NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON NOTICE 2010-60

November 16, 2010

Report No. 1224

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON NOTICE 2010-60[1]

This report conveys the comments of the New York State Bar Association Tax Section concerning various aspects of Internal Revenue Service ("IRS") Notice 2010-60 (the "Notice")[2] which provides preliminary guidance and requests comments on a variety of topics arising from the new information reporting and withholding provisions of Chapter 4 of the Internal Revenue Code of 1986, as amended (the "Code"), enacted pursuant to the Hiring Incentives to Restore Employment Act (the "Act"), which was signed into law on March 18, 2010. These comments address certain limited issues arising from the Notice.

We continue to support Congress, the IRS and the Treasury Department in their efforts to prevent U.S. tax avoidance and increase transparency in the global financial system. Furthermore, we recognize that the Notice is only preliminary guidance on a limited number of topics, and that further guidance is forthcoming. We continue to look forward to guidance on additional matters.

With respect to those topics covered by the Notice as well as the topics on which comments have been requested in the Notice, we believe that certain clarifications or changes to the guidance proposed by the Notice will make the IRS' and Treasury Department's implementation of the Act and the provisions of the Notice more effective and efficient. The purpose of this report is to highlight these proposed clarifications and changes as well as to address certain problematic issues that would arise from the Notice as drafted.

In particular, we recommend that the Treasury Department and the IRS:

Issue further guidance regarding which instruments will be treated as "grandfathered obligations";

- Specifically, we believe that the "grandfathered obligation" rules should be clarified to specifically include obligations issued as binding commitments, such as revolving credit agreements, that are outstanding on

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[1] The principal drafters of this report were Andrew Solomon, Judith Fiorini, Michael Orchowski, Kimberly S. Blanchard, Asher Harris and Dean Marsan, with substantial contributions from Aditi Banerjee. Helpful comments were received from Amy Heller, Peter Connors, Mike Schler, Stephen Land and David Miller. The report may be cited as New York State Bar Association Tax Section, *Report on IRS Notice 2010-60* (Report No. 1224, November 16, 2010).

[2] Internal Revenue Bulletin 2010-37, September 13, 2010.

March 18, 2012, and to include certain obligations that produce "passthru payments";

Provide a mechanism for financial institutions to identify entities that would be treated as foreign financial institutions ("FFIs") because they are primarily engaged in investing, reinvesting or trading in securities, but that are exempted from the application of Chapter 4 (such as holding companies and hedging centers), and integrate this mechanism with the other account classification rules issued by the Treasury Department and the IRS;

Make clear that a non-financial foreign entity ("NFFE") that qualifies for "excepted NFFE" status is excepted for all Chapter 4 purposes;

Modify the rule that generally excepts an NFFE with an active trade or business from Chapter 4 by only permitting an NFFE to qualify for excepted NFFE status if its active trade or business is substantial, and consider whether entities that issue certain types of "tracking stock" should be treated as excepted NFFEs;

Clarify the treatment of non-excepted NFFEs;

- At present, it appears that such entities are effectively treated as FFIs, although the Notice is not explicit on this point. In addition, certain types of entities may meet the definition of an excepted NFFE (*e.g.*, an entity that primarily invests in real estate, a trade organization or a labor union), but not constitute an FFI; it is not apparent to us that effectively treating such organizations as FFIs is appropriate;

Provide further guidance on the treatment of insurance companies;

- Many foreign insurance companies issue both cash-value life and non-life/term life insurance contracts. We recommend that such an insurer be treated as, in effect, a "partial FFI" that is subject to the requirements of Chapter 4 on its cash-value life insurance products, but otherwise exempt. In addition, we believe that it would be helpful for the Treasury Department and IRS to clarify which contracts should be treated as insurance contracts, specify which parties (*i.e.*, the owner, the insured or the beneficiary) should be subject to Chapter 4 reporting and apply a $50,000 *de minimis* threshold to insurance contracts;

Expand the scope of the rules allowing entities with certain identified owners to be treated as deemed-compliant FFIs to "private" FFIs that are owned by other "private" FFIs (in, for example, a trust that is beneficially owned by another trust);

Provide reasonable rules to determine who holds an interest in a foreign trust in which beneficiaries do not have fixed interests;

Broaden the scope of exempted retirement plans, and treat payments made to retirement plans that qualify under Code Section 892 as exempt from Chapter 4 as payments made to a foreign government;

Treat existing securitization vehicles and securitization vehicles that are held exclusively through custodians that are FFIs that enter into an agreement with the Treasury Department and IRS (such FFIs, "Participating FFIs" and such agreements, "FFI Agreements") or U.S. financial institutions ("USFIs") as "deemed compliant" FFIs;

Exempt properly documented charitable organizations from the application of Chapter 4;

Permit NFFEs to self-certify their eligibility for the active trade or business exception, potentially subject to providing documentary evidence of business activity;

Reconsider whether PO Box and "in care of" addresses in certain jurisdictions should be indicia of U.S. status;

Provide Participating FFIs a straightforward method for remitting withheld amounts;

Clarify whose treaty rights are waived if a Participating FFI elects out of withholding responsibility;

Limit the scope of the "passthru payment" rule to payments that are directly related to payments of U.S.-source income or, in the alternative, clarify that refunds are available under an applicable treaty for amounts withheld on passthru payments that are not U.S.-source payments;

Issue guidance providing that partnerships and other pass-through entities are not "beneficial owners" for purposes of Code Section 1474(b)(2) if such treatment would be inconsistent with a treaty obligation of the United States or in other cases where such treatment is unduly harsh;

Provide exemptions to the "account closure" rules for cases where legal restrictions prevent a Participating FFI from closing an account; and

Consider the potential for international automatic information exchange programs to supersede the need for Chapter 4 reporting and build flexibility into any guidance issued to allow Participating FFIs to refrain from reporting information that is duplicative of the information that the IRS obtains from such programs.

I. Grandfathered Obligations.

A. We Request Clarification Regarding Which Instruments Will Be Treated as "Grandfathered Obligations."

Section 501(d)(2) of the Act exempts from the withholding and information reporting provisions of Chapter 4 "obligations" that are outstanding on March 18, 2012. The definition of an "obligation" for this purpose would generally include a fixed-term debt instrument, for example. However, prior to the issuance of the Notice, it was unclear whether other types of instruments would constitute grandfathered "obligations" for this purpose.

The Notice announces that regulations are intended to be issued that would include as an "obligation" for this purpose:

> any legal agreement that produces or could produce withholdable payments;

but would *not* include:

> any instrument that is treated as equity for U.S. tax purposes, or
>
> any legal agreement that lacks a definitive expiration or term.[3]

While the Notice removes some ambiguity surrounding the definition of an "obligation," some confusion remains regarding the treatment of various types of common agreements and instruments. In particular, we interpret the Notice as treating binding commitments to issue obligations (or to enter into legal agreements that produce or could produce withholdable payments) as constituting (or giving rise to) "grandfathered" obligations, because such binding commitments are "legal agreements" and will produce (or at least could produce) withholdable payments.[4] However, the Notice is not entirely clear on this point, and we believe it would be helpful for the Treasury Department and IRS to make this point unambiguous.

We believe that, because such arrangements may have been outstanding before the Act was passed, it is appropriate to treat such binding commitments, even if they are subject to customary conditions precedent, as grandfathered obligations under section 501(d)(2) of the Act. If the IRS and Treasury Department issue final guidance that does not provide such relief, borrowers or issuers who are party to such agreements may find themselves bound by contracts that require them to pay additional amounts to nonparticipating FFIs and holders who refuse to make the certifications required by the Act.

If, in drafting the Notice, the IRS and Treasury Department instead intended to provide that binding commitments or agreements containing such binding commitments would not be treated as grandfathered obligations, we believe that a limited grandfathering rule should apply to

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[3] *See* Notice, § I.

[4] An example of such a payment could include an advance under a revolving credit agreement after March 12, 2012 that was made pursuant to a binding commitment made under the credit agreement before that date, or as of the date of the passage of the Act.

such arrangements entered into before the issuance of guidance clarifying that such arrangements would generally not be grandfathered. In other words, if the IRS clarifies in a subsequent notice that such arrangements are not grandfathered obligations within the meaning of section 501(d)(2) of the Act, the IRS in such notice should grandfather such arrangements that were entered into before the date such notice was issued.[5]

B. Grandfathering for Passthru Payments.

It is not clear from the Notice whether a legal agreement that could give rise to a so-called "passthru payment"[6] (as opposed to a "withholdable" payment) would qualify for grandfathering.

As discussed further below,[7] a "passthru payment" is: (i) any "withholdable payment"[8] as well as (ii) any payment that is "attributable to" a "withholdable payment." Under this definition, certain payments may be "passthru payments," even if they are not "withholdable payments." Various types of common agreements could give rise to passthru payments that may not be grandfathered under the technical language of the Notice. Such arrangements may have been entered into at the same time as, and may in fact be the functional equivalent of, the underlying obligations that are grandfathered. For example, parties may have entered into a back-to-back debt arrangement, under which the original issuer is a U.S. person, and the second issuer is a foreign entity. Payments on such the foreign debt instrument may constitute passthru payments, and absent a grandfather rule for passthru payments, the foreign payor could find itself in the awkward situation of having payments on the underlying debt instrument that are exempt from Chapter 4 reporting and withholding under the grandfather rule, while the passthru payments on the debt obligation with the foreign issuer would be subject to Chapter 4 reporting and withholding. The obligation to withhold could give rise to significant gross-up obligations under the terms of pre-existing agreements and arrangements, and it may be difficult for borrowers facing high gross-up costs to find alternative financing arrangements.

The grandfather rule in the Notice is relatively broad, and given this, we anticipate that the IRS and the Treasury Department had intended to provide that obligations and legal agreements that produce passthru payments that are not withholdable payments are entitled to an analogous exemption. Under such an exemption, rules similar to those that apply to withholdable payments likewise would be appropriate: *i.e.*, passthru payments should not be

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[5] We also note that prompt guidance would be helpful on this point. Uncertainty on this point is creating difficulty in negotiating these arrangements, as lenders do not wish to assume Chapter 4 risk without knowing how the rules will work, and borrowers do not want to assume this risk either.

