

[TEXT OF THE FATCA COMMENT LETTER SUBMITTED BY
NEW YORK STATE BAR ASSOCIATION TAX SECTION]

January 12, 2012

The Honorable Emily S. McMahon
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Report on *IRS Notice 2011-34* n1 and *IRS Notice 2011-53* n2

Dear Ms. McMahon, Mr. Wilkins and Mr. Shulman:

We are pleased to submit New York State Bar Association Tax Section Report No. 1253. This report conveys the recommendations and comments of the tax section of the New York State Bar Association regarding certain aspects of *Notice 2011-34*, and *IRS Notice 2011-53*, and responds, in part, to the request for comments set out in *Notice 2011-34*.

The recommendations and comments in this report address certain limited issues arising from the Notices, particularly those involving passthru payments, deemed compliance, the treatment of private banking relationships and the application of the rule requiring compliance by all foreign financial institution members of an expanded affiliated group . On November 16, 2010, we submitted a report on *Notice 2010-60*, n3 and appreciate that the Internal Revenue Service (“IRS”) and Treasury Department have released guidance that is consistent with certain recommendations made in that report. Although this report does not repeat our prior recommendations, we remain supportive of the recommendations we made in our report on *Notice 2010-60*.

We continue to support the efforts of Congress, the IRS and the Treasury to prevent U.S. tax avoidance, and understand that developing a set of rules that are workable for financial institutions and achieve the statute's goals is a difficult task.

The report makes several recommendation with respect to the Notices.

Reevaluate the Approach that Notice 2011-34 Takes Toward Passthru Payments

We recognize that the “percentage of total assets” approach to passthru payments, proposed in *Notice 2011-34* encourages foreign financial institutions (“FFIs”) to sign an information reporting agreement with the IRS and Treasury Department (such an agreement, an “FFI Agreement,” FFIs that sign an FFI Agreement, “Participating FFIs” and other FFIs, “non-participating FFIs”). We are concerned, however, that this approach may result in rules that extend beyond what Congress intended, and, as we discuss in the report, have other ramifications that were not intended by either Congress or the Treasury Department.

As a result, we recommend that the IRS and Treasury Department reconsider and narrow the approach taken in *Notice 2011-34* with respect to passthru payments. In particular, we suggest:

1. limiting the requirement that Participating FFIs withhold on passthru payments (other than certain passthru payments made on derivatives) to cases where payments are made to “financial accounts”; n4
2. for payments made to financial accounts of non-participating FFIs (but not recalcitrant account holders), limiting passthru payment withholding to Participating FFI payors that are investment-type entities that have a significant percentage of their assets in U.S. investments, or at most, to all Participating FFI payors that have a significant percentage of their assets in U.S. investments;
3. that the IRS and Treasury Department consider a “tracing” rule for certain passthru payments on derivatives (some consideration might also be given to treating derivatives as accounts, but that does not resolve some of the issues we have identified);
4. that the IRS and Treasury Department consider adopting a requirement that U.S. financial institutions (“USFIs”) withhold on passthru payments, so that foreign institutions are not subject to more burdensome rules than USFIs; and

5. that the “passthru payment percentage” calculation rules be simplified to provide that Participating FFIs (other than investment-type entities) be permitted to use a fixed percentage as their passthru payment percentage, if the percentage approach is retained for such non-investment type FFIs.

Remove the Focus in the “Deemed Compliance” Rules on a “Local” Bank’s Jurisdiction of Incorporation

As proposed, the “deemed compliance” rules in *Notice 2011-34* limit the ability of “local” banks to do business with customers organized or located in jurisdictions other than the country where the local bank is incorporated. In our view, this proposal is likely to place severe constraints on small banks’ ability to benefit from these rules by, for example, effectively requiring that banks operating near national borders choose between either (i) not using the deemed compliance route or (ii) closing the accounts of any customers who reside in neighboring jurisdictions. In addition, we recommend that there be “deemed compliance” options for (i) Participating FFI affiliates that operate in multiple jurisdictions if they agree to comply with the rules applicable to single-jurisdiction local affiliates (*i.e.*, agreeing to not maintain accounts for nonresidents, U.S. persons and non-participating FFIs, and transferring any such accounts that are found to a Participating FFI affiliate) and (ii) “local” branches of FFIs.

Allow “Low-Value” Private Banking Accounts to Be Excluded from the “Private Banking” Rules, and Consider Foreign Law and Other Legal Restrictions in Establishing Account Classification Rules

We agree with the IRS and Treasury Department’s decision, in *Notice 2011-34*, to focus the due diligence required by the Act on “private banking” and “high-value” accounts. However, we believe that the definition of a “private banking account” in *Notice 2011-34*, which includes any account serviced by a department providing “services not generally provided to account holders,” would be clearer and more administrable if private banking accounts were limited to accounts that meet or exceed a specified dollar threshold. In our view, formulating a precise, non-monetary standard to define a “private banking account” that applies across jurisdictions and banking institutions will be difficult, and is unnecessary to achieve the goals of the Act. We anticipate that “low-value private banking accounts” are likely to present little tax evasion risk, and that such accounts could be appropriately managed under the rules for retail relationships.

Provide Certain Exemptions for Certain Members of Expanded Affiliated Groups That Cannot Be “Controlled”

In certain circumstances, it may be impractical for all FFIs in an affiliated group to become Participating FFIs, or for a “lead” FFI in each group to oversee the compliance of each member with the Act. Accordingly, we recommend that the IRS and Treasury Department provide guidance allowing affiliated groups of FFIs to include non-participating FFIs in cases where the parent of the group lacks actual control over that affiliate. It may be appropriate, however, to have anti-avoidance rules such as deemed common control when a Participating FFI refers business to an affiliate.

Provide Guidance Extending the Due Diligence Deadlines for USFIs

Notice 2011-53 extended the account due diligence deadlines applicable to Participating FFIs. Although the IRS and Treasury Department may intend to do so, we believe it would be helpful for guidance to clarify that this timetable is also applicable to USFIs.

We appreciate your consideration of the report and our recommendations.

Sincerely,

Jodi J. Swartz
New York State Bar Association
Tax Section

cc:

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Report on *IRS Notice 2011-34* and *IRS Notice 2011-53*
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Under the Act, a “financial account” is generally a depository or custodial account, and any equity or debt instrument issued by an FFI that is not publicly traded. See Section 1471(d)(2).

Report No. 1253

Report on *IRS Notice 2011-34* and *IRS Notice 2011-53*

This report conveys the recommendations and comments of the tax section of the New York State Bar Association regarding certain aspects of Internal Revenue Service (“IRS”) Notice 2011-34 (the

“Notice 2011-34”) n2 and *IRS Notice 2011-53* (“Notice 2011-53”). n3 These IRS notices discuss the IRS and the Treasury’s proposals for implementing certain aspects of the information reporting and withholding provisions of Chapter 4 of the Internal Revenue Code of 1986, as amended (the “Code”), which was enacted pursuant to the Hiring Incentives to Restore Employment Act of 2010 (the “Act”). The recommendations and comments in this report address certain limited issues arising from the two IRS notices. On November 16, 2010, we submitted a report on *Notice 2010-60*, n4 and appreciate that the IRS and Treasury Department have released guidance that is consistent with certain recommendations made in that report. Although this report does not repeat our prior recommendations, we remain supportive of the recommendations we made in our report on *Notice 2010-60*.

