NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE FINAL FATCA REGULATIONS:

DEFINITIONS OF "FFI," "FINANCIAL ACCOUNT" AND RELATED TERMS

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Report No. 1282

New York State Bar Association Tax Section Report on the Final FATCA Regulations: Definitions of "FFI," "Financial Account" and Related Terms

I. Introduction

This report[1] comments on the final regulations under Sections 1471 through 1474 of the Code (commonly referred to as "**FATCA**")[2] issued by the U.S. Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") on January 28, 2013 (the "**Final Regulations**").[3] The Final Regulations reflect significant modifications to the proposed regulations under FATCA that were released in 2012 (the "**Proposed Regulations**").[4] Treasury and the IRS received an enormous volume of comments on the Proposed Regulations from a wide variety of stakeholders and other commentators.[5] Reviewing and considering the comments, concerns and suggestions, and making the judgement calls necessary to finalize the regulations was a daunting task. We commend Treasury and the IRS on this significant achievement. The Final Regulations reflect a careful and thoughtful balancing of many different (and sometimes competing) goals, including reducing administrative burdens and advancing the

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[1] The report may be cited as NYSBA Tax Section Report No. 1282, "Report on the Final FATCA Regulations: Definitions of 'FFI,' 'Financial Account' and Related Terms" (April 29, 2013). The principal author of this report is Philip Wagman. Significant contributions were made by Kimberley S. Blanchard, Andrew H. Braiterman, Saul Brander, Dana Brodsky, Dennis Caracristi, Avrohom Gelber, Stephen B. Land, Jiyeon Lee-Lim, Dean Marsan, David T. Moldenhauer, John Narducci, Rebecca Pereira, Carolina Perez Lopez, Burt Rosen, John Sasopoulos, Michael L. Schler, Jason Schwartz, Crosby A. Sommers, Robert J. Staffaroni, Adina T. Wagman, Andrew Walker, Davis J. Wang, S. Eric Wang, Isaac J. Wheeler and Diana L. Wollman. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] References in this report to "**Section(s)**", unless otherwise stated, are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**") and the regulations thereunder. FATCA was enacted as part of the Hiring Incentives to Restore Employment Act of 2010, Public Law 111-147, which added these sections as chapter 4 of Subtitle A of the Code ("**chapter 4**").

[3] T.D. 9610, 78 Fed. Reg. 5,874 (Jan. 28, 2013).

[4] Notice of Proposed Rulemaking (REG-121647-10), 77 Fed. Reg. 9,022 (Feb. 15, 2012).

[5] We have previously submitted a report on the Proposed Regulations, as well as reports on the statute and the three IRS Notices related to FATCA that preceded the Proposed Regulations. *See* New York State Bar Association Tax Section, *Comments on the Foreign Account Tax Compliance Legislation* (Rep. No. 1199, Jan. 11, 2010); New York State Bar Association Tax Section, *Report on IRS Notice 2010-60* (Rep. No. 1224, Nov. 16, 2010); New York State Bar Association Tax Section, *Report on IRS Notice 2011-34 and IRS Notice 2011-53* (Rep. No. 1253, Jan. 12, 2012); New York State Bar Association Tax Section, *Report on the Proposed FATCA Regulations* (Rep. No. 1267, May 29, 2012).

statute's purpose of using effective information reporting to limit opportunities for tax avoidance. The Final Regulations also include changes designed to integrate the regulations with intergovernmental agreements relating to FATCA ("**IGAs**") that the United States has signed or expects to sign with other countries.

The preamble to the Final Regulations (the "**Preamble**")[6] indicates that Treasury and the IRS will, no later than July 15, 2013, open an electronic portal through which foreign financial institutions ("**FFIs**") that decide to participate in the FATCA reporting regime can register as "participating FFIs." FFIs that opt to become participating FFIs will need to be able to identify which instruments and products they have issued are "financial accounts" and, thus, are subject to the documentation and reporting requirements of FATCA.

Accordingly, the provisions in the Final Regulations that define "financial institution" (and thus define "FFI") and "financial account" will be important in the very near term, because the scope of those definitions will guide foreign entities' decisions whether they should register with the IRS within the next several months as participating FFIs. In addition, foreign entities that do chose to become participating FFIs will need to commence, in the near term, a review of the holders of their financial accounts.

In this report, we discuss suggested clarifications and modifications to the definitions of "financial institution," "financial account" and related terms in the Final Regulations. At present, the definitions of these terms in the Final Regulations are unclear in important respects and, in a number of cases, will lead to results apparently not intended by Treasury or the IRS. We believe that, with modest changes, these provisions in the Final Regulations can better achieve their intended purposes. Our recommendations are, in many cases, in the nature of technical corrections which can be made without reconsidering the policies that appear to underlie the relevant provisions in the Final Regulations. Accordingly, we believe and hope that most of these recommendations could be implemented in the near term, prior to the opening of the electronic portal.[7]

II. <u>Summary of Recommendations</u>

As discussed further in Part III, our principal recommendations are:

1. Paragraph (A) of Treasury Regulation Section 1.1471-5(e)(4)(i) should be clarified to state whether an investment advisor must have authority to make investment decisions on behalf of customers in order to be considered an investment entity under that paragraph. If such authority is not required, the Final Regulations should state more clearly the

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[6] The Preamble is available at T.D. 9610, 78 Fed. Reg. 5,874 - 99 (Jan. 28, 2013).

[7] We may subsequently submit comments on other issues raised by the Final Regulations. We have limited this Report to certain issues that we believed were both time-sensitive and relatively technical.

nature of the services that an entity must perform in order to qualify as an investment entity under paragraph (A). The examples in Treasury Regulation Section 1.1471-5(e)(4)(iv) should be revised so that they illustrate more precisely the requirements of paragraph (A).

2. Paragraph (B) or Treasury Regulation Section 1.1471-5(e)(4)(i) should be clarified to state whether all (or almost all), or alternatively some (significant) minimum portion that is less than all (or almost all), of an entity's assets must be managed in order for the entity to be considered an investment entity under paragraph (B). In addition, it should be clarified that an entity will fall within paragraph (B) if multiple professional managers together manage the specified amount of the entity's financial assets.

3. Paragraph (C) of Treasury Regulation Section 1.1471-5(e)(4)(i) should be clarified to expressly provide that in order for an entity to be an investment entity under that paragraph the entity's gross income must be primarily attributable to investing, reinvesting or trading in financial assets, and equity interests in the entity must have been "held out" to investors.

4. In the definition of "custodial institution" in the Final Regulations, the gross income test should be clarified so that it includes fees for providing financial advice only if the advice relates to financial assets held in custody with that entity.

5. The Final Regulations should be revised to provide that a holding company or treasury center in a corporate group will be a financial institution only if (<u>in addition</u> to satisfying the requirements of Treasury Regulation Section 1.1471-5(e)(1)(v)(A) or (B)), the holding company or treasury center <u>also</u> meets one of the four conditions that would cause the holding company or treasury center to have financial accounts (i.e., the conditions set out in Treasury Regulation Sections 1.1471-5(b)(1)(iii)(B)(1) through (4).

6. Treasury and the IRS should provide further guidance as to when a holding company or treasury center in a corporate group is "formed in connection with or availed of by" an investment fund under Treasury Regulation Section 1.1471-5(e)(1)(v)(B). Particularly if Recommendation 5 is not accepted, the Final Regulations should be clarified to reflect that a holding company or treasury center will be treated as not meeting this requirement if all of the funds that form or avail themselves of the holding company or treasury center are participating FFIs, sponsored FFIs, or Model 1 FFIs. Alternatively, another reasonable approach would be to state that a holding company or treasury center will not be considered to be "formed in connection with or availed of by" an investment fund, unless one or more FFIs that are not participating FFIs, sponsored FFIs or reporting Model 1 FFIs together own (directly or indirectly) at least a specified percentage (say 10% or 20%) by vote or value of the holding company or treasury center.

7. The exclusion from the definition of "financial institution" for holding companies, treasury centers and captive finance companies that are members of a "nonfinancial group" should be clarified in several respects:

(a) The regulation should expressly state that the exclusion is available where an expanded affiliated group ("**EAG**") has been in existence for less than 3 years, so long as the EAG meets the income and asset tests set forth in the regulation for the period during which it has been in existence.

(b) The requirement that no more than 25% of the EAG's income be passive income should be revised to avoid inappropriate inclusion of income from transactions between members of the EAG.

(c) Similarly, the requirement that no more than 25% of the EAG's assets be passive assets should be revised to avoid inappropriate inclusion of interests or obligations issued by an EAG member that are held by another EAG member.

(d) Gain or loss on an EAG member's sale of an interest in or obligation of another EAG member should be characterized as active or passive using look-through principles (and this change should be made to the definition of passive income contained in the NFFE rules, which are incorporated by reference here).

8. The transitional relief provision granting deemed-compliant FFI status (through the end of 2016) to certain securitization vehicles that were formed before 2012 is in need of certain technical revisions, in order to be available in the cases where it was intended to apply.

9. Clarification should be made to the rule providing that debt or equity interests issued by an FFI will not be considered a “financial account” if the debt or equity is publicly traded. The rule incorporates by reference a provision in the NFFE rules which tests whether an entity as a whole is eligible for a publicly-traded exception from treatment of an NFFE, whereas the exclusion of debt and equity interests from the definition of "financial account" applies separately to each class of interests. We suggest specific wording changes to bridge the gaps between the two provisions.

10. The rule in the Final Regulations that treats a non-publicly traded debt or equity interest in a bank, custodian or insurance company as a financial account only if the interest's value is determined primarily by reference to assets that give rise to withholdable payments (or if the interest is otherwise issued with a principal purpose of avoiding FATCA reporting or withholding) should be modified, so that such rule applies whether or not the bank, custodian or insurance company is also an investment entity.

11. In the definition of financial account, it should be clarified that a non-publicly traded debt interest will not be considered to have a value determined primarily by reference to

assets that give rise to withholdable payments solely because the debt is secured by assets of a U.S. person, unless the debt is secured solely or primarily by those assets. In addition, Treasury and the IRS should consider providing that only nonrecourse debt that is so secured will be treated as having a value determined primarily by reference to assets that give rise to withholdable payments.

12. In the rule providing that a debt or equity interest of a holding company or treasury center is a financial account if at least 50% of the EAG's income is derived by investment entities or passive NFFEs, it should be clarified that income will be computed for purposes of such test in a manner consistent with Recommendations 7(b) and 7(d).

13. The definition of "U.S.-owned foreign entity" should be corrected by removing a phantom cross-reference.

14. In the definition of "owner," it should be made clear that the definition does not incorporate constructive ownership concepts.

15. In the definition of "offshore obligation," it should be clarified that equity issued by a foreign entity will be an offshore obligation if the owner purchased the equity in a sale where both the seller and the purchaser acted from offices outside the United States.

In the case of many of these recommendations, we have provided for your consideration specific drafting that could be inserted in the Final Regulations in order to implement the recommendations.

III. Discussion

A. Comments on the Definition of "FFI" and "Deemed-Compliant FFI"

1. Scope of the "investment entity" category of financial institutions

The Final Regulations generally define an FFI as any foreign entity that is a "financial institution."[8] One category of financial institution, in turn, is an "investment entity," which means:

> "any entity that is described in paragraph (e)(4)(i)(A), (B), or (C) of this section.
>
> (A) The entity primarily conducts as a business one or more of the following activities or operations for or on behalf of a customer—
>
> (1) Trading in money market instruments (checks, bills, certificates of deposit, derivatives, etc.); foreign currency;

[8] Treas. Reg. § 1.1471-5(d).

foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures;

(2) Individual or collective portfolio management; or

(3) Otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons.

(B) The entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets (as defined in paragraph (e)(4)(ii) of this section) and the entity is managed by another entity that is described in paragraph (e)(1)(i) [depository bank], (ii) [custodian], (iv) [specified insurance company], or (e)(4)(i)(A) of this section. For purposes of this paragraph (e)(4)(i)(B), an entity is managed by another entity if the managing entity performs, either directly or through another third-party service provider, any of the activities described in paragraph (e)(4)(i)(A) of this section on behalf of the managed entity.

(C) The entity functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets."[9]

The Preamble indicates that one of Treasury's and the IRS's goals in drafting the definition of investment entity was generally to follow the approach taken in the IGAs to defining this term.[10] In paragraph (A) of the definition, the Final Regulations do correspond

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[9] Treas. Reg. § 1.1471-5(e)(4)(i). For purposes of paragraph (A), an entity is treated as "primarily conducting as a business" one or more of the activities described in that paragraph, if "the entity's gross income attributable to such activities equals or exceeds 50 percent of the entity's gross income during the shorter of-- (1) [t]he three-year period ending on December 31 of the year preceding the year in which the determination is made; or (2) [t]he period during which the entity has been in existence." Treas. Reg. § 1.1471-5(e)(4)(iii)(A). (A special rule is provided for start-up entities under which they are considered to meet the "primarily conducting" test based on the anticipated nature of their activities. Treas. Reg. § 1.1471-5(e)(4)(iii)(B).)

For purposes of paragraph (B), an entity's gross income is "primarily attributable to investing, reinvesting, or trading in financial assets" if "the entity's gross income attributable to investing, reinvesting, or trading in financial assets equals or exceeds 50 percent of the entity's gross income during the shorter of-- (1) [t]he three-year period ending on December 31 of the year preceding the year in which the determination is made; or (2) [t]he period during which the entity has been in existence." Treas. Reg. § 1.1471-5(e)(4)(iv)(A). (Again, a special rule is provided for start-up entities under which they are considered to meet the "primarily attributable to" test based on the expected nature of their activities. Treas. Reg. § 1.1471-5(e)(4)(iv)(B).)

