



Institute of International Bankers

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June 13, 2011

Re: Comments on Notice 2011-34 Providing Supplemental Guidance on FATCA

Dear Ms. Corwin and Messrs. Musher and Danilack:

The European Banking Federation (the “EBF”) and the Institute of International Bankers (the “IIB”) appreciate the opportunity to provide comments in response to IRS Notice 2011-34 (the “Notice”), which supplemented and amended IRS Notice 2010-60 (together with Notice 2011-34, the “Notices”) and provided further guidance on the implementation of information reporting and withholding under Chapter 4 of the Internal Revenue Code (the “Code”), as enacted by the Foreign Account Tax Compliance Act (“FATCA”) provisions of the Hiring Incentives to Restore Employment Act of 2010 (the “Act”). As you are aware, the issues raised by FATCA and its implementation are extremely important to our memberships. We have expended a significant amount of time and energy in providing Treasury and the IRS with extensive comment and recommendations.¹

¹ See the joint EBF/IIB Letters of April 23, 2010 (the “April 2010 Submission”) and November 12, 2010 (the “November 2010 Submission”) (for your convenience, copies thereof are enclosed herewith). We have also addressed separately several other discrete issues. We note, with some disappointment, that the Notices in some instances do not address issues upon which we commented or take an approach different from that which we have advocated. We respectfully ask that our comments on the Notice and on the general status of FATCA guidance presented in this letter be read in conjunction with our earlier letters, which continue to represent our views as to how FATCA can be implemented in an effective, practical, administrable and timely manner.

While we are appreciative of the important and constructive changes that the Notice makes to the guidance previously provided in Notice 2010-60 in response to comments by the financial industry, we have very serious concerns that the Notice's approach to "passthru payments" is completely unworkable as applied to those foreign financial institutions ("FFIs"), such as banks and securities firms, that conduct active businesses ("active business FFIs"). These and other concerns – as well as our recommendations for addressing them – are summarized below and discussed in greater detail in the Attachment.

Passthru Payments

The Notice adopts a proportionate allocation approach, based on the ratio of a FFI's U.S. assets to total assets (termed the "passthru payment percentage," or "PPP"), to determine the extent to which FATCA withholding applies to payments made by a participating FFI (a "PFFI") to non-participating FFIs ("NP-FFIs") and recalcitrant account holders (in addition to the withholding tax on U.S. source "withholdable payments"). While this approach may make sense for determining passthru payments in the context of investment funds, it is totally unworkable for active business FFIs (other than in respect of payments from investment funds held in custodial accounts at those institutions). Moreover, the Notice would appear to treat any payment (including swap payments, payments for services, rent and the purchase of property, routine money transfers, etc.) as a passthru payment, which is also unworkable.

Specifically, we are very concerned that the extension, under the Notice, of the proportionate allocation approach to all payments made by an active business PFFI to any other active business FFI will create stresses in the global financial system, with indeterminate consequences. Because active business FFIs necessarily must have extensive business dealings with other active business FFIs, it will be virtually impossible for any active business FFI anywhere in the world – even if it has no U.S. assets or U.S. customers – to avoid either becoming FATCA-compliant or suffering a withholding tax on passthru payments that it receives from PFFIs. However, especially given the absence in the guidance to date of a reasonable, streamlined and low-cost method for FFIs that have very little if any connection with the United States to become FATCA compliant, there is likely to be a significant amount of worldwide exposure to FATCA withholding tax. Thus, for example, small local banks throughout the world with no known U.S. accounts and no investments in U.S. securities that cannot reasonably become PFFIs or deemed-compliant FFIs ("DC-FFIs") will be subject to FATCA withholding (to the extent of the PPP of their counterparties) on each of the numerous payments they receive from PFFIs (whether in respect of routine money transfers, loan syndications, swap transactions, foreign currency trades, etc).

The consequences of FATCA withholding – including litigation risk associated with the withholding (since NP-FFIs can be expected to challenge the withholding on legal and contractual grounds) and the treatment of FATCA withholding exposures of FFIs by their auditors, regulators and capital markets – should not be dismissed lightly.

Nor should the complexity associated with the calculation of passthru payments. The FATCA compliance effort, which is challenging as it is, would need to be extended to business divisions and financial relationships that to date have not been evaluated, and due diligence and other operational procedures as well as IT systems for those divisions would need to

be modified, diverting attention from the daunting task of implementing FATCA in the areas already under focus. Moreover, for most affiliated groups of active business FFIs, the calculation of the PPP and its application to each payment made by each member of the group would involve mind-boggling complexity. Assuming it were even practical to do so, it would take several years for active business FFI groups to implement these rules, and thereafter they would need to expend substantial resources on a continual basis to determine their PPPs and to calculate the amount of FATCA withholding.

The IRS posits that it is necessary to extend the Notice's passthru payments rule to active business FFIs in order to prevent the avoidance of FATCA through the use of PFFIs as "blockers" through which NP-FFIs (and their account holders) might benefit from investment in U.S. assets without complying with FATCA. We do not agree. An investment in an active business FFI entails exposure to diversified business activities that is more akin to investing in an industrial company, rather than to investing in an investment vehicle and its underlying U.S. or non-U.S. assets.²

Providing Practical and Administrable Guidance

Taken as a whole, the emerging approach to FATCA implementation evidenced by the Notices is overly burdensome, and it does not strike a reasonable balance between the legitimate compliance goals of FATCA and the need to implement it in a practical, administratively feasible and cost-effective manner. For example, in addition to our concerns regarding passthru payments, the proposed scope of the private banking rule is problematic and the due diligence process proposed to be implemented for private banking accounts is impractical. Moreover, the Notices' proposals regarding DC-FFIs and other exemptions from full PFFI compliance are, we respectfully submit, woefully deficient in providing an acceptable means through which the many thousands of financial institutions that have very little, if any, connection to the United States can become FATCA-compliant.³

In our prior submissions we have urged Treasury and the IRS to exercise the substantial discretion given to them by Congress to reduce the overall administrative burdens associated with complying with FATCA and have provided specific recommendations as to how these objectives might be accomplished. The comments set forth in the Attachment are similarly intended to explain our practical concerns regarding specific aspects of the Notice and to recommend modifications that, in our view, better balance the tax compliance and administrative feasibility objectives.

² We also note that the proposal does not address potential "blocking" activity that could occur by NP-FFIs holding investments in investment vehicles or PFFIs through U.S. investment partnerships or U.S. financial institutions.

³ In this regard, we respectfully urge Treasury and the IRS to adopt the recommendations that we made in our May 4, 2011 submission regarding an exception from FATCA for those active business FFIs that certify that they have no U.S. accounts. *See also* Part III of the Attachment hereto.

The Timing of Guidance and the Effective Date

We are also very concerned with the slow pace of the development of guidance. Given the short time frame before FATCA becomes effective, the breadth and detail of the guidance that will need to be provided in the FATCA regulations, the number of key areas where the application of FATCA is still unclear, the uncertainty of what final or even proposed regulations will require, and the need for FFIs to build or modify complicated IT systems and other operational procedures to process the massive flow of information necessary for diligence, withholding, and reporting obligations required under FATCA, it will simply not be possible for the financial industry to fully implement the FATCA requirements in the form envisioned in the Notices until several years after the January 1, 2013 effective date.

This timing problem has been greatly exacerbated by the proposal to apply the passthru payment rules to active business FFIs. The broader reach of the passthru payment rules means that significantly more time will be needed before compliance will be possible. Moreover, if the FATCA withholding tax rules become operative prematurely, especially with the expansive approach to passthru payments, there will be massive amounts of overwithholding, with significant adverse consequences to the financial industry and a destabilizing impact on the financial markets.

We urge Treasury and the IRS to address the timing issue by taking an incremental approach to implementing the FATCA rules. We believe that FATCA should be phased-in based on a realistic timetable that takes account of the complexity of the implementation issues that Treasury, the IRS and the financial industry must still address, as well as the time and resources needed to develop effective FATCA compliance systems. To that end, we recommend that Treasury and the IRS initially focus on the key areas that can be implemented on a timely basis with clear, basic rules, and rely on appropriately crafted anti-abuse rules to augment these basic rules. We believe it is necessary to defer guidance and implementation on more complicated areas – as well as the FATCA withholding requirement – until these basic rules are successfully implemented across the financial industry in order to prevent systemic stress on financial institutions and the financial markets. Finally, we strongly recommend that Treasury and the IRS announce their timetable for a phased implementation as soon as possible so that they and the financial industry can turn their attention to developing and implementing what is reasonably achievable on a timely basis.