We continue to support the efforts of Congress, the IRS and the Treasury to prevent U.S. tax avoidance. In addition, we appreciate that developing a set of rules that are workable for financial institutions and achieve the goals of the Act is a difficult task, and that the IRS and Treasury Department intend to offer additional, and more detailed, guidance implementing the Act in the future. To that end, the members of the tax section of the New York State Bar Association hope that the recommendations in this report will assist the Treasury Department and the IRS in the ongoing process of developing guidance implementing the Act.

Summary of Recommendations

We recommend that the IRS and Treasury Department:

A. Reevaluate the Approach that *Notice 2011-34* Takes
Toward Passthru Payments

We appreciate that the “percentage of total assets” approach to passthru payments, proposed in *Notice 2011-34*, encourages foreign financial institutions (“FFIs”) to sign an information reporting agreement with the IRS and Treasury Department (such an agreement, an “FFI Agreement,” FFIs that sign an FFI Agreement, “Participating FFIs” and other FFIs, “non-participating FFIs”). We are concerned, however, that this approach may result in rules that extend beyond what Congress intended, and, as we discuss further below, have other ramifications that were not intended by either Congress or the Treasury Department.

Given these reservations, we recommend that the IRS and the Treasury Department reconsider and narrow the approach taken in *Notice 2011-34*. In particular, we suggest:

1. limiting the requirement that Participating FFIs withhold on “passthru payments” (other than perhaps certain “passthru payments” made on derivatives) to cases where payments are made to “financial accounts”; n5 to cases where payments are made to “financial accounts”; n5
2. for payments made to financial accounts of non-participating FFIs (but not recalcitrant account holders), limiting

“passthru payment” withholding to Participating FFI payors that are investment-type entities that have a significant percentage of their assets in U.S. investments, or at most, to Participating FFI payors that have a significant percentage of their assets in U.S. investments;

3. that the IRS and Treasury Department consider “whether a derivative should be considered a “financial account” and whether a special “tracing” rule should be adopted for certain derivatives;

4. a requirement that U.S. financial institutions (“USFIs”) withhold on “passthru payments”; and

5. that the passthru payment percentage calculation rules be simplified to provide that Participating FFIs (other than investment-type entities) be permitted to use a fixed percentage as their passthru payment percentage.

B. Remove the Focus in the “Deemed Compliance” Rules on a “Local” Bank’s Jurisdiction of Incorporation

As proposed, the “deemed compliance” rules in *Notice 2011-34* limit the ability of “local” banks to do business with customers organized or located in jurisdictions other than the country where the local bank is incorporated. In our view, this proposal is likely to place severe constraints on small banks’ ability to benefit from these rules by, for example, effectively requiring that banks operating near national borders choose between either (i) not using the deemed compliance route or (ii) closing the accounts of any customers who reside in neighboring jurisdictions. In addition, we recommend that there be “deemed compliance” options for (i) Participating FFI affiliates that operate in multiple jurisdictions if they agree to comply with the rules applicable to single-jurisdiction local affiliates (*i.e.*, agreeing to not maintain accounts for non-residents, U.S. persons and non-participating FFIs, and transferring any such accounts that are found to a Participating FFI affiliate) and (ii) “local” branches of FFIs.

C. Allow “Low-Value” Private Banking Accounts to Be Excluded from the “Private Banking” Rules, and Consider Foreign Law and Other Legal Restrictions in Establishing Account Classification Rules

We agree with the IRS and Treasury Department’s decision, in *Notice 2011-34*, to focus the due diligence required by the Act on “private banking” and “high-value” accounts. However, we believe that the definition of a “private banking account” in *Notice 2011-34*, which includes any account serviced by a

department providing “services not generally provided to account holders,” would be clearer and more administrable if private banking accounts were limited to accounts that meet or exceed a specified dollar threshold. In our view, formulating a precise, non-monetary standard to define a “private banking account” that applies across jurisdictions and banking institutions will be difficult, and is unnecessary to achieve the goals of the Act. We anticipate that “low-value private banking accounts” are likely to present little tax evasion risk, and that such accounts could be appropriately managed under the rules for retail relationships.

D. Provide Certain Exemptions for Certain Members of Expanded Affiliated Groups That Cannot Be “Controlled”

In certain circumstances, it may be impractical for all FFIs in an affiliated group to become Participating FFIs, or for a “lead” FFI in each group to oversee the compliance of each member with the Act. Accordingly, we recommend that the IRS and Treasury Department provide guidance allowing affiliated groups of FFIs to include non-participating FFIs in cases where the parent of the group lacks actual control over that affiliate. It may be appropriate, however, to have anti-avoidance rules such as deemed common control when a Participating FFI refers business to an affiliate.

E. Provide Guidance Extending the Due Diligence Deadlines for USFIs

Notice 2011-53 extended the account due diligence deadlines applicable to Participating FFIs. Although the IRS and Treasury Department may intend to do so, we believe it would be helpful for guidance to clarify that this timetable is also applicable to USFIs.

Discussion

I. Passthru Payments

We have substantial concerns about the approach taken by *Notice 2011-34* in relation to “passthru payments” and recommend that the IRS and Treasury Department reevaluate the approach proposed in *Notice 2011-34*.

We recognize that the IRS and Treasury Department carefully considered ~ and did not adopt ~ a “tracing” approach to “passthru payments”. However, we believe that the passthru payment concept was probably intended by Congress to be an anti-avoidance rule, and not a rule that uses a “diffuse attribution” concept to, in effect, provide a secondary incentive (beyond withholding on withholdable payments) to FFIs to become Participating FFIs. As discussed further below, for this reason and others, we are of the view that the “passthru payment” concept would better formulated as a narrower rule that focuses on payments to “financial accounts.”

A. Background

The Act requires that Participating FFIs withhold 30% of any “passthru payment” made to a non-participating FFI or a “recalcitrant account holder” (i.e., a person who fails to comply with reasonable requests for certain information that Participating FFIs must request under the Act).ⁿ⁶ Under the Act, a “passthru payment” is (i) any payment that is itself a “withholdable payment”ⁿ⁷ and (ii) any payment that is not a withholdable payment, to the extent it is “attributable to” a withholdable payment.ⁿ⁸

Notice 2011-34 proposes a rule that, in general, treats payments as passthru payments in proportion to the fraction of the paying Participating FFIs’ total assets that have U.S. nexus (“U.S. Assets”). Specifically, subject to limited exceptions (i) any withholdable payment (e.g., a payment of U.S.-source income) made by an FFI will be treated entirely as a passthru payment and (ii) a portion (the “passthru payment percentage”) of any remaining or other payment made by an FFI will be treated as a passthru payment. For payments made when an FFI is acting as a custodian, the relevant “passthru payment” percentage will be the passthru payment percentage of the issuer of the instrument or interest in the custodial account. In other cases, the applicable passthru payment percentage will be that of the payor FFI.