[10] *See* Preamble at 5,888.

fairly closely to the IGAs' approach, using wording that largely follows that of the IGAs.[11] However, the Final Regulations contain examples of the application of paragraph (A) that appear possibly to be at odds with the substantive requirements of that paragraph and of the IGAs. In addition, paragraphs (B) and (C) represent a departure from the definition used in the IGAs, in ways that it is not clear are intended.

(a) Clarification of the types of activities that an entity must conduct to be described in Treasury Regulation Section 1.1471-5(e)(4)(i)(A)

Under the Final Regulations, it is not entirely clear whether an entity must have authority to make binding investment decisions on behalf of customers whose financial assets it manages, in order to fall within paragraph (A) of the definition of investment entity. It seems that the corresponding portion of the IGAs' definition of investment entity does require such authority,[12] and paragraph (A) can reasonably be read as requiring such authority. Clause (1) refers to the manager "trading in" financial assets for customers; clause (2) refers to "management" of customers' portfolios; and clause (3) refers to "otherwise investing, administering or managing" financial assets on behalf of other persons. Collectively, the quoted words can be read as emphasizing the ability of a manager to decide whether to acquire or dispose of financial assets for customers.

The Model 1 IGA provides that the term "investment entity" means "any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer: (1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading; (2) individual and collective portfolio management; or (3) otherwise investing, administering, or managing funds or money on behalf of other persons." Model 1 Intergovernmental Agreement, clause 1(j). The Model 2 IGA exactly tracks the Model 1 IGA, except that at the end of clause (1), the word "trading" does not appear after "commodities futures." Both model IGAs go on to state that the definition will be interpreted in a manner consistent with similar language set forth in the definition of "financial institution" in recommendations by the Financial Action Task Force. The IGAs into which the United States has entered to date all contain wording that tracks the quoted text from the model IGAs.

[11] The three differences are relatively small: the lead-in wording in the IGAs refers to an entity that "conducts," rather than an entity that "primarily conducts," one or more of the activities listed in (1), (2) and (3); clause (1) in the IGAs does not refer to "foreign currency," instead referencing "foreign exchange"; and clause (3) in the IGAs refers only to "funds or money," rather than "funds, money or financial assets."

[12] In HM Revenue and Customs' Guidance Notes concerning the implementation of the Model 1 IGA between the United Kingdom and the United States, a similar question is addressed: whether an independent financial advisor that provides advice to clients about whether to invest in a fund, but does not itself own and sell interests in that fund, is considered an investment entity. The Guidance Notes conclude it is not. *See* HM Revenue and Customs, *Implementation of International Tax Compliance (United States of America) Regulations 2013: Guidance Notes*, paragraph 2.18 (Advisory-only distributors).

In addition, a reading of paragraph (A) that requires an entity to have authority to make investment decisions could be seen as fitting well with other, related provisions of the Final Regulations. Paragraph (B) of the definition of "investment entity" includes an investment fund or collective investment vehicle that owns financial assets managed by an entity described in paragraph (A) or other financial institution. Such a fund or vehicle would generally have a manager with authority to make investment decisions. Furthermore, this reading of paragraph (A) also would fit naturally with the "sponsored entity" rules in the Final Regulations, pursuant to which an investment vehicle that has a manager with authority to manage and enter into contracts on behalf of the vehicle can opt to be treated as a deemed-compliant FFI and to have the manager perform the same reporting under FATCA as the investment vehicle would need to do if it were a participating FFI.[13]

In the context of the FATCA regime, limiting paragraph (A) to managers that have investment authority over the financial assets owned by customers has a logic to it: such managers are relatively likely to have (and be able to report, under the sponsored entity rules or otherwise) useful information about the types of assets owned by, and the types of income received by, their customers; additionally, if the manager's customer is an investment fund described in paragraph (B) of the definition of investment entity, there might be concerns that the manager could conceivably direct the flow of income earned on the fund's financial assets in a manner that would avoid the intent of FATCA, if the manager was not itself treated as a financial institution.[14] Thus, there are reasons in favor of construing paragraph (A) as referring only to managers that have investment authority over their customer's assets.

If paragraph (A) were read more broadly (as not requiring investment discretion), then it could include any entity that executed trades on its client's instructions, even a brokerage firm. This would lead to an extremely expansive definition of investment entity, especially because of the interplay between paragraphs (A) and (B): for example, an entity with brokerage accounts that the entity (rather than the broker) managed would qualify as an investment entity under paragraph (B). In our view, it is clear that paragraph (A) is not intended to be read so broadly. The Preamble states that passive entities that are not "professionally managed" are treated as NFFEs under the Final Regulations, rather than as FFIs.[15] That statement would prove largely

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[13] Treas. Reg. § 1.1471-5(f)(1)(i)(F)(3), (f)(2)(iii).

[14] For example, the manager could agree with investors that wanted to acquire an interest in the fund's portfolio, but did not want to invest in an FFI, that the manager would receive fees or carried interest from the fund measured based on the performance of the fund's portfolio; and the investors would hold equity interests in the manager that would give them an economic stake in such fees or carried interest. If the manager was not itself an investment entity and was treated as a corporation for U.S. federal income tax purposes, then such investors would not be subject to FATCA reporting on distributions they received from the manager; and such distributions also generally would not be withholdable payments under FATCA. It would be comparatively difficult to engage in this type of behavior if the manager did not have discretion to decide how the fund's financial assets would be invested.

[15] Preamble at 5,876.

meaningless as a practical matter, if every passive entity that held its financial assets in brokerage accounts had to be treated as an investment entity under paragraph (B) (and thus as a financial institution), because the brokerage firm was an investment entity described in paragraph (A). The same point applies to a passive entity that receives other standard types of ministerial or support services from a service provider that has only limited involvement with, and information about, the entity (for example, preparation of a passive entity's financial statements by an accounting firm): the Final Regulations appear clearly not to be designed to cause every investment vehicle that receives such services to be an investment entity under paragraph (B), and every company that provides such services to be an investment entity under paragraph (A).

An alternative approach would be to include within paragraph (A) any manager that either has investment discretion or that performs other significant activities with respect to the financial assets in the customer's portfolio such that it has access to current, complete information about the customers' investments, the income from those investments and, in the case of a customer that is an investment vehicle, the owners of the vehicle and distributions made to those owners. Such a manager would generally be in a good position to handle the FATCA compliance obligations of customers that are investment entities under paragraph (B) (investment funds and similar vehicles) under the sponsored entity rules.[16]

The examples in Treasury Regulation Section 1.1471-5(e)(4)(iv), however, are written in a way that creates some uncertainty whether there are such limits on the scope of paragraph (A). In Example 1, Fund Manager, an investment entity within the meaning of paragraph (A), among

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[16] We note that, under the Final Regulations, a manager described in paragraph (A) that is not a custodian or depository institution normally does not have obligations to report on investment funds (or similar vehicles) that it manages, or on other customers, provided that the manager does not act as a withholding agent with respect to payments made to such funds or customers, or make payments to nonparticipating FFIs in 2015 or 2016. *See* Treas. Regs. §§ 1.1471-4(b)(1), 1.1474-1(d)(4)(iii).

In addition, a manager that does not have broad authority to act on behalf of an investment fund described in paragraph (B) also cannot serve as a sponsor for the fund, under the "sponsored entity" rules as currently drafted. *See* Treas. Reg. § 1.1471-5(f)(1)(i)(F)(3)(i) and (f)(2)(iii)(B). However, in practice, the manager could nevertheless assist the fund with the fund's FATCA reporting obligations.

Whether or not paragraph (A) is intended to be read broadly, so that it extends to an entity that lacks authority to make investment decisions for customers, Treasury and the IRS could consider broadening the sponsored entity rules. Specifically, the rules could be revised so that any entity can serve as a sponsor of an investment vehicle for which it performs services, so long as such entity has access to current, complete information about the income, assets and interest holders of the investment vehicle and also has authority to take actions binding on the investment vehicle with respect to FATCA due diligence, reporting and withholding. If an entity meets these criteria with respect to an investment vehicle for which it performs services, then it would seem that the absence of a broad, general power to make decisions or take actions on behalf of such investment vehicle (including making decisions that are unrelated to FATCA) should not limit as a practical matter the manager's ability to serve effectively as a sponsor for the investment vehicle.

its business activities organizes and manages funds, including Fund A (a fund investing primarily in equities). Fund Manager hires Investment Advisor to provide advice about the assets in which Fund A invests; and Investment Advisor, a foreign entity, has earned over 50% of its gross income over the past three years from providing services as an investment advisor. Example 1 concludes that Investment Advisor is an FFI described in paragraph (A) of the definition of investment entity. The example does not indicate that Investment Advisor has the power to make investment decisions, rather than just recommendations, for Fund A or the other customers that it advises. If it is the case that Investment Advisor does lack such authority, the example does not indicate whether Investment Advisor performs other functions for Fund A or its other customers that give Investment Advisor access to substantial amounts of information about their financial assets, the income those assets generate, and (in the case of Fund A and other customers that are investment vehicles) the customers' owners.

Similarly, in Example 8, IB, an introducing broker, provides investment advice to clients and also uses the services of another entity to execute trades on behalf of clients. IB has gross income for the past 3 years over 50% of which is from services of acting as an investment advisor. IB is s stated to be an investment entity under paragraph (A). The example does not explain whether IB has authority to make investment decisions on behalf of customers or indicate whether IB performs services that give it access to substantial information about funds or other customers that is useful to the FATCA reporting process.

Recommendation 1: We suggest that paragraph (A) be clarified to state expressly whether an entity must have authority to make investment decisions on behalf of customers in order to be treated as an investment entity under that paragraph. If authority to make investment decisions is required, then we recommend that Examples 1 and 8 be clarified, to state that over 50% of the investment advisor's gross income over the past 3 years in each example has come from investment recommendations that the advisor has the authority to implement for its customers. Alternatively, if authority to make investment decisions is not required under paragraph (A), then we recommend that the Final Regulations state more clearly the nature of the services an entity must provide in order to qualify under paragraph (A); and we recommend that the examples in Treasury Regulation Section 1.1471-5(e)(4)(iv) be revised so that they are more precisely tailored to the requirements set out in paragraph (A).

(b) Clarification that an entity will not be an "investment entity" under Treasury Regulation Section 1.1471-5(e)(4)(i)(B), unless one or more managing entities manage all or a substantial portion of its investment portfolio

Treasury Regulation Section 1.1471-5(e)(4)(i)(B) provides that an entity will be considered to be managed by an investment entity described in paragraph (A), a bank, a custodian or an insurance company if the managing entity performs "any of the activities described in paragraph (e)(4)(i)(A) on behalf of the managed entity." These words might

literally be read as covering a case in which a managing entity invests or manages any portion of the total portfolio of the managed entity, no matter how small. For example, if a passive entity owned and managed by family members holds a $10 million portfolio of financial assets, including a few thousand dollars in a managed brokerage account, then that entity might be seen as literally satisfying the definition of "investment entity" in paragraph (B). The same would be true for a holding company hat almost exclusively owns shares of nonfinancial operating subsidiaries, but also has a small managed brokerage account.

Such a reading of "any of the activities described in paragraph (e)(4)(i)(A)" would seem to fit only with difficulty with the language in the preceding sentence of paragraph (B). The preceding sentence refers to "the entity" being managed by another entity, and not just to some assets of the entity being managed. Such reading also would appear to constitute a departure from the corresponding portion of the IGAs' definition of investment entity.[17] We believe that such a reading may well not have been intended, particularly in view of the statement in the Preamble that passive-type entities that are not professionally managed are intended to be treated as nonfinancial foreign entities ("**NFFEs**"), rather than as FFIs.[18]

A reading that would fit better with the overall language of the definition of investment entity and the apparent intent behind that language, would be to view the last sentence as merely clarifying what types of services a manager needs to provide with respect to the (entire) investment portfolio held by a passive entity, in order for the entity to be considered "managed" by that manager. This interpretation fits with the reference in the regulation to "the entity" (i.e., the entire entity) as being managed,[19] and also appears to correspond to the IGAs' approach. Further, this reading fits with the expectation embodied in the Final Regulations (referenced above) that frequently an investment entity will be sponsored by a single manager that will have overall responsibility for the entity.[20]

Assuming this interpretation of paragraph (B) is what is intended, it would be appropriate to amend paragraph (B) to make it clear that investment management services of a professional manager must be provided with respect to all (or almost all) of the financial assets held by the managed entity, instead of stating only that such services must be provided "on behalf of the managed entity." In addition, we believe it also would be appropriate to make it clear that these

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[17] *See* note 11 above. The IGAs refer to an investment entity as an entity that is "managed by" an entity that conducts asset management as a business, with no suggestion that management of part of the entity's assets is sufficient.

[18] "In response to comments, the final regulations treat passive entities that are not professionally managed as NFFEs rather than as FFIs." Preamble at 5,876.

[19] This reading also fits with Example 6 in Treasury Regulation Section 1.1471-5(e)(4)(v), in which a trust is held to be an investment entity because a trust company, as trustee, manages and administers all of the trust's assets.

[20] Treas. Reg. § 1.1471-5(f)(1)(F)(3), (f)(2)(iii)(E).

services may be provided by more than one professional manager. For example, if an investment fund's financial assets are divided into three different portfolios, each of which is overseen by a different manager, there would seem to be no sound policy reason for the fund to be outside of paragraph (B) while the same fund would be in paragraph (B) if it had a single manager.