[6] *See* Code Section 1471(d)(7).

[7] *See* section IV.C, of this report *infra*.

[8] A "withholdable payment" is a payment that is generally subject to withholding under Chapter 4. "Withholdable payments" generally include interest, dividends and other forms of fixed and determinable, annual or periodical income from sources within the United States, along with the gross proceeds from the sale or disposition of property that could give rise to U.S.-source interest or dividends. *See* Code Section 1473(1).

grandfathered to the extent they are attributable to (or are themselves) payments on an instrument treated as equity for U.S. tax purposes or pursuant to any legal agreement that lacked a definitive expiration or term, or to the extent either (i) the underlying obligation to which the passthru payments are attributable, or (ii) the obligation that itself makes passthru payments is not outstanding on March 18, 2012.[9]

C. Grandfathering for Insurance Contracts.

To the extent that payments on cash-value insurance contracts are included in the definition of withholdable payments, it should be made clear that such contracts will be treated as having a definitive expiration or term, notwithstanding any expiration or term that is based on the mortality or morbidity of an individual or group of individuals, the retirement or cessation of employment of an individual or group of individuals, or some other fortuitous event or events.

II. FFIs and NFFEs.

A. Exempted FIs.

Section II.B of the Notice provides that the IRS and Treasury Department intend to exempt certain entities ("Exempted FIs") that are primarily engaged in investing, reinvesting or trading in securities from the definition of a "financial institution." Examples of Exempted FIs include non-financial holding companies, start-up companies, organizations undergoing (or emerging from) a bankruptcy or reorganization and hedging centers of non-financial groups. The Notice further states that the Treasury Department and the IRS "also intend to issue guidance pursuant to section 1472(c)(1) exempting payments beneficially owned by" Exempted FIs from withholding under Code Section 1472(a).

We believe that this guidance is helpful and consistent with other guidance given in the Notice, such as the proposal generally to exempt an NFFE with an active trade or business[10] from Chapter 4 withholding and reporting. Under the account classification rules discussed in section III of the Notice, however, it appears that Participating FFIs and USFIs may be required to treat Exempted FIs as nonparticipating FFIs or non-exempted NFFEs by default. This is because Section III of the Notice requires that a Participating FFI or USFI classify its pre-existing and new accounts on an individual, entity-by-entity basis. There does not appear to be a mechanism for classifying an account on a group-wide basis. For example, in the case of a holding company with a subsidiary that has an active, non-financial trade or business, documentation of the active business status of the subsidiary would presumably not be sufficient to satisfy the documentation requirements with respect to the parent holding company under Section III of the Notice. Therefore, it is not clear how the holding company in this instance would establish its exemption from Chapter 4 withholding and reporting. We anticipate that such a result was not intended. Accordingly, we consider it important that the Treasury

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[9] Alternatively, the Treasury Department and the IRS may wish to consider providing that payments made on a grandfathered obligation are not "withholdable payments." Under this approach, a payment that is attributable to a payment on a grandfathered obligation would not be a "passthru payment."

[10] For a further discussion of this proposal, see Section II.B, of this report, *infra.*

Department and the IRS (i) clarify that Exempted FIs were intended to be treated as Exempted NFFEs for all purposes of Chapter 4, including for purposes of determining the status of accounts held by such entities at FFIs, (ii) develop a methodology by which FFIs and USFIs can document that an account is held by an Exempted FI, and (iii) integrate this methodology with the general account classification rules under Section III of the Notice (*i.e.*, the rules setting forth the procedure to be used by a FFI or USFI in order to classify new and preexisting accounts).

We believe that at least two potential approaches exist for documenting Exempted FIs. First, it may be possible for Participating FFIs and USFIs to conclude that an entity is an Exempted FI through a combination of: (i) self-certification and/or (ii) obtaining documentary or other evidence that another member of the Exempted FI's expanded affiliated group has an active trade or business (or, in the case of an entity in or emerging from a bankruptcy or reorganization, that the entity or a member of its expanded affiliated group formerly had an active trade or business), in a manner analogous to the procedures set forth in section III of the Notice for determining that an NFFE has an active trade or business. Such an entity could then be treated as an excepted NFFE. Alternatively, the Treasury Department and the IRS could also issue FFI EINs to Exempted FIs, which could then be used to claim an exemption from Chapter 4 withholding. We anticipate that either of these approaches would be feasible, although stakeholders in the industry may have strong views as to which of these mechanisms is more straightforward and reliable.

B. Excepted NFFEs.

We applaud the decision by the IRS and the Treasury Department to exempt an NFFE engaged in an active trade or business (an "Active NFFE") from the reporting and withholding rules of Chapter 4. However, we would like to draw your attention to a few items:

1. The IRS and the Treasury Department Should Make Clear that an NFFE that Is Engaged in a Substantial, Active Trade or Business Is an Excepted NFFE for All Purposes of Chapter 4.

Section III of the Notice addresses the obligations of both USFIs and FFIs. As set forth in the Notice, the IRS and the Treasury Department view the obligation of a USFI to determine the classification of the account holders to whom it will make withholdable payments as parallel to the determination a Participating FFI must make in relation to its entity account holders.

Accordingly, Section III of the Notice sets forth parallel systems of inquiry for Participating FFIs and USFIs making withholdable payments to its entity account holders. Under both systems, the financial institution must proceed through a series of successive inquiries ("Steps") in order to determine how to properly categorize its account holders.

i. <u>Participating FFIs.</u>

In the case of a Participating FFI, an account held by an entity that is properly identified (using the enumerated Steps) by the Participating FFI as an Active NFFE will be treated as an account that is "other than a U.S. account for purposes of Chapter 4."[11] Such an account is

[11] *See* Notice, § III.B.3.

exempt from the reporting required by Participating FFIs under Code Section 1471(b)(1)(C) and will not be treated as a recalcitrant account for purposes of withholding under Code Section 1471(b)(1)(D). In addition, an Active NFFE is excluded from the definition of a U.S.-owned foreign entity.

Whether an account is a "U.S. account" or an entity is a "U.S.-owned foreign entity" is relevant for purposes of Code Section 1471 but not for purposes of Code Section 1472.[12] Section V of the Notice states that:

> Treasury and the IRS also anticipate providing an exception in guidance to the withholding required under section 1472 for payments made to an NFFE engaged in an active trade or business by withholding agents other than financial institutions.

Because the proposed rule only applies to withholding agents that are not financial institutions, it would not apply to a payment by a Participating FFI. Nothing in the Notice says that an entity indentified by a Participating FFI as an Active NFFE will be exempt from Code Section 1472 reporting.

ii. USFIs.

A USFI that properly identifies (using the enumerated Steps) an account holder as an Active NFFE may treat that account holder as an excepted NFFE for purposes of Chapter 4. As an excepted NFFE, such NFFE will be exempt from withholding under both Code Sections 1471 and 1472.

The rule does not, however, cover withholdable payments by a USFI that are made to persons that are not account holders of the USFI. This is because the rule that treats an Active NFFE as an excepted NFFE is triggered only during the process of a USFI or a Participating FFI classifying its account holders: the relevant language is (emphasis added): "An entity account holder *identified in this step* as engaged in an active trade or business will be treated as an excepted NFFE and an account of such an entity will be treated as other than a U.S. account for purposes of chapter 4."[13] In addition, as a financial institution, a USFI does not technically qualify for the proposed exemption from Code Section 1472 for payments to Active NFFEs; the proposed exemption would only cover payments to an Active NFFE from a withholding agent that is not a financial institution.[14] As a result, withholdable payments made by a USFI to an Active NFFE that is not an account holder of the USFI (for example, a payment made by a USFI

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[12] Under the Notice a Participating FFI will be required to use the same procedures it uses to classify an entity for Code Section 1471 purposes when classifying an entity for Code Section 1472 purposes.

[13] Notice, § III.B.3.a.4 (Participating FFIs). *See also* Notice, § III.C.1.3.a (USFIs).

[14] *See* Notice, § V.G: "Treasury and the IRS also anticipate providing an exception in guidance to the withholding required under section 1472 for payments made to an NFFE engaged in an active trade or business by withholding agents other than financial institutions."

to a supplier that does not maintain an account at the USFI) would not be exempt from Code Section 1471.

We recommend that future guidance clarify that an Active NFFE is an exempt recipient for all purposes of Chapter 4, and in particular that an FFI does not have any further responsibility under Section 1472 with respect to an Active NFFE and a USFI may rely on this rule when making payments to non-account holders.

2. In Future Guidance, the IRS and the Treasury Department May Wish to Provide that the Exemption for an NFFE Engaged in an Active Trade or Business Includes a Substantiality Test.

As noted above, we believe that the Active NFFE rule provided in the Notice is helpful and will simplify administering the Act. We are, however, concerned that treating *any* NFFE with an active trade or business as an excepted NFFE without requiring a showing that the NFFE's active business pursuits are substantial, either absolutely or in proportion to its overall activities, may open an opportunity for sophisticated persons to avoid reporting. In the absence of such a rule, NFFEs with *de minimis* active businesses could be treated as Active NFFEs. While we think that many such NFFEs would fall within the definition of an FFI, we think it is important to alert you to the possible abuse.

We recognize that administering a substantiality requirement is logistically difficult. Conditioning Active NFFE status on net income may, for instance, be unfair to an NFFE that is engaged primarily in a manufacturing business that has historically been successful, but experiences an unprofitable period, particularly if that NFFE also holds a substantial portfolio of investments to meet future liabilities. Even using other measures such as gross income, defining a "substantial" active trade or business is not necessarily straightforward, and financial institutions may find it difficult to reliably assess whether a customer has a substantial active trade or business if they are required to rely solely on the materials they have on file. The Steps should, accordingly, make clear what evidence may be relied upon by the Participating FFI to determine Active NFFE status and, in particular, what evidence may be used to indicate that the relevant entity's active business is significant, either absolutely or in relation to its other activities.

Given the challenges discussed above, we recommend that the Treasury Department and the IRS permit an entity wishing to be treated as an excepted NFFE because it has an active trade or business to self-certify that its active trade or business is substantial in proportion to its other activities, perhaps according to an objective standard. We also recommend that USFIs and Participating FFIs be permitted (but not required) to accept such a certification in the absence of knowledge (including knowledge obtained through the other due diligence procedures USFIs and Participating FFIs will be required to undertake) or reason to know that this certification is inaccurate.