The passthru payment percentage of a Participating FFI will generally be the fraction of its assets that are U.S. Assets. Under Notice 2011-34, U.S. Assets will be any assets to the extent they could give rise to passthru payments. For purposes of this rule, a debt or equity instrument issued by a U.S. corporation will be treated entirely as a U.S. Asset, and a debt or equity instrument issued by a non-financial foreign entity (an “NFFE”) will not be treated as a U.S. Asset. A debt obligation or equity interest issued by another FFI will be treated as a U.S. Asset to the extent of the issuer’s passthru payment percentage.

A Participating FFI or deemed compliant FFI will be required to compute its passthru payment percentage within roughly three months of the end of each fiscal quarter, on “quarterly testing dates.” Within three months of a quarterly testing date, each Participating FFI and deemed compliant FFI will be required to calculate and publish its passthru payment percentage. In general, an FFI’s passthru payment percentage will be the sum of its U.S. Assets held on the last four quarterly testing dates over the sum of all of its assets held on those dates.

Assets, other than assets held in custodial accounts (which will be disregarded for this purpose), will generally be reflected in passthru payment percentage calculations if (and to the extent) they are shown on a Participating FFI’s balance sheet (as prepared under its method of accounting for reporting to interest holders).ⁿ⁹ An FFI that is not a Participating FFI or a deemed compliant FFI will be deemed, for this purpose, to have a passthru payment percentage of 0%. However, a Participating FFI or deemed compliant FFI that fails to publish its passthru payment percentage will be treated as having a passthru payment percentage of 100%.

As a result of the passthru payment mechanism proposed in the Notice, a foreign bank or securities dealer that is a Participating FFI would effectively be unable to deal with non-participating FFIs, because the withholding tax would likely make such transactions uneconomic. Essentially, any payment that the Participating FFI makes to the non-participating FFI would be subject to a potentially non-refundable tax equal to 30% of the payment times the Participating FFI’s passthru payment percentage. This could be true even if the Participating FFI had no significant U.S. activities. For example, a foreign bank that

is a Participating FFI (with no U.S. branch, lending activities or investments) could have a positive passthru payment percentage only because it had, for example, made loans to other Participating FFIs with passthru payment percentages that are greater than zero.

B. Recommendations

We recommend that the IRS and Treasury Department reconsider whether the “passthru payment” provisions of the Act should be reformulated into a simplified and somewhat narrower rule. We believe that the distinction drawn by *Notice 2011-34* between custodial payments and non-custodial payments is prudent and reflects good policy. However, for non-custodial payments, we are of the view that a simplified (and more limited) rule could achieve the policy objectives of the Act without creating undue burdens for Participating FFIs. Moreover, because the policy concerns are different, we also recommend that this rule differentiate between non-participating FFIs and recalcitrant account holders.

First, we recommend that the rules provide for “passthru payment” withholding only in cases where payments are made on a “financial account” and perhaps, as discussed further below, on certain payments made on derivatives. In our view, narrowing the scope of “passthru payment” withholding in this manner targets withholding to payments that Congress intended to treat as subject to withholding under the Act, but would exempt payments (such as lease payments, payments for services and loan disbursements) that lack a connection to U.S.-source income. We also anticipate that this approach would significantly improve administrability with little detriment to enforcement because even if certain investments (for example, publicly traded debt) do not represent “financial accounts” themselves, such instruments will generally be held through custodial accounts at Participating FFIs and USFIs that are themselves “financial accounts.”

Second, for “passthru payments” that are made to non-participating FFIs, we believe that “passthru payment” withholding should be limited to payments made by a Participating FFI that is (i) an FFI under *Section 1471(d)(5)(C)* ~ that is, an FFI engaged (or holding itself out as engaged) primarily in the business of investing, reinvesting or trading in what broadly could be termed “financial assets” ~ and (ii) has significant holdings of assets that generate “withholdable payments.” We believe this approach would be significantly more straightforward to implement than applying “percentage of total assets” withholding to all Participating FFIs, and would limit the scope of withholding to cases where there is a connection between the withholding and “withholdable payments.” If the IRS and Treasury Department believe this recommendation is too narrow, we recommend that they require “passthru payment” withholding on any payments made on a “financial account” by a Participating FFI if a significant percentage of its assets generate “withholdable payments.” For recalcitrant account holders, we are of the view that a more punitive approach ~ and a broader coverage net ~ is warranted because account holders can avoid “recalcitrant” status by providing the information required by the Act. Moreover, applying “passthru payment” withholding to recalcitrant account holders is, fundamentally, about relationships between Participating FFIs and U.S. persons, rather than relationships between Participating FFIs and foreign persons, and we believe that the United States has a stronger and arguably more appropriate interest in encouraging U.S. persons to supply the requested information. Accordingly, we recommend that any payment made on a “financial account” owned by a recalcitrant account holder should be subject to “passthru payment” withholding.

Third, the IRS and Treasury Department should consider adopting special rules for derivatives. For example, the IRS and Treasury might consider whether a derivative should be treated as a “financial account” such that a Participating FFI would be required to collect information on the counterparty to the derivative. Absent such a rule, investors other than FFIS could invest in derivatives that mimic an investment in U.S. assets without having to provide any identifying information or risk being treated as a recalcitrant account holder.

While treating a derivative as an account would reduce the possibility of some tax avoidance, it does not fully address the problems raised by applying the current “passthru payment” rules to derivatives. That is because under the current rules the percentage of withholding to be imposed on a derivative payment is contingent upon the passthru payment percentage of the paying Participating FFI and is wholly indifferent to the nature of the underlying assets on which the derivative is based. For example, the rate of withholding imposed on payments on a derivative by a Participating FFI is the same regardless of whether the particular derivative has been designed to mimic an investment in U.S. assets or has been designed to mimic an investment in the euro. Similarly, payments of derivatives with identical terms and referencing an identical pool of assets will be subject to very different withholding rates based on the passthru payment percentage of the Participating FFI payor.

To address this problem, the IRS and Treasury department could consider adopting a limited “tracing” rule that would require withholding on certain equity and debt derivatives. In the case of a derivative instrument that references an equity (or index of equities) that produces (or would likely produce) withholdable payments (*i.e.* a derivative that references U.S. assets) any payment on that derivative would be treated entirely as a “passthru payment”ⁿ¹¹. Under this proposal, payments on options, forwards, structured notes and other financial products that reference U.S. equities would all be “passthru payments”. This seems appropriate because in general, the issuer of an equity derivative will hedge its exposure by acquiring an underlying equity security or similar derivative. While an issuer’s hedge may consist of another derivative, rather than a direct interest in the underlying equity security, the terminus of a “chain” of hedges is likely to involve a party holding the underlying equity security, meaning that a payment on the derivative is ultimately “attributable to” a withholdable payment.