If what is intended is that an entity will be considered to be managed by another entity (or entities) even where less than all (or almost all) of the financial assets are so managed, then we suggest that intent be clarified. In that case, we also suggest that it be clarified that paragraph (B) would not apply, if the professional manager(s) managed only a small part of the entity's portfolio. Specifically, we suggest that the regulation provide that a passive entity would be considered to be managed only if a professional financial manager or managers provide services of the type described in paragraph (A) with respect to financial assets representing at least (say) 20% by value of the financial assets held by such entity. (For this purpose, the relevant percentage of assets could be computed in a manner corresponding to the test in Treasury Regulation Section 1.1472-1(c)(1)(iv)(C) for whether an entity is a passive NFFE in a given year: the potential investment entity could determine the value of its assets that are managed by a professional manager, as a percentage of the entity's overall portfolio of assets, on a quarterly basis during the year, and the entity could be given the choice of using fair market value or book value used in the entity's balance sheet.) In addition, if desirable in the case of passive entities with large portfolios of financial assets, the type of percentage-of-assets safe harbor just described could be subjected to a dollar limit; thus, if (for example) a professional investment manager or managers have authority over many millions of dollars (say, $10 million) of financial assets of a passive entity, then the entity will be treated as an investment entity even though such amount may represent only a comparatively small percentage of its total financial assets.[21]

Recommendation 2: We suggest that paragraph (B) be clarified to state expressly that it applies only when all (or all but a minimal amount) of an entity's financial assets are managed by a professional manager. If that is not what was intended, then paragraph (B) should specify a bright line test for the portion of the entity's assets that must be managed (so as to not to encompass an entity that has only a small portion of its financial assets managed). In addition, whatever threshold is selected for the portion of an entity's financial assets that must be

[21] A similar alternative approach would be combine the two requirements currently in paragraph (B) (the entity's income is "primarily attributable" to investment in financial assets, and the entity is managed by a professional manager) into a single test that would require that the entity's income be "primarily attributable" to investment in financial assets that are managed by a professional financial manager. Due to the manner in which the Final Regulations define "primarily attributable," the result of the approach just described would be that financial assets managed by a professional manager would need to generate at least 50% of the entity's income over (normally) a 3-year period, in order for the entity to qualify as an investment entity under paragraph (B). This revision would simplify the regulations, by effectively combining the two requirements of (B) into one. It would require a breakdown of the entity's income along the same basic lines as is currently required by the existing paragraph (B) (income from financial assets, versus other income); the only additional step would e that income from financial assets would need to be divided into income from managed and non-managed assets.

professionally managed, it should be made clear that the threshold is considered satisfied whether a single, or multiple, managers manage that amount of the entity's assets.

(c) Clarification of when an entity "functions or holds itself out as" a fund or similar investment vehicle under Treasury Regulation Section 1.1471-5(e)(4)(i)(C)

As noted above, the wording used in paragraph (C) is unclear. Virtually any entity the principal activity of which is holding financial assets can conceivably be seen, in some respects, to "function as" a vehicle that is "similar" to an investment fund. This could include a family investment vehicle that does not have a professional manager; and it also could conceivably include a a treasury center (or perhaps a holding company) in a corporate group, even if the group only conducts active businesses unrelated to the financial sector.

However, when read in context of the overall definition of "investment entity," it appears that paragraph (C) more likely is intended to be construed as, essentially, a backstop to paragraph (B). To a large extent, the same types of entities – investment funds and other collective investment vehicles – would seem to fall within both provisions. Treasury and the IRS may have been concerned that some entities of this type could, for reasons that could not be fully anticipated, escape from paragraph (B), and thus may have conceived of paragraph (C) as an alternative means of capturing such vehicles as FFIs. In particular, paragraph (C) can be seen as designed to catch entities that are held out to unrelated investors as vehicles for investing in financial assets, and that do in fact invest principally in such assets, but that are not managed by another entity that is a professional financial manager described in paragraph (A), a bank, a custodian, or an insurance company.

The Preamble appears to confirm this view of the intended function of paragraph (C):

> "[T]he Final Regulations limit the scope of the Proposed Regulations' definition of investment entity by treating an entity….the gross income of which is primarily attributable to investing, reinvesting, or trading as an investment entity only if the entity is managed by a depository institution, a custodial institution, another investment entity, or an insurance company that qualifies as a financial institution. Accordingly, passive entities that are not professionally managed are generally treated as passive NFFEs rather than as FFIs. However, entities that function or hold themselves out as mutual funds, hedge funds, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets are investment entities."[22]

[22] Preamble at 5,888.

This interpretation of paragraph (C) is also supported by several aspects of the text of the provision. Paragraph (C) uses the word "fund" 6 times, as well as the phrase "collective investment vehicle," before moving on to the phrase "or similar investment vehicle." The focus here appears to be not just on an entity that invests largely or solely in financial assets, but on an entity that does so as a "fund" or a "collective investment vehicle" – terms that would naturally be understood as referring to a vehicle that is presented to unrelated investors as a means to invest in a portfolio of financial assets. In addition, paragraph (C) refers to an entity that "functions or holds itself out as" such a vehicle; the quoted text can easily be read as referring to a vehicle that either currently is presenting itself to unrelated parties as a means for them to invest in a pool of financial assets ("holds itself out as"), or that has done so in the past, and has attracted investors that now own the vehicle ("functions as"). Finally, this reading of paragraph (C) would appear to be consistent with the definition of "investment entity" in the IGAs. In the case of an entity that holds a portfolio of financial assets, the IGAs look to whether the entity is managed by a professional financial manager (similar to paragraph (B) of the definition of investment entity in the Final Regulations), or whether the entity conducts a "business" of investing or trading in financial assets for the benefit of "customers" (similar to paragraph (C)). Under both the IGAs and our suggested interpretation of paragraph (C), the entity must invest money of independent investors ("customers") in financial assets, having been held out to such persons as willing to do so.[23]

Recommendation 3: Assuming the intent behind paragraph (C) is to reach passive entities that are held out to unrelated investors as vehicles for investing in financial assets, including any such entities that are not managed by another entity, we recommend that several revisions be made to the language in that provision in order to clarify that intent. First, similar to paragraph (B), it should be specifically stated that the entity's gross income must be primarily attributable to investing, reinvesting or trading in financial assets (although the involvement of a professional financial manager should not be required under paragraph (C)).[24] This clarification would seem to be in keeping with (and perhaps mandated by) the language of the statute, which refers to an entity that is engaged or holds itself as engaged "primarily in the business of investing, reinvesting or trading in financial assets."[25]

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[23] We also note that the fact that the Final Regulations contain detailed rules regarding when holding companies and treasury centers in corporate groups will be treated as financial institutions further supports our view about the intended scope of paragraph (C). Paragraph (C) could not have been intended to cover every entity that invests principally in financial assets. In particular, we note that the rules in Treasury Regulation Section 1.1471-5(e)(1)(v)(A) – providing that a holding company or treasury center is a financial institution if it is in the same EAG as an investment entity – would be circular if the holding company or treasury center itself was intended to be treated as an investment entity under paragraph (C).

[24] In other words, the entity's gross income from such activities should equal or exceed 50% of the entity's gross income over the past 3 years. See Treas. Reg. § 1.1471-5(e)(4)(iv)(A).

[25] Section 1471(d)(5)(C).

Second, paragraph (C) should expressly require that interests in the entity are, or have been, held out by a manager or other agent of the entity (which would include any individual who is an employee of, or is an independent contractor acting on behalf of, the entity) to an investor or investors as interests in a vehicle for investing primarily in a portfolio of financial assets. For this purpose, "holding out" should mean that (i) a manager or other agent of the entity has actively attempted to procure investment in equity of the entity by one or more other persons; (ii) such manager or other agent has a profit motive for attempting to attract investment, because the manager or agent is expected to receive a profits interest or fees, salary or other compensation (excluding mere reimbursement of costs or expenses) from or with respect to the entity in exchange for investing, trading, managing or providing other financial services described in paragraph (A) relating to the financial assets held by the entity (or by one or more other entities that are part of the same EAG as such entity); and (iii) the entity has at least one equity investor that is not a member of the entity's EAG and is not otherwise related (within the meaning of Section 267) to any other equity investors in the entity.[26]

We believe the revisions just described would capture the key features of a vehicle that is held out as or functions as a fund, as contemplated by the language currently used in paragraph (C): a sponsor for or agent of the vehicle tries to attract capital from unrelated investors, for the purpose of investing that capital in a pool of financial assets to the mutual financial advantage of the sponsor and the investors.[27] If the drafting is changed in this manner, paragraph (C) would function more clearly and effectively as a reinforcement or support to paragraph (B), and it would not be as likely to be misconstrued to catch a wide range of passive entities beyond those to which it apparently is intended to apply. It also would comport with the concept used in the IGAs of an investment vehicle that has "customers." Thus, the revisions appear appropriate to us as a means to accomplish the Final Regulations' intent.

2. Definition of "custodial institution"

Under the Final Regulations, another type of “investment entity” is a “custodial institution”. Custodial institution is defined to mean any entity that holds, as a substantial portion of its business, financial assets for the benefit of one or more other persons.[28] The regulations go on to provide that an entity is considered to hold financial assets for others as a

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[26] Under our proposed requirement (iii), if members of a single family own all the equity of a passive entity, and it is not managed by a professional financial manager, then it would not be an investment entity under paragraph (C). We believe this result is consistent with the intent expressed in the Preamble normally to treat passive entities without a professional manager as NFFEs rather than FFIs.

[27] *Cf.* Treas. Reg. § 1.1471-5(f)(2)(iv)(A) (providing transitional deemed-compliant status for a securitization vehicle if it is an FFI "solely because it is an investment entity that offers interests primarily to unrelated investors" and meets certain additional requirements).

[28] Treas. Reg. § 1.1471-5(e)(1)(ii).

substantial portion of its business if "the entity's gross income attributable to holding financial assets and related financial services" is at least 20% of the entity's gross income over a testing period of (generally) 3 years.[29] "Income attributable to holding financial assets and related financial services" is defined to mean, among other things, custody and account maintenance fees, commissions from executing trades, income earned from extending credit on financial assets held in custody, and "fees for providing financial advice and for clearance and settlement services."[30] Thus, it appears that if an entity's sole business is to provide financial advice to clients, and it does not conduct any activities of being a custodian or broker, then it literally will qualify as a custodial institution under the Final Regulations: over 20% of its gross income will be fees for providing financial advice, which are considered to be "income attributable to holding financial assets and related financial services." We believe this result may not be intended: such an entity would bear little resemblance to the common conception of a custodial institution; and the relevant language appears in the middle of a detailed listing of other types of fees which all relate in some ways to assets in the custody or control of the entity.

Recommendation 4: Assuming the result described above is not intended, we recommend that the Final Regulations' reference to "fees for providing financial advice" be revised to refer specifically to "fees for providing financial advice with respect to financial assets held in custody by the entity."

3. Holding company or treasury center that is part of a group that includes an FFI, or that is "formed in connection with or availed of by" an investment entity

The Final Regulations provide a series of special rules for determining whether a holding company or treasury center in a corporate group will be treated as a financial institution and what (if any) financial accounts it must report if it becomes a participating FFI. Broadly speaking, these rules appear to have two objectives: to prevent nonparticipating FFIs from using a holding company or financing company as a blocker to facilitate avoidance of withholding or reporting under FATCA; and to ensure that corporate groups that principally conduct active nonfinancial businesses, and that use holding companies, finance companies or treasury centers for reasons unrelated to FATCA are not unnecessarily subjected to the FATCA regime. As currently drafted, we believe these rules may cause holding companies, finance companies and treasury centers for a corporate group to be treated as financial institutions in more cases than is intended, and the precise scope of the rules is uncertain. We suggest in this section and in the following section (Part III.A.4) some clarifications and enhancements that we believe would address these issues.

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[29] Treas. Reg. § 1.1471-5(e)(3)(i)(A).

[30] Treas. Reg. § 1.1471-5(e)(3)(ii).

The Final Regulations describe two cases in which a holding company or treasury center will be considered a financial institution. It either:

> "(A) [i]s part of an expanded affiliated group that includes a depository institution, custodial institution, insurance company, or investment entity described in paragraphs (e)(4)(i)(B) and (C) of this section; or
>
> (B) [i]s formed in connection with or availed of by a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets."[31]

A foreign holding company or treasury center that is a financial institution under the above tests will generally need to become a participating FFI and to report on certain holders of its financial accounts, if it wishes to avoid taxation under FATCA on withholdable payments it receives. For this purpose, its only financial accounts will be debt or equity interests (excluding, however, any debt or equity interests that are publicly traded) that are issued by the entity where one of the following four circumstances is present:

> "(1) The expanded affiliated group of which the entity is a member includes one or more investment entities described in paragraph (e)(4)(i)(B) or (C) of this section or passive NFFEs and the income derived by such investment entities or passive NFFEs is 50 percent or more of the aggregate income earned by the expanded affiliated group;
>
> (2) The redemption or retirement amount or return earned on the interest is determined, directly or indirectly, primarily by reference to one or more investment entities described in paragraph (e)(4)(i)(B) or (C) of this

[31] Treas. Reg. §§ 1.1471-5(e)(1)(v)(A), (B). Paragraph (A) literally states that if a holding company's or treasury center's EAG includes an investment entity, then the holding company or treasury center will not be a financial institution, unless the investment entity is described in paragraphs (B) <u>and</u> (C) of the definition of such term. We believe the "and" is intended to be an "or."

