. entities that would not be considered “specified United States persons” within the meaning of section 1473(3) be excepted from term “financial institution.” In these situations, the investor would either not be subject to the reporting regime applicable to FFIs for investments made directly in the United States, as in the case of the non-financial publicly traded corporation,⁶⁶ or would not otherwise be required to provide information to the investment vehicle as a non-specified United States person.⁶⁷ Therefore, little benefit would result from imposing the full reporting regime applicable to FFIs on investment vehicles established solely on behalf of these entities since no information would be required to be reported in connection with such account holders.

⁶⁵ The Treasury has indicated that there is no single universally accepted definition of an SWF, but uses the term to describe “a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities.” *See, e.g.*, Treasury, *Report to Congress on Economic and Exchange Rate Policies*, June 2007, available at http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_Appendix-3.pdf. SWFs are special purpose funds or arrangements created by a State or a political subdivision for macroeconomic purposes. SWFs hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. They are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses or receipts resulting from commodity exports.

⁶⁶ *See* I.R.C. § 1472(c)(A).

⁶⁷ *See* I.R.C. § 1473(3).

We also recommend that the following entities be excluded from the entire Chapter 4 regime through other avenues provided by statute because of a very low risk of potential abuse:⁶⁸

- (vii) Wholly-Owned Agencies or Instrumentalities of Foreign Central Banks of Issue: We recommend that wholly-owned agencies or instrumentalities of a foreign central bank of issue be excluded from the scope of the Chapter 4 regime, through clarification of sections 1471(f) and 1472(c). Both sections currently exempt foreign governments, political subdivisions of foreign governments, wholly-owned agencies and instrumentalities of such foreign governments and foreign political subdivisions, international organizations, wholly-owned agencies and instrumentalities of such international organizations, and foreign central banks of issue. However, while a wholly-owned agency or instrumentality of a foreign central bank of issue should receive similar relief, it is unclear whether such an exclusion is intended based on the current statutory language. Absent a compelling reason, we recommend that wholly-owned agencies or instrumentalities of a foreign central bank of issue be excluded from the scope of the Chapter 4 regime.

- (viii) Widely-Held Investment Vehicles: We recommend that widely-held investment vehicles that meet an established threshold for number of investors and have a non-concentrated ownership be excluded from the scope of the Chapter 4 regime. This particular exclusion should apply both to funds that are regularly traded on an “established securities market” and to open-end funds that are subject to pervasive regulation and hold themselves out as ready to issue and redeem interests from investors, even though said interests might not be sold directly from one investor to another.⁶⁹ While the broad diversity of ownership would make it

⁶⁸ For example, section 1471(f) provides that the withholding requirements do not apply to payments where the beneficial owner is a certain class of person or institution, including those identified by the Secretary as posing a low risk of tax evasion. Additionally, section 1471(b)(2) provides that certain institutions will be deemed to meet the reporting and withholding requirements, including those to which the Secretary has determined that the application of section 1471 is not necessary to carry out the purposes of the Chapter 4 regime.

⁶⁹ As to prior recognition by the Service of the comparability of actively-traded corporations and widely-held open-ended mutual funds, the preamble to the regulations issued under sections 1441 provides:

Section 1.1441-1(e)(4)(vii) enumerates the instances in which a TIN must be furnished on a withholding certificate. Under the proposed rules, a TIN is required to obtain the benefit of reduced withholding under an income tax treaty, unless the payment consists of dividends paid on publicly traded stocks. Commentators have requested that the exemption from having to furnish a TIN be extended to . . . payments on any mutual fund investment (e.g., an open-end mutual fund) In response to these comments, the final regulation [sic] are amended to expand the categories of income for which a TIN is not required to be furnished. Under the final regulations, the categories [include] . . . dividends on redeemable securities issued by an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1) See § 1.1441-6(b)(2)(ii).

unlikely that the entity would be used by only one or a few investors to evade U.S. taxes, we understand that there may be concerns that this type of vehicle could be marketed primarily to U.S. investors as an indirect way to circumvent the Chapter 4 regime. While an anti-abuse rule may thus be necessary, we urge caution when considering any widely-applicable anti-abuse rule where it is evident from the initial offering documents that the investment vehicle is not being marketed in any way to circumvent the Chapter 4 regime.

- (ix) UCITS Investment Vehicles: We recommend that certain investment vehicles created under the UCITS directive also be considered for exemption from the scope of the Chapter 4 regime. UCITS are investment funds created in the European Union pursuant to a set of EU directives that aim to allow collective investment schemes to operate freely throughout the EU on the basis of a single authorization from one member state. The objective of the original UCITS directive, adopted in 1985, was to allow for open-ended funds investing in transferable securities to be subject to the same regulation in every member state.⁷⁰ Certain UCITS may be appropriate to consider for exemption given the heavy regulation to which UCITS are subject which is comparable to that applied by U.S. security regulation authorities,⁷¹ and given that many UCITS restrict ownership by U.S. persons⁷² or do not actively engage in marketing in the United States.

T.D. 8734, 62 Fed. Reg. 53387 (Oct. 14, 1997).

⁷⁰ EC Council Directive 85/611/EEC, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended (the “Directive”), 1985 O.J. (L 375) 3.

⁷¹ In particular, UCITS are subject to restrictions similar to those imposed upon US mutual funds. UCITS may generally acquire no more than 10% of its net assets in securities of the same issuer whereas a US mutual fund at all times, must insure that no more than 25% of total assets are invested in a single issuer. Directive, *supra* note 70, Article 22(2). Where UCITS hold securities of issuers which individually exceed 5% of the fund’s net assets, the total of all such investments may not account for more than 40% of the total assets of the fund. *Id.* For US mutual funds that are diversified funds, with regard to 75% of its total assets, a fund may place no more than 5% in any one issuer. For non-diversified funds, in order to receive regulated investment company treatment under the Code, at the end of each fiscal quarter, at least 50% of the market value of a fund’s assets must be represented by cash, cash items, US government securities, securities of other regulated investment companies, and any other securities, limited in respect of any one issuer to a value of not greater than 5% of the value of the fund’s total assets and 10% of the outstanding securities of such issuer. UCITS are also prohibited from acquiring any voting shares which would enable it to exercise significant influence over the management of the issuer. *Id.*, Article 25(1). UCITS may acquire no more than 10% of the non-voting shares of the same issuer and 10% of the debt securities of the same issuer. *Id.*, Article 25(2). A diversified US mutual fund may not purchase more than 10% of any issuer’s outstanding shares.

⁷² Note that for purposes of restricting ownership by U.S. persons, most UCITS use the term “U.S. person” as it is defined in Regulation S--Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, which only includes a natural person as a “U.S. person” if the person is resident in the United States. *See* 17 C.F.R.

We believe UCITS should be exempted from the scope of the Chapter 4 regime provided: (A) direct investment in the fund is restricted to persons that are not specified United States persons;⁷³ and (B) foreign entities that invest in the fund certify that the entity has no substantial United States owners or certify that the entity is independently compliant with the requirements of the Chapter 4 regime (*i.e.*, the entity has entered into a Section 1471(b) Agreement or complies with the reporting requirements applicable to NFFEs). Alternatively, if Treasury believes that full exemption of these entities is inappropriate, we recommend that such entities be excepted from the scope of the term “financial institution,” and thus made subject to the less burdensome reporting requirements applicable to NFFEs.

The proposed exemption for UCITS that we suggest may still burden the affected UCITS with a due diligence obligation that is far greater than any currently assumed by such vehicles and, given that fact, such a lightened level of monitoring may be viewed no more beneficially by such vehicles than that which the statute may otherwise compel. A possible alternative approach would be to not put these vehicles under a monitoring obligation, but rather impose on UCITS a marketing obligation, which would restrict the vehicle to only selling outside the United States to local investors. This marketing approach should prohibit any investor having a U.S. address from being admitted, which may be a workable option for these UCITS, but it would still leave room for abuse by U.S. investors based abroad or who utilize non-US entities for investment. Treasury may nonetheless wish to consider this marketing restriction approach if it believes that the burdens otherwise placed on these regulated vehicles by the limited monitoring described above far outweigh the actual or perceived benefits of U.S. tax compliance.

- (x) Foreign Pension Plans. While foreign pension plans come within the definition of a financial institution, because such plans are principally involved in the making of investments, they present little opportunity for U.S. persons to evade U.S. taxes and thus should be excluded from the Chapter 4 regime. For these purposes, a pension plan would mean any person established in a foreign jurisdiction that is (A) generally exempt from taxation in that jurisdiction; and (B) operated principally either (1) to administer or provide pension or retirement benefits, or (2) to earn income for the benefit of one or more persons described in clause (1). If Treasury is concerned that this exclusion may nonetheless be subject to abuse, the exclusion might be limited to foreign pension plans established in jurisdictions with which the United States has entered into a bilateral income tax treaty or that would otherwise impose a substantial tax under an established taxation regime.