In addition, this tracing rule would treat payments made on debt derivatives that (i) are contingent upon, or determined by reference to, a withholdable payment and (ii) involve either an up-front payment or the posting of collateral, as passthru payments. Under this recommendation, payments made on a collateralized total return swap over a bond issued by a domestic corporation (or a structured hybrid note over such a corporate bond) would be passthru payments, but payments on ordinary interest rate swaps would not be passthru payments. This narrower rule is appropriate for debt derivatives because while debt derivatives that involve a capital investment (or the posting of collateral) are likely to be traceable (and therefore clearly “attributable”) to particular debt securities, such a relationship does not necessarily exist in the case of other debt derivatives. Consider, for example, treasury rates, which are relevant to treasury securities (which generate withholdable payments). However, treasury rates are also used to determine the interest rates paid by various non-U.S. (and U.S.) issuers who sell U.S. dollar-denominated debt securities, meaning that an interest rate swap that references treasury rates is not linked to any particular security.ⁿ¹²

Fourth, we believe that any provision requiring withholding on “passthru payments” should apply equally to USFIs and Participating FFIs. In this regard, we believe that the IRS could require USFIs to withhold on “passthru payments” by providing that “passthru payments” to a USFI are subject to withholding unless the USFI enters into an agreement with the IRS to withhold on “passthru payments”.

Fifth, we believe that the IRS and Treasury Department should propose simplified passthru payment percentage rules. In particular, we believe that the IRS could streamline passthru payment percentage calculations by using a “percentage of total assets” approach consistent with the approach described in *Notice 2011-34* for any Participating FFI that is predominantly engaged in investing in U.S. Assets, but permitting any other Participating FFI to use a fixed percentage ~ to be specified by the IRS and Treasury Department ~ as its passthru payment percentage. n13 As discussed in additional detail below, we suggest this approach because for a large, multinational FFI, issues of cross-ownership and the requirement to trace through the passthru percentages of all of its subsidiaries in order to calculate its own passthru payment percentage is likely to be extraordinarily complex, and because certain FFIs may believe that their percentage of U.S. Assets is proprietary information.

These rules should be refined further, but we believe they represent a reasonable starting point that is likely to be easier to administer, effective at preventing tax evasion and consistent with Congress’s intent.

C. Discussion

1. Congressional Intent

Because the legislative history of the “passthru payment” provision in the Act is relatively sparse, we recognize that ascertaining exactly how Congress intended the IRS and Treasury Department to implement this requirement may be difficult.

We acknowledge that a broad “percentage of total assets” approach to passthru payments, such as the approach proposed in *Notice 2011-34*, is likely to further U.S. tax compliance by encouraging FFIs to become Participating FFIs. However, we are concerned that the proposal in *Notice 2011-34* oversteps the Congressional mandate behind the “passthru payment” concept. We recognize that Congress intended the Act to encourage FFIs to become Participating FFIs. However, we think ~ in the absence of evidence that Congress was contemplating something different ~ that Congress probably intended that passthru payment withholding be an anti-avoidance concept. That is, we believe that Congress expected that the rules requiring withholding on “withholdable payments” be the primary mechanism for encouraging FFIs to become Participating FFIs, and that Congress probably viewed “passthru payment” withholding as a backstop to “withholdable payment” withholding, rather than a compliance incentive in its own right.

In addition, even if Congress expected “passthru payment” withholding to have a broader scope, we believe the approach taken by *Notice 2011-34* has the potential to reach beyond payments that are

“attributable to” U.S.-source income, and to affect payments that Congress probably did not expect would be treated as “passthru payments”. For example, we question whether a lease payment made by a German bank (to rent real property located in Germany) or a securities dealer’s payment made to a Malaysian bank for services performed in Malaysia is properly viewed as “attributable to” U.S.-source income, and are not confident that Congress anticipated that such payments would be taxed as “passthru payments”. A rule applying “passthru payment” withholding to any payment made by a Participating FFI also has the potential to reach payments that do not represent either gross income or net income, such as loans advanced to customers who are non-participating FFIs. We doubt that Congress expected such non-income payments to be subject to passthru payment withholding.

Although we are not international law experts, we also have concerns that a broad “percentage of total assets” approach to passthru payments may extend beyond the jurisdiction of the United States, and may be inconsistent with established principles of comity and the United States’ longstanding tradition of respecting the authority of other states to regulate conduct and tax profits arising within their borders. In this regard, we note that the Act is intended to regulate the conduct of FFIs ~ by encouraging information reporting ~ and was not enacted to raise direct revenue. n14 The United States can (and does) assert extraterritorial jurisdiction to regulate a variety of conduct outside the United States. However, in general, such extraterritorial regulation relates to U.S. citizens and residents, and to transactions that have a close nexus with the United States (such as transactions between U.S. citizens and foreigners). Consistent with this, U.S. international relations law has historically accepted limits on a jurisdiction’s right to prescribe conduct outside its borders. n15

Although again, we are not international law experts, we believe that a broad “percentage of total assets” formulation of the “passthru payment” concept may well go beyond these traditional limits. When it requires withholding on “passthru payments” made by Participating FFIs to non-participating FFIs, such withholding regulates which *foreign* entities a Participating FFI can deal with (at least without being subject to a penalty tax that is likely to make any transactions uneconomic), and it should be considered whether such regulation is appropriately within the United States’ jurisdiction.

The proposal in *Notice 2011-34* may raise a number of other foreign policy considerations that we think should be considered carefully from an international law/foreign relations perspective. For example, Participating FFIs may have service agreements with institutions in embargoed countries (such as Iran, Cuba or North Korea), which are unlikely to become Participating FFIs. We can imagine that FATCA could be seen as an extension of these embargoes by some US trading partners, which raises issues beyond the scope of our expertise as U.S. tax lawyers.

In addition, the formulation of “passthru payments” that is proposed in *Notice 2011-34* may raise questions regarding whether assessing such a tax is within the United States’ taxing jurisdiction. n16 Accordingly, foreign jurisdictions may view such passthru payment withholding as an illegitimate tax and may consider the imposition of such a tax as an illegal interference with their right to govern conduct and tax activity arising within their boundaries. n17

Given the above, we expect that if Congress had intended “passthru payment” withholding to extend the United States’ regulatory jurisdiction in such a way, the legislative history of the Act (if not the Act itself) would have provided clear direction to that effect.

Our first and second recommendations are intended to address these concerns. We think limiting “passthru payment” withholding to payments made on “financial accounts” and certain derivatives would be an approach that is more consistent with Congressional intent and does not raise the international law issues ~ that the proposal in *Notice 2011-34* may raise. Doing so would prevent “passthru payment” withholding on payments that are not income, or at least are not “financial” income that could bear a relationship to U.S.-source withholdable payments. Similarly, in the case of payments made to non-participating FFIs, we think it is more consistent with Congress’s intent to limit “passthru payment” withholding to cases where a clear connection between the payment and U.S.-source withholdable payments (such as payments made by an FFI engaged ~ or holding itself out as engaged ~ primarily in the business of investing, reinvesting or trading in what broadly could be termed “financial assets” that holds significant investments in assets that generate withholdable payments). An argument can be made that payments that are not closely connected to U.S.-source income that are made to recalcitrant account holders should also not be “passthru payments.” However, in our view, there are stronger arguments for regulating an FFI’s conduct with respect to recalcitrant account holders because “recalcitrant” status can be avoided if the holder supplies the requested information, and the ultimate objective of the regulation does not have the effect of preventing the FFI from dealing with the recalcitrant account holder. Moreover, a requirement that Participating FFIs withhold on payments made to recalcitrant account holders does not raise the same jurisdictional questions as withholding on non-participating FFIs because such withholding is targeted at regulating the dealings of Participating FFIs with U.S. persons (or at least potential U.S. persons), something that we believe the United States has a much stronger interest in regulating than it has in regulating the relationships between Participating FFIs and persons that are known to be non-U.S. persons. Accordingly, we think applying “passthru payment” withholding to any payment made to a “financial account” that is beneficially owned by a recalcitrant account holder may well be less vulnerable to criticism under principles of traditional international law.