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Particularly in view of the concerns we express herein and the accompanying Attachment, we would welcome the opportunity to meet with you to discuss our comments.


Sincerely,

EUROPEAN BANKING
FEDERATION

INSTITUTE OF INTERNATIONAL
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DETAILED COMMENTS ON NOTICE 2011-34

I. Passthru Payments.

A. Overview.

Section 1471(d)(7) defines “passthru payment” as “any withholdable payment or other payment to the extent attributable to a withholdable payment.” In general, withholdable payments include U.S. source dividends, interest and other fixed or determinable annual or periodical (“FDAP”) income, as well as any gross proceeds from the sale or other disposition of property that can produce U.S. source dividends or interest.¹ A participating foreign financial institution (“PFFI”) is required to withhold a 30% tax from each passthru payment that it makes to a recalcitrant account holder or a nonparticipating FFI (“NP-FFI”).

The Notice adopts a proportionate allocation approach to determine the amount of any “other payment to the extent attributable to a withholdable payment,” based on the ratio of U.S. assets to total assets of the relevant foreign financial institution (“FFI”) that is participating or deemed compliant (a “DC-FFI”).² This ratio is referred to as the “passthru payment percentage” (“PPP”). The Notice applies these rules to every FFI, regardless of whether it is an investment vehicle or custodial account held at a FFI,³ on the one hand, or a bank, securities firm, insurance company or similar FFI that conducts an active business (“active business FFI”), on the other hand.

Moreover, the Notice does not narrow the scope of what is a “payment.” Thus, in the absence of further guidance, every payment of principal or interest on debt or dividend or other distributions on equity (regardless of whether the debt or equity is “regularly traded”⁴), every money transfer, every payment under a swap or other derivative instrument, every payment to purchase a financial or other asset, and every payment for services or rent would be encompassed within the passthru payments rule and thus potentially subject to FATCA withholding.

The rationale given in the Notice for the breadth of this definition is the concern that a narrower definition of “passthru payments” – limited to withholdable payments or

¹ Section 1473(1). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or to the Treasury regulations promulgated thereunder.

² The PPP of a NP-FFI is zero, on the theory that passthru payments received by that NP-FFI have already been subject to the FATCA withholding tax.

³ As used herein, a “custodial account” refers to an account or other arrangement that gives rise to a “custodial payment” within the meaning of Section II.C of the Notice.

⁴ *I.e.*, equity or debt interests which are regularly traded on an established securities market within the meaning of section 1471(d)(2). While regularly traded debt or equity interests in a FFI are excluded from the definition of a “financial account,” payments thereon are not excluded from the term “passthru payments.”

payments directly traceable to withholdable payments – would allow PFFIs to be used as “blockers” through which NP-FFIs (and their account holders) might benefit from indirect investment in U.S. assets without being subject to withholding or entering into an FFI agreement with the IRS. The worry is that a NP-FFI can invest in U.S. assets indirectly without having to comply with FATCA by investing in a PFFI that holds U.S. assets. The Notice also expressed concern with the administrability of a tracing approach, both for FFIs and the IRS, given the diversity of capital structures and payment arrangements of FFIs.

Treasury and IRS officials have indicated in public comments that the proportionate allocation approach is viewed as a simplifying approach and is intended to provide PFFIs with a tool to incentivize recalcitrant account holders and NP-FFIs to come into compliance by giving the FFIs the information they need to report.⁵

We understand that certain Treasury and IRS officials have expressed the concern that Treasury does not have the statutory authority to limit the definition of passthru payments to withholdable payments or payments directly traceable to withholdable payments because this narrower definition would render meaningless the second part of the statutory definition of passthru payment, namely any “other payment to the extent attributable to a withholdable payment.”

We also understand that the Notice’s approach was developed in response to suggestions from certain members of the fund industry that a proportionate allocation approach be adopted rather than a tracing approach due to administrability concerns with a tracing approach.

We appreciate the very difficult practical and policy considerations that Treasury and the IRS have sought to balance in arriving at a proportionate allocation approach for passthru payments. While we defer to the fund industry associations as to whether this approach is reasonable for determining passthru payments in the context of investment funds, it is important to note that this approach entails very burdensome compliance costs. Accordingly, we have several suggestions to ease some of those burdens and costs. We also agree that custodial accounts at active business FFIs should be treated similarly to investment funds, as intended by the Notice’s rule for custodial payments, and thus our discussion herein of investment funds includes custodial accounts at active business FFIs to the extent they hold interests in investment funds (and our discussion of active business FFIs excludes custodial accounts holding interests in investment funds).

However, we have very serious concerns regarding two aspects of the Notice’s proportionate allocation approach – (i) the proposed broad application of this approach to active business FFIs, and (ii) the all-encompassing scope of “payments” that are treated as passthru payments.

Diversified financial businesses such as banks, securities firms and insurance companies are fundamentally different from FFIs that are investment vehicles. Many of these active business FFIs are huge multinational groups that are engaged in numerous business

⁵ See, e.g., “Drafters of FATCA Notices Offer Insight Into Latest Guidance, Future Plans,” 2011 TNT 97-5 (May 19, 2011).

activities (e.g., M&A and corporate finance advisory businesses, active lending, market making in securities and derivatives, etc.) and in millions of financial transactions and payments each year. An investment in these entities cannot fairly be viewed as an indirect investment in the U.S. securities held by these institutions any more than can an investment in a foreign multinational industrial group of companies that has a U.S. subsidiary. In both cases, the return that an investor receives is based on the profits from the various *business activities* in which the company participates and the substantial amount of goodwill and related intangibles, not on the change in value of the underlying financial assets that the company holds. Likewise, investors do not typically attempt to invest in U.S. assets by purchasing stock in an active business FFI that owns U.S. assets.

The basic distinction between interests in investment funds and active business FFIs provides a powerful basis for limiting the Notice's proposed approach to investment funds. Moreover, the extension of the Notice's proportionate allocation approach to all payments made by active business FFIs raises significant administrability, competitive, fairness, and policy concerns regarding the Notice's approach. These concerns and our recommendations for limiting the scope of the Notice's passthru payment rule are set out in detail below.

B. Systemic Stress Concerns.

Application of the Notice's proportionate allocation rule for passthru payments to active business FFIs will create enormous administrability problems for these FFIs and for many of the countless number of counterparties with which they deal. As explained in Part II.C, below, the magnitude of the administrative problems that many active business FFIs would face is almost incalculable. Even if it were practical to apply the passthru payment rule to active business FFIs, it will likely take several years to implement the Notice's passthru payments approach on a global basis. In the meantime, there would be massive amounts of inaccurate withholding, giving rise to tax and contractual exposures and business uncertainties for FFIs throughout the world. We are very concerned that this could very well create stresses in the global financial system, with indeterminate consequences, for the reasons described below.

Significantly, the proportionate allocation rule suggested in the Notice will reach even active business FFIs that do not invest in U.S. assets at all, either directly or indirectly, whether for their own account or for the account of their customers, simply because these FFIs will have numerous business transactions with PFFIs and financial accounts with, or debt or equity investments in, other active business FFIs that are PFFIs. Only the most insular of financial institutions could avoid transacting business with other financial institutions that are PFFIs, and it is inconceivable that any active business FFI would have a PPP of zero.

The Notice's approach appears to be intended to make it virtually impossible for any active business FFI anywhere in the world – even if it has no U.S. assets or U.S. customers – to avoid either becoming FATCA-compliant or suffering a withholding tax on passthru payments that it receives from PFFIs. The Notice's approach does so by treating a portion of each payment made by an active business FFI as a passthru payment. Because the world financial system is deeply interconnected, this creates a powerful “club” to induce active business FFIs that might otherwise have second thoughts about becoming PFFIs or DC-FFIs to do so.