230.902(k). A citizen of the United States resident in a foreign country, therefore, would not be a “U.S. person” for these purposes.

⁷³ UCITS seeking exemption from the Chapter 4 regime, therefore, may need to develop procedures to identify all “specified United States persons” investing in the fund, regardless of whether such persons are “U.S. persons” for purposes of Regulation S. *See supra* note 72.

Additionally, in certain cases it may not be entirely clear whether a particular entity is a financial institution and whether it should thus be treated for Chapter 4 purposes as an FFI or an NFFE. In such cases the foreign entity and the withholding agent may disagree as to the classification for the entity. While we believe that it would be helpful for guidance to provide presumption rules which would enable a withholding agent to more easily differentiate between FFIs and NFFEs, we understand the difficulty in establishing appropriate rules in such a case and are still considering possible options for such rules.⁷⁴

B. Clarify Procedures and Requirements that Must Be Met for a Financial Institution to Be Deemed to Meet the Section 1471 Reporting Requirements

Section 1471(b)(2)(A) provides an important exception to the Chapter 4 regime in that certain FFIs will be deemed to meet the reporting requirements if the FFI (i) complies with prescribed procedures to ensure that the FFI does not maintain United States accounts; and (ii) meets prescribed requirements with respect to accounts of other FFIs held by the FFI. We recommend that guidance be issued indicating that this exception applies to an FFI that (i) certifies that it has no United States accounts and (ii) agrees to implement internal procedures to monitor and maintain the absence of United States accounts. We recommend that this exception also require the FFI to establish that if it has any other FFIs as customers, such FFI customers have entered into valid Section 1471(b) Agreements with the Treasury or are otherwise excepted from the Chapter 4 regime. Where an FFI has non-compliant FFI customers, we recommend that it be permitted either to (i) withhold any required withholding tax on payments attributable to such customers under a regime similar to the passthru regime outlined in section 1471(b)(1)(D); or (ii) make a valid Section 1471(b)(3) Election to be withheld upon with respect to such passthru payments.⁷⁵

Additionally, section 1471(b)(2)(B) provides an exception that certain FFIs will be deemed to meet the reporting requirements if the FFI is a member of a class of institutions with respect to which the Treasury has determined that the application of the reporting requirements are not necessary to carry out the purposes of the Chapter 4 regime. We recommend that FFIs with *de minimis* United States accounts be exempted from the Chapter 4 regime under this provision.⁷⁶ The legislative history cites “certain

⁷⁴ Cf. Reg. § 1.1441-1(a)(1) (establishing payee presumptions in the absence of documentation).

⁷⁵ As discussed elsewhere, we recommend that an FFI making a Section 1471(b)(3) Election obtain the consent of the payor to whom it is effectively shifting withholding responsibility with respect to passthru payments.

⁷⁶ As previously outlined, a “United States account” under section 1471(d)(1) generally includes any financial account (broadly defined in section 1471(d)(2) to include not only depository accounts and custodial accounts, but also any debt or equity interest in the FFI that is not regularly traded on an established security market) held by one or more specified United States persons or United States owned foreign entities (defined in section 1471(d)(3) as a foreign entity with a “substantial United States owner,” which under section 1473(2) generally includes any specified United States

controlled foreign corporations owned by U.S. financial institutions” as an example of the types of entities that it might be appropriate to exclude under this authority, but there is no indication that the authority of the Treasury is intended to be exercised only in such narrow circumstances.⁷⁷ Exclusions of foreign entities with *de minimis* United States accounts can be justified on the grounds that (i) it may often be cost-prohibitive for such funds to meet the requirements imposed by section 1471(b); (ii) such vehicles do not provide a significant opportunity for U.S. persons to avoid taxes due to minimal direct or indirect investment⁷⁸ by U.S. persons in such vehicles; (iii) application of withholding to foreign entities with few United States accounts will, in many cases, result in excessive overwithholding; and (iv) the failure to provide an exemption may simply lead many such funds to exclude U.S. investors or avoid U.S. capital markets (*i.e.*, institutions with minimal U.S. investments, U.S. customers or U.S. owners may simply decide to opt out of U.S. securities and divest their U.S. account holders rather than enter into a Section 1471(b) Agreement that imposes substantial new obligations and significant regulatory, privacy and data protection burdens (both United States and local), financial risks, and reputational exposures). To simplify the process by which these FFIs identify their *de minimis* United States accounts, such FFIs would be permitted to rely on certifications from account holders as to whether the account holder is a specified United States person or a United States owned foreign entity, so long as the FFI does not have knowledge that the information provided is incorrect. To qualify as an FFI with *de minimis* United States accounts, an FFI would also be required to ensure that the established *de minimis* level of United States accounts was not exceeded for a significant period of time (such as a period aggregating to 30 days within a calendar year, for example). While the quantification of *de minimis* is not specifically articulated in other sections which use that term,⁷⁹ we recommend that in the instant case Treasury establish a safe harbor for a specified percentage of accounts that will be deemed to be *de minimis*, such as 5% of total financial accounts, so that the application of section 1471(b)(2)(B) to these cases is both certain and administratively practicable.

person owning more than 10% of the ownership interests in the entity). An FFI with *de minimis* United States accounts would thus have limited direct ownership by specified United States persons and limited indirect ownership by specified United States persons through United States owned foreign entities. Note that under section 1473(2)(B), in the case of indirect investment in an FFI which is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interests therein, a “substantial United States owner” for purposes of determining whether the investing entity is a United States owned foreign entity is a specified United States person owning *any* (more than 0%) of the interests in the investing entity.

⁷⁷ The Technical Explanation of the revenue provisions in the HIRE Act states that institutions deemed to meet the requirements of section 1471(b) “may include certain controlled foreign corporations owned by U.S. financial institutions and certain U.S. branches of foreign financial institutions that are treated as U.S. payors under present law.” Joint Committee on Taxation, *supra* note 17, at 41.

⁷⁸ Such vehicles would have minimal indirect investment of the type that is targeted by the Chapter 4 regime, *i.e.*, minimal investment by foreign entities with one or more “substantial United States owners.” See I.R.C. §§ 1471(b)(1), (d)(1), (d)(3), 1473(2).

⁷⁹ See, *e.g.*, I.R.C. § 132(e); Reg. § 1.132-6.

We also recommend that Treasury consider whether, for certain classes of institutions that do not pose a high risk of tax evasion, some form of abbreviated or otherwise less burdensome reporting is appropriate in lieu of either full reporting or complete exemption under the Chapter 4 regime: for example, if the FFI is resident in a jurisdiction that has entered into a U.S. bilateral income tax treaty, has internal laws that are not conducive to tax evasion, and has a history of prosecuting tax evasion, a lesser degree of documentation may be appropriate. As discussed above in connection with FFIs that have a low threshold percentage of investments in U.S. property, such FFIs would be permitted to rely on certifications from their account holders as to whether they are specified United States persons without complying with the additional due diligence and verification procedures contemplated by section 1471(b)(1)(B), unless the FFI has knowledge that the information received from the account holder is incorrect. Such FFIs would also be required to report only the information required in section 1471(c)(1)(A) and (B) to satisfy the reporting requirement of section 1471(b)(1)(C).⁸⁰ An FFI subject to the second tier regime would enter into a Section 1471(b) Agreement which reflects these less extensive requirements.

C. Clarify Scope of the Term “Withholdable Payment” and Expressly Exclude Certain Payments Representing a Low Risk of Tax Evasion or Tax Abuse

We recommend guidance to clarify the scope of the term “withholdable payment,” and to expressly exclude from such term those payments identified in the legislative history of the HIRE Act or otherwise as presenting a low risk for tax abuse or tax evasion. Specifically, we recommend that the guidance exclude or otherwise clarify the following:⁸¹

⁸⁰ Section 1471(c)(1)(A) and (B) would require an FFI under the second tier regime to report only the name, address, TIN, and related account number of each account holder which is a specified United States person and, in the case of any account holder which is a United States owned foreign entity, the account number and the name, address, and TIN of each substantial United States owner of such entity. The Service could then use this basic information for initiating further inquiries where evasion of U.S. taxes is suspected.

⁸¹ In addition to the recommended exclusions specifically outlined in the Comments, some working group members expressed the view that there should be an exemption for OID on obligations with a term of 183 days or less that is currently excluded from the definition of an OID obligation under section 871(g)(1)(B)(i). However, other members of the working group expressed concern that such exemption may be open to abuse. As a result, no recommendation was made. Also, a withholdable payment does not include any income taken into account under sections 871(b)(1) or 882(a)(2) that is effectively connected with a U.S. trade or business. Some members expressed the desire for clarification of whether this exemption would apply if the income that may otherwise be taxable is exempt from taxation under a treaty (for example, due to the absence of a permanent establishment). On balance, no recommendation was made, but Treasury may wish to clarify that point.