2. Avoidance Potential

In addition to the concerns discussed above, we are unsure whether the “passthru payment” concept proposed in *Notice 2011-34* will accomplish the anti-avoidance goal that Congress likely contemplated when it included a requirement that Participating FFIs withhold on passthru payments. Specifically, we think it is likely that Congress had payments on derivatives over assets that generate withholdable payments in mind when it included the passthru payment provisions of the Act. Under the proposed rules, however, payments made on such derivatives will be treated as passthru payments only to the extent of a Participating FFI’s passthru payment percentage. This rule leads to dissimilarities in withholding among Participating FFIs that are issuers of otherwise nearly identical products and, more importantly, could permit significantly reduced withholding on instruments that mimic investment in the United States.

Further, the guidance to date does not impose a parallel requirement on USFIs to withhold on passthru payments. Absent a provision requiring withholding by USFIs, a non-participating FFI could invest in an offshore S&P 500 fund through a U.S. custodian without suffering withholding on the payments it receives. As a result, we are not confident that the rules proposed in *Notice 2011-34* will be effective to limit the ability of non-participating FFIs and recalcitrant account holders to invest in U.S. assets. While we understand that Treasury Department and the IRS are aware of this problem and may address it, we believe it is important to note.

Our third and fourth recommendations ~ which would provide either that a derivative is a “financial account” or provide a limited “tracing” rule for derivatives over assets that generate withholdable payments and require USFIs to withhold on passthru payments ~ are intended to address these concerns. n18

We are aware that the Act does not explicitly require USFIs to withhold on “passthru payments”. However, *Section 1474(f)* provides that the Secretary of the Treasury “shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of,” the Act’s withholding provisions. Thus, the IRS and Treasury Department have the authority to issue legislative regulations, which are afforded “controlling weight unless they are arbitrary, capricious or manifestly contrary to the statute” n19 to implement the Act. In our view, requiring both USFIs and Participating FFIs to withhold on passthru payments is consistent with the Act’s intent and “appropriate to carry out the purposes of, and prevent the avoidance of” the Act. Accordingly, we believe that *Section 1474(f)* should authorize the IRS and Treasury Department to issue regulations requiring USFIs to withhold on “passthru payments”.

3. Implementation Challenges

We also believe that withholding on “passthru payments” as proposed by the Notice may create logistical difficulties. While we recognize that the IRS and the Treasury Department may have considered the “percentage of total assets” approach as easier to implement than a rule that “traces” U.S.-source income and applies “passthru payment” withholding to those amounts, this approach creates three specific implementation problems. First, while the calculation of a passthru payment percentage based on a ratio of assets may be relatively straightforward for certain Participating FFIs (e.g., some investment funds), such a calculation is likely to be quite difficult for banks. As an example, tracing through wholly-owned subsidiaries, partially owned subsidiaries, hedges, derivatives and investments to make these calculations is likely to be extraordinarily complex for a multinational bank.

Second, Participating FFIs (other than funds that are required to disclose their holdings to investors for other reasons) may view their holdings of U.S. Assets, expressed through a published passthru payment percentage, as proprietary information.

Third, the approach proposed in *Notice 2011-34* is detrimental to Participating FFIs with a larger percentage of their investments in U.S. assets by requiring such Participating FFIs to withhold on a larger percentage of their payments to non-participating FFIs. Because Participating FFIs may, from a commercial perspective, need to bear the burden of any “passthru payment” withholding, entering into

business agreements with such entities could be more expensive for Participating FFIs with larger holdings of U.S. Assets. Moreover, in certain scenarios, particularly if certain FFIs elect to remain non-participating FFIs, the proposal in *Notice 2011-34* could discourage foreign investment in U.S. Assets because Participating FFIs may hope to maintain a “passthru payment percentage” that is as low as possible.

Our fifth recommendation ~ requiring entities that are, in effect, funds, to use an “accurate” passthru payment percentage, but permitting other Participating FFIs to use a fixed, IRS-prescribed passthru payment percentage ~ is intended to address these concerns. We think our suggested approach will simplify administration and is unlikely to lead to more tax evasion than the methodology proposed in *Notice 2011-34*. To begin, because the IRS and Treasury Department intend that most accounts of recalcitrant account holders eventually be closed, and because a significant passthru payment levy is likely to discourage non-participating FFIs from investing in assets that give rise to passthru payments, we anticipate that the actual volume of withholding on passthru payments is likely to be quite low. Moreover, to the extent passthru payment withholding is intended to function as a “penalty,” there is little value in having “accurate” figures, so long as the rate of withholding is high enough to encourage compliance with the Act. We therefore believe the benefits of requiring an “accurate” calculation are likely to be outweighed ~ at least when an “accurate” calculation is quite complex ~ by the difficulty of making such a determination, and that an elective “fixed percentage” approach makes sense for FFIs that are not, in effect, funds.

II. Deemed Compliance

A. Background

Under the Act, certain FFIs may be “deemed” to meet the requirements of *Section 1471(b)* (and therefore will not be required to enter into a full FFI Agreement otherwise required for an FFI to avoid withholding under the Act on certain payments it receives). n20 *Notice 2011-34* states that future regulations will treat certain local banks, investment funds and retirement plans as deemed compliant FFIs and outlines the requirements for qualification under each category.

“Local” banks, under *Notice 2011-34*, include the following:

1. Affiliated Banks that Are Organized and Operate in a Single Jurisdiction

Under *Notice 2011-34*, each member of an affiliated group of FFIs may be treated as a deemed compliant FFI if each FFI in the “expanded affiliated group” n21 (i) is licensed and regulated as a bank or similar organization authorized to accept deposits in its country of organization; (ii) is organized in the same country as the other FFIs in the expanded affiliated group; (iii) does not maintain operations outside its country of organization; (iv) does not solicit account holders outside its country of organization; and (v) implements policies and procedures to ensure that it does not open or maintain accounts for non-residents, non-participating FFIs or NFFEs (other than “excepted NFFEs” that are organized

and operate in the same jurisdiction in which the members of the expanded affiliated group are organized and operate). n22

2. Members of a Participating FFI Group that Only Operate in Their Home Jurisdiction

Pursuant to *Notice 2011-34*, an FFI that is a member of an expanded affiliated group that includes one or more Participating FFIs may be treated as a deemed compliant FFI if (i) the member does not operate outside its country of organization; (ii) the member does not solicit account holders outside its country of operation; (iii) the member implements the preexisting account and customer identification procedures applicable for Participating FFIs to identify U.S. accounts, accounts of non-participating FFIs and accounts of NFFEs (other than excepted NFFEs that are organized and operate in the same jurisdiction in which the member is organized and operates); and (iv) the member agrees that if any of the types of accounts described immediately above are found, it will (a) enter into an FFI Agreement; (b) transfer the account to an affiliate that is a Participating FFI within the time prescribed in future regulations; or (c) close the account.

