IRS ISSUES PROPOSED FATCA REGULATIONS

February 16, 2012

To Our Clients and Friends:

On February 8, 2012, the IRS issued long-awaited proposed regulations under the FATCA (Foreign Account Tax Compliance Act) withholding and reporting regime.

Also on February 8, 2012, the United States issued a Joint Statement with France, Germany, Italy, Spain and the United Kingdom that it intends to explore entering into a bilateral agreement with each of those countries providing for the reciprocal automatic exchange of information on financial accounts, in lieu of the procedures in the FATCA regulations, for financial institutions in those countries.

BACKGROUND

Under FATCA, payments to foreign financial institutions ("FFIs") and foreign entities that are not FFIs ("NFFEs") of (i) dividends, interest and certain other items of income from U.S. sources and (ii) gross proceeds from the disposition of U.S. stocks and securities (together, "withholdable payments") generally will be subject to a new 30% withholding tax unless the recipient complies with U.S. reporting and other requirements (including, in the case of a "participating FFI," the requirement to enter into an agreement with the IRS as described below) or an exception applies.

An FFI generally includes any non-U.S. entity that:

- is a bank;
- holds, as a substantial portion of its business, financial assets for the account of others (*e.g.,* a broker-dealer or trust company); or
- is engaged primarily in the business of investing or trading in securities, partnership interests or commodities (*e.g.*, a private equity or hedge fund).

To avoid the new 30% withholding tax, an NFFE will generally be required to (i) certify that it does not have any "substantial" U.S. owners or (ii) provide information regarding each such U.S. owner. Publicly traded corporations and certain of their affiliates and certain other foreign entities generally will be exempt from this requirement.

For FFIs, the reporting requirements are considerably more substantial. Unless an FFI qualifies for an exemption as a "deemed-compliant" FFI or otherwise, in order to avoid the new withholding tax it generally will be required to enter into an agreement with the IRS (an "FFI Agreement") pursuant to which the "participating FFI" agrees to:

- comply with diligence, reporting and other procedures with respect to its "U.S. accounts" (generally, financial accounts it maintains, as well as its non-traded debt or equity interests that are held by U.S. persons or foreign entities with a specified level of U.S. ownership); and
- withhold on "passthru payments" (generally including withholdable payments and other payments "attributable" to withholdable payments) to its account holders that fail to comply with reasonable information requests ("recalcitrant account holders") or to FFIs that do not themselves enter into FFI Agreements or otherwise comply with the requirements of FATCA ("nonparticipating FFIs").

Under the statutory language, the new withholding tax generally would apply to payments made after December 31, 2012, except for payments on certain obligations outstanding on March 18, 2012. Under Notice 2011-53, issued on July 14, 2011, the imposition of the new withholding tax would apply only to payments made after December 31, 2013 (and to payments of gross proceeds made after December 31, 2014).

HIGHLIGHTS OF THE PROPOSED REGULATIONS

Extension of grandfather date

- The proposed regulations postpone the statutory grandfather date for preexisting obligations from March 18, 2012 to January 1, 2013. Therefore, obligations outstanding on January 1, 2013, other than instruments or legal agreements treated as equity for U.S. tax purposes or that lack a definitive term, generally will be exempt from FATCA withholding (unless they are materially modified after such date). To qualify as outstanding on January 1, 2013, any obligation constituting indebtedness must have an issue date before January 1, 2013, and for any other obligation, the legally binding arrangement between the parties establishing the obligation must be executed before January 1, 2013. Life insurance contracts payable upon the earlier of attaining a stated age or death, and term certain annuity contracts, outstanding on January 1, 2013 will also qualify for grandfathered status.
- The proposed regulations provide that a revolving credit facility entered into prior to January 1, 2013 (presumably including loans made pursuant to such a facility after such date) generally will be considered a grandfathered obligation.

Reservation on "foreign passthru payments" and extension of effective date for foreign passthru payment withholding

- The proposed regulations do not include the controversial rules that had been included in Notice 2011-34, issued on April 8, 2011, under which a participating FFI making a non-custodial payment to a nonparticipating FFI or recalcitrant account holder would have been required to withhold on such payment based on the percentage of the payer's gross assets that are U.S. assets. Instead, the proposed regulations reserve on the scope of the term "foreign passthru payment" (*i.e.*, passthru payments other than withholdable payments).

- Withholding with respect to foreign passthru payments will not be required until 2017 at the earliest. Beginning in 2014, a participating FFI will be required to withhold with respect to passthru payments that are withholdable payments (*e.g.*, dividends on stock of a U.S. corporation held in a custodial account of an FFI).

Expansion of deemed-compliant FFI rules

- The proposed regulations generally divide the universe of "deemed-compliant" FFIs that do not have to enter into FFI Agreements into two broad classes, and expand the categories of deemed-compliant FFIs.