In addition, we note that the Final Regulations provide that a holding company will be a financial institution if it is a member of an EAG that includes an insurance company, and either the holding company or the insurance company issues, or is obligated to make payments with respect to, a cash value insurance contract or an annuity contract. Treas. Reg. § 1.1471-5(e)(1)(iv). In view of this specific rule for a holding company of an insurance company, it is not clear whether Treasury Regulation Section 1.1471-5(e)(1)(v)(A) is meant to apply to such holding companies. For example, a holding company that owns a property and casualty insurer would not be a financial institution under clause (e)(1)(iv); but it may literally be a financial institution under clause (e)(1)(v)(A) – notwithstanding that the insurance company that causes the holding company to be a financial institution under clause (e)(1)(v)(A) is not, itself, a financial institution. Assuming this type of anomalous result is not intended, we suggest that the reference to insurance companies be deleted from paragraph (e)(1)(v)(A).

section or one or more passive NFFEs that are members of the entity's expanded affiliated group (as determined under paragraph (b)(3)(vi) of this section);

(3) The value of the interest is determined, directly or indirectly, primarily by reference to assets that give rise (or could give rise) to withholdable payments (as determined under paragraph (b)(3)(v)) of this section); or

(4) The interest is issued with a principal purpose of avoiding the reporting or withholding requirements of chapter 4."[32]

Recommendation 5: We believe that the Final Regulations should be amended to more precisely define the circumstances under which a holding company or treasury center is treated as a financial institution, in order to better achieve the purposes of the special rules in the Final Regulations for such entities. Specifically, we propose that a holding company or treasury center should be considered a financial institution only if, in addition to satisfying the requirements of Treasury Regulation Section 1.1471-5(e)(1)(v)(A) or (B), the holding company or treasury center also meets one of the conditions set out in Treasury Regulation Sections 1.1471-5(b)(1)(iii)(B)(1) through (4) (quoted immediately above). In other words, the holding company or treasury center would be a financial institution only if it is part of an EAG that includes a depository institution, custodial institution, insurance company, or investment entity described in paragraph (B) or (C) of the definition of such term, or it is formed in connection with or availed of by a fund or similar vehicle, and in addition, it also: (1) is part of an EAG over 50% of the income of which is derived by EAG members that are investment entities or passive NFFEs; (2) issues debt or equity with economics that are linked to the performance of an EAG member that is an investment entity; (3) issues debt or equity with economics linked to assets that give rise to withholdable payments; or (4) otherwise issues debt or equity with a purpose of avoiding the requirements of FATCA.

A holding company or treasury center that satisfies this proposed test to be a financial institution would have as its only financial accounts debt or equity interests that are described in clauses (2), (3) or (4) above, or, if the holding company or treasury center is described in clause (1) above, then all of its outstanding debt and equity would be treated as financial accounts (i.e., in all cases, the same types of debt and equity as are financial accounts under the Final Regulations as currently drafted).

Our suggested change in the definition of financial institution would be helpful for several reasons. First, the Preamble suggests that Treasury and the IRS wished to treat holding companies and treasury centers as financial institutions in cases where such entities potentially

[32] Treas. Reg. § 1.1471-5(b)(1)(iii)(B)(1) – (4). We discuss further in Part III.B.4 below an interpretive issue concerning how the 50% of gross income test in (1) is applied.

could be used by FFIs as blockers to shelter payments from FATCA withholding.[33] If revised as suggested by us, the regulations would continue to be designed in a manner that targets such cases.[34]

Second, in practice, the effect of this change would be that all entities that are financial institutions and also have financial accounts under the current regulations, would continue to be financial institutions and would continue to have financial accounts. By comparison, all holding companies and treasury centers that are financial institutions under the current regulations, but that do not have financial accounts under those regulations (because none of circumstances (1) through (4) described above is present), would no longer be treated as financial institutions. We believe this to be an appropriate outcome. It seems unlikely to us that Treasury and the IRS intended the Final Regulations to produce results in which a significant number of foreign holding companies and treasury centers would be financial institutions and, thus, would be required to become participating FFIs to avoid FATCA withholding, and yet would not have any financial accounts on which they are required to report. We believe, however, that would be the result under the Final Regulations. This would seem to increase administrative burden for taxpayers and the government, without generating truly useful information reporting: such entities (to the extent they are aware of this issue) would generally enter into FFI agreements but would have no financial accounts on which to report.

The two types of reporting that such entities would be required to do under the Final Regulations if they were participating FFIs with no financial accounts are (i) reporting on withholdable payments the entity makes to nonparticipating FFIs that are not holders of

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[33] *See* Preamble at 5,889.

[34] It can be asked, both with regard to the Final Regulations as currently drafted and with regard to our proposal, whether the apparent goal of preventing the use of FATCA blockers has been fully achieved. In particular, under the Final Regulations, if a holding company or treasury center is "formed in connection with or availed of by" an investment fund that is not a member of the holding company's or treasury center's EAG, then in order to escape FATCA withholding on payments it receives, the holding company or treasury center will need to become a participating FFI. However, in general, the practical impact of its doing so will simply be that it will need to report on dividend or interest payments it makes to the investment fund. *See* Treas. Reg. § 1.1474-1(d)(2)(i)(D), (d)(4)(iii)(C). The investment fund that owns an interest in the holding company or treasury center will be an FFI. However, whether or not it opts to become a participating FFI, the investment fund will receive foreign-source dividend and interest payments from the holding company or treasury center free of FATCA withholding, in the absence of foreign passthru payment withholding rules. It also will be able to sell its interest in the holding company or treasury center without any FATCA withholding on the sale proceeds. As a result, the investment fund may not have any strong incentive to become a participating FFI and report on its U.S. investors.

Our proposal would neither aggravate nor remove this issue. As mentioned in a prior report on FATCA, one possible means of addressing this issue would be for the fund, in cases that show a clear abuse, to be subject to withholding on gross proceeds from its disposition of interests in the holding company or treasury center. *See* New York State Bar Association Tax Section, *Report on the Proposed FATCA Regulations* (Rep. No. 1267, May 29, 2012), at 25 n.43.

accounts,[35] and (ii) reporting for 2015 and 2016 on "foreign reportable payments" (i.e., payments of FDAP income that would have a U.S. source if paid by a U.S. person) that the entity makes to nonparticipating FFIs that are not holders of accounts.[36] As to the first type of reporting, we note that the entity would generally be required to do such reporting anyway under the Final Regulations (i.e., even if it were not a participating FFI), because it would be a withholding agent with respect to such withholdable payments.[37] As to the second type of reporting, the effect of our proposal is that the entity would not be required to do such reporting). This result appears appropriate – if foreign reportable payments do not merit reporting when received they are received directly by a specified U.S. person that owns debt or equity of the entity (because the debt or equity is not a financial account), then it would seem logical that such reporting also would not be required if the recipient of the payment is a nonparticipating FFI that owns such debt or equity.[38]

A third consideration weighing in favor of our proposed change is that it would significantly lessen uncertainty and potential pitfalls for corporate groups. We believe corporate groups that are largely devoted to the conduct of an active nonfinancial business will frequently have at least one member that is a financial institution. Under the current formulation in the Final Regulations, the presence of that one financial institution in the EAG (no matter how small it is relative to the EAG as a whole) would mean that each foreign holding company and treasury center in that group would be an FFI. We believe that our proposal will lessen the likelihood that a corporate group will unexpectedly find itself in the position that its holding company and treasury center members are FFIs.

In addition, if the proposed change is not made, then the second test under which a holding company or treasury center is considered to be a financial institution will be an important test and that test is inherently difficult to apply. It is not at all clear what the Final Regulations mean when they say a holding company or treasury center is "formed in connection

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35 Treas. Reg. § 1.1471-4(a)(3).

36 Treas. Reg. § 1.1474-1(d)(2)(i)(D), (d)(4)(iii)(C).

37 *See* Treas. Reg. § 1.1474-1(c), (d).

38 A third type of reporting that could in the future be required of such entities if they were participating FFIs with no financial accounts is reporting on "foreign passthru payments" made to nonparticipating FFIs. Such reporting will be required only if and when rules addressing foreign passthru payments are promulgated and, in any event, will not be required for periods before 2017. *See* Treas. Regs. §§ 1.1471-4(b)(4), 1.1471-5(h)(2), 1.1474-1(d)(2)(i)(C). In the event that rules regarding foreign passthru payments are ultimately adopted, we believe that questions about the range of entities that should be required to report on such payments could be addressed at such time. (However, similar to our observation in the text above, we note that the Final Regulations as currently drafted would not require a participating FFI to report a foreign passthru payment made directly to a U.S. person that does not hold a financial account; accordingly, there does not appear to be a compelling reason why reporting should be required for such a payment made to a nonparticipating FFI that does not hold a financial account.)

with or availed of by" an investment entity described in Treasury Regulation Section 1.1471-5(e)(4)(i)(B) or (C). The quoted words are meant to cover something other than the investment entity and the holding company or treasury center having sufficient common ownership to be part of the same EAG; Treasury Regulation Section 1.1471-5(e)(1)(v)(A) already covers that case, so paragraph (B) must be meant to reach other, less straightforward relationships. The wording indicates the need for a factual inquiry into the intent of the fund or similar vehicle that formed or acquired a stake in the holding company or treasury center, but the wording is open-ended and does not specify what type of relationship or use is germane. For example, "formed in connection with or availed of by" suggests that a holding company or treasury center does not need to be newly formed by a fund, in order to be "availed of" by it. Is a holding company or treasury center "availed of" by an investment fund in a case where the fund acquires a small equity position in the holding company or treasury center or a relatively small portion of such entity's historically outstanding debt? Or is more than that necessary – for example, acquiring a stake of a sufficient size to be able to exercise effective practical control over the entity; or the actual exercise of practical control? Also, if a holding company or treasury center is newly formed at the time a fund acquires an interest in such entity, is such entity automatically considered to have been formed "in connection with" the fund? Finally, if a holding company or treasury center is "formed in connection with" a fund or similar investment vehicle, does that mean the entity retains its status as a financial institution for the remainder of its existence, irregardless of what intervening events may arise: for example, sale by the fund or similar investment vehicle of its entire interest in the entity to a third party that is not an FFI; or a public offering by the parent of the relevant EAG, following which the fund owns only a modest minority interest in the parent and the other members?

Recommendation 6: Treasury and the IRS should ultimately provide guidance regarding the meaning of "formed in connection with or availed of." However, if the revision proposed in Recommendation 5 is made in the near term, that would lessen the pressure to articulate more precisely the meaning of this phrase because holding companies and treasury centers would know that, so long as none of the four circumstances described above is present, they will fall outside the definition of financial institution, irregardless of the meaning of the quoted language.

However, if Recommendation 5 is not accepted, then we suggest that, at a minimum, the Final Regulations be clarified to reflect that a holding company or treasury center that is "formed in connection with or availed of" by one or more investment funds will not be a financial institution if all of those funds are participating FFIs, sponsored FFIs or reporting Model I FFIs. In each of those cases, the potential for abuse that concerned Treasury and the IRS (i.e., the holding company or treasury center being used as a blocker to shield a nonparticipating FFI from FATCA) is not present. Such an entity is more appropriately treated as an NFFE.

An alternative approach would be to provide that a holding company or treasury center will not be considered to be "formed in connection with or availed of by" an investment fund unless at least one FFI that is not a participating FFI, sponsored FFI or reporting Model 1 FFI

owns (directly or indirectly) at least a specified percentage (say 10% or 20%) of the vote or value of the outstanding equity of the holding company or treasury center. Thus, a holding company or treasury center would not be a financial institution unless FFIs with no reporting responsibilities under FATCA owned a material interest in such entity.

4. Exclusion from financial institution status for holding companies, treasury centers and captive finance companies in a "nonfinancial group"

The Final Regulations do provide a limited exclusion from financial institution status for certain holding companies and treasury centers that fall within the requirements of Treasury Regulation Section 1.1471-5(e)(1)(v)(A) or (B) (set out above), but that are in a "nonfinancial group," which generally means an EAG that consists mostly of companies operating active nonfinancial businesses, rather than financial institutions or other passive entities.[39] Under the Final Regulations as currently drafted, this exclusion is a particularly important one for a corporate group, because it often will provide the sole means by which the group's foreign holding companies and treasury centers can fall outside of the potentially costly FFI reporting and withholding regime, if the group includes at least one member that is a financial institution.

If our Recommendations 5 or 6 are adopted, then the effect would be to narrow materially the circumstances in which holding companies and treasury centers would be FFIs. This would, in turn, lessen the considerable importance of the "nonfinancial group" exclusion. Nevertheless, we expect that exclusion would continue to play a significant role particularly because the "nonfinancial group" exclusion turns on objective, numerical criteria that (with the corrections and clarifications described below) will clearly indicate cases where a holding company or treasury center is not a financial institution.

Under the "nonfinancial group" exclusion, an entity is not a financial institution if it serves as a holding company, treasury center or captive finance company (or performs some combination of these functions) in a nonfinancial group, provided that the entity is not a depositary institution or custodian other than for members of its EAG, and provided that it does not hold itself out as (and was not formed in connection with or availed of by) an arrangement or investment vehicle that is a private equity fund, venture capital fund, leveraged buyout fund or similar investment vehicle.[40] A "**nonfinancial group**" is defined for this purpose as an EAG that satisfies the following requirements:

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[39] Treas. Reg. § 1.1471-5(e)(5)(i). This exclusion from financial status also is available for a "captive finance company" in an EAG, which is defined in the Final Regulations as an entity the primary activity of which is to enter into financing or leasing transactions with suppliers, distributors, dealers, franchisees, or customers of such entity or of any member of such entity's EAG that is an active NFFE. Treas. Reg. § 1.1471-5(e)(5)(i)(E).