We are aware that self-certification is not a perfect option. At the same time, however, we think it is important that the Act be implemented in a way that does not permit entities that Congress did not intend to treat as excepted NFFEs to claim that status. When combined with the other due diligence procedures required under the Notice, we think that requiring

substantiality, but allowing it to be self-certified, represents an appropriate compromise between administrability and rigor.

3. Entities that Issue "Tracking Stock" Should Not Be Treated as Excepted NFFEs.

As discussed above, the Notice expresses an intent to treat any entity with an active trade or business as an excepted NFFE. In general, we believe this is an appropriate treatment. However, one concern that we wish to draw to your attention is the possibility that NFFEs—even NFFEs with large, substantial active businesses—could issue "tracking stock" or other securities whose value is derived from the value of a portfolio of investments in unrelated entities.

We believe it is inconsistent with the purposes of the Act to permit entities that issue "tracking stock" or similar securities to be treated as excepted NFFEs. We did not reach a consensus regarding how issuers of "tracking stock" should be treated: arguments can be made for treating them as FFIs, "partial FFIs" (in a manner analogous to the "partial FFI" treatment that we recommend for certain insurance companies later in this report)[15] or non-excepted NFFEs. However, given that such entities are, in effect, "holding financial assets for the account of others"—a function of a "financial institution"[16]—we believe treating issuers of tracking stock as excepted NFFEs may open an opportunity for sophisticated persons to avoid reporting.

Future Guidance Should Clarify the Treatment of Non-Excepted NFFEs.

Under the reporting requirements of Code Sections 1471 and 1472, U.S. withholding agents and Participating FFIs are required to gather information on an NFFE's "substantial U.S. owners" unless the NFFE is an excepted NFFE. The definition of a substantial U.S. owner uses a 10% ownership threshold (which is reduced to a greater than 0% ownership threshold for investment vehicles). In contrast, the category of "specified U.S. persons" is much broader and includes any U.S. person other than:

> A corporation whose stock is regularly traded on an established securities market, or which belongs to an expanded affiliated group that contains a corporation whose stock is regularly traded on an established securities market,
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> Tax-exempt organizations under Code Section 501(a),
>
> Individual retirement plans,
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> U.S., state or local governmental agencies or instrumentalities,
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> Regulated banks,
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> Real estate investment trusts,
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> Regulated investment companies,
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> Common trust funds, and

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15 *See* section II.C.1 of this report, *infra*.

16 *See* Code Section 1471(d)(5).

Certain trusts.[17]

With respect to NFFEs that are not "excepted," the Notice requires FFIs and USFIs to collect information on any "specified U.S. person" that owns any portion of an NFFE that is not an "excepted NFFE."[18] This would require the withholding agent to gather information on and report all U.S. owners, not just "substantial U.S. owners" as required by the Act. In effect, the rules set forth in the Notice would require a financial institution to get almost the same information from an NFFE as would be required from certain "small" FFIs that are described in Code Section 1471(d)(5)(C) (generally investment funds and other entities primarily engaged in the business of investing, reinvesting or trading in securities, partnership interests or commodities interests or in any interest in any of them) in order for such NFFEs to be treated as "deemed compliant" FFIs.[19] Effectively, this is reading the 10% threshold out of the information-gathering and reporting requirements.

We understand that the reason for this may be that the IRS views any entity that is technically an NFFE, but is not an excepted NFFE, as an FFI. Although this may be true in many cases, we believe that this is an over-simplification of what is actually the case. At the very least, it would be helpful for future guidance issued under the Act to be explicit on this point so that types of affected persons can be identified and appropriate mechanisms designed to deal with them.

We believe, moreover, that there are many types of entities that fall into the residual category: entities that meet the definition of an NFFE but are neither an FFI nor an excepted

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17 *See* Code Section 1473(3).

18 *See* Notice § III.B.3.a.4.c.

19 *Compare* Notice § II.B.3 ("Treasury and the IRS intend to issue guidance under which certain foreign entities that are FFIs described in section 1471(d)(5)(C), but are not described in section 1471(d)(5)(A) or (B), would be treated as deemed-compliant FFIs if the withholding agent (i) specifically identifies each individual, specified U.S. person, or excepted NFFE that has an interest in such entity, either directly or through ownership in one or more other entities, (ii) obtains from each such person the documentation that the withholding agent would be required to obtain from such person under the guidance described in Section III of this Notice if such person were a new account holder or direct payee of the withholding agent, and (iii) the withholding agent reports to the IRS, in such manner as will be provided in future guidance, any specified United States person identified as a direct or indirect interest holder in the entity (Documented FFIs)") *with* Notice § III.B.3.a.4.c ("If the documentation provided by the account holder in step 4(b) above indicates that the account holder is an NFFE, the participating FFI must either obtain documentary evidence (or rely on existing documentary evidence in its account files) that the NFFE is an excepted NFFE, or the FFI must (i) specifically identify each individual, and each other specified U.S. person that has an interest in such entity, either directly or through ownership in one or more other entities, other than through ownership in an excepted NFFE, a participating FFI, a deemed-compliant FFI, or an entity described in section 1471(f), and (ii) if a specified U.S. person is identified in (i), treat the account as a U.S. account and obtain with respect to each such person the documentation that the participating FFI would be required to obtain from such person if such person were a new account holder and report any such specified U.S. person to the IRS.").

NFFE (even assuming that all Active NFFEs and all Exempted FIs are properly excluded from the residual category). For example, investment companies that primarily invest in real estate or intellectual property, foreign charitable and religious organizations that are not primarily funding organizations, trade organizations and unions: all of these entities do not qualify as FFIs, and are therefore by definition NFFEs. They are, however, unlikely to qualify for an exemption under Code Section 1472(c)(1) or to have an active trade or business. Additional guidance on the treatment of such entities would be helpful. We would suggest, at a minimum, that, with respect to account holder identification, the 10% threshold for U.S. ownership be retained, at least on an optional basis, for these types of entities (*i.e.*, entities that appear to be non-excepted NFFEs, but that appear not to be, or certify that they are not, FFIs).

C. Insurance Companies.

In Section II.B.2, the Notice states that the Act gives the Treasury Department the authority to exclude or include insurance companies, and certain products sold by insurance companies, from the definition of "financial institution" and "financial account." The Notice observes, moreover, that the Treasury Department and the IRS do not view the issuance of contracts without cash value as implicating the concerns of Chapter 4, and that, therefore, they intend to issue regulations treating entities that solely issue such contracts as non-financial institutions.

The Notice requests comments with respect to the appropriate treatment under Chapter 4 of entities that do issue cash-value contracts, annuity contracts and similar arrangements, and with respect to the appropriate definition of such contracts for this purpose.

As a threshold matter, it is not clear to us that the language of the statute itself supports the treatment of insurance companies as "financial institutions," since they do not fall within any of the three enumerated categories that are so defined in Code Section 1471(d)(5): they do not typically accept deposits in the ordinary course of a banking or similar business; typically, they do not hold financial assets for the account of others as a substantial part of their business; and they do not engage primarily in investment activities. The legislative history of the portions of the Act that relate to Chapter 4 states:

> It is anticipated that the Secretary may prescribe special rules addressing the circumstances in which certain categories of companies, such as certain insurance companies, are financial institutions, or the circumstances in which certain contracts or policies, for example annuity contracts or cash-value life insurance contracts, are financial accounts or United States accounts for these purposes.[20]

[20] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10 February 23, 2010) at 44.

Thus, although the statutory basis for such treatment is not entirely clear, we presume that the guidance contemplated in the Notice regarding insurance companies and products is predicated on this statement in the legislative history.

1. Future Guidance Should Focus on Insurance Products, Rather than Insurance Issuers in Determining the Application of Chapter 4 Reporting.

The Notice distinguishes between two broad categories of insurance contracts: those with cash value, and those without cash value. It then states that an entity whose business consists solely of issuing the latter should not be treated as a "financial institution."

In our view, the distinction drawn in the Notice between contracts with or without cash value is confusing, as the Notice does not clearly distinguish between the status of the contract in question and the status of the entity that issues such contracts. This leaves unclear the status of non-cash-value products issued by companies whose predominant business activities are the issuance of cash-value products that are treated as "financial accounts," as well as the status of cash-value products issued by companies whose predominant business activities are the issuance of other products. If an entity's predominant activity is the issuance of cash-value products, is the Notice suggesting that the entity is an FFI? If so, does that treatment hold for all purposes? In contrast, if a business entity does not have the issuance of cash-value life insurance contracts as its predominant business activity, but nonetheless issues some such contracts, are such contracts exempt from reporting because of the nature of the issuing entity?

In this regard, it should be noted that in many parts of the world, insurance-related products are issued by companies that do not fit the typical U.S. mold of an insurance company. Insurance products may, in these regions, be issued by entities that are affiliates of banks, securities dealers and other types of entities. The statute itself draws a line at the entity level, between those foreign entities that are financial institutions as opposed to non-financial institutions. Where does that leave financial accounts that are held at non-financial institutions?

Because the objectives of Chapter 4 seem more closely related to the substance of the contract, rather than the predominant business activity of the entity that issues the contract, we believe that future guidance should treat insurance products as subject to Chapter 4 reporting based on their specific characteristics. Under this approach, any foreign business entity that issues both products that are "financial accounts" and other insurance policies would be treated as a "partial FFI." Such an entity would be subject to Chapter 4 reporting with respect to those insurance products that meet the criteria discussed below, and would be exempt from reporting with respect to those products that do not have the requisite investment components to justify the imposition of the reporting requirements.

If this partial FFI approach for insurance companies is adopted, an insurance company that is a partial FFI would be treated as an FFI for purposes of accounts it holds at other financial institutions and would either need to show that it had entered into an agreement with the Treasury Department to report with respect to those insurance contracts that meet the applicable criteria or that it is otherwise exempt from Section 1471 withholding. We recognize that a partial FFI approach may give rise to logistical difficulties. Nevertheless we are concerned that

treating bona fide foreign insurance companies that issue some cash-value products as FFIs for all purposes is overreaching.