B. Discussion and Recommendations

We believe that the “deemed compliance” rules proposed in *Notice 2011-34* are helpful, particularly given the requirement in the Act that each affiliate of a Participating FFI must also be a Participating FFI or a deemed compliant FFI. If implemented properly, these deemed compliance rules are likely to encourage FFIs with affiliates to become Participating FFIs and comply with the Act.

We recognize that the Treasury and IRS are open to suggestions for how the deemed compliant rules may be extended to other FFIs without jeopardizing the objectives of the Chapter 4 rules. The current proposals focus on the local bank’s jurisdiction of incorporation or organization. For example, the deemed compliant exception for local banks requires that the bank not solicit deposits outside the jurisdiction in which it is organized. We believe that banks should be entitled to qualify as local banks even where they are soliciting in certain jurisdictions other than the jurisdiction in which they are organized provided that they are not soliciting U.S. accountholders (or non-participating FFIs). Although we recognize that some limits must be placed on local banks, we think it is reasonable and appropriate to allow local banks to solicit in countries that share a common market (such as the European Union) with the home jurisdiction of the local bank, and in any other counties that share a border with the local bank’s home jurisdiction.

Moreover, we believe that local banks should be permitted to accept accounts from excepted NFFEs that are organized in a jurisdiction other than the “home” country of the local bank, so long as the NFFE is organized, resident or doing business in the “home” jurisdiction of the local bank, a neighboring country or a country that shares a common market with the local bank’s jurisdiction. Although, as above, we recognize that the local bank rules are intended to have some limits, we believe that the current rule places severe constraints on the ability of local banks to conduct ordinary operations: it would, for example, prohibit a local bank from providing financial services to a local branch of a mul-

tinational, which is a significant limitation on a local bank's ability to provide services in its own "home" market that does not seem to further any particular compliance goal.

We also recommend that there be a "deemed compliance" option for affiliates of a Participating FFI that operate in more than one jurisdiction, but agree to transfer any U.S. Accounts, accounts of non-participating FFIs and accounts held by non-local NFFEs to a Participating FFI affiliate. Permitting such transfers may be a straightforward mechanism for affiliates of Participating FFIs that are located in jurisdictions with bank secrecy laws that would prohibit the required reporting to manage their compliance obligations to both the U.S. and the local jurisdiction. We recognize that the IRS may have concerns that allowing this rule to be used by multinational affiliates (which are presumably larger banks) could encourage FFI groups to reduce their service levels to U.S. accountholders, or to refuse service to U.S. accountholders (such as U.S. citizens who reside abroad) who reside in particular jurisdictions altogether. However, we think these concerns could be remedied with a "non-discrimination rule" that would require Participating FFI Groups to offer a substitute account with terms (other than terms required by the Act) equivalent to the terms offered by any affiliate that does not accept U.S. accounts, to any person that would, but for its status as a U.S. person, meet the bank's criteria for a local account.

Notice 2011-34's proposal to permit a local member of a Participating FFI group to be treated as a deemed compliant FFI requires that this local member be a separate legal entity. Many foreign branches operate in separate jurisdictions through branches rather than a separate legal entity. Although they are not separate legal entities, these branches function independently and are, in effect, "local" business units that are subject to supervision by local regulators. We see no policy or other reason why branches of a Participating FFI that otherwise meet the requirements for the "local member" exception should not be entitled to qualify under it. n23

In addition, we note that because the deemed compliance exception for certain local banks requires each FFI in a local bank group to be licensed to accept deposits, it is also not clear that a bank holding company parent of the group could qualify (even though it would likely be an FFI). We recommend that this requirement be dropped or, in the alternative, not apply to the parent of a banking group in which all of its subsidiaries are licensed to accept deposits.

III. Account Identification Rules

A. Background

Notice 2011-34 proposes a modified version of the account due diligence procedures originally set forth in *Notice 2010-60* and requests comments on this approach. Most notably, *Notice 2011-34* creates new steps in these procedures for "high value accounts" (i.e., accounts with a balance or value of more than \$ 500,000 at the end of the year preceding the effective date of the FFI's FFI Agreement) and for "private banking accounts." In general, a private banking account is an account maintained by the FFI's "private banking department" or serviced as part of a "private banking relationship," and includes an account held by an entity, nominee or other person to the extent the account is associated with a private banking relationship with an individual client. For this purpose, a "private banking department" is

generally any department that gathers information about clients' personal, professional and financial histories beyond what is ordinarily collected from retail customers or provides certain services that are "not generally provided to account holders." A "private banking relationship" exists when one or more officers or other employees of the FFI gather such information about clients or provide such services.

In addition, *Notice 2011-34* observes that the IRS and Treasury Department are still considering what measures should be taken to address long-term recalcitrant accounts (including whether, and in what circumstances, FFI Agreements should be terminated due to the number of recalcitrant account holders remaining).

B. Discussion and Recommendations

As in our report on *Notice 2010-60*, we believe that banks and other financial institutions are in a better position to provide input regarding how practical *Notice 2011-34*'s proposals in this area are, and how they could be made more effective. However, we do have some concerns about how straightforward the definition of a "private banking account" proposed in *Notice 2011-34* will be to implement and suggest that the IRS and Treasury Department consider providing a dollar threshold, under which certain accounts are not "private banking" accounts. We also believe that the IRS and Treasury Department should consider foreign law in developing account due diligence rules.

1. Private Banking

We believe that targeting "private banking" and "high value" accounts for additional due diligence is prudent, given that such accounts are likely to have the most potential for tax evasion. However, the standard provided in *Notice 2011-34*, which would require that any account be treated as a "private banking account" if, among other factors, the holder receives services "not generally provided to account holders," is sufficiently imprecise that it will be difficult for banks to classify many accounts as not being "private banking" accounts. We also think that without a dollar threshold, it may be difficult for any standard to permit a bank to conclusively determine that an account is not a private banking account.

Given the above, we think it would be helpful for the IRS and Treasury Department to prescribe a dollar threshold below which a bank may ~ unless the value increases ~ treat an account as an ordinary account, even if other indicia of "private banking" exist. In our view, such "low-value private banking" accounts have little potential for tax evasion, and arguably do not represent relationships of the type the IRS and Treasury Department intend to identify for additional scrutiny. For this purpose, the \$ 500,000 threshold prescribed for "high-value" accounts may be a reasonable point at which banks could differentiate "private banking accounts" from "low-value private banking accounts." However, we are hesitant to suggest a specific figure because we view doing so as a judgment call that is best made by the IRS and Treasury Department, and other limits may also be appropriate.