[40] Treas. Reg. § 1.1471-5(e)(5)(i)(A).

"(1) For the three-year period preceding the year for which the determination [of nonfinancial group status] is made, no more than 25 percent of the gross income of the expanded affiliated group (excluding income derived by any member that is an entity described in paragraph (e)(5)(ii) or (iii) of this section) consists of passive income (as defined in § 1.1472–1(c)(1)(v)); no more than five percent of the gross income of the expanded affiliated group is derived by members of the expanded affiliated group that are FFIs (excluding income derived from transactions between members of the expanded affiliated group or by any member of the expanded affiliated group that is a certified deemed-compliant FFI); and no more than 25 percent of the fair market value of assets held by the expanded affiliated group (excluding assets held by a member that is an entity described in paragraph (e)(5)(ii) or (iii) of this section) are assets that produce or are held for the production of passive income; and

(2) Any member of the expanded affiliated group that is an FFI is either a participating FFI or deemed-compliant FFI."[41]

We believe that the wording of this exclusion should be revised in four respects in order to achieve the results that Treasury and the IRS intended: first, it should be clarified that the reference to a 3-year measuring period is not meant to prevent entities from qualifying for this exclusion where the EAG has existed for less than 3 years; second, the 25% passive income test can be read as leading to double-counting in an arbitrary manner, because the wording of that test is not drafted in a way that clearly eliminates intercompany income flows within the EAG from being counted; third, the wording of the 25% passive asset test similarly does not make it

[41] Treas. Reg. § 1.1471-5(e)(5)(i)(B). Although paragraph (1) quoted in the text refers to the definition of passive income in paragraph (v) of Treasury Regulation Section 1.1472-1(c)(1), that cross-reference is erroneous: the definition in fact appears in paragraph (iv) of such regulation. "Passive income" is defined there for purposes of determining whether an NFFE is an active or passive NFFE, and it includes, among other types of income: (1) dividends, including substitute dividend amounts; (2) interest; (3) income equivalent to interest, including substitute interest and amounts received from or with respect to a pool of insurance contracts if the amounts received depend in whole or part upon the performance of the pool; (4) rents and royalties, other than rents and royalties derived in the active conduct of a trade or business conducted, at least in part, by employees of the NFFE; (5) annuities; and (6) the excess of gains over losses from the sale or exchange of property that gives rise to any passive income described in (1) through (5). *See* Treas. Reg. § 1.1472-1(c)(1)(iv).

Paragraph (1) of the quoted text also makes reference to entities described in Treasury Regulation Sections 1.1471-5(e)(5)(ii) and (iii). Paragraph (ii) describes a foreign entity that either has been formed within the past 24 months and is starting up a nonfinancial business, or has reached a decision within the past 24 months to operate a new line of business, provided the entity meets certain requirements. Paragraph (iii) describes a foreign entity that either is in the process of liquidating or is reorganizing with the intent to continue or recommence operations as a nonfinancial entity, provided the entity meets certain requirements.

clear that interests issued by one EAG member to another are not counted; and fourth and finally, the wording suggests that when one EAG member sells an interest in another EAG member to a third party, gain or loss from that sale is tested under the 25% income test on a "look through" basis (i.e., by reference to the nature of the assets and activities of the member in which an interest is sold), but the rules do not make clear precisely how a look though approach should be applied.[42] We discuss each of these issues in turn.

(a) Three-year measuring period

Recommendation 7(a): By its terms, the nonfinancial group exclusion applies only when a holding company, treasury center or captive finance company is a member of an EAG that has existed for at least 3 years.[43] We assume this is inadvertent and that the exclusion is meant to apply when the EAG has existed for less than 3 years, provided the financial tests are met for all of the years that the EAG has been in existence. That would be comparable to the approach taken elsewhere in the Final Regulations.[44]

(b) 25% passive income test: transactions between EAG members

The test for whether over 25% of an EAG's gross income is passive income can be read as not excluding income from transactions between group members and, as a consequence, creating distortive results in some cases. We believe that such results are unintended. Two examples will illustrate the issue we perceive, as well as leading to suggestions about how the issue can be addressed:

> **Example 1**: Parent, a foreign corporation, owns 100% of the stock of 4 foreign corporate subsidiaries: Subs 1, 2 and 3, and FFI. Over the past 3 years, Sub 1's gross income has consisted solely of $1,000 of income from actively conducting a manufacturing or services business unrelated to the financial sector or investment in financial assets. Sub 1 is the borrower under an intercompany loan from Sub 2 and has accrued $1,000 of interest expense under that loan. Sub

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[42] This fourth issue actually arises, in the first instance, in a provision in the NFFE rules (Treasury Regulation Section 1.1472-1(c)(1)(iv)), which is incorporated by reference in the "nonfinancial group" exclusion. As discussed below, we recommend that the issue be addressed by revisions to the relevant portion of the NFFE rules.

[43] It appears that the entity does not need to have been a member of that EAG throughout this three-year period, and this makes sense to us. If a holding company or treasury center were formed or acquired by the EAG within the past 3 years, it seems reasonable to still apply the 3-year test to the EAG and to still permit the EAG to qualify under the nonfinancial group exception..

[44] *Cf.* Treas. Reg. §§ 1.1471-5(e)(3)(i)(A)(2), (B) (the regulations generally take into account income over a 3-year period in order to determine whether an entity is a custodial institution, but the period is shortened where the entity has existed for less than 3 years); Treas. Reg. §§ 1.1471-5(e)(4)(iii)(A)(2), (B) (the regulations generally take into account income over a 3-year period to determine whether an entity is described in clause (A) of the definition of investment entity, but the period is shortened where the entity has existed for less than 3 years).

2 has conducted no activities other than holding this loan and borrowing from Sub 3, and Sub 2 has accrued $1,000 of interest expense under that loan. Sub 3, in addition to holding the loan to Sub 2, also has invested in a portfolio of stock and debt of third parties that has generated $1,000 of dividend and interest income. FFI is a small bank, life insurance company or custodian that earns a small amount of interest income (assumed for sake of mathematical simplicity to be $0).

Intuitively, one might expect in such a case that the EAG's total income should be $2,000, consisting of the $1,000 of active income earned by Sub 1 and the $1,000 of passive income earned by Sub 3. This would be the result if, for example, elections had been filed to treat the three Subs as disregarded entities. The EAG's passive income would be 50% of its total income; and Parent thus would be a financial institution, because it would be a holding company in an EAG that also includes an FFI as a member.[45] However, the Final Regulations can be read as providing that the EAG has $4,000 of gross income, including the interest paid by Sub 1 to Sub 2, and by Sub 2 to Sub 3. Under a "look-through" rule in the NFFE rules, it appears that such interest would not be treated as passive income, because the interest would appear to be "properly allocable" to the $1,000 of active income earned by Sub 1.[46] Accordingly, the EAG would have $3,000 of active income, representing 75% of the group's total gross income. The EAG thus would be a nonfinancial group, and Parent could qualify for the exclusion from financial institution status described in Treasury Regulation Section 1.1471-5(e)(5)(i).

Example 2: Same facts as Example 1, except that the direction of the intercompany loans is reversed: Sub 1 has lent to Sub 2, which has lent to Sub 3. In addition, Sub 1's income (other than interest derived on its loan to Sub 2) consists solely of $3,000 of income from actively conducting its nonfinancial trade or business.

This case is the reverse of Example 1. Intuitively, one might expect the EAG to be viewed as having $4,000 of income: Sub 1's $3,000 of active income, and Sub 3's $1,000 of passive income. Instead, the Final Regulations can be construed as providing that the group has $6,000 of income, with $3,000 (50%) being passive income.

It seems clear to us that these results were not intended by Treasury and the IRS. The importance of the character of the income earned by Sub 1 (in Example 1) and Sub 3 (in

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[45] *See* Treas. Reg. § 1.1471-5(e)(1)(v)(A).

[46] The NFFE rules' definition of "passive income" includes a "look-through" rule, under which dividends, interest, rent and royalties received by an entity from a person related to such entity under Section 954(d)(3) are characterized as active income to the extent such dividend, interest, rent or royalties are "properly allocable" to income of the payor that is active income. Treas. Reg. § 1.1472-1(c)(1)(iv)(B)(1); *cf.* Treas. Reg. § 1.904-5. Members of the same EAG are related to one another under Section 954(d)(3).

Example 2) is magnified, in a manner that plainly is distortive. The Final Regulations conceivably could be read as providing for a different, and more rational, outcome, in which the intragroup interest payments among the three Subs are disregarded when applying the 25% passive income test. The test refers to 25% of "the gross income of the expanded affiliated group" (emphasis added), and not (for example) to 25% of "the sum of the gross incomes of each one of the members of the expanded affiliated group." Conceivably, the language that is used is meant to refer to single-entity principles. However, absent further clarification, we believe the Final Regulations can be read as producing the results set forth above in the Examples 1 and 2.

One way to address these issues might be to revise the 25% passive income test so that it expressly excludes all income earned by a member of the EAG from transactions with other group members. However, we note that in order for such an approach to work properly, it would be necessary to have special rules dealing with sales of property between group members. In order to avoid distortions in the income test, it would be necessary not only to exclude gains from such intra-group transfers of property, but also to compute gain or loss on a subsequent sale of such property by the group to a third party in a manner that disregards increases (or decreases) in the tax basis of the property that have resulted from intra-group sales. This could lead to significant complexity, similar to that inherent in Treasury Regulation Section 1.1502-13. For that reason, we recommend that either or both of two simpler alternatives be adopted.

Recommendation 7(b) (Alternative 1): First, interest, dividends, rent and royalties that receive "look-through" treatment under the passive NFFE rules could be completely disregarded for purposes of the 25% passive income test, while continuing to take into account other types of income from intercompany transactions (e.g., gain from intercompany sales of property). In relatively straightforward cases like Examples 1 and 2, this approach would lead to outcomes that appear correct as a policy matter. In more complex cases (such as those involving intercompany sales of property), this approach would only serve to improve the operation of the rules, although it would not eliminate all issues.[47]

Recommendation 7(b) (Alternative 2): A second possible means of addressing the issue described above would be to provide a safe harbor under which an EAG the shares of whose parent are regularly traded on an established securities market (as determined using the test for such trading found in Treasury Regulation Section 1.1472-1(c)(1)(i) (discussed further in Part III.B.1 below)) could apply the 25% passive income test by reference to the group's consolidated income shown in its audited financial statements.[48] In practice, such an approach would

[47] The suggested approach would be conceptually similar to the "look-through" rule in the passive foreign investment company (PFIC) regime, under which a foreign parent corporation that owns at least 25% of a subsidiary disregards dividends and interest received from the subsidiary and, instead, takes into account a ratable share of the subsidiary's income. *See* Section 1297(c)(2).

[48] *Cf.* Treas. Reg. § 1.1472-1(c)(1)(iv)(C) (for purposes of applying the asset test for passive NFFE status, an entity can measure its assets by reference to the amounts shown on its balance sheet).

generally lead to results similar to those that would be obtained if the income test were modified so as to disregard income from intra-group transactions, and compute gain or loss on sales of property to third parties without taking into account any adjustments to the property's tax basis that resulted from previous intra-group transfers of the property. A test based on a group's consolidated financial statements often would be relatively simple for a taxpayer to apply. In addition, there would be a fairly low risk of attempts to manipulate the manner in which total consolidated income or the amounts of specific items of income were computed on the financial statements, in view of the material non-tax function the financial statements serve. Treasury and the IRS could consider extending this approach to EAGs with a non-publicly traded parent, where the facts indicate a low opportunity for abuse or manipulation (e.g., cases where the EAG has audited financial statements that are prepared for a non-tax purpose, such as filings required under a local regulatory regime or contractual covenants to provide financial information to a third-party lender or other third-party counterparty to a transaction).[49]

(c) 25% passive asset test: application where an EAG member's assets include stock or debt issued by another EAG member (or a lease or license entered into with another EAG member)

The 25% passive asset test in the definition of "nonfinancial group" can be read as applying based on the sum of the fair market values of the assets held by each member of the EAG. There is no express exclusion for stock, debt, a lease or a license held by an EAG member that has been issued by, or entered into with, another member of the EAG. Thus, questions arise under the 25% passive asset test that are quite similar to those just discussed under the 25% passive income test.

Specifically, the 25% passive asset test defines an asset as active or passive based on the character of the income it produces. If one EAG member holds an interest in, or obligation of, another EAG member, and such interest or obligation must be taken into account as an asset held by the EAG for purposes of the 25% passive asset test, then one could ask whether such asset should be viewed as active or passive, in view of the fact that such asset generates (or could generate) income that is tested under the "look-through" rule to determine whether the income is active or passive. For reasons that we discuss further in Part III.A.4(d) below, we believe that such assets should be, and are intended to be, characterized as active or passive by reference to

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[49] We note that Treasury Regulation Section 1.1472-1(c)(1)(iv)(C), does not by its terms require audited financial statements. However, for purposes of our Alternative 2 described in the text, we have proposed the use of audited financial statements as we believe these would be more reliable and less susceptible to manipulation.