1. *Exclude Certain Routine Payments Made in the Ordinary Course of Business*

The legislative history indicates that the Treasury may exclude certain payments made for goods, services, or the use of property if the payment is made pursuant to an arm's-length transaction in the ordinary course of the payor's trade or business.⁸² In a recent teleconference, a representative of the U.S. Treasury offered as an example an EU software developer that was well established in the business of developing and licensing software.⁸³ Even if the stock of the software developer was not publicly traded, the example as presented would indicate that royalties paid to the developer by a U.S. licensee that uses the software in its trade or business would not be subject to withholding under the ordinary course of business exception.

Although we recognize that it may be necessary to have a facts and circumstances test as a back stop for transactions not explicitly covered, to create certainty in transactions and not impede the flow of business, we recommend that guidance specify that routine payments for goods, services, or the use of property made to an unrelated party operating in the ordinary course of business are not considered withholdable payments. Absent such an exception, the ability of U.S. entities to obtain inventories, supplies and services from foreign vendors on account could be significantly curtailed. To the extent that a foreign vendor receives little or no other U.S. source income, the vendor may not be willing to comply with the reporting required under the Chapter 4 regime. Moreover, such vendors would likely be unwilling to incur any risk of Chapter 4 withholding tax imposed on the principal amount of their investment. As a consequence, many foreign vendors may cease to be a source of products and services to U.S. entities. Although some U.S. entities may be able to replace the affected borrowings with inventories, supplies and services from other U.S. sources (at possibly higher rates), many U.S. entities may suffer significant shortfalls in required inventories that could drastically limit their business or even challenge their viability.

To the extent that Treasury or the Service believe an anti-abuse provision related to this exception is warranted, we believe it would be helpful to businesses in planning their affairs that the guidance indicate factors that will be considered in determining whether a particular transaction is abusive. We also recommend that the guidance provide an explanation as to why each factor listed is indicative of abuse.

⁸² The Technical Explanation of the revenue provisions in the HIRE Act states that “[i]t is anticipated that the Secretary [of the Treasury] may exclude certain payments made for goods, services, or the use of property if the payment is made pursuant to an arm’s length transaction in the ordinary course of the payor’s trade or business.” Joint Committee on Taxation, *supra* note 17, at 46.

⁸³ Remarks of Itai Grinberg, Young IFA Network (YIN) Webinar, “*What You Need to Know About the Foreign Account Tax Compliance Act*,” Apr. 14, 2010.

Additionally, we believe that certain types of income and payments pose little opportunity for U.S. tax evasion and should be explicitly excluded from the scope of the withholdable payment definition.

For example, payments under a qualified hedging transaction under section 1221(b)(2) entered into with a counterparty that is a dealer in the type of contract entered into for the purposes of Regulation section 1.475(c)-1 are already circumscribed by the requirement of section 1221(b)(2) that the transaction be entered into in the normal course of the taxpayer's business and in accord with the specific identification requirements of the regulations under such section. If the counterparty is also a dealer in the type of contract entered into, objective arm's-length comparisons of the terms of the contract are likely to be available to make tax avoidance transactions less likely.

We recommend that installment obligations and accounts payable incurred in the ordinary course of business with unrelated parties likewise be excluded as sufficiently limited by the "ordinary course" and "arms-length" standards mentioned in the legislative history⁸⁴ to be unlikely to be used for tax avoidance transactions.

Similarly, U.S. source gross transportation income subject to the four percent tax under section 887 is not subject to withholding tax under sections 871 or 881. The tax is collected by a return and is subject to reduction by treaty. Thus, the imposition of the Chapter 4 withholding tax would unnecessarily cause non-U.S. persons subject to the tax or eligible for treaty exceptions to the tax to be continually requesting refunds significantly beyond the tax due.

A more extreme example of a short-term instrument that is unlikely to facilitate tax evasion is the overnight credit facility used between financial institutions. Notwithstanding that this would constitute a withholdable payment made to an FFI, such payments could have no practical use in a tax evasion scheme since they are normally settled on the next day or next business day basis. The inclusion of such facilities in withholdable payments would likely increase transaction costs for dealing with the United States without commensurate benefits.

2. *Clarify Application of "Withholdable Payment" to Adjustments Treated as Dividends*

Section 1473(1) provides that a withholdable payment includes any payment of U.S.-source dividends as well as the gross proceeds from the sale or disposition of any property of a type which can produce U.S.-source dividends. It is unclear whether the scope of this definition is intended to cover certain adjustments, such as adjustments made to warrants under section 305, that may be treated as dividends for purposes of the Code. "Deemed" dividends that arise in other contexts, such as in the case of certain stock purchases made by a related corporation under section 304, are treated as dividends

⁸⁴ Joint Committee on Taxation, *supra* note 17, at 46.

that are subject to withholding under chapter 3 if made to a foreign corporation.⁸⁵ It is unclear under the statute and legislative history whether the Chapter 4 regime is intended to similarly apply to such “deemed” dividends and adjustments treated as dividends. Furthermore, it is unclear whether the sale of certain property, such as a warrant that could give rise to adjustments treated as “dividends” under section 305, generates “gross proceeds” within the meaning of the withholdable payment definition, since section 1473(1)(A)(ii) states that gross proceeds arise from the disposition of any property which can produce U.S. source dividends.

We recommend that the guidance clarify whether the scope of the term withholdable payment is intended to cover such adjustments or other cases resulting in “deemed” dividends under the Code. While we recognize that there is a technical argument that such deemed dividends should be included, we believe that applying the Chapter 4 regime to these dividends would result in withholding in instances where there is unlikely to be any tax abuse.

D. Exemption for Regularly Traded Debt or Equity Interests--Clarify the Meaning and the Scope of the Term “Established Securities Market” as Used in Section 501 of the HIRE Act

In defining a “financial account,” section 1471(d)(2) excludes debt or equity interests in a financial institution that are “regularly traded on an established securities market.” The term “established securities market” is not explicitly defined in the relevant sections. The term has been used in at least 27 different Code sections and their related regulations (including some repealed sections). In at least eight cases there is no definition of the term established securities market at all, either directly or by cross reference to another section or regulation.⁸⁶ Under other sections, the term “established securities market” is defined in such a way as to exclude foreign exchanges.⁸⁷ Yet other sections provide stand-alone definitions of an established securities market which include foreign exchanges that meet certain requirements, such as minimum trading volumes and government oversight, coverage by regulations similar to SEC rules, or other requirements.⁸⁸ The various definitions also differ in whether an over-the-counter market or a market with a market maker qualify as an established securities market.

From these various definitions it appears that Treasury makes situational decisions about which definition of an established securities market to use in a given context based on which policy objectives are sought to be achieved. With that in mind, assuming that the goal of the Chapter 4 regime is to discourage U.S. persons and U.S.-

⁸⁵ Rev. Rul. 92-85, 1992-2 C.B. 69.

⁸⁶ See, e.g., I.R.C. §§ 67, 249, 482, 704, 752, 988, 2701, 6111.

⁸⁷ See, e.g., Reg. § 1.453-3(d)(4), and sections 167, 1232 (now repealed), and 3406, which refer to the section 453(f) definition.

⁸⁸ See, e.g., I.R.C. §§ 401(a), 883, 884, 7704.

owned entities from investing in foreign funds without paying U.S. tax on income or gain from the investment, an exemption from the definition of a financial account any equity interest in any fund that is traded on a major non-U.S. exchange would not seem to us to support this policy objective. In such a case, tax evaders will simply shift investment out of foreign private funds into foreign publicly-traded funds. There are no stock exchange rules in foreign countries of which we are aware that would prevent a U.S. person from investing in a foreign publicly-traded fund, particularly a U.S. person living outside the United States.⁸⁹

We would note that a more permissive definition of an established securities market⁹⁰ might be used due to the difficulty which a foreign publicly-traded fund might encounter in collecting and submitting all of the information required by the Chapter 4 regime on all of its shareholders during a given year. For example, Treasury could adopt the definition of “established securities market” that is used in the publicly-traded partnership context, which includes foreign securities exchanges that, under the law of the jurisdiction where it is organized, satisfy regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934; regional or local exchanges; and an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.⁹¹ In the event that Treasury believes this definition is too broad and subject to abuse, we recommend that Treasury consider restricting which foreign exchanges are within the term “established securities market” based on a certain threshold trading volume or annual value.⁹²

Given the uncertainty regarding which definition of an established securities market is intended for purposes of the Chapter 4 regime, we recommend that guidance explicitly clarify and define the scope of the term for purposes of these sections.

E. Clarify Issues Related to “Passthru” Payments Made to Recalcitrant Account Holders

Under the Chapter 4 regime, a “passthru payment” is any withholdable payment or other payment to the extent attributable to a withholdable payment. Section

⁸⁹ Even the SEC does not define a “U.S. person” to include a U.S. citizen living outside of the United States, so there is also no SEC hurdle to such foreign funds marketing to U.S. people who live outside the United States of which we are aware.