Unfortunately, as discussed in Part III below, the Notice has not gone nearly as far as we believe advisable to provide simplified compliance rules for FFIs that do not have investments in U.S. assets and/or do not have U.S. accounts (*i.e.*, FFIs that are good candidates for “deemed-compliant” status because of the low risk they present). These FFIs can reasonably be expected to have a low tolerance for bearing the costs and burdens of FATCA compliance, especially if compliance is more costly than the penalties of non-compliance. Accordingly, these institutions – and as noted below, the PFFIs with which they transact business or in which they hold debt or equity investments – will be in a particularly difficult position if they are exposed to FATCA withholding tax because of existing business activities but do not have a reasonable, streamlined and low-cost method for becoming FATCA-compliant.

The interconnectedness of the world financial system means that a disruption in one part of the system can have ripple effects on all parties that are connected through the system. A PFFI will need to withhold tax from each passthru payment made to each NP-FFI, which, as noted above, may include many categories of payments that do not themselves relate directly or indirectly to investments in U.S. assets. This “leakage” of withholding tax from the financial system – or even the uncertainty of such leakage – will undoubtedly be very disruptive to the system as a whole, and will affect the business relationships among active business FFIs in unpredictable ways because different financial entities will decide to act in whichever manner will minimize their short-term and long-term costs and risks.

Moreover, in order to be FATCA-compliant, a PFFI will need to have information regarding the PPP of each and every active business (and other) FFI in which it holds any type of equity or debt interest (whether regularly traded or not, and whether or not that FFI is related to it), unless the PFFI determines that an entity is a NP-FFI.⁶ To the extent any of those FFIs do not provide current PPPs upon which the PFFI can rely, for purposes of determining its withholding on payments to customers the Notice requires the PFFI to use a PPP of 100%. Additionally, as noted in Part I.C below, there is a significant circularity problem due to the deep inter-relatedness of active business FFIs worldwide, which will exacerbate the withholding tax leakage issue by forcing FFIs to use higher PPPs than are actually required.

Thus, even if a PFFI group is able to overcome the internal challenges of determining the group’s and each member’s PPP on a timely basis, its ability to implement FATCA without material business disruption will be dependent on the ability of substantially all of the active business (and other) FFIs with which it transacts to become FATCA-compliant. Optimistically, it will take several years beyond the January 1, 2013 effective date of FATCA before that level of worldwide compliance is achieved. In the interim, PFFIs will face difficult legal, contractual and business issues in dealing with NP-FFIs.⁷

⁶ Likewise, because DC-FFIs must also determine and publish their PPPs, it appears that they will be required to obtain information regarding the PPP of each and every active business (and other) FFI in which they hold any type of equity or debt interest.

⁷ For the reasons explained below, these issues will arise even before the January 1, 2013 effective date, as FFIs determine how to deal with their numerous counterparties and investors.

PFFIs must resolve any ambiguities in interpreting the application of the rules to specific situations and address the significant administrative complexities and costs described in Part I.C below to implement the passthru payment rules. For example, if a PFFI continues to transact with a NP-FFI or be an issuer of debt or equity to that NP-FFI after the effective date, it will need to withhold tax on passthru payments made to the NP-FFI. However, before it can withhold, it will need to investigate whether it is legally permitted to do so under applicable local and other foreign laws and whether it is contractually permitted to do so without having to “gross-up” the payments.⁸

Based on preliminary analyses regarding the laws of several countries, which have been reported in various comments submitted to Treasury and the IRS, compliance with the FATCA withholding requirements may be inconsistent with local and other foreign laws in at least a dozen countries. To the extent it is not clear that a FFI can withhold on passthru payments it makes to a NP-FFI without any risk of challenge, the PFFI will expose itself to liability to the NP-FFI (or for violating applicable laws). As an alternative, the PFFI may decline to transact business with the NP-FFI, although this may not be possible in many cases (for example, it may not be possible to terminate the rights of an NP-FFI that owns a debt or equity interest in the PFFI, or that is a party to a long-term derivative contract with the PFFI). In addition, PFFIs will need to evaluate the implications of any course of action upon their business relationships.

The gravity of these concerns should not be underestimated. These and other complications arising from the interconnectedness of the financial markets will cause considerable uncertainty regarding factual and legal issues involving numerous counterparties, which may engender financial and legal exposures to many financial institutions and their customers, as well as inaccurate withholding as a result of these uncertainties. It is unclear how these various institutions and other entities, as well as their auditors, regulators and the financial markets generally, will respond to these uncertainties and exposures.

Accordingly, and also for the other reasons set forth in this Part I, we urge Treasury and the IRS to limit the passthru payment rule to investment funds. Moreover, and at a minimum, we urge the Treasury and the IRS to proceed with caution when contemplating the timetable for FATCA compliance implementation requirements. We believe a generous phase-in period is needed with respect to the more difficult aspects of FATCA generally, but is particularly necessary with respect to the treatment of passthru payments and, more generally, the FATCA withholding requirements.

⁸ In this regard, it is important to recognize that the FATCA withholding by a PFFI (or DC-FFI) in respect of passthru payments would be the result of a contractual agreement between the PFFI and the IRS (*i.e.*, the FFI agreement of the PFFI or the DC-FFI’s acceding to that status), and thus recalcitrant holders and NP-FFIs may still have contractual and/or legal claims against the PFFI (or DC-FFI) for the gross amount owed to them. Questions have also been raised as to whether requiring a PFFI (or DC-FFI) to withhold on passthru payments (albeit contractually, pursuant to a FFI agreement) is consistent with U.S. treaty provisions applicable to the PFFI (or DC-FFI), since many treaties generally preclude the United States from imposing any tax on payments of dividends or interest by a qualified treaty resident.

A gross-up of payments to a NP-FFI or recalcitrant holder would be prohibitively expensive and impractical as a commercial matter; it would also not serve FATCA’s compliance objective.

C. *Administrability Concerns for FFIs and Their Affiliated Groups.*

One significant aspect of the administrability issue is the sheer enormity of determining the passthrough payment percentage, or PPP, of each FFI within an affiliated group of active business FFIs on a rolling quarterly basis. To provide a summary snapshot of the mind-boggling complexity involved, consider the following steps that a typical group would need to perform:

First, for each FFI, the portion of the gross assets on the quarterly financial statements (and certain off-balance sheet assets to be identified in future guidance) that are U.S. assets, based on the rules of the Notice, must be identified in order to find that FFI's PPP. This step will require numerous individualized assessments of specific items, on a quarterly basis, including for many subsidiaries for which there are no quarterly financial statements and for off-balance sheet items.⁹

Second, based on that PPP, the equity value of each such active business FFI and the portion thereof that will be characterized as a "U.S. asset" under the Notice must be identified.¹⁰ Furthermore, it appears that the value of debt interests in affiliates would also need to be determined on some basis. It would be unusual for an affiliated group to prepare separate quarterly financial statements for most of its numerous subsidiaries, and thus these calculations would need to be prepared specifically for this purpose.

Third, the portion of the value of the equity or debt of each FFI that is treated as a "U.S. asset" must be taken into account, directly or indirectly, by each upper-tier FFI within the group that owns an equity or debt interest in the lower-tier active business FFI, tiering up from the lowest level FFIs to the next level in the ownership chain, etc. Similarly, the PPP of the ultimate parent of the group is dependent on all of the information being passed up from all direct and indirect subsidiaries below it.

For many groups, this analysis would need to be performed on a quarterly basis for hundreds and even thousands of companies, and with respect to thousands (or more) different positions.

⁹ Based on the experience of foreign banks in the context of determining their U.S. assets and liabilities for purposes of determining their interest expense deduction under regulation section 1.882-5, the calculation of off-balance sheet items will likely be complicated.

¹⁰ The Notice does not contain any specific guidance as to how an affiliated group of FFIs would determine the PPP of entities that hold interests in subsidiary FFIs and, for example, does not provide for the determination of the PPP of the group on a consolidated basis by ignoring debt and equity interests in affiliates. An affiliated group look-through approach might somewhat ease the burden of determining the PPP of the group and many of its members, but would not necessarily provide an appropriate PPP for determining the withholding on passthrough payments made by individual FFI members of the group.

Also, unlike most financial assets that are held in a FFI's trading account, which typically are marked to market for financial reporting purposes, investments in subsidiaries are generally recorded at historic carrying cost, and thus the relative values of the assets of the group may be distorted for purposes of calculating its PPP.