2. Other Concerns

In developing account due diligence rules, we also believe that the IRS and Treasury Department should consider the non-U.S. regulations that FFIs may be subject to. For example, certain foreign countries may have antidiscrimination laws that prohibit FFIs and other parties from treating customers differently on account of their place of birth or national origin. Such laws could be interpreted as prohibiting banks from using a U.S. place of birth as an indicium of U.S. status. We believe it is important that any final guidance accommodate banks that wish to become Participating FFIs but must comply with such rules.

In addition, we think it is important for the IRS and Treasury Department to recognize that Participating FFIs may be unable to close all recalcitrant accounts. For example, some jurisdictions have “universal service obligation” requirements for banks that require banks to offer a “basic” bank account to all residents, and it is possible that these regulations could prohibit the closure of recalcitrant accounts. Moreover, certain interests that are technically “financial accounts,” such as existing equity instruments, may not be redeemable. ⁿ²⁴ Although we see withholding on passthru payments made to such accounts as an appropriate measure, we recommend that the IRS and Treasury Department consider these restrictions and not penalize banks for not closing recalcitrant accounts that they are not entitled to ~ either because of a contractual obligation existing on the date when final regulations are issued or a foreign legal obligation to close.

IV. Expanded Affiliated Group Rules

A. Background

Section 1471(e) provides that the withholding, reporting and other requirements of the Act will generally apply with respect to U.S. accounts maintained by the FFI, and except as otherwise provided by the Secretary, with respect to U.S. accounts maintained by any other FFI (other than any FFI that otherwise meets the requirements of *Section 1471(b)*) that is a member of the same expanded affiliated group that includes the FFI (each an “FFI affiliate” of an “FFI Group”). As noted above, an “expanded affiliated group” includes another financial institution if (i) one financial institution controls the other financial institution directly or through a chain of controlled entities or (ii) they are both under the common control (directly or through a chain of controlled entities) of a single corporation (whether or not such corporation is a financial institution itself). In addition, a partnership or any other entity (other than a corporation) is treated as a member of an expanded affiliated group if such entity is “controlled” ⁿ²⁵ by members of an expanded affiliated group.

Notice 2011-34 provides that “Treasury and the IRS intend to issue regulations under *Section 1471(e)* requiring that *each* affiliate in an FFI Group must be a participating FFI or a deemed compliant FFI,” and provides further, that “[*e*]ach participating FFI affiliate will be responsible for its own due diligence, withholding and reporting obligations, and return filing requirements under its FFI Agreement with respect to its account holders” and that “[*e*]ach FFI affiliate will be issued its own FFI-EIN.” However, Notice 2011-34 also suggests Treasury and the IRS will continue to study whether and under what conditions it may be possible to allow an FFI Group to include one or more non-participating FFI affiliates.

B. Discussion and Recommendations

A rule requiring each FFI affiliate of a Participating FFI or deemed compliant FFI to become a Participating FFI or a deemed compliant FFI risks making complying with the Act impractical for certain FFIs, particularly in cases where FFIs own interests in limited partnerships that are themselves FFIs.

For example, consider a German bank that wishes to be a Participating FFI, which owns 51% of the vote and value of a French bank. The French bank is treated as a corporation for U.S. tax purposes, and is an FFI affiliate included in the German bank's expanded affiliate group because the German bank owns more than 50% of the vote and value in the French bank. In addition, the German bank owns a 60% beneficial interest through a limited partnership interest in a Dutch investment fund, which is treated as a partnership for U.S. tax purposes, but has no management or other voting rights in the fund. The fund will be included in the German bank's expanded affiliated group because it owns more than a 50% interest (by value) of the fund. This is likely true even though the German bank ~ as a limited partner ~ will have no say in the management or governance of the fund, and thus will not be able to manage or monitor compliance of the fund. Nevertheless, the German bank may not be able to enter into an FFI Agreement unless the Dutch fund agrees to do so.

Given the potential for such situations, we recommend that the IRS and Treasury Department provide exemptions to any requirement that all FFIs in an FFI Group become Participating FFIs or deemed compliant FFIs in cases where the parent of the FFI Group lacks actual control over the FFI affiliate. We recognize, however, that "effective control" may exist in some circumstances where actual control does not. To that end, we suggest that this proposed rule be subject to an anti-avoidance provision that deem FFIs to be under common control when a Participating FFI refers business to an affiliate.

V. USFI Account Identification and Due Diligence

A. Background

Notice 2011-53 extended the account due diligence deadlines applicable to Participating FFIs. However, IRS and Treasury Department guidance has not, thus far, provided a similar extension for the diligence and account identification procedures for accounts that are maintained by USFIs.

B. Discussion

Under *Notice 2011-53*, a Participating FFI will have two years after the effective date of its FFI Agreement to complete the account diligence procedures for its preexisting individual and entity accounts other than private banking accounts. Thus, a Participating FFI will have until June 30, 2015 to complete such procedures for such accounts, assuming its FFI Agreement is effective on July 1, 2013. In addition, a Participating FFI will have until June 30, 2013 to put in place account diligence procedures for its new individual and entity accounts.

Because *Notice 2011-53* is silent with respect to the timetable for USFI account identification and diligence, the existing timetable in *Notice 2010-60* still appears to apply. Under *Notice 2010-60*, a USFI

must complete its account diligence procedures by December 31, 2014 for its preexisting accounts and January 1, 2013 for its new accounts.

Because it is likely that USFIs will need to modify their information, accounting and other systems to comply with the account identification and diligence procedures outlined in *Notice 2010-60*, we recommend the USFI account identification and diligence procedure timetable for preexisting and entity accounts be made consistent with the timetable in *Notice 2011-53* for a Participating FFI.

FOOTNOTES:

n1

Internal Revenue Bulletin 2011-19 (May 9, 2011) (“Notice 2011-34”).

n2

Internal Revenue Bulletin 2011-32 (August 8, 2011). (“Notice 2011-53” and collectively with *Notice 2011-34*, the “Notices”).

n3

Internal Revenue Bulletin 2010-37, (August 27, 2010). See New York State Bar Association Tax Section, Report on *IRS Notice 2010-60* (Report No. 1224, November 16, 2010).

n4

Under the Act, a “financial account” is generally a depository or custodial account, and any equity or debt instrument issued by an FFI that is not publicly traded. See *Section 1471(d)(2)*.

n1

The principal drafters of this report were Judith Fiorini, Michael Orchowski and Andrew Solomon, with substantial assistance from Dean Marsan. Helpful contributions were also received from Michael Schler and other members of the Executive Committee of the Tax Section. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

n2

Internal Revenue Bulletin 2011-19, May 9, 2011.

n3

Internal Revenue Bulletin 2011-32, August 8, 2011.

n4

Internal Revenue Bulletin 2010-37, August 27, 2010. *See* New York State Bar Association Tax Section, Report on *IRS Notice 2010-60* (Report No. 1224, November 16, 2010).

n5

Under the Act, a “financial account” is generally a depository or custodial account, and any equity or debt instrument issued by an FFI that is not publicly traded. *See Section 1471(d)(2)*.

n6

See Section 1471(b)(1)(D). The Act also requires withholding on “passthru payments” that are made to FFIs that have elected to be withheld upon.

n7

Generally, withholdable payments are U.S.-source interest, dividends, rents, salaries, wages and other income generally described as “FDAP” income, along with the gross proceeds from the sale of securities that generate U.S.-source interest or dividend income.

n8

The legislative history of the Act does not further define what facts or circumstances should cause a payment to be characterized as a “passthru payment”, although *Notice 2010-60* requested comments on how this feature of the Act should be implemented.