⁹⁰ For example, Regulation section 1.871-1(m) defines an established securities market to include (i) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); (ii) a foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority; and (iii) any over-the-counter market.

⁹¹ Reg. § 1.7704-1(b).

⁹² For example, Regulation section 1.883-2(b)(1) limits an “established securities market” to foreign securities exchanges that are officially recognized, sanctioned, or supervised by a governmental authority of a qualified foreign country in which the market is located, and that have an annual value of shares traded on the exchange exceeding \$1 billion.

1471(b)(1)(D) requires a provision be included in every Section 1471(b) Agreement between the Service and an FFI, stating that if the FFI makes a passthru payment to a recalcitrant account holder that does not provide information about potential U.S. status, or a non-compliant FFI (that is, an FFI that has not itself entered into a valid Section 1471(b) Agreement), the FFI must withhold on the payment. The withholding rate of 30% would apply to the portion of the passthru payment consisting of a withholdable payment or allocable to a withholdable payment. Alternatively, the FFI can make a Section 1471(b)(3) Election to be withheld upon, provided that the FFI provides its upstream payor (*i.e.*, the person making the withholdable payment to the FFI) sufficient information to determine the appropriate amount of withholding.

We recommend that guidance clarify a number of points related to this withholding mechanism. Some of these issues relate to the mechanics of such withholding, and some are specific to investment funds. For purposes of this discussion, a “downstream” entity is an FFI that receives a withholdable payment attributable to recalcitrant account holders and makes a Section 1471(b)(3) Election to be withheld upon with respect to that payment; an “upstream” entity is the payor of the withholdable payment to the FFI that is attributable to recalcitrant account holders.

1. *Clarify Whether the Election to be Withheld Upon Requires Consent of the Upstream Payor*

If a downstream FFI elects to be withheld upon rather than to withhold, this will create many of the same issues for an upstream payor as do payments to a qualified intermediary or nonqualified intermediary under current law. The upstream payor will need to do “split rate” withholding, since only the portion allocable to the recalcitrant account holders and non-compliant FFIs is subject to withholding. Furthermore, if the downstream FFI is a bank or brokerage, it might only be holding U.S. securities for the accounts of certain of its customers, so allocations could change for every payment.

Financial institutions have managed to agree to methods for managing these issues under current law; for example, by developing mechanisms for downstream institutions to give allocation information to upstream institutions, or by having downstream institutions segregate their holdings into pools with uniform withholding tax characteristics. However, it would seem unreasonable to allow a downstream institution to impose these complications unilaterally upon an upstream payor. We suggest, therefore, that an Section 1471(b)(3) Election by a downstream institution require consent by the upstream institution.

2. *Clarify Scope and Application of the Term “Recalcitrant Account Holder”*

Section 1471(d)(6) defines a recalcitrant account holder as one who either: (i) does not comply with “reasonable requests” for information regarding its possible status as U.S. or U.S.-owned; or (ii) does not, upon request, furnish a waiver of bank secrecy

laws that would prevent reporting of information required to be reported. The potential breadth of this definition raises several issues.

First, in some situations, the holder of a bank account might instruct a bank not to send account statements or other communications to the account holder, but to hold them for collection when the account holder next visits the bank (a “hold mail” account). It is our understanding that, under the local law in some jurisdictions, such an account holder is deemed to be on notice of any correspondence that is made available at the bank for the holder to collect. One suspects that typically, the relationship manager at the bank would know some way of contacting the account holder, even though that information might be highly confidential. In a situation where local KYC rules are not accepted as sufficient, it is not clear whether the account holder should be deemed to be recalcitrant.⁹³ For example, it is not clear whether a “hold mail” account should be deemed *per se* recalcitrant until the account holder comes in to provide the necessary information. It is also not clear whether banks should be allowed to follow whatever notification procedures are used for other accounts, on the theory that in fact, a diligent relationship manager who was looking out for the interests of the client would find some way to alert the client to the request for information. In such a case, a “hold mail” account might not be deemed to be recalcitrant until a certain number of attempts were made to notify the account holder of the requested information.

Second, we recommend that detailed guidance address how one identifies a recalcitrant account holder. For example, we recommend that guidance address items such as how many times and in what manner one must request an account holder to provide the requested information before a financial institution may/must treat the account holder as recalcitrant. The level of detail contained in the rules for “B Notices” under the backup withholding rules⁹⁴ might be too much for a compulsory rule, but perhaps suggestive of a safe harbor rule.

3. *Clarify Required Treatment By a Foreign Financial Institution of Its “Recalcitrant Account Holders”*

As mentioned previously, a “recalcitrant account holder” includes an account holder who fails to provide a waiver of any foreign law that would prevent the financial institution from collecting such information. With respect to the waiver of foreign law, section 1471(b)(1)(F)(ii) indicates that if the FFI is unable to obtain a waiver within a reasonable amount of time, that it must agree to close the recalcitrant account holder’s account. However, with respect to a recalcitrant account holder who simply refuses to provide the information necessary to determine whether the account is a United States

⁹³ Note that under article 6 of the EU Third Money Laundering Directive, *supra* note 52, new anonymous accounts and passbooks must not be created, and the beneficiaries of existing anonymous accounts and passbooks must “be made the subject of customer due diligence as soon as possible, and in any event before such accounts or passbooks are used in any way.”

⁹⁴ Reg. § 31.3406(d)-5.

account, the FFI need not close the account but must simply agree to withhold on payments attributable to the account under section 1471(b)(1)(D).

We recommend that the guidance clarify whether an FFI is obligated to close the account of a recalcitrant account holder who fails to provide a waiver of any applicable foreign law, or whether the FFI may simply institute withholding with respect to such an account under section 1471(b)(1)(D). Further, we recommend that the guidance address those situations in which foreign law may preclude the FFI from either obtaining the required information or from closing the account where the account holder refuses to provide such information. We also recommend that the guidance clarify whether in such cases withholding with respect to the account is sufficient, and whether closure of the account is necessary where a waiver is not obtained if the account holder receives no U.S.-source income.

4. *Clarify Application of Passthru Payment Withholding Regime to Certain Defined Financial Institutions, Such as Foreign Investment Funds*

Since a foreign investment fund is treated as an FFI under section 1471(d)(5)(C), the Section 1471(b) Agreement with such a fund will have to incorporate provisions dealing with passthru payments. This raises a number of issues peculiar to such funds.

First, the fund must determine the composition of each payment that it receives, such that it can ascertain how much constitutes a passthru payment. In theory, this should be straightforward--albeit possibly burdensome--for a fund that makes its own investments. However, the world is full of "fund of funds," which do not invest in stocks, securities, etc., directly, but rather in other funds ("investee funds"), typically not under common management, that make the investments. Experience suggests that investee funds are not always as forthright as might be wished regarding the U.S. withholding tax characteristics of the income that they pay. Unless the fund of funds makes the election to be withheld upon rather than to withhold--which, as previously discussed, presents issues of its own--it would seem that the investee fund's own Section 1471(b) Agreement will have to require it to provide the investing fund of funds and other FFIs with the information necessary to determine the composition of payments made from the investee fund to the investing fund of funds, such that the investing fund of funds can ascertain how much of the received payment constitutes a passthru payment. Many funds may not be willing to provide such information.

Second, a fund may invest in both U.S. and non-U.S. securities. Suppose a fund makes a distribution in the middle of the year, which is less than the income received to date. There will need to be a determination of how to allocate distributions between different categories of income, such that it can be determined how much of the payment is a passthru payment. This problem already exists under the current withholding tax rules for U.S. partnerships with foreign partners.⁹⁵ Such a partnership must withhold

⁹⁵ Reg. § 1.1441-5(b)(2)(i)(A).

“when any distributions that include amounts subject to withholding ... are made.” No guidance has yet been issued under this provision, perhaps because of the complexities it presents. One can postulate several possible rules, such as treating a payment as coming out of U.S.-related income (and thus, to that extent, a passthru payment) first, last, or proportionately. We recommend that the guidance clarify this point.

Third, we recommend that the guidance clarify the treatment of a situation in which a fund that has entered into a Section 1471(b) Agreement does not distribute all of its income every year. The rules with respect to section 1441 withholding for U.S. partnerships with non-U.S. partners specify that in that case, the partnership must withhold on the non-U.S. partners’ share of undistributed income for any particular year when the K-1s for the year are due or distributed, whichever is earlier.⁹⁶ This solution, however, is not workable for funds organized as corporations. Partnerships are expected to maintain capital accounts for each partner, so that if certain partners are subject to passthru payment withholding, the economic burden can be allocated especially to them. Corporations do not maintain separate capital accounts in this way, and all shares of the same class of a corporation generally must have the same economic rights, unless the class is divided into series. It is unclear how the burden of withholding on passthru payments is to be passed through to the investors on whom withholding must be performed. Is a fund with a Section 1471(b) Agreement expected to be able to segregate recalcitrant account holders and non-compliant financial institutions into separate classes of shares (or series of the same class)? This might not be possible under the operative documents of existing funds, and it might be difficult or impossible to amend the documents. If the amounts to be withheld are to be deducted from the fund’s assets generally, without specially assigning the economic burden to any particular shareholder, then all shareholders would be forced to share the economic burden created by the behavior of a few of them, which would seem to be unfair, and may be illegal. A third possibility would be for the fund to redeem on a compulsory basis a sufficient number of shares owned by the recalcitrant account holder or non-compliant FFI to provide the necessary funds. This would make sure that the costs are imposed solely upon the investor who is causing the problem, while keeping all outstanding shares fungible. Such a course of action might have local tax consequences, and in addition, it might be necessary to amend the fund’s operative documents.