Furthermore, the necessary information often is not available. For example, many positions that the Notice requires be reported on a gross basis are netted and quarterly financial statements are not prepared for many subsidiaries. This mind-boggling complexity becomes even more daunting when one considers the broad definition of “payment” that must be applied separately by each PFFI in the group, as elaborated under the second and third administrability issues, below.

A second significant aspect of the administrability issue is that in addition to needing the PPP of every FFI in a group in order to determine the PPP of the parent entity, each active business FFI within a group – and for many groups there are hundreds and even thousands of such entities – would need to apply its own PPP to every payment made by it to every NP-FFI or recalcitrant account holder with which it transacts. This greatly magnifies the number of calculations needed to be performed on an ongoing basis.

A third, very significant, aspect of the administrability issue is that the Notice does not limit the scope of what a “payment” is for purposes of Section 1471(d)(7)’s definition of passthru payment as “any withholdable payment or other *payment* to the extent attributable to a withholdable payment” (emphasis added). Thus, each active business PFFI may need to treat as a passthru payment not only withholdable payments (*i.e.*, U.S. source FDAP and gross proceeds from sales of U.S. stocks and securities) and payments of interest, dividends and other distributions from the FFI to a NP-FFI (or recalcitrant account holder) that are allocable to withholdable payments,¹¹ but potentially also an allocable portion of (i) any payment to a NP-FFI of principal on any indebtedness issued by the FFI, (ii) any payment to a NP-FFI under a swap or other derivative, (iii) any purchase price paid to a NP-FFI for the acquisition of any asset from the NP-FFI, (iv) any money transfer payment or (v) any payment to a NP-FFI for any service, rental or license of property, etc.

These various categories of payments arise in different business divisions of an FFI and thus would necessitate substantial modifications to multiple business operations and IT systems, daily tracking of such payments, and performing due diligence with respect to every single counterparty, service or property provider or independent contractor with which the PFFI has any transactions. For a typical large active business FFI group, this involves millions of separate payments each year, made in the aggregate by hundreds or thousands of separate FFI subsidiaries each of which having different PPPs, determined separately several times a year.

A fourth aspect of the administrability issue is that, as alluded to above, each PFFI will need to obtain information about the status (as a PFFI, DC-FFI, NP-FFI, exempt entity, etc.) of each counterparty, service or property provider or independent contractor with which the PFFI has any transactions or investments, for two purposes. First, it will need such information in order to determine whether it must withhold on any payment made to any person. Second, with respect to any counterparty as to which the PFFI’s right to receive a payment gives rise to, or is related to, an “asset” (including off-balance sheet assets to be identified in guidance), the FFI must determine whether the counterparty is a FFI (other than a NP-FFI) and if so, what its PPP is on a rolling quarterly basis. Presumably, this would include swaps and various other derivatives,

¹¹ As noted above, these would include payments on regularly traded debt and equity interests issued by the PFFI or DC-FFI. Moreover, bearer bonds issued by FFIs locally, in compliance with TEFRA and the Act, would also be covered notwithstanding that the issuer is unable to identify the holders.

which depending on changes of value from one day to the next, may flip between constituting assets or liabilities. Obtaining this information from counterparties, vendors, issuers, etc. as to which a FFI was never required to maintain KYC/AML documentation will be a massive task, if feasible altogether.

A fifth aspect of the administrability issue is that because active business FFIs are deeply interconnected due to numerous cross-dealings with, and investments in, one another (as discussed in Part I.B above), one FFI cannot accurately determine its PPP without knowing the PPP of each FFI as to which it has a position that is an “asset.” This circularity problem will lead to inflated PPPs unless and until more accurate information about the PPPs of most FFIs is widely available.

A sixth aspect of the administrability issue is that the foregoing calculations – almost unfathomable in their intricacy and complexity – will necessitate very extensive, expensive and time-consuming overhauls of the IT systems of FFI groups, costing millions of dollars for many financial institution groups and taking several years to implement, assuming it is even practical to do so. For example, whereas most IT systems can typically handle no more than a handful of withholding tax rates, the Notice’s approach calls for a system that can handle at least 101 different effective withholding tax rates (assuming it is permissible to round a PPP to the nearest whole percentage point).¹²

A seventh aspect of the administrability issue is that even more costly than the up-front costs will be the need to commit substantial personnel and resources on a continuing basis in order to make the necessary determinations, since a lot of these calculations cannot be handled on a purely automated basis and will need to be conducted on a daily and quarterly basis. For example, information regarding the PPP of every FFI as to which a financial institution has a position will need to be gathered and entered into the FFI’s withholding systems manually, on a rolling quarterly basis. This would require hiring a complement of staff members dedicated solely to searching for and inputting this information.

Some of the administrability concerns would exist even if, as we recommend in Part I.H below, the Notice’s proportionate allocation rule were limited to investment funds. However, limiting this rule to investment funds significantly lessens the administrability problems, and, as explained in Part II.D, does not limit the rule’s effectiveness in preventing NP-FFIs from making indirect investments in U.S. assets without incurring withholding. We also make several recommendations in Part I.H below for mitigating the burdens of the Notice’s proportionate allocation rule on investment funds.

¹² It is facile to suggest that the IT systems would need to handle only two FATCA withholding tax rates – 30 percent and zero – because the systems will have to incorporate individualized PPPs for each payment stream received, which will vary each quarter. Assuming the PPPs can be rounded to the nearest whole percentage, that would produce 101 different effective rates on the payment stream base.

D. The “Blocker” FFI Concern.

Treasury and the IRS have expressed the belief that an expansive passthru payments rule is necessary to prevent the avoidance of FATCA through the use of PFFIs as “blockers” through which NP-FFIs (and their account holders) might benefit from investment in U.S. assets without complying with FATCA. We believe that this concern is adequately addressed by having the Notice’s proportionate allocation approach apply only to investment funds, rather than applying this approach to an active business FFI. Active business FFIs cannot practically serve as blockers for potential tax evaders because, as explained in Part I.A above, an investment in a typical active business FFI generally entails exposure to diversified business activities comparable to the exposure to an industrial company and not exposure to changes in the value of underlying U.S. or non-U.S. assets.

We acknowledge that, to some extent, there may be characterization issues of whether investment funds are masquerading as active business FFIs, but we believe that those issues can be addressed through the combination of (i) a clear definition of “active business FFI” that takes into account the extent to which the returns on and value of the interest held by investors track the returns on and value of the underlying assets and (ii) an appropriately crafted anti-abuse rule. Our suggestions in this regard are described in Part I.H below.

In any event, we respectfully submit that the marginal benefit of catching the few investment arrangements that are masquerading as active business FFIs that would result from applying the Notice’s proportionate allocation approach expansively to active business FFIs in their entirety is far outweighed by the serious risks, costs and administrability problems of that approach. As we noted in our previous submissions, if FATCA is to be successfully implemented, a pragmatic and reasonable balance must be struck between FATCA’s legitimate compliance objectives and the costs, commercial challenges, and the legal, operational and regulatory risks related to its administrability. In our judgment, applying the Notice’s approach expansively to active business FFIs seriously jeopardizes that delicate balance.

E. The USFI Blocker Issue.

While the perceived FFI blocker concern does not exist in the case of active business FFIs, we would like to draw your attention to the fact that, under the current guidance, U.S. financial institutions (“USFIs”) do provide a “blocker” opportunity for NP-FFIs because the passthru payment rule does not apply to USFIs, only to PFFIs, thereby putting PFFIs at a competitive disadvantage.

Thus, a NP-FFI could open a custodial account with a USFI securities firm, or make an investment in an investment fund that is treated as a U.S. partnership for tax purposes, through which it invests in the stocks and debt instruments of active business FFIs, investment vehicle FFIs and other products / securities giving rise to non-U.S. source payments, without being subject to FATCA or other withholding. Since the payments it receives would be non-U.S. source payments that are not subject to the passthru payments rule, the NP-FFI would simply be required to provide the USFI with a valid W-8BEN or W-8IMY to avoid any U.S. withholding tax. Similar results could be obtained if a NP-FFI enters into a swap or other derivative with a USFI where the underlying assets are interests in FFIs.

F. Clarification of the Traceability vs. Proportionate Allocation Approaches.

In a previous comment letter to Treasury and the IRS we recommended that a payment “should be considered ‘attributable to a withholdable payment’ [within the meaning of Section 1471(d)(7)] and thus a passthru payment only where there is a traceable link between the account holder and the withholdable payment and the withholdable payment is highly correlated to the non-U.S. source amount received by the account holder.”¹³ In rejecting our recommendation in favor of a proportionate allocation approach, we believe that the Notice may have misconstrued our use of the “traceable link” concept.