2. Treasury and the IRS Should Clarify Which Products Should Be Treated as Insurance Contracts that Are Subject to Chapter 4.

The Notice observes that certain insurance products, such as cash-value life insurance contracts and annuities, "may present the risk of U.S. tax evasion that chapter 4 is designed to prevent." In light of the ambiguity in the statute and the legislative history of the Act, we believe that the focus of reporting should be on insurance contracts aimed at insured persons that are "offshore," relative to the insurance company or branch issuing the contract. Investment-oriented insurance contracts insuring the lives of residents of the insurer's "home" jurisdiction represent "investment" opportunities for very few U.S. persons, and extending Chapter 4 reporting to the issuers of such contracts may, as discussed above, cause substantial disruption to the ordinary business activities of foreign insurers. In contrast, such "offshore" contracts—policies covering the lives of persons who are nonresidents of the issuer's home jurisdiction[21]—are much more likely to be used by U.S. persons as investment vehicles.

The Treasury Department and the IRS could distinguish "offshore" insurance policies from "home market" products by analogy to Code Section 953(e)(2)(B)(ii), which provides a definition of "applicable home country risks." Under this provision, "applicable home country risks" are risks taken in connection with property in, liability arising out of activity in, or the lives or health of residents of the home country of the insurance company or branch that is insuring those risks. As a general matter, we believe it is appropriate to treat "home market" cash-value insurance policies, such as insurance policies that would satisfy Code Section 953(e)(2)(B)(ii), as arrangements that are not "financial accounts." However, like the "minimum home country income" concept of Code Section 953(e), we recommend conditioning eligibility for this exemption on the insurance company or branch's ability to demonstrate that it derives a substantial fraction of its premiums from policies that insure "home country risk."[22] Although

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[21] For this purpose, however, the Treasury Department and the IRS may wish to consider treating the European Union and other common markets where insurance companies may "passport" into another country for regulatory purposes, as a single jurisdiction.

[22] Code Section 953(e)(2)(B)(i) provides:

> In general, no contract of a qualifying insurance company or of a qualifying insurance company branch shall be treated as an exempt contract unless such company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this paragraph) -
>
> (I) which cover applicable home country risks, and
>
> (II) with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in section 954(d)(3)).

this definition may need to be modified to be applied to Chapter 4,[23] we think its general approach is reasonable, and could help distinguish traditional insurance and annuity contracts from "offshore" products that could be used to facilitate tax evasion.

Alternatively (or in conjunction with exempting insurance contracts and annuities that are not sold in the "offshore" market), the Treasury Department and the IRS might consider exempting life insurance contracts that are adequately "mortality-oriented" from Chapter 4 reporting. Under such an approach, a test that treats a policy as adequately "mortality-oriented" if it meets a pre-determined ratio of premiums (or death benefits) to cash-value may be appropriate.[24]

3. Future Guidance Should Clarify that It Is the Owner of an Insurance Contract that Should Be the Subject of Reporting.

We believe that it would be helpful for regulations to clarify, in the context of insurance products that do give rise to a reporting obligation, *which person* should be the subject of that reporting. Insurance policies typically have an owner, an insured and a beneficiary. We believe it is clear that the reporting obligation should be based on the tax status of the owner of the policy, rather than on the insured life or the beneficiary, but it would be helpful for this to be stated explicitly in the regulations. For example, assume that a non-U.S. person purchases a life insurance policy on his own life, and names a family member residing in the United States as beneficiary. Assume also that the policy has enough investment characteristics to make it subject to Code Section 1471 reporting under the criteria ultimately adopted by Treasury and the IRS. Any income earned on the policy during the life of the owner would obviously not be subject to U.S. income tax, and thus the entity that issues the policy should not be required to comply with Chapter 4 reporting with respect to the policy. In contrast, a non-compliant policy owned by a U.S. person should not be exempt from reporting simply because the beneficiary is not a U.S. person. Similarly, reporting with respect to any policy that is owned by a trust should follow the same pattern. If the income of the trust is includible in the taxable income of a U.S. person, then the trust (and, if relevant, its owners) should be the subject of reporting. If not, the trust should not be subject to reporting.

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[23] For example, Section 953(e)(2)(B)(ii) also governs health insurance contracts and term life insurance contracts, which presumably would be exempted from Chapter 4 reporting.

[24] Another potential approach may be to exempt those insurance contracts that meet the definitional requirements of Code Section 7702. The general exclusion of death benefits payable on such contracts from gross income makes it unlikely that insurance policies meeting the requirements of Code Section 7702 will be used to facilitate tax evasion. *See* Code Section 101(a). However, most foreign insurance contracts that have investment aspects will not satisfy the definitional requirements of Code Section 7702. Even for those that do, the resources that are required to test for Code Section 7702 compliance may be so costly that this may not be the most useful test for purposes of Code Section 1471.

4. Future Guidance Should Apply the $50,000 Threshold of Code Section 1471(d)(1)(B)(ii) to Insurance Products.

We also believe that it would be helpful for regulations to provide a *de minimis* threshold that would apply in the case of insurance products. We think, in this regard, that it would be reasonable (and consistent with Congressional intent) to exempt any insurance policy held by a natural person with a cash value of less than $50,000 from the definition of a "financial account." This proposed $50,000 threshold is analogous to the $50,000 threshold for deposit accounts in Code Section 1471(d)(1)(B)(ii).[25] Future regulations would need to provide guidance as to how "aggregate value" should be determined for that purpose. Presumably, aggregate value should be defined as the amount that the policyholder would receive if the policy were surrendered, rather than the amount payable on the death of the policyholder.

The Treasury Department and the IRS should also consider how the thresholds provided in Section III of the Notice should apply to life insurance policies. For example, it would be helpful if regulations would clarify that the dollar thresholds set forth in Section III.B, apply to the cash value of the policy, as opposed to its death benefit. This is consistent with the overall approach regarding the distinction between cash value and death benefit. Similarly, policies that are fully or largely paid up prior to the effective date of an FFI Agreement may pose less of a risk of tax evasion than bank accounts. The Treasury Department and the IRS may wish to consider whether a life insurance policy in which the policyholder is not required to make premium payments should be treated as a pre-existing account indefinitely, rather than requiring that such policies be re-documented.

In summary, although we recognize that insurance policies that are largely investment-oriented pose issues that are similar to those posed by other financial contracts, we believe that the Treasury Department and the IRS should consider the specific characteristics of insurance policies. Regulations should take these specific characteristics into account for purposes of applying the document collection rules set forth in Section III of the Notice, rather than simply adopting rules that were written for other types of financial products.

D. Future Guidance Should Expand the Rule Permitting Entities with Certain Identified Owners to Be Treated as "Deemed Compliant" FFIs and Provide for Reasonable Rules to Determine Who Holds an Interest in a Foreign Trust in Which Beneficiaries Do Not Have Fixed Interests.

1. Expand the Rule Permitting Entities with Certain Identified Owners to Be Treated as "Deemed Complaint" FFIs.

Section II.B.3 of the Notice provides that FFIs that are described in Code Section 1471(d)(5)(C) (*i.e.*, entities engaged primarily in the business of investing, reinvesting or trading), but that are not described in Code Section 1471(d)(5)(A) (*i.e.*, entities that accept deposits in the ordinary course of a banking or similar business), or (B) (*i.e.*, entities, that as a substantial portion of their business, hold financial assets for the account of others) may be

[25] We think, like deposit accounts, an insurance policy with a cash value of less than $50,000 is unlikely to be used for tax evasion.

treated as deemed-compliant FFIs if the withholding agent identifies each individual, specified U.S. person[26] or exempted NFFE that has a direct or indirect interest in the FFI, obtains appropriate documentation from each such beneficial owner and reports each specified U.S. person with a direct or indirect interest in the entity.

We applaud the IRS and Treasury for adopting this simplification rule. Otherwise, many family and community investment vehicles would have to enter into FFI Agreements, which would impose considerable costs on them and the IRS. We are concerned, however, because of the structure of many family investment vehicles, that the option may be less helpful than intended.

Although this guidance is helpful, it is not clear whether an FFI that would otherwise be eligible for this rule (a "Private FFI") would be eligible for this provision if it were, in whole or in part, owned by another Private FFI. It is not uncommon for a trust to hold its investments through an investment company, or for one trust to have another trust as its beneficiary. The first paragraph of the Notice seems to suggest that a Private FFI with such a structure would not be eligible to be treated as a deemed-compliant FFI, even if it were to certify all of its beneficial owners to the relevant withholding agent. We see no policy or other reason why such a Private FFI should not be entitled to claim such relief. Accordingly, we would recommend that any final guidance issued by the Treasury Department and IRS provide that Private FFIs, perhaps any FFI that is not described in Code Section 1471(d)(5)(A) or Code Section 1471(B), be treated as deemed compliant so long as it provides the relevant information to the withholding agent.

We also believe that it would be helpful for the IRS and the Treasury Department to further elucidate what they mean by a "small" family trust. A trust can, for instance, be "small" because it has a small number of beneficiaries, but a trust created for the benefit of a single child could nonetheless hold billions of dollars in assets. Although such a trust arguably has the financial means to comply with Chapter 4 even if it is not treated as a deemed-compliant FFI, requiring such compliance is unlikely to reduce tax evasion any more effectively than would treating such a trust as a deemed-compliant FFI. Alternatively, a trust may hold few assets, but have a large number of potential beneficiaries (it is not uncommon, for instance, for trusts to be created for the benefit of all of a settlor's descendants, who can be numerous in a large family).[27] We question whether the tax compliance benefit of not treating such a trust as a deemed-compliant FFI justifies the costs associated with requiring such a trust to sign an FFI Agreement.

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[26] Under the Act, a "specified U.S. person" is any U.S. person that is not exempted from the definition, either by regulatory guidance or because such U.S. person meets a statutory exemption (*e.g.*, publicly traded corporations, their affiliates, governmental units and banks are generally entitled to a statutory exemption). *See* Code Section 1473(3).

[27] In this regard, we note that the example in the Notice consists of a trust created by a settlor for his children. It is quite common for trusts to be created for the benefit of all of the settlor's descendants, so there may be relatively few trusts that meet the exact fact pattern given in the Notice.