5. *Clarify Application of Passthru Payment Regime to Certain Financial Institutions Engaged in an Active Financial Business*

A foreign commercial bank engaged in the active financial business of accepting deposits and making loans is considered a financial institution under section 1471(d)(5). As a general matter, such FFIs receive money from depositors and other debt or equity investors, and then lend the received money out in the form of loans or other investments, profiting on the rate spread between the cost of funds received and the amount received on the various investments made by the FFI. Such an FFI is continually receiving payments of interest on its investments and making payments of interest to its various

⁹⁶ Reg. § 1.1441-5(b)(2)(i)(A).

depositors and other stakeholders. This business model creates a situation in which the passthru payment regime would be, in our estimation, unworkable.

For example, an FFI of the kind described above may purchase U.S. securities as “*nostro*” securities, *i.e.*, securities for the account of the house rather than for the account of certain customers, as part of the overall composition of its various investments. Further, as part of its debt-funding structure the FFI may issue a series of bonds that are not regularly traded on an established securities market. Such bonds would constitute financial accounts under section 1471(d)(2), and under a Section 1471(b) Agreement the FFI would be required to report required information regarding such “financial accounts” held by specified U.S. persons. If a U.S. bondholder refuses to provide requested information such that the bondholder is a recalcitrant account holder within the meaning of section 1471(d)(6), it is unclear how the FFI applies the passthru withholding regime outlined in section 1471(b)(1)(D). Presumably the payments of interest on the bonds would be foreign-source income and therefore would not be considered withholdable payments. However, a passthru payment is defined to include not only withholdable payments but also payments to the extent that they are attributable to withholdable payments. The FFI in this case would, as a general matter, be receiving payments of interest on the U.S. securities it holds for its own account that would constitute withholdable payments. To at least some extent, these withholdable payments received provide the funding for the FFI to make the payments of interest to its bondholders, its depositors, and its other stakeholders. There does not appear to be an available or reasonable manner for determining how much of the interest ultimately paid to a recalcitrant account holder is attributable to a withholdable payment received by the FFI since the U.S. securities are not held for the specific account of a recalcitrant account holder, but rather for the account of the FFI. This same issue would arise with respect to cash value policies issued out of the “general account” of a life insurance company, where the company does not earmark particular assets as held for the account of particular shareholders.

We recommend, therefore, that the guidance clarify the application of the passthru payment regime to such situations.

F. Clarify Scope of the Grandfathering Provision and Expressly Define the Term “Obligation” as used in the Provision

Section 501(d) of the HIRE Act grandfathers “obligations” that are outstanding on or prior to March 18, 2012, stating that the Chapter 4 regime “shall not require any amount to be deducted or withheld from any payment under any obligation outstanding on the date which is 2 years after the date of the enactment of this Act or from the gross proceeds from any disposition of such an obligation” (the “Grandfathering Provision”). The Grandfathering Provision is particularly important in light of the current uncertainties regarding the operation of the Chapter 4 regime. However, the legislation does not define “obligation” for this purpose, and the meaning of the term is unclear.

While we believe a term loan or bond clearly is an obligation and common equity almost certainly is not, there are many arrangements between parties that are less clear, such as a declared but unpaid dividend, a license agreement, a project finance agreement, a litigation judgment or settlement, a guarantee, preferred stock subject to a redemption provision, or a forward contract.

When an obligation arises also is not always clear. For instance, a borrower and a lender may have entered into a revolving credit agreement long before the rules for the Chapter 4 regime were finalized, but not draw on that revolver until after March 18, 2012. In such a case, the lender had an obligation to lend money to the borrower prior to March 18, 2012, but the borrower had no obligation to repay money until after March 18, 2012.

Finally, the application of the Grandfathering Provision to instruments or arrangements that are modified after March 18, 2012 is also uncertain. For the reasons described below, we suggest that Treasury adopt a broad definition of obligation that will help relieve taxpayers of the more immediate administrative burdens and enable parties to maintain the anticipated benefits and burdens of their negotiated transactions.

As discussed more fully below, we suggest that Treasury clarify that (i) an “obligation” is any requirement, actual or contingent, to make a payment to another party, including inchoate obligations under an executed agreement and (subject to anti-avoidance rules) fixed-term straight preferred stock, (ii) a revolving credit agreement itself (and not just the drawdowns on such revolver) constitutes an obligation and (iii) a significant modification of an obligation creates a new obligation for purposes of the Grandfathering Provision only if the principal purpose of the modification was the avoidance or evasion of the Chapter 4 regime.

1. *Expressly Provide a Broad Definition of the Term “Obligation” for Purposes of the Grandfathering Provision*

The term “obligation” is not uniformly or broadly defined in the Code. However, the Supreme Court in *Deputy v. Dupont*, in concluding that a short sale created an obligation but not a debt, noted, “although an indebtedness is an obligation, an obligation is not necessarily an ‘indebtedness’”⁹⁷ In addition, while an “obligation” is defined in debt-related provisions by reference to indebtedness,⁹⁸ a number of other Code or regulatory provisions include a substantially more expanded definition. For instance, in defining a partnership liability, Regulation section 1.752-1(a)(4)(ii) states: “an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations

⁹⁷ *Deputy v. Dupont*, 308 U.S. 488, 497 (1940).

⁹⁸ *See, e.g.*, Reg. § 1.249-1(b)(1) (regarding limitation on deduction of bond premium; an obligation means “any bond, debenture, note or certificate or other evidence of indebtedness”).

under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.” Similarly, the S corporation regulations anticipate that an obligation may be treated as equity for tax purposes, stating that an instrument, obligation or arrangement may be treated as a second class of stock “[i]f the instrument, obligation, or arrangement constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law.”⁹⁹

We recommend that the guidance provide for a broad reading of “obligation” similar to that in Regulation sections 1.752-1(a)(4)(ii) and 1.1361-1(l)(4)(ii)(A)(1), and clarify that an obligation is any requirement, actual or contingent, to make a payment to another party, including inchoate obligations under an executed agreement. Based on this approach, common stock and perpetual preferred stock would not be treated as obligations, but declared but unpaid dividends, forward contracts, swaps, licensing agreements, leases, equipment finance agreements, and fixed-term preferred stock each would be treated as obligations.

We believe that such a broad interpretation of obligation is consistent not only with the applications of the term in other contexts, but also with the purpose of the Grandfathering Provision. Congress presumably included the Grandfathering Provision in order to ease the administrative burden of compliance and to allow taxpayers to maintain the benefits of bargains entered into prior to the full development of the Chapter 4 regime. We expect that Treasury will need time to issue the necessary regulations and guidelines, and it is not yet clear which FFIs will be able to comply with whatever guidelines finally are issued. In particular, government officials have acknowledged the difficulties of making the compliance requirements consistent with foreign law.¹⁰⁰

Many standard contracts include requirements that obligors “gross up” payments to make payees whole for any withholding obligation imposed as a result of a change in law, such as the passage of the Chapter 4 regime, and we expect that under many such contracts, even the issuance of interpretive regulations would be viewed as a “change in law.” Thus, we recommend that the guidance provide a broad exemption available for payments under agreements entered into while these issues are being resolved. In

⁹⁹ Reg. § 1.1361-1(l)(4)(ii)(A)(1).

¹⁰⁰ See, e.g., *JCT Staffer Says 2013 FATCA Effective Date Resulted From Consideration of Foreign Law*, DAILY TAX REPORT (BNA), Apr. 30, 2010. Swiss banking laws, for instance, make it a crime for a bank employee to disclose a secret entrusted to the employee in his or her capacity as an employee of the bank. See, e.g., BNA Portfolio 986-3rd: Business Operations in Switzerland. We acknowledge that section 501 of the HIRE Act is intended in part to prevent abuse by U.S. persons of foreign bank secrecy rules, but we point out the bank secrecy issue as an illustration of the problems faced. In that regard, we would note that Switzerland and other bank secrecy jurisdictions that have agreed to the OECD standard of transparency and exchange of information have agreed to pierce bank secrecy when a requesting treaty party makes a specific request of information pursuant to the standards set forth in the OECD exchange of information article. In order to deal with bank secrecy, a number of these jurisdictions have had to amend their internal law in order to be able to exchange the information once the new treaty exchange of information provision becomes effective. The information required under the Chapter 4 regime would not be covered under a bilateral income tax treaty exchange of information article.

addition, to the extent that parties already have, or will have prior to the time further guidance is provided, entered into binding arrangements, the Grandfathering Provision prevents the Chapter 4 regime from distorting the economics of these arrangements or from having to anticipate what the ultimately issued guidance will look like.