Two basic questions must be addressed in developing an approach for passthru payments. The first question is the scope of the rule – what types of payments with respect to what types of activities should be covered? The second question is, once the scope is determined, how should the amount of a passthru payment that is subject to the rule be determined? With respect to the second question, we have no cavil with the use of a proportionate allocation approach for determining the amount of a passthru payment that is subject to the rule, for the reasons advanced by the investment fund industry, although we believe that this approach must be simplified if it is to be administrable (and we make some suggestions in this regard in Part I.H below). The recommendation in our prior submissions regarding a “traceable link” relates to the first question, as to which we have explained why (i) the passthru payment rule should apply to investment funds and custodial accounts at active business FFIs, but not to the active business FFIs in their entirety (*i.e.*, what is referred to in our November 2010 Submission as “general funds payments,” or payments that a bank or other financial institution makes from general funds), and (ii) with respect to investment funds and other custodial accounts, there should be a *de minimis* rule for administrability reasons if the PPP is below a certain threshold.

We will elaborate on these recommendations in Part I.H below after addressing the question of statutory authority and legislative history of the passthru payment rule.

G. Statutory Authority for a Narrower Passthru Payment Rule.

We understand that certain Treasury and IRS officials have expressed the concern that the Treasury does not have the statutory authority to limit the definition of passthru payments to withholdable payments or payments directly traceable to withholdable payments because that would render meaningless the second part of the definition of passthru payment. In other words, concern was expressed that the clause “other payment to the extent attributable to a withholdable payment” in Section 1471(d)(7) would be superfluous if the Notice’s proportionate allocation approach, as applied to all FFIs, were to be narrowed, since these payments would be “withholdable payments” and thus covered under the first clause of the definition of passthru payment.

Having had extensive discussions with the staffs of the Congressional tax-writing committees (as well as Treasury) both before and after the passthru payments concept was added to the legislation – and being apprised of discussions with the staffs that other interested parties were having during this period – we are surprised by that concern.

¹³ The November 2010 Submission, pg. 23. *See also* the April 2010 Submission, pp. 14 – 15.

The initial version of FATCA, as introduced on October 27, 2009,¹⁴ did not contain the concept of passthru payments, and would have imposed a 30% withholding tax on payments to NP-FFIs only if those payments constituted “withholdable payments” (defined to include only U.S. source dividends and interest and gross proceeds from securities giving rise to U.S. source dividends and interest). It was pointed out that this definition was flawed because any dividend or interest payment by a non-U.S. investment fund that is a corporation for U.S. tax purposes would not be a withholdable payment because the dividends and interest would be foreign source income.¹⁵ Thus, we believe that Congress intended to close this large loophole in the statute by introducing the second clause of the definition of passthru payments. The addition of the second part of the “passthru payment” definition has great significance in achieving that result regardless of whether the provision is expanded to include other payments made by active business FFIs.

Moreover, we had extensive discussions with the Congressional and Treasury staffs regarding three concerns, all of which strongly support the view that Treasury has the statutory authority to construe the definition of passthru payments more narrowly than articulated in the Notice. First, after the passthru payments concept was introduced in the legislation, we expressed concern that it would be problematic for this concept to apply to bank deposit interest and other general funds payments made by banks, and we were assured by the staffs that this issue could and would be considered as part of the regulatory process (albeit without any commitment as to what the resolution might be). Second, we had long discussions with the staffs regarding the prospect that FATCA would likely result in a two-tier system in which many FFIs would elect to opt out of the system without adverse consequences by not investing in U.S. securities and could become a haven for U.S. tax evaders;¹⁶ the substance of these discussions would have been very different had the staffs believed that passthru payments included the PPP of all payments made by active business FFIs to NP-FFIs. Third, the Congressional staffs made it clear that Treasury was granted broad discretion in Section 1474(f) and elsewhere in the FATCA provisions to develop appropriate guidance regarding the implementation of FATCA.

Finally, our view of the legislative history and statutory authority for a narrower passthru rule than is contained in the Notice is supported by one of the sponsors of the legislation, Congressman Clay.¹⁷

¹⁴ H.R. 3933, S. 1934.

¹⁵ See, e.g., Cleary Gottlieb Steen & Hamilton LLP, “Proposed Legislation Focused on Offshore Tax Evasion,” 125 *Tax Notes* 892, 895 (November 23, 2009).

¹⁶ This concern is reflected in the April 2010 Submission on pp. 2, 3 and 9.

¹⁷ See Letter from Congressman Wm. Lacy Clay to Secretary of the Treasury Timothy Geithner dated September 13, 2010, 2010 TNT 188-28 (“I believe it would be consistent with both the plain language and intent of the legislation for Treasury to clarify that, except in the case of structures designed for avoidance of withholding taxes, a payment is considered attributable to a withholdable payment only where the payment is directly linked to a withholdable payment received by the FFI.”)

H. Recommendations.

In light of the foregoing, we respectfully make the following recommendations concerning the treatment of passthru payments and related matters:

1. *Active Business FFIs:* Except as discussed below, the passthru payment rule should be limited to investment funds and custodial payments in respect of investments in investment funds. Thus, passthru payments should not include any payment made by an active business FFI, and active business FFIs should not be required to determine their own PPPs.
2. *Bank Deposit Interest:* As a result of the foregoing recommendation, bank deposit (and other) interest paid by an active business FFI would not be a passthru payment to any extent. We understand that Treasury and the IRS feel that it is important to provide PFFIs with a withholding tax tool to incentivize recalcitrant account holders and NP-FFIs to come into compliance. However, for the reasons set forth above, it is simply not practical for active business FFIs to determine their PPPs, and in any event a bank deposit with a FFI cannot fairly be viewed as an indirect investment in U.S. securities. In the event Treasury and the IRS nonetheless wish to provide PFFIs with a withholding tax “stick” to use against recalcitrant account holders and NP-FFIs, we note that the practical problems with calculating a PPP may be overcome by treating, say, 5% of bank deposit interest paid to such persons as passthru payments.¹⁸ However, this approach still raises significant legal issues adverted to in Part I.C above. Thus, before such an approach could be implemented, it would be necessary to resolve those legal issues, including that in many countries it may be illegal for a FFI to collect tax on payments that cannot fairly be viewed as U.S. source payments.
3. *Definition of Active Business FFI:* An “active business FFI” should be defined as any entity that is a bank or other deposit-taking institution, securities broker-dealer, derivatives dealer, commodities broker-dealer or insurance company, or that is a member of an expanded affiliated group (or a member of a subgroup headed by such an entity) in which more than 50% of the financial assets of the group (or subgroup), determined by looking through any interests in members of the group, are held by any such entities or their subsidiaries. However, a member that is an investment entity (*i.e.*, in general, an entity described in Section 1471(d)(5)(C) that is not a bank or other deposit-taking institution, securities broker-dealer, derivatives dealer, commodities broker-dealer or insurance company) would not be treated as an active business FFI if and to the extent it issues equity¹⁹ or specified debt or other contractual instruments (as defined in Recommendation 4 below), directly or indirectly, to persons outside its expanded affiliated group.²⁰

¹⁸ A 5% withholding tax would correspond to a PPP of 16.67%.

¹⁹ Issuances of equity by the parent or “straight” preferred stock should be excluded.

²⁰ The treatment of issuances by investment entities of instruments to non-members should be coordinated with guidance regarding securitization vehicles and the treatment of regularly traded debt. *See also* Recommendation 6 below.

While a case can be made for a broader definition of active business FFIs, our proposal limits the definition to situations in which regulated entities and their subsidiaries constitute a majority of the value of the group. Our proposal would also exclude from this definition any subsidiary or affiliate of a regulated entity if and to the extent such subsidiary or other affiliate issues to non-group members instruments (other than conventional debt) that would be subject to FATCA if the entity were separately tested. We believe that this narrow definition of active business FFI – buttressed with an appropriately crafted anti-abuse rule – should ensure that the passthru payments rule reaches investment entities and similar arrangements while solving the substantial practical impediments to extending that rule to active business FFIs.