In addition, it should be noted that interpretive issues similar to those described above regarding the 25% passive income test apply to the definition of "financial account" in Treasury Regulation Section 1.1471-5(b)(1)(iii)(B)(1), which provides that debt or equity of a holding company or treasury center is a financial account if at least 50% of the aggregate income of the EAG is derived by financial institutions or passive NFFEs. We discuss that provision further in Part III.B.4.

the character under the "look-through" rule of the income they produce (i.e., stock, debt, a lease or a license of an EAG member is not automatically treated as a passive asset merely because it generates income that, generally speaking, is passive). Assuming we are correct in understanding that is how the Final Regulations are intended to be applied, we note that the 25% passive asset test in the definition of "nonfinancial group" can produce distortive results much like those described above for the 25% passive income test.

> **Example 3**: Parent, Holdco A, Holdco B, Sub 1, Sub 2 and FFI all are foreign corporations. Parent owns the stock of Holdco A (worth $1,500), which in turn owns as its sole asset the stock of Holdco B (worth $1,500). Holdco B owns as its sole asset the stock of Sub 1 (worth $1,500); and Sub 1 owns assets of an active nonfinancial business that are worth $1,500. In addition, Parent directly owns the stock of Sub 2 (worth $1,000); and Sub 2 owns a portfolio of securities issued by unrelated parties worth $1,000. Parent also directly owns the stock of FFI; FFI is a small bank, life insurance company or custodian (whose assets are assumed to be worth $0 for sake of mathematical simplicity).

Although not entirely clear, it appears that under the Final Regulations, the EAG members may be considered to own assets worth $8,000, and that $6,000 (75%) of these assets will be considered to produce or be held for the production of active income. A more intuitive result (and the result if disregarded entity status were elected for all of Parent's subsidiaries) would be that the EAG owns $2,500 of assets, of which $1,500 (60%) generate active income.

> **Example 4**: Same facts as Example 3, except that Sub 1 owns a portfolio of securities worth $1,500 (rather than an active nonfinancial business), and Sub 2 owns an active nonfinancial business worth $4,500.

Although not entirely clear, it appears the EAG may be considered to hold $15,000 of assets, of which $9,000 (60%) produce or are held for the production of active income. A more intuitive result would be that the EAG owns $6,000 of assets, of which $4,500 (75%) produce active income.

As with the 25% passive income test, we believe that the 25% passive asset test as currently drafted can conceivably be read to operate an aggregate basis, by disregarding an asset held by one EAG member that has been issued by, or is an obligation of, another EAG member. The asset test refers to "assets held by the expanded affiliated group," rather than to "assets held by each of the members of the expanded affiliated group." However, absent additional guidance, we believe the Final Regulations can also plausibly be read as producing the results described in Examples 3 and 4.

Recommendation 7(c): The same types of revisions that we have proposed to the 25% passive income test would help to avoid the types of seemingly unintended results just illustrated under the 25% passive asset test. One approach would be to eliminate from consideration under

the asset test any stock, debt, leases or licenses held by an EAG member that have been issued by, or are obligations of, another EAG member – i.e., assets that generate income the character of which as passive is tested under the "look-through" rule in the NFFE rules. Another relatively simple alternative would be to apply the asset test, at least in the case of an EAG the parent of which has stock regularly traded on an established securities market, by reference to the consolidated balance sheet included in the EAG's audited financial statements. We believe that the advantages of each of these two approaches are essentially the same as described above in our discussion of the 25% passive income test.

We should stress that, whichever of the two approaches described above is chosen for the 25% passive income test, the same one should be chosen for the 25% passive asset test, in order to have a coherent and consistent set of rules that test income and assets under the same framework.

(d) Gain from a sale or exchange of an interest in an EAG member

As noted above, the 25% passive income test incorporates the definition of passive income that is found in the NFFE rules, where it is used to distinguish between active and passive NFFEs. Passive income is defined to include the excess of gains over losses from sales or exchanges of property that generates dividends, interest and certain other types of passive income (including rents and royalties that are not derived in an active trade or business conducted by employees). A question arises if a member of an EAG recognizes gain or loss on a sale of stock, debt, a lease or a license that has been issued by, or is an obligation of, another EAG member. Under the "look-through" rule in the definition of passive income, if such property generates dividends, interest, rent or royalties, the character of such income as active or passive will be determined based on the character of the underlying income earned by the EAG member that is the issuer, lessee or licensee. It appears to be consistent with the intent of this "look-through" rule to apply a similar look-through approach to gain or loss from a sale of such property.[50] However, it is not clear precisely how such an approach should be applied.

Recommendation 7(d) (Part 1): The NFFE rules should be revised to address the point described above, by adopting either of two approaches:

1. One simple and reasonable approach would be to treat gain or loss on a sale of stock, debt, a lease or a license that has been issued by, or is an obligation of, an EAG member as passive if the issuer or obligor is a financial institution or a passive NFFE, and as active in all other cases. This would be broadly consistent with the principle that the nature of the income and activities of an entity should

[50] *Cf.* P.L.R. 200813036 (Mar. 28, 2008) (applying the look-through principles of Section 1297(c) to a foreign parent's gain from a sale of stock of a corporation in which the parent held a greater-than-25% stake); P.L.R. 200604020 (Jan. 27, 2006) (same); P.L.R. 200015028 (April 14, 2000) (applying the Section 1298(b)(3) change-of-business exception to PFIC status to a foreign parent that sold stock of an operating subsidiary).

dictate the character of gain or loss on a sale of an interest in or obligation of that entity. This approach would be relatively easy to apply.

2. Although the above is our preferred approach because it assigns a single character to all the gain or loss from the sale of the stock, debt, lease or license, a more nuanced approach could instead be adopted: the stock, debt, lease or license could be treated as partially passive and partially active based upon how a dividend, interest, rent or royalty payment made by the issuer in the year of the sale would be characterized under the income "look-through" rule, and the gain (or loss) from a sale of such asset would be classified accordingly.

We suggest that the NFFE rules' definition of passive income be revised to specifically provide for either of the two possible approaches just described.

Recommendation 7(d) (Part 2): If the above change is made in the NFFE rules, then the 25% passive income test in the definition of "nonfinancial group" will use the same approach (due to incorporation by reference of the definition of passive income from the NFFE rules). We believe that approach should lead to appropriate results in the definition of nonfinancial group.

5. Transitional deemed-compliant FFI status for securitization vehicles

The Final Regulations provide transitional relief for securitization vehicles formed before 2012 (i.e., before the organizers of the vehicle could have known what FATCA compliance burdens would be imposed on such entities). Previously, comments had been made that such vehicles might find it difficult to achieve participating FFI status due to restrictions in the documents that govern the vehicles' existence and operations. The Final Regulations responded by including a section labeled as "transitional" which provides that a securitization vehicle will be treated as a certified deemed-compliant FFI prior to January 1, 2017, if it meets all of the following requirements:

> "(A) The FFI is a collective investment vehicle formed pursuant to a trust indenture or similar fiduciary arrangement that is an FFI solely because it is an investment entity that offers interests primarily to unrelated investors.
>
> (B) The FFI was in existence as of December 31, 2011, and the FFI's organizational documents require that the entity liquidate on or prior to a set date, and do not permit amendments to the organizational documents, including the trust indenture, without the agreement of all of the FFI's investors.
>
> (C) The FFI was formed for the purpose of purchasing (and did in fact purchase) specific types of indebtedness and holding those assets (subject to reinvestment only under prescribed circumstances) until the termination of the asset or the vehicle.

(D) All payments made to the investors of the FFI are cleared through a clearing organization that is a participating FFI, reporting Model 1 FFI, or U.S. financial institution or made through a trustee that is a participating FFI, reporting Model 1 FFI, or U.S. financial institution.

(E) The FFI's trust indenture or similar fiduciary arrangement only authorizes the trustee or fiduciary to engage in activities specifically designated in the trust indenture, and the trustee or fiduciary is not authorized through a fiduciary duty or otherwise to fulfill the obligations that a participating FFI is subject to under §1.1471-4 absent a legal requirement to fulfill them, even if the consequence of the trustee failing to fulfill these obligations is to cause the FFI to be withheld upon. Further, no other person has the authority to fulfill the obligations that a participating FFI is subject to under §1.1471-4 on behalf of the FFI."[51]

Based upon the text of these requirements and the explanation in the Preamble, one can glean that this transitional provision is based upon the following general principles.

First, relief from FATCA withholding is appropriate for special purpose investment vehicles set up before FATCA's requirements became apparent which, because they operate

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[51] Treas. Reg. §§ 1.1471-5(f)(2)(iv)(A) – (E). The Preamble explains this provision as follows:

> "Limited Life Debt Investment Entities
>
> The Treasury Department and the IRS received comments stating that certain investment vehicles will be unable to comply with the registration and due diligence requirements in the regulations, thus necessitating a deemed-compliant category for such entities. In particular, comments have noted that vehicles that have a fixed lifespan and that were created for the purpose in investing in a limited type of debt obligation with the intent to hold such obligations until maturity or until the liquidation of the vehicle will often provide the trustee of the vehicle with limited authority to act in manner not specifically provided for under the agreement. In most cases, the trustee would not be permitted to register the vehicle as a participating FFI or comply with the due diligence requirements of a participating FFI unless the trust indenture requires the trustee to do so, the trustee is required to do so under a provision of law, or all of the investors in the vehicle agree to amend the trust agreement to provide the trustee with the power to act in such a manner. In order to provide time to address these limitations, the final regulations permit these entities to qualify as deemed-compliant FFIs for a limited period of time. After December 31, 2016, the deemed-compliant status of these entities terminates, and each such entity will be required to comply with the terms of any applicable IGA or otherwise register as a participating FFI."

Preamble at 5,892.

pursuant to restrictive documentary requirements, will find it difficult to obtain the consents and information from investors they would need to enter into an FFI agreement and to comply with their withholding and other obligations as participating FFIs.

Second, this relief should apply only to vehicles that operate in a manner that indicates there is a low risk that the vehicle would be used by U.S. persons to circumvent U.S. taxation.

Third, this relief should apply only if the vehicle has touch-points with U.S. financial institutions or participating FFIs, such that information about the investors would be likely to be available from these other sources.

Fourth, it should not be possible to "recycle" a grandfathered vehicle and effectively use it for new deals. In this connection, the relief for such vehicles should be temporary in nature because they often will reach the prescribed end of their corporate existence before the relief expires (or, failing that, they at least will have a period of several years to tackle the problem of amending their organizing documents so as to become FATCA-compliant).

Recommendation 8: We are concerned that the relief provision, as drafted, does not achieve these goals in the manner that we believe was intended by Treasury and the IRS. We propose below some technical revisions to the wording of the Final Regulations, which we believe are necessary in order for relief to be available in the cases where it was intended to apply.[52]

With respect to paragraph (A), in many cases an entity used to hold a pool of debt instruments in a securitization transaction is not "formed pursuant to" a trust indenture or similar fiduciary arrangement. Frequently, the securitization vehicle is established as a non-U.S. company.[53] For example, it is typical for a securitization vehicle in the collateralized loan obligation ("**CLO**") market to be formed as a foreign limited liability company, rather than as a U.S. trust or partnership. In that case, the entity is formed pursuant to the relevant country's limited liability company law, rather than pursuant to a trust indenture or similar fiduciary arrangement. The entity does, however, typically enter into a trust indenture or similar agreement related to the notes it issues; and in practice, that agreement will contain such detailed restrictions on the actions the vehicle is permitted to take that the agreement effectively functions as the governing constitutive document of the vehicle for the entire period the notes are

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[52] After the Final Regulations were issued, the Cayman Islands announced that it will seek to enter into a Model 1 IGA. See *Cayman Opts for Model 1 IGA for FATCA*, Tax Notes Today, 2013 TNT 54-38 (Mar. 15, 2013). In view of the large number of securitization vehicles incorporated in the Cayman Islands, this is potentially a helpful development. However, the benefit provided by the IGA to a significant extent will depend on what requirements a pre-FATCA securitization vehicle will need to meet, in order to qualify as a "nonreporting financial institution" under the IGA.

[53] The use of a non-U.S. company rather than a U.S. pass-through vehicle may be beneficial, for example, for securities law reasons as it widens the classes of investors eligible to purchase securities issued by the vehicle.

outstanding. This same structure is also commonly used for securitization vehicles other than CLOs. We suggest that Treasury and the IRS clarify that the relevant requirement in paragraph (A) is for the entity to be either "formed under or have entered into" a trust indenture agreement or similar arrangement that effectively governs substantially all of its activities, rather than be "formed pursuant to" such an agreement or arrangement.

Paragraph (B) provides that the entity must be required by its trust indenture to liquidate by a set date. Often, the securitization transaction documents do not set forth a date by which the legal entity must be liquidated. Instead, all of the debt instruments in the vehicle's portfolio will be due by a certain date; and no reinvestment of proceeds is permitted at that point, with the result that the entity is expected to liquidate by the last maturity date of the debt held by it as of the end of its reinvestment period. We propose that paragraph (B) be clarified to say that an entity will be treated as being required under its trust indenture (or similar arrangement) to liquidate by a set date if the entity is required to pay off all its outstanding notes no later than a fixed period following maturity of the last debt instruments held by the entity to mature, with such fixed period being specified either in the trust indenture (or similar arrangement) or in some other agreement that is legally binding on the entity. It is typically the case that securitization vehicles will issue instruments that have an outside maturity date, so that the governing indenture will terminate by a fixed date, even if the vehicle itself does not have a mandatory liquidation date.