2. *Include Fixed-Term Straight Preferred Stock within the Definition of an Obligation for Purposes of the Grandfathering Provision, Subject to Anti-Abuse Provisions*

One potential point of concern would be including preferred stock (even fixed-term or redeemable preferred stock) in the definition of an obligation. Unlike a payment under a license, debt obligation or other contract, a redemption right under preferred stock is not typically enforceable by the shareholder, making the obligation less clear. However, if the issuer does not redeem the stock, the shareholder usually has the right to replace the board of directors and take control of the company, at least until the stock is redeemed.

Compared to debt instruments and contract rights, preferred stock is less likely to include a gross-up provision that would be implicated by the Chapter 4 regime, meaning that the issuer will not be economically disadvantaged apart from the administrative costs of withholding. Even so, the Chapter 4 withholding tax will be a new burden for equity issuers. Therefore, we recommend that the guidance include any preferred stock where the issuer has an obligation (contingent or otherwise) to redeem the holder in the definition of an obligation, subject to anti-abuse provisions such as those below. For these purposes, “preferred stock” could include any stock which (i) is not entitled to vote; (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (iii) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (iv) is not convertible into another class of stock.¹⁰¹

Since the definition of preferred stock does not include a specified term limit, taxpayers potentially could abuse the distinction between perpetual preferred stock (where the issuer does not have a set obligation to redeem the holder) and fixed-term preferred stock by setting, for instance, a 100-year term to force the instrument within the definition of an obligation and exempt payments on the instrument for an almost perpetual period. One potential solution would be to set a limit on the term of grandfathered fixed-term preferred stock, such as 20 years. If Treasury or the Service remains concerned about potential abuse associated with fixed-term preferred stock, even with such a term limitation, we recommend that any guidance that treats preferred stock as an obligation only do so with respect to preferred stock outstanding when such guidance is issued.

¹⁰¹ See I.R.C. § 1504(a)(4).

3. *Include Revolving Credit Agreements, Irrespective of Drawdowns, within the Definition of an Obligation for Purposes of the Grandfathering Provision*

Due to the lack of clarity as to whether a revolving credit agreement is itself an obligation, parties to such agreements are faced with the prospect of amending the agreements in an attempt to prematurely deal with the Chapter 4 regime.

We recommend that the guidance treat the revolver itself as an obligation, even if each drawdown also could be viewed as an obligation, because the revolver is a contract that creates the requirements to make payments that apply for the entire term of the contract. The revolver is one bargained-for obligation that has as its terms certain other obligations (the drawdowns). Moreover, including revolvers in the definition of an obligation would be consistent with allowing taxpayers the benefit of bargains arranged before the finalization of all the new rules under the Chapter 4 regime.

Absent such inclusion, unless lenders were willing to renegotiate the revolver with the borrower, borrowers could face a situation where, if they draw down on the revolver after March 18, 2012, they could be subject to a gross-up with respect to the Chapter 4 withholding tax, materially increasing the cost of borrowing under existing revolvers and creating artificial market pressures as many borrowers seek to refinance existing credit agreements earlier than they ordinarily might. To the extent Treasury believes that the inclusion of revolving credit agreements within the Grandfathering Provision would be subject to abuse, we believe that this concern could be appropriately addressed by setting a maximum term on the length of revolving credit agreements that will be included within the Grandfathering Provision, such as revolving credit agreements with a maximum term of ten years or less.

4. *Provide that a Significant Modification of an Obligation Create a New Obligation for Purposes of the Grandfathering Provision Only if the Principal Purpose of the Modification was the Avoidance of the Chapter 4 Regime*

Finally, the degree to which a modification of an obligation after March 18, 2012 should remove the obligation from the Grandfathering Provision is also a difficult question. A significant modification of a debt instrument is deemed to be an exchange of that debt instrument for a new debt instrument, which presumably would mean that the “new” debt instrument would be treated as issued after March 18, 2012. By analogy, other obligations outstanding before March 18, 2012 that are significantly altered after March 18, 2012 may be considered new obligations and not eligible for grandfathering under section 501(d) of the HIRE Act. However, we believe that such an approach to the definition of an obligation could prevent economically appropriate modifications of debt instruments by imposing a significant financial penalty on such modifications.

The Service previously has recognized that debt modifications that ordinarily would be treated as “significant modifications” should not be treated as modifications in

circumstances where doing so would create economic distortions. Specifically, Revenue Procedure 2008-28¹⁰² was designed to permit mortgage modifications under foreclosure prevention programs. Many mortgages are owned by REMICs, and such modifications ordinarily would be treated as significant modifications that would jeopardize a REMIC's tax-favored status. In order to ensure that REMIC servicers did not need to wait until an imminent foreclosure to modify a mortgage--in other words, to avoid tax issues materially adversely affecting ordinary commercial relationships in a challenging market--the Service identified various situations in which loan modifications would not be treated as significant modifications for tax purposes.

Acknowledging similar potential issues in applying the Grandfathering Provision to modified loans, the Joint Committee on Taxation noted: "It is anticipated that the Secretary may provide guidance as to the application of the material modification rules under section 1001 in determining whether an obligation is considered to be outstanding on the date that is two years after the date of enactment."¹⁰³ Accordingly, we suggest that a significant modification of an obligation create a new obligation for purposes of the Grandfathering Provision only if the principal purpose of the modification was the avoidance or evasion of the Chapter 4 regime.

- G. Define "Beneficial Ownership" for Purposes of Section 1474(b)(2) so as to Target the Impact of Withholding Tax Credit or Refund Denial to Noncompliant FFIs, Their Managers and Influential Investors

As indicated above, section 1474(b)(2)(A) provides that, if Chapter 4 withholding tax is imposed on a "specified financial institution payment" to an FFI, no credit or refund is available to the FFI unless the FFI is entitled to a reduced rate of tax on such payment by reason of a U.S. treaty obligation and all other applicable requirements are satisfied. Section 1474(b)(2)(B) defines a specified financial institution payment as "any payment if the beneficial owner of such payment is a[n] FFI." Accordingly, where the Chapter 4 withholding tax is imposed on a payment to an FFI that (i) is not the beneficial owner, or (ii) is the beneficial owner but is not entitled to an applicable treaty benefit, no refund may be claimed by the FFI. The availability of a credit or refund to the FFI depends, therefore, on whether the FFI is the "beneficial owner" of such payment.

Neither section 501 of the HIRE Act nor its legislative history indicate how beneficial ownership is to be defined for purposes of section 1474(b)(2). In general, section 1474(b)(1) provides that the chapter 3 rules apply for chapter 4 credit and refund purposes, but that general rule does not apply to section 1474(b)(2), which governs refunds to FFIs. Given that refunds to FFIs are handled other than under the general rules of chapter 3, we recommend that the definition of a beneficial owner for purposes of applying section 1474(b)(2) differ from the general definition of beneficial owner that

¹⁰² 2008-23 I.R.B. 1054.

¹⁰³ Joint Committee on Taxation, *supra* note 17, at 49.

applies for purposes of chapter 3.¹⁰⁴ We believe that for this purpose it would be permissible to define a beneficial owner under section 1474(b)(2) according to conduit or other traditional principles, and not determine beneficial ownership by reference to whether the FFI includes the amounts it receives in income under the principles of section 61.

A further consideration in crafting an appropriate definition of beneficial ownership for section 1474(b)(2) purposes is consistency with the policy underlying the passthru payment provision. The effect of that provision, which was added to the December 9, 2009 version of H.R. 4213 passed by the U.S. House of Representatives as an amendment to FATCA and was preserved in the HIRE Act,¹⁰⁵ was to target the impact of the Chapter 4 withholding tax to non-compliant FFIs and account holders, and to limit or eliminate the impact on other parties.¹⁰⁶ Thus, we respectfully suggest that the definition of beneficial ownership under section 1474(b)(2) be one that limits the impact of the Chapter 4 withholding tax to the person(s) responsible for the noncompliance with the Chapter 4 regime that occasioned the tax. Where the occasion for the tax is a choice by the FFI not to enter a Section 1471(b) Agreement or otherwise comply with section 1471, the definition should limit the impact of the tax to the FFI and to persons in a position to influence the FFI's choice.