4. *Definitions of Specified Debt or Other Contractual Instruments:* For purposes of the active business FFI test described in Recommendation 3, “specified debt or other contractual instruments” of an investment entity should include any instrument (howsoever denominated) that provides the holder with a participation in the returns of the entity or a pool of assets owned by that entity, but should not include any securities repos or securities loans or other “straight” debt financings that are on conventional market terms.²¹

The intention of this proposal is to subject to FATCA those interests that are held by non-members in investment entities within an active business FFI group, other than conventional debt financings of the sort that FFIs engage in to finance their financial assets. Such conventional debt financings cannot fairly be considered indirect investments in U.S. securities, and for the reasons discussed in Recommendations 5 and 6 below, FFIs are not in a position to set up the due diligence and IT systems necessary to apply FATCA to their straight debt financings (or derivatives businesses) by FATCA’s effective date.

5. *Swaps and Other Derivatives Issued by Active Business FFIs:* Except as discussed herein, swaps and other derivatives issued by active business FFIs should not give rise to passthru payments. The treatment of swaps and other derivatives raises very complex conceptual, practical implementation and competitiveness issues, some of which are described in Parts I.B, I.C and I.E above. Payments under these derivatives should not be treated as passthru payments, at least until all the ramifications and conditions are carefully analyzed. If, after careful analysis, it is determined that any payments under derivative contracts should be treated as passthru payments, financial institutions should be given the considerable amount of time necessary to implement any such rule.

In this regard, it is important to recognize that neither the statute nor any guidance

²¹ However, derivatives issued by a derivatives dealer or other active business FFI should be a specified debt or other contractual instrument only if and to the extent provided in Recommendation 5 below.

prior to the Notice indicated that PFFIs would need to perform due diligence on the identities and FATCA status of persons that are counterparties to swaps and other derivatives, or to set up operating and IT systems for applying FATCA to their derivatives business operations. Indeed, to date the focus of the government and the financial industry has been on depository, custodial and similar financial accounts, and both the government and the financial industry face enormous challenges in implementing FATCA with respect to these core businesses. The considerable efforts and resources that would need to be dedicated by both the government and the financial industry to figure out and implement rules relating to the complex derivatives dealing businesses of financial institutions would be a huge diversion from the enormous task of implementing FATCA with respect to the core businesses and would seriously jeopardize their ability to implement FATCA anytime close to its scheduled effective date (which already is unlikely to be met). In addition, the U.S. derivatives businesses of both FFIs and USFIs are already under great pressure as the industry attempts to conform to the Dodd-Frank Act requirements.

Consequently, it is vital that payments under derivatives not be treated as passthru payments without careful analysis and discussion with the industry to ensure that there are no adverse and unintended market disruptions.²²

6. *Non-Regularly Traded Equity and Debt of Active Business FFIs:* For reasons similar to those discussed in Recommendation 5 above, the application of FATCA to non-regularly traded equity or debt interests in active business FFIs should be deferred. Likewise, it is important to clarify that the “passthru payment” rule will not encompass regularly traded debt (or equity) issued by active business FFIs. Financial institutions issue enormous amounts of non-bank deposit debt, of varying types and maturities, to finance their operations, including through medium-term notes, commercial paper, bankers’ acceptances, securities repos and securities loans, both in registered and in bearer form. Determining whether, to what extent and how FATCA should be extended to any of these categories of debt and then issuing guidance,²³ setting up the necessary due diligence and IT systems and coordinating with clearinghouses, capital markets practices and applicable laws will be a complicated multi-year process, and should not divert valuable resources and time from the immediate task of implementing FATCA with respect to the core areas being addressed in the Notices.²⁴

²² We recognize that in certain limited situations, total return swaps and similar derivatives could be used to avoid the FATCA withholding tax, and we would welcome the opportunity to discuss with Treasury and the IRS possible targeted stop-gap measures to prevent such abuse pending a more complete analysis of the appropriate treatment of derivatives.

²³ For example, there is not yet guidance on the standard for applying the exception for regularly traded debt, which has presented vexing line-drawing issues in other tax law contexts.

²⁴ As noted in our April 2010 Submission (pg. 22):

“Depending on the country and market practices, these debt instruments may be issued in bearer form, and in any event, systems may not be in place to track beneficial ownership.

7. *Other Payments by Any FFI:* Additionally, the term “payment” for purposes of the second clause of the definition of passthru payments should not include any payments other than interest, dividends, gross proceeds and other specified payments on financial assets (thus excluding, for example, ordinary course of business payments such as for services, rent or the purchase of any financial asset or other property, or money transfers), whether any such payment is made by an active business FFI or an investment entity. Payments of interest, dividends and gross proceeds on regularly traded debt or equity interests or in respect of grandfathered obligations (as described in section 501(d)(2) of the Act) should not be passthru payments.
8. *De Minimis Rule:* A *de minimis* rule should exempt from passthru payments any situation in which the applicable PPP is less than 5 or 10%. A *de minimis* exemption would permit those investment funds that have only incidental direct and indirect investments in U.S. stocks and securities to avoid the very substantial administrability issues faced by investment funds in determining the applicable PPP (similar to some of the concerns described in Part I.C above with respect to active business FFIs), and should not have a material impact on the effectiveness of FATCA.
9. *PPP with Respect to a Specified Pool of Assets:* Where an (equity, debt or other contractual) interest in a FFI is determined by reference to a specific pool of assets (such as in the case of a segregated pool, series fund, or a partnership with special allocations), the PPP test with respect to the different classes of interests should be applied by reference to the related pool of assets. While this proposal may require certain FFIs to perform additional PPP calculations, we believe that in general this is necessary and appropriate to ensure that, where different investors have different exposures to U.S. assets, the PPP applied to each investor properly matches its exposure.²⁵
10. *Liberal Rules for Determining PPP:* FFIs and holders of interests in FFIs should be permitted to apply liberal rules for estimating the PPP of any FFI (or specific pool of assets). Thus, FFIs should be permitted to determine their PPPs on an annual basis, and should be permitted to estimate their PPPs based on their asset allocation guidelines. Similarly, where an FFI does not publish its PPP, holders of interests in the FFI should be permitted to estimate the PPP of that FFI based on information provided by the FFI regarding the nature of its assets.

We see no reason why such non-deposit debt instruments should be treated differently under FATCA than similar instruments issued by non-financial companies, and in particular we do not believe it necessary for U.S. tax compliance purposes to upset the capital markets practices in various countries for these issuances. These debt instruments do not afford investors the same regulatory and legal protections as deposits. Moreover, as in the case of similar debt instruments issued by non-financial companies, any FFI account through which an investor holds such debt instruments would be subject to the FATCA compliance requirements.”

²⁵

However, it would appear to be appropriate to permit FFIs some discretion to aggregate pools, on a consistent basis, where that makes sense due to the small size of the assets in the pool, immateriality of the differences, undue complexities or other reasons.

This recommendation is prompted by the view that a readily determinable and reasonably determined PPP is sufficient to provide PFFIs with the necessary “stick” to induce NP-FFIs and recalcitrant holders to provide the necessary information, and that it is essential to minimize the costs of compliance to the extent possible.

11. *Dissemination of PPP.* FFIs that must determine their PPP should be required to provide the applicable PPP to holders of debt or equity (or other) interests therein when they make a payment of interest or dividends (or other payment for which the PPP is relevant). Such a requirement would facilitate timely and automated incorporation of that information in the calculations that the recipient needs to perform.

In addition, an FFI that provides its PPP information to all its investors and counterparties should not be required to publish that information (for example on a website or database readily searchable by the public). Many PFFIs and DC-FFIs have a limited number of investors and counterparties, and broad publication of their PPPs seems unnecessary and may conflict with privacy concerns.