2. Provide for Reasonable Rules to Determine Who Holds an Interest in a Foreign Trust in Which Beneficiaries Do Not Have Fixed Interests

Many Private FFIs are likely to be foreign trusts. The rules for deemed-compliant FFI treatment will require such a foreign trust to provide information on its interest holders. In the case of certain trusts, the answer to the question of who holds an interest in a trust is often ambiguous, particularly in the case of large classes of remote beneficiaries. For example, in the case of a discretionary trust (or another trust in which beneficiaries do not have fixed interests), making such an identification will be particularly difficult without a rule that allows a trustee to ignore remote beneficiaries. Similarly, in situations where a trustee or a third party has the power to add beneficiaries or where a beneficiary or third party has a broad power of appointment, (*e.g.*, the power to appoint trust property to any person other than herself, her creditors, her estate or the creditors of her estate) the potential class of beneficiaries could be enormous. These concerns are present both with Private FFIs and with trusts that will be required to satisfy the "regular" rules of Code Section 1471(b).

We recommend that Treasury Department and the IRS adopt a "remoteness" rule that will avoid a situation where a foreign trust investing in the U.S. must make a massive number of filings about potential beneficiaries. Under a remoteness rule in the case where a beneficiary (i) has no actuarially defined interest, (ii) is not in a named class of beneficiaries (*i.e.*, a person specified through his or her given name as a potential beneficiary, or a person in a family or small group of families identified as potential beneficiaries)[28], and (iii) has not received a distribution from the trust for a period of time, say in the last 10 years, such beneficiary should be treated as a remote beneficiary and ignored for purposes of the reporting and withholding rules of Section 1471.

Even with these rules, however, we note that Private FFIs may have mechanical difficulties in claiming deemed-compliant FFI status. For example, a withholding agent will often have no information about the beneficiaries of a trust, which will typically need to be obtained from the trustee. We think it would be helpful if guidance from the Treasury Department and the IRS could provide that withholding agents may rely on certifications provided by the trustee, instead of needing to obtain documentation from the beneficiaries. Such a rule could greatly simplify administration, particularly in the case of so-called "quiet trusts" (trusts that do not disclose their terms and assets—or perhaps even their existence—to their beneficiaries until a certain time).

E. Future Guidance Should Broaden the Scope of Exempted Retirement Plans.

In the Notice, the IRS and the Treasury Department indicate an intent to exempt certain retirement plans under Code Section 1471(f) because such plans present a low risk of tax evasion. We recommend that the IRS consider broadening the scope of retirement plans that are exempted from the Act under this provision, because we believe the exemption proposed in the

[28] The IRS may, in addition, wish to consider limiting the size of any "named class" to a reasonable number. We believe 500 beneficiaries, by analogy to Section 12(g) of the Securities Exchange Act, would be reasonable in this regard.

Notice does not encompass many traditional, employer-sponsored retirement plans that would similarly present a "low risk of tax evasion."

The Notice indicates that the IRS and the Treasury Department intend to identify a foreign retirement plan as posing a low risk of tax evasion (resulting in payments beneficially owned by such a retirement plan being exempt from withholding under Code Section 1471(a)) only if the plan:

> (i) qualifies as a retirement plan under the law of the country in which it is established;
>
> (ii) is sponsored by a foreign employer; and
>
> (iii) does not allow U.S. participants or beneficiaries other than employees who worked for the foreign employer in the country in which the retirement plan is established during the period in which benefits accrued.[29]

We understand that the IRS and the Treasury Department likely intend to include most employer-sponsored retirement plans, other than individual retirement accounts and their foreign equivalents, within the scope of this exclusion. The exemption set forth in the Notice may not, however, include many such plans in the absence of further clarification. For example, it is uncertain whether the exemption proposed in the Notice would apply to a single-employer pension plan that permits a U.S. person to claim benefits as a surviving spouse, a common feature (if not requirement) of retirement plans. In addition, it is not clear whether the exemption proposed in the Notice would apply to a multiemployer plan or a union plan. Multijurisdictional plans, such as the proposed European Union-wide pension plans, may also not qualify for this exemption as it is drafted in the Notice.

It is likely that the arrangements listed above are types of retirement plans that the IRS and the Treasury Department intend to exempt from the withholding provisions of Chapter 4. To the extent that such pension plans are not exempted, however, we urge the IRS and the Treasury Department to reconsider this view because such arrangements have little, if any, utility in fostering tax evasion. In particular, we would recommend that this exemption be revised to exclude a plan if it:

> (i) qualifies as a retirement plan under the law of the country in which it is established;
>
> (ii) is sponsored, in whole or in part, by a foreign employer (or a foreign subsidiary of an U.S. employer) or by a foreign government or labor union for employees of a foreign employer (or a foreign subsidiary of an U.S. employer);
>
> (iii) subject to a *de minimis* exemption described below, does not allow U.S. participants or U.S. beneficiaries who are not:

[29] *See* Section II.C. of the Notice.

(a) employees who worked for a foreign employer in the country in which the retirement plan is established (or another country in which the retirement plan qualifies as a retirement plan) during the period in which benefits accrued, or

(b) persons entitled to benefits as a survivor, spouse or dependent; and

(iv) owes less than some *de minimis* amount (for example, 2% of the benefits that have accrued actuarially) of its accrued benefits to U.S. participants and U.S. beneficiaries who are not persons in the categories listed in (iii)(a) and (iii)(b) above.

In addition to the above, we recommend that the term "U.S. participants" be limited to U.S. citizens and permanent residents. For example, a foreign citizen could be transferred by his or her employer to a U.S. office, but prefer to remain in his or her home country's retirement plan for non-tax reasons (*e.g.*, it is possible that the terms of such a plan entitle the employee to a larger benefit than would the U.S. plan in which he or she would otherwise be entitled to enroll). Such arrangements are unlikely to foster tax evasion, but under a broad definition of a "U.S. participant," could jeopardize such a retirement plan's exemption.

F. Foreign Governmental Pension Plans and Section 892.

Payments to foreign governments are expressly exempted from withholding under Code Sections 1471(f) and 1472(c). The statute does not define the term "foreign government," but the term is used in Code Section 892 and is defined in the regulations promulgated thereunder.[30] Those regulations include within the category of foreign governments certain pension plans formed for the exclusive benefit of employees of foreign governments and public service employees.[31]

Section II.C of the Notice requests comments on the scope of an exemption for foreign pension plans. Regardless of what guidance is issued to deal with foreign pension plans generally, we believe that governmental pension plans of the type encompassed by Code Section 892 should be treated as foreign governments for this purpose and should be exempt from Chapter 4 in the same manner as foreign governments generally. In particular, we believe that guidance should define the term "foreign government" as used in Chapter 4 by cross-reference to the regulations under Code Section 892.

G. Foreign Central Banks.

Under Code Sections 1471(f)(3) and 1472(c)(1)(F), a payment is exempt from Chapter 4 withholding to the extent that the beneficial owner of the payment is a foreign central bank of issue. There is no corresponding exemption, however, for payments received by such banks on securities that they hold as collateral. Like the U.S. Federal Reserve Banks, foreign central banks make loans to the banks they regulate as part of their monetary and fiscal policy and, like

[30] Treas. Reg. § 1.892-2T.

[31] Treas. Reg. § 1.892-2T(c).

the U.S. Federal Reserve Banks, they take collateral for these loans. Under U.S. tax principles, it is unlikely that the foreign central banks would be treated as the beneficial owners of this collateral. We understand that the face amounts of U.S. government and other securities held by foreign central banks as collateral are very large. The extent of these loans, the nature of the collateral pledged and the identity of the pledgors are often kept confidential by the central banks. As governmental institutions engaged in non-public governmental functions, these central banks may view a request by the United States that they enter into an FFI Agreement as overly intrusive or as an effort by a foreign sovereign to regulate their internal affairs. It would not be surprising if they were unwilling to do so. (One can imagine what the Federal Reserve Bank of New York would say to a similar request from a foreign government—in effect, to serve as the foreign government's withholding agent with respect to collateral posted by troubled U.S. banks in order to force the troubled U.S. banks to comply with a policy imposed by the foreign government.)

Foreign central banks should not, as a general matter, have to enter into FFI Agreements for several reasons: as a matter of comity to foreign governmental institutions; because, as a practical matter, transactions by such institutions involve a low risk of tax evasion; and, because such an exemption is consistent with the policy of Code Section 895, which generally exempts the non-commercial banking activities of foreign central banks of issue. Accordingly, we would recommend that a foreign central bank of issue be a deemed compliant FFI, and accordingly, not be required to enter into an FFI Agreement unless, as a substantial portion of its business, it conducts one or more commercial banking activities, in addition to its activity as a central bank, that would not be considered exempt from tax under Section 895.

H. The Treasury Department and the IRS Should Clarify the Status of Securitization Vehicles.

The Notice does not specifically address the status of securitization vehicles such as real estate mortgage investment conduits and fixed investment trusts.

In our view, the Treasury Department and IRS should consider treating existing securitization vehicles as deemed compliant FFIs, and further consider treating all securitization vehicles as deemed compliant FFIs to the extent all interests in such vehicles are held through USFIs or Participating FFIs.[32] As a practical matter, it may be extremely difficult for existing securitization vehicles to become Participating FFIs, because such vehicles are typically governed by pre-existing documents that specifically define the powers of the parties managing the vehicle and present substantial barriers to amendment.

We believe that existing securitization vehicles generally present a low risk of tax evasion, because interests in these arrangements are generally held by large institutional investors and over time, such arrangements will generally terminate and be replaced by

[32] Although it may also seem plausible to treat securitization vehicles as entities that are exempted from Section 1471, but treated as NFFEs under Section 1472, we believe that such an approach does not substantially simplify the logistical issues presented by securitization vehicles, as securitization vehicles may have difficulty identifying their beneficial owners.

securitization vehicles that can more easily comply with Chapter 4. In addition, we are of the view that there is little to be gained by requiring any securitization vehicle that is held exclusively through a Participating FFI or a USFI to sign an FFI Agreement. Section IV.E of the Notice provides that in cases where Chapter 4 requires multiple FFIs to report on a single payment, only the FFI that is in a direct payment relationship with the account holder will be responsible for reporting under Code Section 1471(c), meaning that securitization vehicles that are held through Participating FFI custodians are unlikely to need to engage in actual withholding or reporting. Moreover, given that USFIs are also responsible for reporting on their U.S. accountholders[33] and withholding on payments made to nonparticipating FFIs and noncompliant NFFEs,[34] we see little reason to require securitization vehicles that are held through USFI custodians to sign an FFI Agreement that, particularly if USFIs are responsible for withholding on passthru payments, will generally duplicate the withholding and reporting responsibilities that the USFI custodian will already be required to assume.