- "Registered deemed-compliant FFIs" must obtain confirmation of deemed-compliant status from the IRS and renew their certification every three years. This class of deemed-compliant FFIs includes (i) banks and other financial institutions that operate exclusively in their home jurisdictions, (ii) certain investment funds in which interests with values in excess of $50,000 are held exclusively by participating FFIs and certain other types of investors and (iii) certain investment funds in which interests cannot be sold to U.S. persons, nonparticipating FFIs or certain NFFEs with one or more substantial U.S. owners.

- "Certified deemed-compliant FFIs" can establish an exemption from FATCA by certifying their status to withholding agents. This class includes (i) certain small banks that operate exclusively in their home jurisdictions, (ii) certain funds that provide retirement and pension benefits, (iii) certain nonprofit organizations and (iv) FFIs (not including investment funds) that do not have any financial accounts with values in excess of $50,000 or more than $50,000,000 in total assets.

Modification of diligence procedures for accounts

- The proposed regulations exempt certain accounts from the identification and documentation procedures required under FFI Agreements and provide simplified

procedures for certain classes of accounts. For example, an account opened prior to the effective date of an FFI Agreement is generally exempt if it has a value of $50,000 or less, in the case of an account held by an individual, or a value of $250,000 or less, in the case of an account held by an entity or an account comprised of one or more cash value insurance or annuity contracts held by an individual. With respect to pre-existing individual accounts below a $1,000,000 value threshold, a participating FFI generally need not review its paper records to determine if the account holder has U.S. indicia, but may instead rely on a search of its electronic databases.

Limitation on the definition of "account"

- Although non-traded debt and equity interests issued by an FFI generally are treated as "accounts" under the statutory language, under the proposed regulations only a participating FFI that is engaged primarily in the business of investing or trading (*e.g.*, a private equity or hedge fund) generally must treat its non-traded debt or equity interests as accounts subject to the requirements of its FFI Agreement. An anti-abuse rule applies to non-traded debt or equity interests of other FFIs (such as banks) whose value is determined primarily by reference to assets that give rise to withholdable payments. As the proposed regulations reserve on the definition of "foreign passthru payments," however, it is not clear whether debt or equity securities of a participating FFI, even though not accounts of such FFI, may give rise to foreign passthru payments when they are held through a non-U.S. intermediary. Therefore, all FFIs should continue to consider disclosure regarding FATCA in their securities offerings to non-U.S. investors.

Treatment of U.S. source payments to non-U.S. intermediaries

- In many circumstances, the proposed regulations require withholding agents to look through intermediaries, partnerships, trusts and other flow-through entities to their underlying beneficiaries or owners in order to determine the agents' withholding obligations under FATCA. For example, if a withholding agent pays U.S. source interest or dividends to a participating FFI that is acting as an agent or intermediary or to a foreign partnership (other than a qualified intermediary or partnership that assumes primary withholding responsibility), the persons for whom the FFI is acting as agent or intermediary, or the partners of a foreign partnership, will generally be treated as the payees, and so the withholding agent will be responsible for determining whether those persons are exempt from FATCA withholding.

Insurance companies

- Under the proposed regulations, a foreign insurance company (or foreign holding company of an insurance company) that issues or is obligated to make payments with respect to an account is an FFI. For this purpose, insurance contracts treated as having "cash value" and annuity contracts issued or maintained by a financial institution are considered accounts. Term life insurance contracts providing for limited cash value are not considered accounts. Insurance companies that issue only property and casualty insurance contracts, or that only issue life insurance contracts lacking cash value (or that provide for limited cash value) generally should not be considered FFIs.

- The IRS has indicated that it is considering adding an additional deemed-compliant FFI category for entities that issue certain insurance or annuity contracts, with requirements analogous to the requirements for banks that operate exclusively in their home jurisdictions.

THE JOINT STATEMENT

As noted above, on February 8, 2012, the United States issued a Joint Statement with France, Germany, Italy, Spain and the United Kingdom that it intends to explore entering into a bilateral agreement with each of those countries providing for the reciprocal automatic exchange of information on financial accounts. We understand that the U.S. Treasury is also discussing reciprocal arrangements with other foreign countries.

The Joint Statement contemplates that a participating foreign country would implement legislation that would require FFIs in that country to undertake the necessary diligence procedures to identify U.S. accounts and to report information regarding such accounts to the government of that country, which would then transfer the information, on an automatic basis, to the United States. In consideration of this enhanced information exchange, FFIs in that country would not be required to enter into FFI Agreements or to undertake passthru payment withholding on payments to recalcitrant account holders or to other FFIs subject to a similar system. The Joint Statement also indicates that the United States would commit to reciprocal measures to report to that country information on accounts of residents of that country maintained in the United States, which would impose additional costs on U.S. financial institutions.

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