12. *Anti-Abuse Rule:* If the regulations contain an anti-abuse rule to ensure, *e.g.*, that the rules regarding active business FFIs, interests in FFIs or in specific pools of assets, and the determination of PPP are not applied in a manner that would contravene the purpose and intention of FATCA, it is important that the rule be carefully crafted and circumscribed to avoid confusion as to its intended scope.
13. *U.S. Branches of FFIs:* The Notice’s proposed treatment of passthru payments underscores the need to revise the proposed approach towards U.S. branches of FFIs set forth in section II.D.1 of Notice 2010-60 in the manner we recommended in our November 2010 Submission (pp. 10 – 11) and subsequently discussed with you. Thus, it is imperative for the effective working of FATCA for both U.S. branches of FFIs and the numerous USFIs and other U.S. counterparties with which they transact business that the U.S. branches be treated as USFIs (and as distinct and separate persons from their head office or other branches), rather than as FFIs, for all purposes of FATCA. Otherwise, there would be huge operational problems for both the U.S. branches and their USFI counterparties since none of their systems are set up to handle the FATCA-related information that would be required to be provided on a payment-by-payment basis in respect of the enormous volume of passthru payments that are made between them. As explained in our November 2010 Submission, under our proposal the U.S. branches would be required to comply fully with the FATCA rules for all actual and deemed payments that they make to their head office or other branches.

II. Procedures for Identification of Preexisting Individual Accounts (Notice, Section I).

A. Private Banking and Accounts of \$500,000 or More.

We commend Treasury and the IRS’s decision to differentiate between those categories of accounts that have a higher risk of potential tax evasion and those with a lower risk,

and to provide for reduced due diligence procedures for pre-existing lower-risk accounts. We believe that this approach will lessen the administrative burden on FFIs of performing customer diligence while achieving Congress's goal of deterring tax avoidance. In general, we agree that private banking accounts and accounts with substantial balances may warrant greater scrutiny than other categories of accounts, although we suggest that the appropriate threshold should be \$1 million rather than \$500,000. This section makes recommendations to better tailor these rules to cover only truly higher-risk accounts and to reduce compliance costs and burdens associated with implementing this rule.

1. Definition of "Private Banking Account" (Notice, Section I.A.1).

We believe that the Notice's definition of "private banking accounts" is too broad, and will unintentionally capture a large number of lower-risk accounts and subject these accounts to unnecessarily stringent and costly diligence procedures. For example, for marketing reasons, many banks use terminology similar to that contained in the Notice's description of private banking account to describe accounts that are held by retail local-market customers, with modest account balances. In addition, many small, low-risk accounts would be included in the definition of "private banking account" because they receive some investment advisory services, despite the fact that they may have low account balances.

We have considered how the private banking definition might be modified to better reach the intended group, but have concluded that any modifications that we might propose would likely result in a definition that is either over-inclusive or under-inclusive given the range of criteria that different financial institutions use to describe this category of accounts. Accordingly, we recommend that Treasury and the IRS add a \$500,000 or \$1 million threshold requirement to the definition of "private banking account." Adding this threshold would make the private banking rule materially more administrable for FFIs while still achieving the goal of requiring greater diligence on higher-risk accounts. We note that the PATRIOT Act, which requires special due diligence on private banking accounts in order to prevent money laundering, reflects the lower-risk nature of accounts with lower account balances by using a definition of "private banking account" that requires "a minimum aggregate deposit ... of funds or other assets of not less than \$1,000,000..."²⁶ We therefore recommend that the definition of "private banking account" be narrowed by including a similar account balance threshold.

2. Private Banking Procedures (Notice, Section I.A.2).

We also recommend that certain changes be made to the diligence procedures for private banking accounts in order to make the customer account diligence performed by an FFI more effective and efficient.

The private banking rule requires that all of the FFI's private banking relationship managers perform a "diligent review of the paper and electronic account files and other records for each client with respect to whom they serve as a private banking relationship manager." We concur that the private banking relationship managers should have an important role in the due diligence effort. However, we do not believe that they are well-suited to actually perform a

²⁶ USA PATRIOT Act of 2001, section 312, 31 U.S.C. 5318(i).

“diligent review of the paper and electronic account files and other records” for each of their clients. Many of these files will not be in their possession or under their control. Moreover, these individuals are account relationship officers, and are not typically tasked with, well-suited or trained to perform such a diligence function. Thus, neither the FFI nor the IRS should have a high degree of confidence that these tasks will be adequately performed by them.

Additionally, for the reasons discussed in our April and November 2010 Submissions, we are concerned that any procedure that requires a diligent review of the paper account files for each client – even if limited to private banking accounts and accounts of \$500,000 (or, as we suggest, \$1 million) or more – will be extremely burdensome, time-consuming and costly, with only marginal benefits.

Accordingly, we recommend the following set of procedures for private banking accounts and other accounts of \$500,000 (or, as we suggest, \$1 million) or more:²⁷

- (i) The FFI must perform a search of the electronically searchable information maintained by the FFI that is associated with a private banking account or any other account of \$500,000 (or, as we suggest, \$1 million) or more, including the aggregation of related accounts as discussed below, to identify any accounts with U.S. indicia, in accordance with the Notices;
- (ii) Each private banking relationship manager must review lists of the clients with respect to whom he/she serves as a private banking relationship manager, as well as the personal contact information retained by the private banking relationship manager, and identify each individual account holder who, to the best knowledge of the private banking relationship manager, has U.S. indicia and an aggregate account value (including any related accounts with, *e.g.*, brokerage, investment and wealth management divisions) of \$500,000 (or, as we suggest, \$1 million) or more; and
- (iii) The FFI must obtain documentation from all account holders that have been identified as having U.S. indicia.

Furthermore, an FFI should not be required to perform these procedures with respect to private banking accounts or other accounts of \$500,000 (or, as we suggest, \$1 million) or more for which the FFI has a valid W-8BEN certifying that the holder is a non-U.S. person and documentary evidence establishing non-U.S. status in accordance with the Notice.

3. Associated Family Members (Notice, Sections I.A.1 & I.A.2).

We request that Treasury and the IRS clarify the rules regarding “associated family members” on page 10 of the Notice. First, clarification should be provided that a person is an “associated family member” only if that person has an account with the FFI that is linked to the

²⁷ Essentially, the procedures for private banking accounts and other accounts with balances of \$500,000 (or, as we suggest, \$1 million) or more would be the same, except that for private banking accounts the private banking relationship managers would be required to perform the important functions described in (ii) below.

client account in question on the FFI's computerized database or if that person is identified on the client's database as a contact person or as having a power of attorney or signatory or other authority or responsibility with respect to the account.

Second, we interpret the rules as providing that if there are any U.S. indicia regarding an associated family member pursuant to Step 3(A)(ii), the FFI must request documentation with respect to the *client* (rather than the associated family member) to establish whether the *client's* account is a U.S. account, pursuant to Step 3(A)(iii). However, this process should not be affected by the existence of the associated family member, and in particular no specific documentation is required in respect of the associated family member if the documentation provided pursuant to Step 3(A)(iii) establishes that the account is not a U.S. account. We suggest that this be clarified.

B. Other Issues Regarding Preexisting Account Procedures.

1. Deadline for Completing Preexisting Customer Account Diligence Procedures (Notice, Section I.A.2).

With respect to the preexisting individual customer diligence procedures specified in the Notice, we request that Treasury and the IRS clarify the compliance deadline described by the phrase "after the end of the first year in which the FFI's FFI Agreement is in effect." We recommend that such deadline be one year's time from the later of the signing date or the effective date of the FFI Agreement, and not the end of the first calendar year after the FFI Agreement is in effect, since it would often be impractical for FFIs that enter into FFI agreements in the middle, or towards the end of, a year to complete their due diligence by the end of that year.

2. Aggregation of Related Accounts (Notice, Section I.A.2).

We appreciate Treasury and the IRS' efforts to be responsive to comments received with respect to the ability of financial institutions to aggregate accounts with partial or complete common ownership using their existing computerized information management systems. We request further clarification that no aggregation is required where the account balance information for the different accounts that are associated with one another cannot be shared due to legal constraints or cannot be readily accessed due to systems limitations. We also think it would be acceptable to add an appropriately crafted anti-abuse rule that would require the aggregation of accounts that a private banking relationship manager knows or has reason to know should be aggregated.

3. Employee Name Requirement of "Maintained Documentary Evidence" (Notice, Section I.A.2).

The Notice provides (on pages 7 – 8) that where it does not retain a copy, a participating FFI has "maintained documentary evidence" only if any record of the documentary evidence examined includes the type of document and the name of the employee who reviewed the documentary evidence. Many financial institutions adopted and scrupulously followed AML/KYC due diligence and documentary evidence review procedures under best practices that did not require the name of the employee who reviewed the documentary evidence to be recorded. We are concerned that the introduction of this new requirement with respect to pre-existing

accounts, as to which FFIs were never previously aware, would cause many items of otherwise properly recorded documentary evidence to not qualify as “maintained documentary evidence” and would force many financial institutions to incur significant burdensome and costly efforts to re-document their accounts. As explained in our April and November 2010 Submissions, this may not be practical, depending on the volume of accounts involved. We therefore request that the employee name requirement for maintained documentary evidence be dropped.