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Participating FFIs will also be required to include off-balance sheet transactions to the extent provided in future guidance.

n10

If this recommendation is adopted, we would suggest that the IRS and Treasury Department define “significant” by reference to a percentage; as a bar association, we do not believe we are in the best position to suggest what this percentage should be.

n11

To the extent that Code *Section 871(m)* (which provides a resourcing rule for certain dividend equivalent payments) re-characterizes a payment as U.S. source, that payment would be a withholdable payment subject to 30% withholding if paid to a non-participating FFI or a recalcitrant account holder without the need to invoke the “passthru payment” rules. To the extent a payment is not re-characterized as U.S. source under Code *Section 871(m)* there would be Chapter 4 obligations only to the extent the payment is re-characterized as a “passthru payment”.

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The approach outlined above is intended to cover most cases when a strong connection exists between a withholdable payment and a payment made on a derivative. However, we recognize that a limited “tracing” approach would not be fully comprehensive, and may leave avenues open for non-participating FFIs to earn income that is related to withholdable payments. For example, it may be possible for a non-participating FFI to create a synthetic U.S. treasury security through a combination of credit default swaps, interest rate swaps, currency swaps and foreign sovereign debt. We anticipate that such arrangements are likely to be complicated and unattractive to non-participating FFIs. However, to the extent it becomes apparent that non-participating FFIs are using synthetic debt instruments to avoid the Act, we believe the IRS and Treasury Department should consider using targeted anti-avoidance rules to apply passthru payment withholding to these arrangements.

n13

Without such an approach, there is the potential to have circularity in the calculation of passthru payment percentages. In particular, as proposed, the rules require a Participating FFI to know the passthru payment percentages of each other Participating FFI in which it owns a debt or equity interest. While the calculations “look back” one quarter, this presents a circularity problem for getting the first round of numbers when there is cross-ownership. For example, Bank A, a European bank, may own an investment in Fund B, an index fund of major European banks (that invests in Bank A). If each of Bank A and Fund B are Participating FFIs, Bank A will need to know the passthru payment percentage of Fund B to calculate its own passthru payment percentage, and vice versa.

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See Prepared Statement of William J. Wilkins, IRS Chief Counsel, Before the House Ways and Means Subcommittee on Select Revenue Measures on the “Foreign Account Tax Compliance Act of 2009,” November 5, 2009, at 3. “The bill would, therefore, create a strong incentive for

global foreign financial institutions to provide the IRS with the information it needs to ensure that U.S. account holders are complying with U.S. tax laws.”

n15

See, e.g., Restatement (Third) of the Foreign Relations Law of the United States *section 402.*

n16

For example, the Restatement (Third) of the Foreign Relations Law of the United States observes that a state may tax “a natural or juridical person who is not a national, resident or domiciliary of the state and is not present or doing business therein, with respect to income derived from property located in the territory of the state.” Restatement (Third) of the Foreign Relations Law of the United States *section 403.* Given the limited connection between the source of certain potential passthru payments (foreign-source interest paid by a Participating FFI) and the United States, we are unsure whether such amounts are likely to be viewed by the affected states as “income derived from property located in” the United States.

n17

Various trade organizations have questioned whether banks would be entitled to withhold passthru payments under local law. *See, e.g.,* Australian Bankers Ass’n, Letter to Douglas H. Shulman (Commissioner, Internal Revenue Service) (June 7, 2011); and Japan Securities Dealers Ass’n, Comments on Foreign Account Tax Compliance Act Provisions (June 7, 2011). Thus, we are concerned that foreign countries may determine that collection of passthru payment withholding is illegal, and the payee may be able to sue the withholding agent and collect for the illegally withheld tax. As is the case for Chapter 3 withholding, under the Chapter 4 withholding rules, the United States agrees to indemnify a withholding agent against the claims of other persons for the withheld tax, meaning that the U.S. Treasury could be responsible for such amounts. Again, we think the fact that the legislative history of the Act does not address these points or specify that a “diffuse attribution” approach should be used suggests that Congress may not have intended for passthru payment withholding to be as comprehensive as the proposal set forth in *Notice 2011-34.*

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In addition, we note that requiring Participating FFIs to treat every payment that is made outside of a custodial capacity as a passthru payment to the extent of its passthru payment percentage creates significant commercial difficulties. Such a broad withholding rule could impose significant burdens on exchanges, for instance. Similarly, a rule requiring withholding on any payment could make periodic net settlement of amounts difficult and impose a tax that is effectively a trap for the unwary because it is a levy on amounts that are not representative of income yet could

potentially be reduced through careful planning. We recognize that the Act provides a refund mechanism in cases where a beneficial owner that is withheld upon is eligible for treaty benefits, even if that beneficial owner is a non-participating FFI. See *Section 1474(b)(2)*. However, such refunds may take time, and no interest is to be paid on such refunds.

n19

Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984). To the extent that there was ambiguity regarding whether this standard would apply, we believe that *Mayo Foundation for Medical Education and Research v. United States*, No. 09-837 (Jan. 11, 2011) indicates that a regulation requiring USFIs to withhold on passthru payments should be entitled to similar deference.

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See *Section 1471(b)(2)*.

n21

Under the Act, a financial institution is generally part of an “expanded affiliated group” that includes another financial institution if (i) one financial institution controls the other financial institution directly or through a chain of controlled entities or (ii) they are both under the common control (directly or through a chain of controlled entities) of a single corporation (whether or not such corporation is a financial institution itself). More specifically, the Act defines an “expanded affiliated group” as an “affiliated group,” as defined by *Section 1504(a)*, but by substituting a more-than-50% ownership requirement for the at-least-80% ownership requirement in each place where it appears in *Section 1504(a)*, and disregarding the *Section 1504(b)(2)* prohibition on including insurance companies in an affiliated group and the *Section 1504(b)(3)* prohibition on including non-U.S. corporations in an affiliated group. It also includes partnerships and trusts if they are controlled, within the meaning of *Section 954(d)(3)*, by other members of the expanded affiliated group (including other controlled partnerships or trusts).

n22

Pursuant to *Notice 2010-60*, an “excepted NFFE” includes an NFFE that is engaged in an active trade or business.

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In this regard, our proposal would require the entity or branch to be regulated as a bank in the jurisdiction of the branch.

n24

We recognize and appreciate that *Notice 2011-53* clarified that the IRS and Treasury Department intend to issue guidance treating obligations that give rise to passthru payments that are outstanding on March 18, 2012 as “grandfathered obligations” that are not subject to withholding under the Act. However, because equity instruments will not be “obligations” for this purpose, holders of such instruments may still be recalcitrant account holders.

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Within the meaning of *Section 954(d)(3)*.