I. Foreign Charities and Other Documented Foreign "Non-Governmental Organizations" ("NGOs") Should Be Exempt from Chapter 4.

1. Background.

Section II.E of the Notice requests comments concerning the treatment of "any foreign charitable organizations that may fall within the definition of an FFI." More generally, that Section of the Notice requests suggestions for identifying classes of foreign entities that should be excluded from the definition of FFI, deemed to meet the requirements of Code Section 1471(b) by reason of Code Section 1471(b)(2), or identified as posing a low risk of tax evasion pursuant to Code Section 1471(f). Section II.E of the Notice does not make any reference to Code Section 1472.

Some foreign charitable organizations, as well as other types of foreign nonprofit organizations, may presumptively be classified as FFIs under Code Section 1471(d)(5)(C). That provision sweeps in foreign entities "engaged . . . primarily in the business of investing." Because nonprofit organizations do not usually engage in active business operations, and will usually manage a portfolio of investments as part of their endowment, this portion of the FFI definition will often cover them. Code Section 1471(b)(2)(A) provides that an FFI will be a deemed-compliant FFI if it complies with any procedures the IRS may prescribe to ensure that it does not maintain U.S. accounts and meets such other requirements as the IRS may prescribe with respect to any of its FFI accounts. More broadly, Code Section 1471(b)(2)(B) provides that an FFI will be a deemed-compliant FFI if it is a member of a class of persons that the IRS has determined that the application of Code Section 1471 is unnecessary.

Code Section 1471(f) provides that the withholding tax imposed by Code Section 1471(a) will not apply to any payment beneficially owned by, inter alia, any class of persons identified by the IRS as posing a low risk of tax evasion.

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[33] *See* Code Section 6041 (many types of fixed and determinable, annual or periodical income); Code Section 6042 (dividends); Code Section 6045 (gross proceeds) and Code Section 6049 (interest).

[34] *See* Code Section 1471(a) (Nonparticipating FFIs); Code Section 1472(a) (NFFEs).

If a foreign charitable or other nonprofit organization does not fall within the definition of an FFI, it would be an NFFE subject to Code Section 1472. Generally, therefore, it would be required under Code Section 1472(b) to provide a certification that it does not have any substantial U.S. owners in order to avoid withholding. Code Section 1472(c) sets forth various exceptions from this rule, including any class of persons identified by the IRS for purposes of that subsection.

For the reasons described below, we believe that properly documented foreign charitable organizations should be exempt from withholding under both Code Sections 1471 and 1472. We further believe that such organizations should be treated as other than FFIs, and as NFFEs should either be exempt under Code Section 1472(c) or be deemed to have satisfied the requirement of Code Section 1471(b)(2)(B), because by their nature, such organizations cannot have any owners, whether U.S. or foreign. In short, we believe that a properly documented foreign charitable organization should be exempt from Chapter 4 entirely. We discuss below how such an organization may document its status to potential withholding agents.

We also believe, as discussed below, that the IRS and Treasury Department should exercise their authority to treat other foreign nonprofit organizations, generally corresponding to the types of organizations described in the various paragraphs in Code Section 501(c), in the same manner as foreign charitable organizations.

2. Discussion.

i. Treatment of Foreign Charitable Organizations Under the Code.

Code Section 501(c)(3) exempts from U.S. federal income tax any organization, domestic or foreign, "described in" that section. In order to be described in Code Section 501(c)(3), it is not always necessary that an organization have a letter from the IRS acknowledging its status. Code Section 508 requires that most charities apply for and obtain an IRS determination but contains several important exceptions (*e.g.*, for churches and certain grandfathered charities). Code Section 4948(b) provides that Code Section 508's notice requirements do not apply to foreign charities so long as they are not "U.S. supported," a term of art that generally requires the foreign charity to derive more than 15% of its support from U.S. sources.[35]

Most foreign charities do not apply to the IRS for a determination letter because they are not required to do so and because having such a letter requires them to file annual returns even long after they have no U.S. contacts. Nevertheless, they are exempt from U.S. tax, including from withholding tax under Code Sections 1441 and 1442. (Code Section 1443 imposes withholding tax on payments of unrelated business taxable income and the so-called "audit tax" on foreign private foundations.) The problem is how a withholding agent knows when a foreign payee is described in Code Section 501(c)(3).

Traditionally, this knowledge problem was dealt with informally, often by the foreign charity giving the withholding agent a copy of an opinion received from U.S. counsel. In the

[35] For background, see Dale, *Foreign Charities*, 48 Tax Law. 655 (1995); Blanchard, *U.S. Taxation of Foreign Charities*, 8 Exempt Org. Tax Rev. 719 (October 1993).

alternative, the IRS has set forth guidelines pursuant to which foreign charities can self-certify as to their exempt status under what is known as the "equivalency doctrine."[36] These rules were tightened when the current Code Section 1441 regulations were finalized, and Treasury Regulations Section 1.1441-9 now requires the withholding agent to secure an IRS letter or opinion of counsel before recognizing the payee's exempt status.

Similar rules have never been promulgated for other types of entities exempted under Code Section 501(c). The reason for this is clear: the statute limits most other types of exempt organizations to domestic organizations. Examples of such entities might include foreign community development or beautification associations, foreign chambers of commerce and many other types of NGOs that would be exempt if formed under U.S. law, but are not actually exempt under Code Section 501(c). As a practical matter, these types of organizations probably do not earn enough U.S.-source income to warrant any special withholding tax rules for them, particularly given that most of them would be exempt from U.S. tax either by reason of the portfolio interest exception or under an applicable tax treaty.

ii. Characteristics of Foreign Exempt Organizations Relevant to Chapter 4.

It is believed that the great majority of foreign charities, like their U.S. counterparts, have no owners. That is because such organizations are generally formed to promote some broader, often quasi-governmental, public purpose. The same is probably true of most foreign NGOs that would not qualify under Code Section 501(c)(3) but that would generally parallel other domestic organizations listed in Code Section 501(c). Thus, in the great majority of cases, these types of organizations cannot be and are not being used by U.S. persons to invest anonymously.

Some foreign NGOs are so closely allied with their sponsoring foreign government that they may qualify for exemption as a foreign government under Code Section 892. Such organizations are also specifically exempt under Code Sections 1471(f) and 1472(c). Even foreign NGOs that cannot qualify as a foreign government often serve to relieve the sovereign of certain public burdens, just as they do in the United States.

Like other entities that are exempt under Code Section 1472(c), foreign charities and NGOs are caught up in the definition of FFI only by reason of Code Section 1471(d)(5)(C) because they may have investment income. Charities and NGOs typically do not have active business operations, and use their investments and endowments to support their charitable or social activities. Moreover, precisely because their operations are not for profit, many foreign charities and NGOs lack the kinds of reporting systems needed to deal with the kinds of financial reporting that Chapter 4 requires. The case for their exemption from Chapter 4 is thus more compelling than that of holding companies and the other commercial entities listed in Code Section 1472(c).

iii. Documenting Foreign Exempt Status.

As noted above, the withholding tax regime is quite stringent when it comes to documenting foreign entitlement to the Code Section 501(c)(3) exemption, and does not

[36] *See, e.g.*, Rev. Proc. 92-42, 1992-2 C.B. 507.

acknowledge an exemption for other types of foreign NGOs. Where the U.S. tax base is at stake, this seems appropriate. However, Chapter 4 was not enacted to collect tax, but to ensure that U.S. persons do not hide behind foreign veils to avoid their tax obligations. Because foreign exempt organizations pose a very low risk of such activity, documentation for purposes of Chapter 4 need not be as rigorous as that imposed under the withholding tax rules, and should be more focused on proving that the foreign entity has no U.S. owners than it should be on proving that the foreign entity is "just like" a domestic tax-exempt entity. In other words, the focus should be on the entity's ownership, not the entity itself.

For this reason, we believe that a foreign entity should be able to prove its entitlement to exemption from Chapter 4 in one of two ways. First, it should be sufficient to submit to the payor, in advance of any payment, an official copy of its organizing documents clearly evidencing the fact that it does not and cannot have equity holders (other than a foreign government). Such evidence should generally be valid for a period of years, possibly for three years to parallel the similar requirements for Forms W-8. As a variation on this approach, the IRS could over time assemble a list of such foreign nonprofit entities that potential withholding agents could rely upon.

Second, a foreign organization should be exempt from Chapter 4 if it submits a letter from a responsible agency of the foreign country or political subdivision in which it is organized, stating that the foreign organization is operated on a nonprofit basis and has no equity owners (other than a foreign government) entitled to share in any earnings of such organization.

III. Collection of Information and Identification of Persons by FFIs Under Code Sections 1471 and 1472.

The Notice provides extensive, and detailed, rules for how FFIs and USFIs will be required to classify their accounts under Chapter 4. Given the level of detail, we note a variety of specific issues and concerns regarding these rules from a compliance perspective. Because, however, we believe that the industry participants who will be responsible for complying with these rules are likely to be able to present a better picture of what is (and is not) practical in this area, we have limited our comments on this section to two specific concerns: (i) NFFE self-certification and (ii) PO Box and "in care of" addresses.

A. Future Guidance Should Permit NFFE Self-Certification with Respect to the Active Trade or Business Exception.

Under the Notice, an account of an Active NFFE will be treated as a non-U.S. account not subject to withholding or information reporting under Chapter 4. Under the Notice, a USFI or FFI may review its existing documentation to make this determination. According to the Notice, the IRS and the Treasury Department are also considering allowing a USFI or FFI to partially rely on information collected from third-party credit databases in making this determination. However, the Notice does not appear to allow an NFFE to self-certify that it is engaged in an active trade or business.