4. Chief Compliance Officer Certification (Notice, Section I.A.3).

We understand and accept the rationale for the required certification by a “responsible officer,” but we have a few suggestions to address a concern that as drafted, this certification requirement may dissuade some FFIs from entering into FFI agreements. First, the chief compliance officer is not necessarily the most knowledgeable and appropriate person for the certification. Therefore, we recommend that either (A) the “responsible officer” should include a designee of the chief compliance officer or other equivalent-level officer who has senior-level responsibility for FATCA compliance at the FFI or (B) the chief compliance officer or other equivalent-level officer should be permitted to state in his or her certification that he/she relied on representations provided by one or more persons with senior-level responsibility for FATCA compliance.

Also, some members have expressed concern that some chief compliance officers may have difficulty providing the broad and imprecise certification that, “between the publication date of the Notice and effective date of the FFI Agreement, FFI management personnel did not engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging, or assisting account holders with respect to strategies for avoiding identification of their accounts as U.S. accounts under the procedures described” in the Notice. One concern is that in most financial institutions, the details of the Notice will not be disseminated for some time and therefore it is difficult to certify that none of the suspect activities have taken place since the publication date of the Notice.²⁸ Also, the terms “FFI management personnel,” and “informal policies and procedures” are imprecise, and no opportunity is provided to cure any inadvertent or rogue activity that might be problematic.

Accordingly, we suggest that (i) the certification be to the best knowledge of the responsible officer, after due inquiry with senior divisional management responsible for customer relations, and (ii) the certification allow for a description of any deviations and steps taken to cure the problem.

5. Documentation for New Accounts.

We recommend that the definitions of “documentary evidence,” “documentary evidence establishing non-U.S. status” and “documentation” that are contained in Section I.A.1 of the Notice apply equally to the procedures in Notice 2010-60 for new accounts.

²⁸ Some Treasury and IRS officials have indicated that the intended date is not May 9, 2011, the date the Notice was published in the Federal Register, but rather April 8, 2011, the date the Notice was released.

III. Deemed-Compliant FFIs (Notice, Section III).

A. In General.

The Notice describes two categories of FFIs that will be deemed compliant pursuant to section 1471(b)(2) – certain local banks and local FFI members of PFFI groups. In addition, the Notice indicates that Treasury and the IRS intend to issue guidance regarding certain collective investment vehicles and other investment funds, as well as retirement plans and retirement accounts, qualifying as DC-FFIs, and are continuing to consider other possible exceptions. These steps are welcome, but we greatly fear they are and will be too narrow, inadequate and untimely.

As we explained at length in our April and November 2010 Submissions, we believe it imperative to the successful implementation of FATCA that large swathes of the FFI population be explicitly carved out of FATCA under easily applied and administrable rules because such entities present little risk of U.S. tax evasion. Otherwise, the IRS and the financial industry will be overwhelmed with both (A) tens of thousands of entities seeking to become PFFIs (but many of which will fail to do so) and (B) tens of thousands of entities concluding that they cannot comply with FATCA on a cost-effective basis, and therefore will become NP-FFIs.

In Part I.B above we described our grave concern that the decision to apply the Notice's proportionate allocation approach for passthru payments to active business FFIs will result in potentially serious disruptions to the world financial system, as PFFIs face difficult legal, contractual and business issues in dealing with NP-FFIs in a broad array of business transactions having no connection to U.S. investments, as well as exposures arising from massive amounts of inaccurate withholding under FATCA. As we observed, these systemic stress concerns are exacerbated by the fact that to date Treasury and the IRS have not provided the sort of broad carveouts from FATCA that we believe are imperative and were envisioned by Congress in enacting section 1471(b)(2).

B. Local Banks and Local FFI Members of PFFI Groups.

The Notice's proposals for treating certain local banks and local members of PFFI groups as DC-FFIs contain restrictive qualification conditions and burdensome procedures that will likely make these exceptions available only to very few FFIs. For example, a local bank that seeks to qualify as a DC-FFI must implement policies and procedures to ensure that it does not open or maintain accounts for non-residents, NP-FFIs, or NFFEs (other than excepted NFFEs that are organized in the FFI's jurisdiction). A local member of a PFFI group that seeks to qualify as a DC-FFI must satisfy similar conditions with respect to U.S. accounts, NP-FFIs and NFFEs except that any such existing accounts must be transferred to an affiliate that is a PFFI within a reasonable time or closed.

It is unrealistic to expect that a bank would never open or maintain accounts for non-residents (which would include, for example, European residents of one country that work in a neighboring country, or former residents and expatriates). It is also unrealistic to expect that an essentially local bank that is seeking to minimize its FATCA-related burdens would institute burdensome procedures – of the sort required by the Notice – to determine whether particular

accounts are held by FFIs or NFFEs, and whether such FFIs are NP-FFIs and such NFFEs are both excepted NFFEs and are organized in the same country as the bank. Moreover, as a commercial matter, it seems unrealistic to expect a bank to turn away long-standing customers that, for example, are active businesses that are local branches of foreign entities or that are offshore foreign investment vehicles organized by local customers of the bank for family planning purposes. Even in the case of a local member of a PFFI group, we think it would be problematic as an administrative and customer relations matter to move all its NP-FFI accounts and many NFFE accounts to affiliated PFFIs. Nor do we believe that such restrictive conditions are necessary in order to achieve FATCA's compliance objectives.

Moreover, as discussed in Part I above, the Notice's approach to passthru payments would require every DC-FFI to incur costly and burdensome processes to determine and publish its PPP. These requirements will likely render the entire DC-FFI concept as envisioned by the Notice unattractive to many institutions.

We urge Treasury and the IRS to reconsider the very narrow and burdensome scope of the DC-FFI rules that it is proposing in light of the specific concerns raised about these rules and the broader concerns discussed in Part III.A above, as well as the statutory directive of section 1471(b)(2). In this regard, we respectfully submit that, in devising guidance under section 1471(b)(2)(A),²⁹ it would be appropriate for Treasury and the IRS to distinguish between FFIs that are investment vehicles and those that are active business FFIs. Thus, it is very important to monitor the status of FFIs that hold accounts in an investment entity (or a custodial account in an active business FFI), due to the blocker FFI concern discussed in Part I.D above, but it should not be necessary (and would eviscerate the utility of any DC-FFI rule) to do so in the case of deposit and other non-custodial accounts at active business FFIs.

Consistent with the foregoing views, on May 4, 2011 we submitted a proposal for implementing the "no U.S. account" exception contemplated by section 1471(b)(2)(A). To clarify, we believe that our proposal is appropriate for active business FFIs (as to which the "blocking issue" should not be of concern, as discussed in Part I.D above), and have not considered what modifications might be appropriate in the context of investment funds. We respectfully request that Treasury and the IRS adopt our suggested approach.

IV. Reporting on U.S. Accounts (Notice, Section IV).

We appreciate the relaxation of the account balance rules to require only year-end balances or values. While we also appreciate the adoption of new, more practical methods for reporting certain cash flows, we recommend that Treasury and the IRS allow FFIs to report the gross amounts of (i) dividends, (ii) interest, (ii) other income, and (iv) gross proceeds aggregated together if and to the extent that this is how such information is recorded or maintained by the FFI.

²⁹ Section 1471(b)(2)(A) grants Treasury and the IRS regulatory authority to designate as a DC-FFI an FFI that "(i) complies with such procedures as the Secretary may prescribe to ensure that such institution does not maintain United States accounts, and (ii) meets such other requirements as the Secretary may prescribe with respect to accounts of other foreign financial institutions maintained by such institution."

Additionally, many financial institutions do not track gross proceeds, and therefore reporting such amounts would be burdensome, as it would require some FFIs to create new systems to track this information. In lieu of reporting gross proceeds, we recommend that Treasury and the IRS allow FFIs to elect to report withdrawals from accounts in addition to year-end account balances, inasmuch as these data should give sufficient indication of those accounts that involve material amounts of activity.