Paragraph (B) also requires that an entity's organizational documents can be amended only through unanimous consent by its investors. This requirement raises particular concern. Many (perhaps most) securitization vehicles will have the basic problem that the requirement is meant to address (that is, their voting structure makes it unlikely that they could obtain the consent required to amend their organizational documents in a manner that would allow them to become participating FFIs); but these vehicles will not be able to meet the requirement as it is currently drafted. This is because a securitization vehicle's organizational documents usually do not require unanimous consent to make any and all amendments. Instead, vehicles usually have different consent requirements for different types of amendments: changes to certain core economic terms of the notes issued by the vehicle, like the interest rate or principal amount owed, would normally require unanimous consent;[54] certain ministerial amendments may be permitted without any consent, upon receipt of legal opinions to the effect that no investor would be adversely affected; and, for everything in between, majority (or in some cases super-majority) consent is required. The requirement as drafted therefore will normally not be true, because for

[54] We note that in the case of many securitization vehicles, nominal equity is issued to a charitable trust or other third party for non-tax reasons, such as to achieve bankruptcy remoteness for the vehicle. Such third party's consent typically is not required for amendments to the entity's organizational documents, because the third party has at most only a nominal amount at stake. We read paragraph (B) as currently drafted as not requiring the consent of such a party, because such a party is not an "investor" in the vehicle in a manner that is at all analogous to the noteholders. If paragraph (B) is amended then, at a minimum, it ought to be expressly confirmed this is the case.

most vehicles a variety of consent thresholds might apply for different kinds of amendments. The amendments necessary to permit an entity to become a participating FFI might not require unanimous consent.

The issue at which this requirement is aimed, however, is commonly present in pre-FATCA securitization vehicles: as a practical matter, even a small number of investors can prevent the vehicle's organizational documents from being amended to permit entry into an FFI agreement. This is true even if the consent threshold set forth in the transaction documents is only majority consent, for the following reasons. One might think that the adverse consequences of FATCA withholding (particularly principal proceeds withholding) would be so adverse that all investors would have strong interests in avoiding FATCA withholding and consent would be readily granted. However, even in securitizations where the vehicle issues a single class of interests, a small number of investors may engage in strategic behavior and attempt to exploit holdup power to extract something of value from other investors or the issuer. This problem is exacerbated in multi-class securitizations: often the consent threshold applies on a class-by class-basis, and the consent of each affected class is required; or alternatively, one class, typically the most senior or "controlling class," may control all important decisions while it remains outstanding and majority approval of that controlling class, rather than of all investors, would be needed. Under both of these voting structures, the most senior class often would be least affected (or even unaffected) economically if failure to amend results in FATCA withholding. Moreover, the result of failing to become FATCA compliant may not be ongoing FATCA withholding taxes as assumed above as a practical matter but an initial FATCA tax, which would then trigger a mandatory tax redemption causing the deal to be wound up. One particular class of investors may be happy to have the deal unwind early even if other classes are not, and therefore withhold consent to a proposed amendment.

On balance, we believe it would be best to remove the unanimous consent requirement from the Final Regulations, for two reasons. First, we believe it is unnecessary in light of other requirements in Treasury Regulation Section 1.1471-5(f)(2)(iv). For example, the requirement in paragraph (D) that payments on a securitization vehicle's notes be made through a participating FFI, Model 1 IGA FFI or U.S. financial institution, all of which have FATCA reporting obligations, means that between now and the end of 2016, the government will receive information about the vehicle's noteholders, even if the vehicle itself does not become a participating FFI.

Second, it is difficult to formulate a test requiring a specified level of consent (unanimous or otherwise) that will accurately capture all the circumstances in which amending the organizational documents is difficult enough to justify transitional relief. The capital structure and contractual terms of securitization vehicles vary widely between different categories of vehicles; and even within a single category (CLOs, for example), there is not a universally adopted structure or set of terms. However, a requirement that tests whether, under all the facts,

an investor may prevent the necessary amendments will necessarily be subjective and uncertain in application.[55]

If Treasury and the IRS determine that it is appropriate to retain a requirement of a certain minimum threshold for consent to amendments, then we suggest replacing the unanimous consent requirement with an approach that more accurately reflects common market terms. Specifically, in the case of single-class securitization vehicles, the test could be that at least a super-majority (66 2/3%) consent of noteholders is required to amend documents to permit the vehicle to enter into an FFI agreement and to require noteholders to take the actions necessary for the vehicle to comply with that agreement (i.e., to require the investors to provide FATCA information, to consent to its release to the IRS if necessary, and to be redeemed or forced to sell their notes without their consent if they fail to comply). In multi-class securitizations, the test could be that the most junior classes of notes (which for this purpose would be defined as the most junior classes representing at least, say, 25% of the capital structure) would be unable to amend the documents to achieve the foregoing even if holders of such classes were unanimously in favor of such an amendment. These tests are designed to reflect the practical realities described above that enable a small investor group to prevent revision of the vehicle's organizational documents.[56]

Paragraph (C) might possibly be read to require that a vehicle engage in no activities other than debt investment. Most securitization vehicles engage in other activities incidental or related to their debt investments, for example, hedging their exposures to currency or interest rate risks using derivatives. We believe the better reading of paragraph (C) is that it does not prevent a securitization vehicle from undertaking activities incidental to or directly relating toits ownership of debt instruments, because such activities are not at odds with a conclusion that the vehicle was formed for the purpose of purchasing and holding debt instruments; however, express confirmation of that reading would be helpful. Similarly, we believe that paragraph (C) is best read as permitting a securitization vehicle to sell or dispose of debt instruments, when doing so is consistent with the vehicle's basic purpose of buying and holding such instruments. For example, rating agency-driven requirements in the transaction documents for CLOs typically require loans that become distressed or non-performing to be sold in various circumstances; such sales are consistent with the vehicle’s purpose of holding (and earning money from) debt instruments. Here again, it would be useful to have express confirmation that occasional sales of debt instruments, in circumstances prescribed in a vehicle's indenture or similar documents that

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[55] We note that paragraph (B) as currently drafted could be construed as being met in any case where the documents literally do not require unanimous consent but, under the particular facts, an amendment of the organizational documents could be prevented by one or more investors.

[56] If these suggestions do not capture the role that the consent requirement was intended to play, we encourage you to reach out to us or industry participants for additional information and assistance in revising the consent requirement appropriately.

do not conflict with the purpose of buying and holding debt instruments until maturity, is permitted under paragraph (C).

Paragraph (D) requires all payments by the FFI to be cleared by a clearing organization or made through a trustee, in either case that is a participating FFI, Model 1 IGA FFI or U.S. financial institution. It is not unusual in multi-class securitizations like CLOs that the most junior class is held in certificated form (for example, to limit transfers in a way that will ensure compliance with ERISA). Such class sometimes will not be held by an institutional trustee, although invariably payments will be made on such class through an intermediary institution that is a major bank or similar institution. To address this, we recommend that the Final Regulations be modified to provide that payments on notes not held through a clearing system must be "made through a trustee *or paying agent*" that is a participating FFI, Model 1 IGA FFI or U.S. financial institution.

Regarding paragraph (E), the transaction documents for a securitization vehicle often contain a provision that entitles the trustee or other representative to take actions on behalf of the vehicle that are required in order for the vehicle to be compliant with applicable law. Such a clause is likely insufficient to authorize a trustee to cause a securitization vehicle to enter into an FFI agreement. This is because an FFI will not “violate” the requirements of FATCA if it does not enter into an FFI agreement; rather, it simply will be subject to withholding on payments in respect of non-grandfathered obligations. We believe this situation therefore is not one described in paragraph (E) but that is not entirely clear. The Final Regulations should expressly provide that the presence of this type of clause in an FFI's organizing documents will not cause the FFI to fail the requirements in paragraph (E).

B. Comments on the Definition of "Financial Account" and Related Terms

1. Exclusion from the definition of financial account for publicly traded debt and equity

The Final Regulations state that a debt or equity interest in an FFI is not a financial account, if the interest is regularly traded on an established securities market.[57] While the intent here appears reasonably clear, "regularly traded on an established securities market" is defined through a cross-reference to provisions in the NFFE rules;[58] and those provisions are tailored to testing whether a corporation is a publicly traded corporation, rather than testing whether a

[57] Treas. Reg. §§ 1.1471-5(b)(1)(iii)(A) (parenthetical clause), (B) (parenthetical clause), (C) (parenthetical clause). Each of these clauses cross-refers to Treasury Regulation Section 1.1471-5(e)(3)(iv) for the definition of "regularly traded on an established securities market." These cross-references should be corrected: the definition is in fact in Treasury Regulation Section 1.1471-5(b)(3)(iv).

[58] Treasury Regulation Section 1.1471-5(b)(3)(iv) cross-refers to Treasury Regulation Sections 1.1472-1(c)(1)(i)(A) and (C).

particular interest (or class of interests) is regularly traded. As discussed further below, the NFFE provisions that are incorporated by reference do not fit smoothly, and some clearly seem to have been so incorporated by accident. As a result, the Final Regulations have the potential to create uncertainty that could impact capital markets transactions. We are recommending revisions to eliminate such uncertainty.

The relevant NFFE rules exempt a publicly traded corporation from passive NFFE status. A corporation is exempted if its stock is regularly traded on an established securities market (or markets), meaning that: (1) one or more classes of the corporation's stock representing in aggregate over 50% by value and voting power are listed on established securities markets; and (2) with respect to each class of stock relied on to meet test (1), at least a minimum volume of trades on established securities markets are effected on a quarterly and an annual basis.[59] It makes sense to apply test (1) in order to determine whether a corporation should be exempted from NFFE status, due to trading of its stock: the test is meant to ensure that the corporation's controlling shareholders cannot satisfy the definition of public trading merely by creating the superficial appearance of trading activity, while they continue to own a separate class of stock that preserves their control. However, this test does not work very well, when determining whether particular debt or equity interests of an FFI should be viewed as publicly traded (and thus be excluded from being a "financial account").

In the case of debt, if the cross-reference in the definition of "financial account" to the public trading tests in the NFFE rules is applied mechanically, by simply substituting "debt" for "stock" in tests (1) and (2), then debt instruments will never be able to satisfy the literal requirements of test (1), due to a lack of voting power.

In the case of equity, it is possible to apply test (1) as written, but it does not appear this was intended. In the case of an entity that has a class of equity that is listed on an exchange as well as a non-listed class of equity, the NFFE rules seek to test whether the listed class has sufficient economics and governance rights to merit providing an exemption from the NFFE regime for the entity. By comparison, if an FFI has separate classes of listed and non-listed equity, the publicly-traded exemption from the financial account reporting regime should be available for the publicly-traded class only. Thus, the test should be a class-by-class test, rather than an entity-wide test.

Accordingly, we believe that the financial account definition's cross-reference to the 50% of voting power or value test in the NFFE rules was accidental, and that the intent was to cross-refer only to the trading volume test (i.e., clause (2) above) in the NFFE rules. We note that the Proposed Regulations provided only for trading volume requirements when testing whether debt and equity of an FFI was regularly traded on an established securities market; no voting power or

[59] Treas. Reg. § 1.1472-1(c)(1)(i)(A)(1), (2).

value requirement was provided.[60] The Preamble gives no indication that any change was intended in the Final Regulations.

As a further comment, we note that the trading volume test is designed to apply to a "class" of stock. Even though the Final Regulations do not elaborate on what “class of stock” means, the concept is relatively well understood from other provisions in the Code and Treasury Regulations.[61] We also do not foresee any particular difficulties in applying the concept to equity of issuers other than corporations. In the case of debt, however, it is not clear how the per-class trading volume requirements test would work. There is no body of precedent for determining when debt interests constitute a "class" that is comparable to the precedents dealing with stock; nor does the concept of a "class" necessarily translate smoothly from stock to debt. On balance, it appears that the original issue discount regulations' concept of an "issue" of debt would serve fairly well as a means to identify a "class" for purposes of the financial account rules. Under the original issue debt regulations, an issue of debt generally consists of a group of debt interests that have identical terms, and that are issued either at the same time as part of a single plan, or else in a "qualified reopening" under circumstances designed to ensure fungibility of the debt instruments originally issued and those that are issued later in the reopening.[62] We believe this definition of issue captures the same basic idea of identity of terms that is normally inherent in the notion of a "class" of equity, while at the same time recognizing particular considerations as to debt instruments. We recommend that the Final Regulations be clarified to expressly state that a "class" of debt has the same meaning as an "issue" of debt in the regulations under Section 1275.[63]

Finally, the cross-reference to the NFFE’s trading tests references paragraphs (A) and (C) but omits paragraph (B). That paragraph (Treasury Regulation Section 1.1472-1(c)(1)(i)(B)), includes three special rules for applying the trading tests: (i) a rule modifying the volume requirements for the year in which a class of publicly traded instruments is first issued, in order to take into account the fact that the issuance may not occur until the middle or end of the year, (ii) a rule covering cases where a class of instruments is listed on a U.S. exchange and regularly

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[60] Prop. Reg. § 1.1471-5(b)(3)(iv).

[61] *See* Sections 302(c), 368(c); Treas. Reg. § 1.305-3(b); *see also* Treas. Regs. §§ 1.883-3(c), (d)(1), 1.884-5(d)(3), (4).

[62] Treas. Regs. §§ 1.1275-1(f), 1.1275-2(k).