We believe that it is appropriate for an NFFE to be able to certify its status as an excepted NFFE by certifying that it is engaged in a substantial active trade or business. This would make

the administrative process more efficient and allow for more timely classification of entities because the Participating FFI would not be required to first do an exhaustive review of its own files or seek independent information from a third party. In order to avoid potential abuses of self-certification, the IRS and Treasury may consider requiring an NFFE to provide supporting information or documentation in order to make such certification. For example, such certification process could require the NFFE to provide a summary of its balance sheet and/or an income statement or it could require the NFFE to provide a detailed description of its business activities and other evidence of its business activity such as payroll records, invoice statements, marketing materials, evidence of membership in trade organizations or other easily produced evidence. Moreover, as noted above, we believe that it is appropriate for an entity to only be treated as an Active NFFE if it has a substantial active trade or business, something that Participating FFIs may need assistance from the NFFE to ascertain.

B. The Rule Regarding PO Box and "in Care of" Addresses May Not Be Suited for Some Jurisdictions.

We note that the list of indicia of potential U.S. status in the Notice includes an account for which the sole address on file is a PO box, an "in care of" address or a "hold mail" address. Presumably, this applies to an address anywhere in the world. However, many countries and regions do not have residential mail delivery (for example, we understand, Dubai),[37] and certain rural areas do not have assigned street addresses at all, meaning that under the Notice as drafted, presumably every resident of these countries and regions would be identified as having potential U.S. status. Although it is possible that exempting PO box and similar addresses from this indicium could create potential avenues for tax evasion, we would recommend that the IRS and Treasury Department clarify the scope of this rule, and in so doing, carefully consider whether this criterion is necessary, and balance its utility in preventing tax evasion from its potential to discourage financial institutions operating in these jurisdictions from becoming Participating FFIs. We would suggest that, at the minimum, the rule be limited to those jurisdictions or regions where alternative addresses are available, so that something that is the norm in a jurisdiction or region not be treated as being an unnecessary indicium of U.S. status.

IV. Additional Comments.

The Notice also requests comments on a variety of additional subjects. Our comments on the topics on which we believe our recommendations may be helpful are below.

A. Participating FFIs Should Have an Easy Method for Transmitting Withheld Amounts.

We recommend that the IRS provide guidance as to the mechanics of the payment requirements, and that such guidance should allow some flexibility for foreign financial institutions that are required to make payments of withheld taxes.

Section V.F of the Notice states that the Treasury Department and the IRS intend to require financial institutions to comply with Chapter 4 through electronic filing, but the Notice does not address the mechanics by which payment of the withheld amounts will be made. In

[37] *See* Explorer Publishing, Dubai: The Complete Residents' Guide (10th ed., 2006).

general, the rules governing the payment of withholding taxes are set forth in Code Section 6302, and the regulations thereunder. The IRS should consider whether the rules of Code Section 6302 will apply to amounts withheld under Chapter 4.

In general, the IRS is phasing in rules that will require taxpayers to make tax payments through the Electronic Funds Transfer Payment System ("EFTPS").[38] We believe that this requirement is inappropriate in the case of FFIs that may need to submit withheld taxes to the Treasury Department. Many of these entities are not otherwise subject to the U.S. tax regime, and may not have U.S. bank accounts, or any bank accounts denominated in U.S. dollars. Such entities may have difficulty both navigating through and complying with these payment rules. It seems both unfair and counterproductive to require foreign entities to make payments to the Treasury Department without providing a convenient method to do so.

We suggest that the Treasury Department consider alternative payment methods for amounts withheld by non-U.S. persons under the Act. For example, the electronic form under which information is transmitted may also be integrated with wire transfer instructions, so that any withheld funds can simply be transferred via normal interbank payment mechanisms. In the absence of such a payment mechanism, some foreign entities that are required to withhold may fail to comply simply because of the logistical difficulties.

B. Future Guidance Should Clarify the Scope of the Treaty Waiver When an FFI Elects to Be Withheld Upon

We recommend that the IRS and the Treasury Department clarify whose treaty rights are waived if a Participating FFI elects out of withholding responsibility (such a Participating FFI, an "Electing FFI"). Code Section 1471(b)(3) permits a Participating FFI to enter into an agreement with the Treasury Department under which it would not perform the withholding, but would agree to provide sufficient information to the withholding agent or payor that makes a withholdable payment to the FFI so that the withholding agent can determine how much of the payment is allocable to recalcitrant account holders or nonparticipating FFIs and withhold on that portion of the payment to the FFI.

In addition to the Electing FFI providing sufficient information for the withholding agent to determine the proper amount to withhold from recalcitrant account holders and non-participating FFIs who have financial accounts with the Electing FFI, the Electing FFI will be required under Code Section 1471(b)(3)(C)(ii) to include in the agreement with the IRS a "waiver of any right under any treaty of the United States with respect to any amount deducted and withheld pursuant to an election…".

While there may be valid policy reasons to preclude a credit or refund to a recalcitrant account owner or nonparticipating FFI who has failed to provide the required U.S. account information to the Electing FFI, it is questionable whether a juridical entity can affirmatively waive another person's rights under a U.S. tax treaty. Rather, such person must waive his or her own treaty rights in the manner and time prescribed by the Treasury Department. In this case,

[38] *See generally* Notice of Proposed Rulemaking (Preamble to Prop Regs), Fed. Reg. Vol. 75, No. 162 p. 51707 (8/23/2010).

Code Section 1471(b)(3)(C)(ii) may be read to require an Electing FFI who wants to elect out of its withholding responsibilities to be required to waive its own rights to a reduced rate of tax under a U.S. treaty and therefore a credit or refund otherwise available to it under Code Section 1474(b)(2)(A)(i)(I).

It is unclear if the drafters intended such a result for the Electing FFI who may want to be otherwise compliant with the reporting requirements under Code Sections 1471(b)(1)(A) and (c), but who would prefer to put the withholding responsibility *vis-a-vis* its recalcitrant account holders and non-participating FFIs on the USFIs and other withholding agents who have the resources and systems already in place to withhold such U.S. tax and deposit it on a timely basis with the IRS. If the Treasury Department concludes that the provision mandates that an Electing FFI must enter into its own waiver to preclude it from claiming a reduced rate of tax under a U.S. treaty as a refund or credit then very few FFIs, if any, will decide to elect out of new Code Section 1471 withholding in favor of the withholding agents who are much better suited to effectuate the required withholding under this new provision.

The Treasury Department should provide guidance to clarify whether the election is intended to require an Electing FFI to provide its own waiver of any rights it may have under a U.S. treaty and thereby likely preclude an Electing FFI from otherwise being entitled to a refund or credit under a treaty with the United States, or whether the provision should be read to require the Electing FFI to obtain such waivers from the recalcitrant account holders or non-participating FFI who have financial accounts with the electing foreign financial institution.

C. Passthru Payments Should be Limited to Payments that Are Directly Related to Payments of U.S.-Source Income.

The Notice requests comments regarding methods that a Participating FFI could use in order to determine whether payments it makes are "passthru payments" (*i.e.*, payments attributable to withholdable payments under Code Section 1471).

As a general matter, it is unclear how broad the scope of an "attributable" payment is. For example, where a German bank makes an interest payment, it would generally be considered a non-U.S.-source payment, but if the German bank has a U.S. branch, then, arguably, under the statute, the interest payment could be attributed to a withholdable payment under Code Section 1471 and thus be treated as a passthru payment. Similarly, if a foreign manufacturing company has a U.S. subsidiary that regularly pays dividends to its foreign parent, under a broad view of the definition of a "passthru payment," a portion of the dividends paid by the foreign parent could be considered passthru payments.

Similarly, another general concern regarding the concept of passthru payments is that small non-U.S. banks may keep deposits with larger banks and thus become non-compliant because of the larger bank's investments in U.S. securities. For example, assume a large German bank ("LGB") signs an FFI Agreement and invests in U.S. Treasury securities. If a small German bank does not enter into an FFI Agreement but does keep a depositary account with LGB, such account would presumably be subject to withholding under the passthru payment rules because the LGB's interest payments to the small German bank would be, in part, attributable to U.S.-source interest earned on the LGB's investment in the U.S. securities.

Accordingly, unless the scope of the concept of passthru payments is more precisely defined, the interest payment from the LGB to the small German bank could constitute a "passthru payment" subject to withholding if the small German bank is not a Participating FFI. Thus, a small bank that does not invest in U.S. securities or have U.S. account holders may become subject to withholding and information reporting under Chapter 4 simply because it maintains a deposit account with a Participating FFI.

We believe that a broad interpretation of the "passthru payment" rules could create logistical difficulties, and we therefore recommend that the scope of "passthru payments" be defined in a narrow manner and limited to payments that are directly related to payments of U.S.-source income. To the extent, however, that the IRS and the Treasury Department intend this rule to have a "broad application," we would urge prompt action to clarify and precisely define the scope of the passthru payment concept. If, for example, dividends paid by multinational corporations are to be passthru payments in some proportion to such corporations' U.S.-source profits, such corporations will need significant time to develop reporting and accounting systems that are capable of determining how much of each of their dividends constitutes a "passthru payment."

Furthermore, if it is the case that a non-participating small foreign bank resident in a treaty country will be subject to withholding on passthru payments of interest it receives on its account with a Participating FFI, it would be helpful for future guidance to clarify that where the small foreign bank is otherwise eligible for the benefits of a U.S. income tax treaty, the small foreign bank is eligible for a refund under the "Other Income" provisions of such treaty if the treaty does not specifically address non U.S.-source income.

The rules should also clarify the application of the rules for passthru payments made to or by a USFI that is acting as an intermediary. A USFI has withholding obligations with respect to "withholdable payments" under Code Sections 1471 and 1472. "Withholdable payments" are limited to U.S.-source payments and the gross proceeds from the sale or other disposition of property that can produce U.S.-source interest or dividends.[39] On the other hand, a Participating FFI has withholding obligations with respect to passthru payments which include non-U.S.-source payments to the extent attributable to a withholdable payment.[40] The effect of this distinction is that if a passthru payment is made to a USFI that is acting as an intermediary and the USFI then makes a related payment to a non-U.S. holder, the USFI does not have any information reporting or withholding obligations under Code Section 1471 or 1472 with respect to that payment. On the other hand, a Participating FFI would be required to withhold if the second payment were made to or allocable to a recalcitrant account holder.[41]

We believe this problem could be addressed in a number of ways. One solution could be to allow USFIs to become "participating" USFIs subject to the same rules governing FFIs. As such, the USFI would enter into an agreement with the Treasury Department and thereby agree to withhold on passthru payments to recalcitrant account holders. A USFI that did not enter into

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[39] Code Section 1473(1).