In accordance with these principles, we recommend that the beneficial owner of any portion of a withholdable payment received in the account of a non-compliant FFI be treated: (i) as the FFI, to the extent it is legally entitled to retain such portion; and (ii) as an FFI account holder, to the extent the FFI is not entitled to retain such portion. Thus, beneficial ownership in both instances would depend on entitlement to a passthru

¹⁰⁴ A beneficial owner, under chapter 3, is “the person who is the owner of the income for tax purposes *and* who beneficially owns that income. A person shall be treated as the owner of the income to the extent that it is required under US tax principles to include the amount paid in gross income under section 61 (determined without regard to an exclusion or exemption from gross income under the [Code]).” Reg. § 1.1441-1(c)(6)(i) (emphasis added). The regulation indicates further that beneficial ownership is determined under conduit and “other applicable general U.S. tax principles” and that accordingly, “a person receiving income in a capacity as a nominee, agent, or custodian for another person is not the beneficial owner of the income.”

¹⁰⁵ A new subparagraph (D) was added to the reporting and other requirements for FFIs in section 1471(b)(1), indicating in part that an FFI was to withhold a 30% tax from any “passthru payment” made to a “recalcitrant account holder” or to an FFI which did not meet the requirements of section 1471(b). Definitions of the terms “recalcitrant account holder” and “passthru payment” were added in new paragraphs (6) and (7) to section 1471(d). *Compare* Tax Extenders Act of 2009, H.R. 4213, 111th Cong. § 501 (1st Sess. 2009) *with* FATCA, *supra* note 5, § 101.

¹⁰⁶ Under the FATCA version of section 1471, when a withholding agent withheld the applicable 30% tax from a withholdable to a payment that had not met the requirements of section 1471(b), there was no way to channel the impact of this withholding tax to uncooperative account holders. *See* FATCA, *supra* note 5, § 101.

payment, meaning a right to receive the payment and, in the case of an FFI, to retain it, and not on the tax status of the FFI.¹⁰⁷

This definition is consistent with the portion of the chapter 3 beneficial owner definition that relies on existing definitions of beneficial ownership and therefore does not treat agents, custodians, or conduit entities as beneficial owners.¹⁰⁸ At the same time, it does not track the portion of the chapter 3 definition requiring the beneficial owner to be a person who must include the withholdable payment in income.

We recommend that the proposed definition avoid causing the Chapter 4 withholding tax from reducing the income of persons other than an FFI that chose not to comply with section 1471 or persons responsible for the FFI's failure to enter into a Section 1471(b) Agreement. For example, in the case of a hedge fund or private equity fund, although a payment to an equity investor that is required to be funded by a withholdable payment to an FFI might be reduced by the Chapter 4 withholding tax, such investor generally would be entitled to a refund or credit as the beneficial owner of the payment received. An exception might be made for the carried interest of a manager who was in a position to make or influence the decision of the fund not to comply with section 1471, perhaps by treating any payment to such manager that is attributable to a withholdable payment made to the FFI as a payment permissibly retained by the FFI. Any portion of a withholdable payment so retained would not be entitled to a refund or credit, because the non-compliant FFI would be treated as the beneficial owner of such portion.

The proposed definition would also avoid reducing the income of persons other than the FFI or those who control its decisions in other contexts. For example, the entire amount of a withholdable payment to the “*nostro*” account of a foreign commercial bank would be beneficially owned by the bank and therefore ineligible for credits or refunds, because the bank could retain *nostro* account earnings and use such earnings (or some other source of funding) for any expenditure.¹⁰⁹ To the extent that the bank chose to fund payments to bank obligees out of *nostro* account earnings, obligees would not be affected because payments would have to be made as scheduled under the terms of the obligation, without regard to the source of such payments or any Chapter 4 withholding tax thereon.¹¹⁰ The Chapter 4 withholding tax would also have no impact on the terms agreed to with existing obligors of the bank. While the bank might make smaller loans or loans on less-favorable terms to new borrowers because the Chapter 4 withholding tax

¹⁰⁷ Retention would not be relevant in the case of an FFI account-holder, so that any pledge of its right to receive a passthru payment would leave its beneficial ownership of such payment undisturbed.

¹⁰⁸ See Reg. § 1.1441-1(c)(6)(i). A beneficial owner is ordinarily defined as the person who has a level of control over, or entitlement to, the funds or assets in an account.

¹⁰⁹ See the discussion of commercial bank “*nostro*” accounts in Recommendation E.5. above.

¹¹⁰ Obligees would be harmed only in the unlikely event that the tax caused the bank to become insolvent.

would have reduced bank resources, such persons would not suffer unavoidable harm, as they would have been free to borrow from a bank unaffected by the tax.

Only equity investors in a non-compliant foreign commercial bank would likely be harmed by the impact of the Chapter 4 withholding tax, as the tax would reduce the bank's net profit and the amount thereof distributable to such investors. Refunds or credits would be unavailable because *nostro* account earnings would be only one potential source of such profits; and equity investors would not normally be entitled to a dividend payment based on a specified portion of the earnings in the *nostro* account. Any bank effort to avoid section 1474(b)(2) by requiring payments to equity investors or obligees to be sourced in whole or in part out of the *nostro* account could be blocked through an anti-abuse rule. The resulting adverse impact on equity investors in such a case would be appropriate since, unlike passive investors in a hedge fund or mutual fund, such investors would be in a position to influence the bank's decision not to comply with section 1471. Exceptions might be appropriate for holders of minimal voting rights or value.

It should be noted that where the business of an FFI is to hold or invest funds on behalf of customers, most monies received in an account in the FFI's name are usually required to be paid into commingled or segregated accounts for the benefit of such customers. In such cases, whether the FFI is a traditional bank or an investment fund, the proposed definition of beneficial ownership permits credits or refunds with respect to Chapter 4 withholding tax allocations that reduce such payments to customer accounts. Where the FFI is engaged in a different business, such as commercial lending, all or most monies received in its own account are used to finance the business. Thus, the account serves a purpose similar to that of a foreign financing subsidiary in a multinational group of operating companies. If guidance excepts financing subsidiaries from the term "financial institution,"¹¹¹ and the business of an operating company for purposes of this exception may include, *e.g.*, making loans, we recommend an anti-abuse rule treating passthru payments to a financing subsidiary as payments to FFIs in the MNC group with interests in such subsidiary, as necessary to prevent avoidance of section 1474(b)(2).

H. Clarify How a Withholding Agent Determines Whether to Withhold on Payments Made to an FFI

A withholding agent is required to withhold a tax equal to 30% on any withholdable payments made to a non-compliant FFI. It is unclear precisely how a withholding agent determines whether an FFI has complied with the requirements of section 1471(b), whether the FFI is deemed to meet the requirements of section 1471(b), or whether the FFI is an entity that is excluded from the Chapter 4 regime.

We recommend that Treasury publish a list of those FFIs that (i) have entered into a valid section 1471(b) agreement; (ii) are deemed to have met the reporting requirements of section 1471(b); and (iii) are otherwise excepted from the regime; and clarify how

¹¹¹ See Recommendation A. (iii) above.

frequently this list will be updated.¹¹² Treasury should also consider whether any form of self-certification by the FFI is appropriate.

Additionally, we recommend that Treasury provide further guidance on distinguishing those entities that are considered FFIs from NFFEs. While we believe that it would be helpful for guidance to provide presumption rules which would enable a withholding agent to more easily differentiate between FFIs and NFFEs, we understand the difficulty in establishing appropriate rules in such a case and are still considering possible options for such rules.

I. Provide Regulatory Safe Harbors Available to Financial Institutions to Use in Determining Whether an Account is a “United States Account”

Under section 1471(b)(1)(A) and (B) an FFI must obtain such information as is necessary to determine whether an account is held by a specified United States person or a United States-owned foreign entity, and comply with any required verification and due diligence procedures with respect to such information. Fundamentally, this means that an FFI may have to prove a negative proposition that an account holder is not a specified United States person or a United States-owned foreign entity. Existing KYC and AML information reporting regimes were not designed to elicit the information required under the Chapter 4 regime and thus information and records obtained through such protocols may not identify whether an account holder is a United States person; further, such regimes are not necessarily consistent over different foreign jurisdictions. In certain cases, a particular jurisdiction may wholly lack an adequate KYC or AML regime.

We recommend, therefore, that detailed guidance be provided regarding what procedures an FFI is expected to comply with in identifying whether its accounts are United States accounts. Different guidance would be appropriate for accounts existing at the time section 501 of the HIRE Act was enacted and those accounts opened following enactment, since without making a U.S.-centric inquiry (*i.e.*, questioning all account holders as to whether such holder is a specified United States person), which may be offensive to customers and contrary to local law, an FFI may not be able to obtain the requisite information. We recommend also that the guidance clarify procedures to be followed by an FFI where foreign law conflicts with the promulgated reporting requirements and prevents or prohibits the FFI from obtaining such information, particularly where foreign law may prevent the FFI from closing the account or prevent the account holder from waiving application of the foreign law.¹¹³ Where an FFI

¹¹² Such a list appears to be contemplated by section 1474(c)(2), which indicates that the identity of an FFI meeting the requirements of section 1471(b) is not treated as return information for purposes of section 6103. Further waiver of section 6103 may be required for identifying those entities excepted from the reporting regime under section 1471(f). Consents may also be required under other U.S. and foreign privacy laws.