[40] Code Section 1471(d)(7).

[41] Code Section 1471(b)(1)(D).

an agreement to be a participating USFI would be subject to withholding on the passthru payments it received from a participating FFI (where the USFI is not the beneficial owner of the payment).[42] Another option would be to make USFIs subject to the same passthru payment rules that Participating FFIs will need to comply with. (The USFI would, of course, need a simple and clear way to determine when a payment it received was a passthru payment.)

D. Future Guidance Should Provide Exceptions to the Recalcitrant Account and Account Closure Rules.

Under the Notice, the Treasury Department and the IRS request comments on how to address long-term recalcitrant accounts, including whether, and in what circumstances, FFI Agreements should be terminated.

An FFI that undertakes all efforts to comply with the information reporting and withholding requirements under Chapter 4 may nevertheless be "punished" if it has a large number of recalcitrant account holders and is thereby treated as a noncompliant FFI. The requirement for an FFI to close the account of a recalcitrant account holder may not always be feasible and may lead to potential abuse by recalcitrant account holders. Having a large number of recalcitrant accounts may not always warrant the termination of an Agreement if the relevant Participating FFI is endeavoring to comply with the requirements of Chapter 4.

For example, certain investment funds may have lock-up provisions that prohibit the redemption of shares. In addition, local regulatory and legal requirements may not permit banks to close accounts except in certain very narrowly defined circumstances, and an FFI may thus be prohibited from closing an account due to the failure of a holder to provide certain documentation. In such cases, an FFI may not be able to close the recalcitrant account and may, as a result, end up with a large number of recalcitrant accounts (particularly if it is located in a jurisdiction that is governed by such laws). It may not be appropriate in this situation to terminate the FFI Agreement, provided that the FFI is making all reasonable efforts to obtain and report information.

On the other hand, requiring an FFI to close an account of a recalcitrant account holder could, perversely, work to the favor of the recalcitrant account holder. Such holder could essentially force a redemption by not providing the requested information in a timely manner, meaning that these rules could present certain account holders with an opportunity to liquidate their investments that they may not have had otherwise, simply by being recalcitrant.

Accordingly, we recommend that the IRS and the Treasury Department consider granting certain exceptions under which some recalcitrant accounts would not count against the compliance record of an FFI; for example, to the extent an FFI cannot close the account of a recalcitrant account holder because of local legal restrictions, such accounts should not be treated as recalcitrant accounts when considering whether to terminate an FFI Agreement.

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[42] *See* Code Section 1471(d)(1)(C). Because the USFI is not required to report when it makes a passthru payment to its foreign account holder, arguably, it is not exempt from the reporting and withholding rules that must be imposed by the participating FFI.

E. The Treasury Department and the IRS Should Issue Guidance Providing that Partnerships and Other Pass-Through Entities Are Not "Beneficial Owners" for Purposes of Code Section 1474(b)(2) If Such Treatment Would Be Inconsistent with a Treaty Obligation of the United States or in Other Cases Where Such Treatment Is Unduly Harsh.

In general, the tax withheld under Chapter 4 is not a final tax. If the beneficial owner of the payment complies with the relevant identification requirements, a refund of the tax withheld from the payment is generally available[43] (albeit without interest for the first 180 days after a claim is filed). A limitation, however, applies if the beneficial owner of the payment is an FFI. Under Code Section 1474(b)(2), an FFI is entitled to a refund of the withheld tax only to the extent that a tax treaty so provides, and no interest is paid on any such amounts refunded. In the case of an FFI that is a pass-through entity, it is unclear whether this limitation is intended to apply at the entity level or at the partner/beneficiary level.

Consider the case of a Cayman Islands partnership that invests in debt securities, all of whose partners are resident in the European Union and entitled to relief from withholding tax on interest under treaties between the United States and the United Kingdom, France, etc. Furthermore, assume that all of the members of the partnership are treated as partners of the Cayman Islands partnership for purposes of British, French, etc. law, and that all of them are either individuals or excepted NFFEs. The Cayman Islands investment partnership is clearly an FFI and is not eligible for treaty benefits in its own right. The partnership's members, however, are treaty-eligible, and if they held the partnership's assets directly, would have been entitled to a refund of tax even if they were FFIs. Not to give treaty relief in that case would be contrary to the treaties between U.S. and these other countries.[44] Conversely, consider the case of an FFI that is an Irish collective investment undertaking that is treated as a partnership for U.S. federal income tax purposes, but is eligible in its own right for the benefits of the U.S.-Ireland tax treaty.[45] Not to grant a refund of the withheld tax in the case of such an entity (because its

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43 *See* Code Section 1474(b).

44 *See, e.g.*, Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Jul. 24, 2001, Art. 1, §8; Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31, 1994 (as amended by the Protocol Amending the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Paris on August 31, 1994, as Amended by the Protocol Signed on December 8, 2004) Art. 4, § 3.

45 *See* Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, July 28, 1997, Art. 4, § 1(d). We note, however, that partnerships and pass-through entities established in most countries with which the United States has a tax treaty are not eligible, in their own right, to claim treaty benefits, which instead are claimed by the ultimate beneficial owners.

members may be FFIs and not treaty-eligible) would violate the terms of the U.S.-Ireland tax treaty.

Accordingly, we would apply the beneficial ownership test in a manner so as to avoid a conflict with any treaty obligation of the United States. That is, we would recommend that a pass-through entity be considered the beneficial owner of a payment only if that results in the application of a treaty exemption from withholding (or a reduced rate of withholding) at the entity level, and otherwise (including to the extent that it gives rise to a lesser rate of withholding tax), that the members of the pass-through entity be treated as the beneficial owners of the payment.

Finally, consider the case of a Cayman Islands investment partnership that has non-FFI members who are not eligible for treaty benefits. We note that, in that case, its non-FFI members could well be exempt or excepted NFFEs (*e.g.*, foreign governments, international organizations, tax exempt institutions, publicly traded corporations—foreign or domestic, or active foreign businesses) or would have been entitled to a refund of the withheld Chapter 4 tax had they held the investment directly. Ordinarily, it is the members of a pass-through entity that would be considered the relevant taxpayers, and, with respect to taxes imposed under Code Sections 871 and 881, withholding would have been based on their status.[46] One might say that the FFI status of the entity "carries over" or "taints" the partners'/beneficiaries' investment in the partnership (much like a permanent establishment of a partnership gives rise to a permanent establishment for a partner), and that while taking an "aggregate approach" to withholding makes sense under Code Sections 871 and 881, part of the intent of this rule is to encourage FFIs, including partnerships and pass-through entities, to enter into FFI Agreements. We recognize these concerns and believe they warrant careful consideration; however, in our view, this rule seems unduly harsh, particularly in light of the need for the relevant partner or beneficiary to identify itself to the IRS to obtain the relevant refund.[47] That identification serves the purpose of Chapter 4, and therefore the denial of a refund to those persons would seem to be unnecessary. This is not like the permanent establishment case, where the existence of the partnership's permanent establishment changes the nature of the partnership's (and therefore the partners') income. In these cases, the income is treated as investment income whether earned by the entity or the member.

F. Future Guidance Should Have the Flexibility to Adapt to Developments in Information Exchange Programs.

Section V.H of the Notice requests comments on potential approaches to reduce the burden imposed by Chapter 4 on Participating FFIs, and, in particular, alludes to potentially exempting Participating FFIs from the obligation to perform withholding on passthru payments

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46 *See generally* Treas. Reg. § 1.1441-5.

47 While we recognize that if the Cayman Islands investment vehicle were a corporation no refund would be permitted, we note that for U.S. federal income tax purposes partners in a partnership are treated differently than shareholders in a corporation. Namely, in a partnership the tax obligations flow through to the partners and it is usually the partner's status that is relevant for tax purposes. We think that it is reasonable to expect that these rules would also follow that flow-through treatment.

to individual recalcitrant account holders in cases where information that allows the IRS to identify those recalcitrant account holders can be obtained through an information exchange request.

To the extent identifying such individual recalcitrant account holders through information exchange requests is technically feasible, we think this proposal is appropriate and helpful. More significantly, however, IRS officials have expressed interest in using Chapter 4 as the basis of a unified, international information exchange program.[48] To the extent that automatic information exchange becomes an international standard, it has the potential to obviate the need for much, if not all, Chapter 4 reporting. For example, to the extent that the IRS is able to identify an FFI's U.S.-person accountholders through an automatic information exchange program, we believe there is little reason to require Participating FFIs to report the same information to the IRS. Although such international programs are generally at the conceptual stage, and issuing specific guidance on this topic is likely premature, we urge the Treasury Department and the IRS to consider building flexibility into the guidance they issue on Chapter 4 to minimize the amount of information required to be reported by Participating FFIs to the extent it duplicates information that is reported to the IRS through an automatic information exchange system.

For example, to the extent that regulations are adopted to implement Chapter 4, we would strongly urge that such regulations have a placeholder for such multilateral or bilateral alternatives to Chapter 4 reporting, and allow, as an alternative to compliance with the terms of an FFI agreement, an FFI to comply with the relevant terms of any multilateral or bilateral international agreement set forth in a revenue procedure or otherwise. This would be a signal to other countries and multilateral organizations that the United States intends to be cooperative in eliminating tax evasion through the use of offshore accounts, and in implementing Chapter 4. In this way, other jurisdictions and international organizations will have an incentive (i) to cooperate in the implementation of Chapter 4 and (ii) to coordinate the implementation of their own anti-tax evasion rules with the United States. It will also permit such international rules, if they do become a reality, to be adopted by the United States, without the need for full implementing regulations.

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We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters or if we can assist you in any other way.

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[48] *See* Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman before the OECD/BIAC (June 8, 2010) ("We hope that all countries with developed tax systems will soon begin coming together to work on a unified information reporting system on a multi-lateral basis.").