¹¹³ Section 1471(b)(1)(F) currently provides that the FFI should obtain a waiver of such foreign law from the account holder or close the account. However, foreign law may not in all cases permit the account holder to make such a waiver or permit the FFI to close the account.

complies with the promulgated guidance, we recommend that the FFI be considered satisfactorily compliant with all necessary due diligence procedures with respect to identifying its United States accounts. To aid the government in effectively using the gathered and reported information, we recommend that special consideration be given to whether the information gathered is consistent and uniform across jurisdictions and whether it can be fed into an electronic-reporting mechanism.

Until such time as guidance is provided regarding the required due diligence procedures for identifying and verifying United States accounts, we recommend that FFIs be permitted, notwithstanding the limitations identified above, to rely on their existing applicable KYC and AML regimes.

A safe-harbor inquiry may be appropriate for an FFI in determining whether its accounts are United States accounts. For example, in the case of an individual account, Treasury might promulgate a safe harbor that permits an FFI to determine that the account is not a “United States account” after making the following inquiry of the account holder:

- (i) Are you a U.S. citizen?
- (ii) If you are not a U.S. citizen, do you hold a U.S. permanent immigration card or “green card”?
- (iii) If you are not a U.S. citizen and you do not hold a green card, do you plan on spending 183 or more days in the United States in the current year?
- (iv) If you do not expect to spend more than 183 days in the United States in the present year, have you spent 183 days or more in the United States in any of the preceding three years? Or, alternatively, if you do not expect to spend more than 183 days in the United States in the present year, have you spent 121 days or more in the United States in any of the preceding three years?

J. Provide Guidance on Account Valuation Principles for FFIs that Enter a Section 1471(b) Agreement

Among the requirements that an FFI that entering into a Section 1471(b) Agreement must satisfy is to report the account balance or value of its United States accounts. Where an account holds cash or cash equivalents or publicly-traded instruments, valuation information may be easy to obtain. However, where non-publicly traded securities are held by a fund or in a United States account, such valuation information may be quite difficult to obtain. In addition, where a fund invests in a foreign fund, the foreign fund may be unwilling to provide this valuation information. It is unclear under current section 1471(c)(1)(C) how such investments and accounts are to be valued. We recommend that the guidance adopt rules permitting an FFI to rely on information it receives on the valuation of an investment or to use such information as it would normally rely upon for purposes of valuation, such as net asset value. Where such

information is not available, we recommend that the FFI be entitled to report the account value based upon book value or adjusted basis as reported in an audited financial statement or some other validated report.

K. Provide Guidance on Transition Rules that Should Be Applicable to Existing Foreign Funds

We recommend that substantial consideration be devoted to transition rules for existing foreign funds. In many cases, investments made by such FFIs may not fall within the definition of an obligation for purposes of the grandfathering provision in section 501(d) of the HIRE Act. Or, existing FFIs may lack the right to demand the information from account holders to make a determination of whether the entity holds United States accounts. In addition, existing agreements may not contain provisions permitting the entity to redeem the interests of investors who do not provide waivers of foreign secrecy laws required under section 1471(b)(1)(F).

In these cases, it may be impossible for such FFIs to enter into Section 1471(b) Agreements, leaving such funds at a significant competitive disadvantage. Failure of only one or a few account holders to agree to revisions to existing fund agreements may prevent the entity from making a valid election under section 1471(b)(3). As the failure to enter into a Section 1471(b) Agreement may constitute a significant burden to such funds, we recommend that guidance be provided regarding transition rules for existing foreign funds. Ultimately, we recognize that any transition rule created will be somewhat arbitrary, but we would propose that where an existing fund is able to substantially comply with reporting requirements with respect to its United States accounts by the effective date of the Chapter 4 regime, the fund be granted additional time to address those situations described above that might prevent a fund from successfully entering into a Section 1471(b) Agreement.¹¹⁴

L. Clarify Scope of the Term “Financial Account” and Expressly Exclude Insurance Policies and Products Not Used to Store Wealth

The legislative history suggests that only certain insurance contracts or policies will be considered financial accounts under the Chapter 4 regime.¹¹⁵ Notwithstanding Treasury’s apparently broad authority to bring a wide variety of insurance products within the scope of the Chapter 4 regime, only a limited number of insurance policies and

¹¹⁴ For example, if a fund were able to obtain and report required information with respect to 90-95% of its account holders, it would be considered to be in substantial compliance with the necessary reporting obligations and would be granted an additional 12-24 months to address obtaining required waivers and other necessary information from remaining account holders without being subject to the Chapter 4 withholding tax.

¹¹⁵ The legislative history provides that “[i]t is anticipated that [Treasury] may prescribe special rules addressing the . . . circumstances in which certain contracts or policies, for example annuity contracts or cash value life insurance contracts, are financial accounts or United States accounts.” Joint Committee on Taxation, *supra* note 17, at 44.

products such as annuities and cash value life insurance policies can serve as an effective means to store wealth and thus, by extension, serve as an effective means to evade U.S. taxes.¹¹⁶ Therefore, we recommend that Treasury not include within the scope of the Chapter 4 regime those insurance policies and products that do not present the risk of U.S. tax avoidance that the Chapter 4 regime is designed to prevent. These policies and products include a variety of property and casualty insurance products, such as homeowner’s insurance, auto insurance, workers’ compensation insurance, crop insurance, product liability insurance, medical malpractice insurance, commercial liability insurance, directors and officers insurance, and excess casualty insurance. Payments on these policies depend on the occurrence of a loss arising from a certain contingency and do not represent the type of account that can be effectively used for U.S. tax evasion.

Similarly, we recommend that Treasury not include reinsurance accounts within the scope of the Chapter 4 regime since such accounts pose a low risk of U.S. tax evasion. Only insurance companies can purchase reinsurance, so individuals (or shell corporations or other entities formed by individuals) which are the focus of the Chapter 4 regime are not involved in reinsurance transactions. As with the property and casualty accounts identified above, payments on a reinsurance account depend upon the occurrence of a loss arising from a certain contingency and do not represent the type of account that can be effectively used for U.S. tax evasion.

M. Clarify Whose Waiver is Required if an FFI Makes a Section 1471(b)(3) Election To Be Withheld Upon

A Section 1471(b)(3) Election permits an FFI to avoid the obligation under section 1471(b)(1)(D) to withhold with respect to passthru payments made to recalcitrant account holders and non-compliant FFI account holders. Under this election, the FFI must agree to provide sufficient information to the withholding agent or payor making a withholdable payment to the FFI so that the withholding agent can determine how much of the payment is allocable to recalcitrant account holders or non-compliant FFIs and withhold the required tax with respect to that portion of the payment.

In addition, the election requires the FFI to include in its Section 1471(b) Agreement a “waiver of any right under any treaty of the United States with respect to any amount deducted and withheld pursuant to [a Section 1471(b)(3) Election].”¹¹⁷ Although we recognize that there may be valid policy reasons to preclude a credit or refund to a recalcitrant account holder or non-compliant FFI that has failed to provide the required U.S. account information to the electing FFI, we question whether another juridical entity could affirmatively waive another person’s rights under a U.S. tax treaty. Rather, we believe that such person must waive his or her own treaty rights in the manner and time prescribed by Treasury. In this case, section 1471(b)(3)(C)(ii) may be read to

¹¹⁶ See *supra* note 64.

¹¹⁷ I.R.C. § 1471(b)(3)(C)(ii).

require an FFI making a Section 1471(b)(3) Election to waive its own rights to a reduced rate of tax under a U.S. treaty and therefore a credit or refund otherwise available to it under section 1474(b)(2)(A)(i)(I).

It is unclear whether the drafters intended such a harsh result for an FFI making a Section 1471(b)(3) Election that would otherwise be compliant with the required reporting obligations under sections 1471(b)(1)(A) and 1471(c), but that would prefer to put the withholding responsibility with respect to its recalcitrant account holders and non-compliant FFI account holders on withholding agents who may already have the resources and systems in place to withhold such U.S. tax and deposit it in a timely basis with the Service. We believe that if a Section 1471(b)(3) Election mandates that an FFI enter into its own waiver to preclude it from claiming a reduced rate of tax under a U.S. treaty as a refund or credit that very few FFIs, if any, will make such an election. This would likely have a detrimental effect since many of the withholding agents who would perform withholding on behalf of the FFI under a Section 1471(b)(3) Election would be better suited to effectuate the required withholding under the Chapter 4 regime.

We suggest that guidance clarify that the Section 1471(b)(3) Election is intended to require an electing FFI to obtain any necessary waivers from its recalcitrant account holders or non-compliant FFI account holders.