[63] In multiple places, Treasury Regulation Section 1.1275-2(k) refers to whether debt instruments are "publicly traded" within the meaning of Treasury Regulation Section 1.1273-2(f). If Treasury and the IRS accept the recommendation that is made in the text, then they may well want to provide that such references in Treasury Regulation Section 1.1275-2(k) to debt that is "publicly traded" should be construed as references to the rules regarding "regular trading" of debt on an established securities market in the Final Regulations. It would seem incongruous for the definition of "regular trading" of debt in the Final Regulations to incorporate by reference a separate, inconsistent concept of "publicly traded" debt in the original issue discount regulations.

quoted by a dealer and (iii) an anti-abuse rule where trading occurs with a purpose of meeting the trading requirements. We believe these three special rules were intended to be included in the cross-reference; in the case of the first special rule, the Preamble contains a comment to this effect,[64] and in the case of the other two rules there would be no reason not to include them as well. We suggest expressly stating this.

Recommendation 9: Assuming that our analysis set forth above is consistent with the intent of the Final Regulations, we believe that our suggested changes could be implemented by replacing the first sentence of Treasury Regulation Section 1.1471-5(b)(3)(iv) with the following two sentences (italicized text is new):

> Debt or equity interests described in paragraph (b)(1)(iii) of this section are regularly traded on an established securities market if the requirements of § 1.1472-1(c)(1)(i)(A*)(2)(i) and (ii), (B)* and (C) are met. *In the case of equity of an entity other than a corporation, references in § 1.1472-1(c)(1)(i)(A)(2)(i) and (ii) and (B) to a class of stock of a corporation shall mean a class of equity of such entity; and in the case of debt, references therein to a class of stock shall mean an "issue" of debt as defined in § 1.1275-1(f) and § 1.1275-2(k) (provided that references in such provisions to debt that is "publicly traded" (within the meaning of § 1.1273-2(f)) shall be construed as references to debt that is "regularly traded on an established securities market" (within the meaning of this § 1.1471-5(b)(3)(iv))), and references to a "number of shares" shall mean the principal amount of such debt.*

2. Treatment of certain non-publicly traded debt and equity interests as financial accounts

Under the Proposed Regulations, debt or equity that was not regularly traded on an established securities market, and was issued by a depository bank, custodian or insurance company, would have been treated as a financial account only if the value of the debt or equity was determined primarily by reference to assets that gave rise to withholdable payments. This was the case regardless of whether the issuer, in addition to being one of the types of financial institutions just described, was also an investment entity.[65] By comparison, the Proposed Regulations provided that in the case of an entity that was an investment entity and was not also

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[64] "A number of comments were received regarding the exception from financial account status for debt and equity that is regularly traded on an established securities market. The Final Regulations respond to comments by adopting the definitions provided in the Final Regulations under section 1472, including the revisions made to those regulations that provide a special rule for the initial year of public offering." Preamble at 5,886.

[65] Prop. Reg. § 1.1471-5(b)(1)(iii) (first sentence).

some other type of financial institution, all of the entity's non-publicly traded debt and equity interests would be treated as financial accounts.[66]

The Final Regulations adopt an almost opposite approach. An entity that is an investment entity described in paragraphs (B) or (C) of the definition of that term must treat all of its non-publicly traded debt and equity interests as financial accounts, even if the entity qualifies as a depository bank, a custodian or an insurance company.[67] Thus, if there is (for example) a depository bank, custodial institution or insurance company that, in the course of its business activities, holds a substantial portfolio of financial assets that is managed by a professional financial manager (including potentially a manager that is a member of the bank's, custodian's or insurance company's EAG), then that entity is an investment entity and, apparently, all non-publicly traded debt and equity issued by that entity constitute financial accounts.[68] It appears this departure from the Proposed Regulations may have been unintended. There is no indication in the Preamble of a deliberate change in approach on this issue. In addition, the rationale for the Proposed Regulations' approach of applying to these "overlap" entities the normal rules for banks, custodians and insurance companies (rather than the rules for investment entities) – i.e., that in the normal course of such entities' business activities they may frequently also be investment entities – still holds true under the Final Regulations.

Recommendation 10: We recommend modifying the rule in the Final Regulations that treats a non-publicly traded debt or equity interest in a bank, custodian or insurance company as a financial account only if the interest's value is determined primarily by reference to assets that give rise to withholdable payments (or if the interest is otherwise issued with a principal purpose of avoiding FATCA reporting or withholding), so that such rule applies whether or not the bank, custodian or insurance company is also an investment entity.

3. Debt with a value determined primarily by reference to assets giving rise to withholdable payments

The Final Regulations provide that non-publicly traded debt is considered to have a value determined primarily by reference to assets giving rise to withholdable payments if the debt is

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[66] Prop. Reg. § 1.1471-5(b)(1)(iii) (second sentence).

[67] Treas. Reg. § 1.1471-5(b)(1)(iii)(A). By comparison, the Final Regulations provide that a bank, custodian or insurance company that is not also an investment entity is required to treat a non-publicly trade debt or equity interest as a financial account only if the interest's value is determined primarily by reference to assets that give rise to withholdable payments, or if the interest is otherwise issued with a principal purpose of avoiding FATCA reporting or withholding. Treas. Reg. § 1.1471-5(b)(1)(iii)(C).

[68] In the case of an insurance company, it should be noted that its reserving activities will not cause it to be an investment entity. Treas. Reg. 1.1471-5(e)(6). The Final Regulations do not provide a definition of "reserving activities," which could potentially be construed to cover a relatively broad range of investment activity. Future guidance on this topic would be helpful.

"secured by assets of a U.S. person."[69] The regulations identify this as one of three ways that debt will be considered to have a value "primarily" determined by assets that generate withholdable payments, with the other two alternatives being that the debt is convertible into stock of a U.S. person or that it provides for payments determined primarily by reference to the profits or assets of a U.S. person.[70]

The Final Regulations appear to be based on an assumption that the value of debt will be determined primarily by reference to assets of a U.S. person if the debt is secured by such assets. If the debt is recourse debt, it is questionable whether that assumption is accurate: an investor would normally determine the value of recourse debt based principally on the credit quality of the borrower, rather than the security for the debt. The nature of the security for the debt would have significantly greater importance for an investor in nonrecourse debt.[71]

Whether the debt is recourse or nonrecourse, however, it clearly is the case that the value of the debt will not be determined primarily by reference to assets of a U.S. person if those assets compose only a small part of the overall pool of assets securing the debt. We believe the Final Regulations are intended only to cover cases where debt is secured solely or primarily by assets of a U.S. person.

Recommendation 11: We recommend that the Final Regulations be clarified to state that debt will not be considered to have a value determined primarily by reference to assets giving rise to withholdable payments solely because the debt is secured by assets of a U.S. person, unless the debt is secured "solely or primarily by assets of a U.S. person." For this purpose, "primarily" would appropriately be defined to mean that at least 50% by value of the security for the debt consists of a U.S. person's assets.[72] In addition, we suggest that Treasury and the IRS consider expressly providing that only nonrecourse debt that is so secured will be considered to have a value determined primarily by reference to assets of a U.S. person.

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69 Treas. Reg. § 1.1471-5(b)(3)(v)(B)(3).

70 Treas. Reg. §§ 1.1471-5(b)(1)(iii)(B)(3), (b)(1)(iii)(C)(1), (b)(3)(v)(B)(1) and (2).

71 *Cf.* Treas. Regs. §§ 1.1001-3(e)(4)(iv)(A), (vi), 1.1001-3T(e)(4)(iv)(B) (a change in the security for recourse debt is a significant modification only if it changes payment expectations from primarily speculative to adequate, or vice versa; by comparison, any alteration of a substantial amount of nonfungible security for nonrecourse debt will be a significant modification).

72 *Cf.* Treas. Reg. § 1.1471-5(e)(4)(iii)(A), (e)(4)(iv)(A) (in the definition of investment entity, 50% test for whether the entity "primarily conducts" a business of providing financial management service, and for whether the entity's income is "primarily attributable" to investing, reinvesting or trading in financial assets).

4. Debt or equity of a holding company or treasury center

Treasury Regulation Section 1.1471-5(b)(1)(iii)(B)(1) defines a financial account to include debt or equity of a holding company or treasury center, where such entity's EAG includes one or more investment entities described in paragraphs (B) or (C) of the definition of such term or passive NFFEs and the income derived by those investment entities or passive NFFEs is at least 50% of the aggregate income earned by the EAG. This test raises issues very similar to those described in Part III.A.4(b) above (discussing the income test in the definition of "nonfinancial group"), to the effect that a failure to exclude income from intragroup transactions leads to distortive results.

Recommendation 12: In order to apply Treasury Regulation Section 1.1471-5(b)(1)(iii)(B)(1), a fraction must be constructed, with a numerator equal to the aggregate income of the members of the group that are investment entities and passive NFFEs, and a denominator equal to the entire EAG's income. We believe that the EAG's income for purposes of the denominator clearly should be computed using one of the same approaches as are recommended in Part III.A.4(b): either disregarding dividends, interest, rent and royalties paid between EAG members, or else using the EAG's consolidated financial statements to compute the income of the EAG. These two approaches are appropriate for the same reasons as described above: they are relatively simple to implement, and they lead to far better results than if intragroup transactions are taken into account. In addition, for purposes of the numerator, we believe it should be required to compute the aggregate income of the investment entities and passive NFFEs in the EAG based on the same methodology as is used in the denominator – i.e., by determining how much these entities have contributed to the EAG's aggregate income in the denominator. This type of approach appears to us to be both straightforward and fair.

5. Definition of "U.S.-owned foreign entity"

The Final Regulations define a "U.S. account" as a financial account held by a specified U.S. person or a U.S. owned foreign entity.[73] "U.S. owned foreign entity" is defined in Treasury Regulation Section 1.1471-5(c) as a foreign entity with one or more substantial U.S. owners, "including a foreign entity described in subparagraph (c)(2) of this section." The regulation does not contain a subparagraph (c)(2), and there does not appear to be any other provision that is intended to be cross-referenced.

The corresponding provision in the Proposed Regulations did divide paragraph (c) into subparagraphs (1) and (2).[74] Subparagraph (2) in the Proposed Regulations treated an owner-documented FFI with one or more direct or indirect owners that were specified U.S. persons as a U.S. owned foreign entity, for purposes of the rules in Proposed Regulation Section 1.1471-4(d)

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[73] Treas. Reg. § 1.1471-5(a)(2).

[74] Prop. Reg. §§ 1.1471-5(c)(1), (2).

that required a participating FFI to report on its U.S. accounts.[75] The effect of this rule was to ensure the participating FFI had to report on any account held by an owner-documented FFI that, in turn, had any specified U.S. persons as owners. By comparison, the Final Regulations contain special reporting rules under Treasury Regulation Section 1.1471-4(d) for accounts that are held by owner-documented FFIs; these special rules were not present in the Proposed Regulations.[76]

Recommendation 13: It seems to us that in Treasury Regulation Section 1.1471-5(c), the cross-reference to subparagraph (c)(2) can be removed, because in the Final Regulations, accounts held by owner-documented FFIs are subject to their own tailored reporting rules. Thus, such accounts no longer need to be treated as accounts held by U.S. owned foreign entities, in order to be made subject to a participating FFI's obligation to report on U.S. accounts, as was the case under the Proposed Regulations.

6. Definition of "owner"

For purposes of the Final Regulations, "owner" is stated to have the same meaning as "substantial U.S. owner" (as defined in Treasury Regulation Section 1.1473-1(b)(1)), except that the requirements that the person in question be a U.S. person and own over 10% of the equity of an entity do not apply.[77] A person that owns a discretionary interest in a trust and receives a distribution in the calendar year from the trust is specifically included within the definition of "owner."

The definition of "substantial U.S. owner" set forth in Treasury Regulation Section 1.1473-1(b)(1) includes a person that has either direct or indirect ownership of an interest in an entity; and detailed attribution rules are provided elsewhere in Treasury Regulation Section 1.1473-1(b) to measure indirect ownership.[78] It is unclear whether those attribution rules are incorporated by reference into the Final Regulations' definition of "owner." However, on balance, we believe that "owner" in the Final Regulations is meant to be interpreted in the common, ordinary sense of the word, without reference to such attribution rules. For example, it would be very difficult to make sense of the definition of "beneficial owner" and the rules governing identification by a participating FFI of the owners of its financial accounts, if the term "owner" was meant to incorporate attribution rules.

Recommendation 14: To avoid confusion, we recommend that the definition of owner in the Final Regulations be amended to expressly state that the attribution rules in Treasury Regulation Section 1.1473-1(b) are not incorporated by reference.

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[75] *Id.*

[76] Treas. Reg. §§ 1.1471-4(d)(2)(ii)(D), d)(3)(iv), d)(5)(iii).

[77] Treas. Reg. § 1.1471-1(b)(83).

[78] *See* Treas. Reg. § 1.1473-1(b)(2).

7. Definition of "offshore obligation"

When a withholding agent determines whether to withhold under Section 1471(a) on a withholdable payment, the withholding agent generally is entitled to rely on relatively relaxed, flexible rules regarding documentation of the payee's chapter 4 status, if the payment in question is made pursuant to an "offshore obligation."[79]

The special withholding regime and financial account reporting rules that apply to a participating FFI under Section 1471(b), in turn, deal with the question of how to document the chapter 4 status of persons receiving payments from, and holding accounts with, a participating FFI by incorporating by reference large parts of the documentation rules applicable to withholding agents under Section 1471(a).[80] The rules that are incorporated by reference include, among others, those dealing with offshore obligations.

The Final Regulations define an offshore obligation as an account, instrument or contract that is "maintained and executed" at an office outside the United States, and further specify that the term "includes any equity interest in a foreign entity that is purchased by the owner of such interest outside of the United States either directly from the entity or from another person that is located outside of the United States."[81]

Recommendation 15: We request that the definition of offshore obligation be amended, in order to elaborate on when an equity interest in a foreign entity (for example, an interest in a foreign investment fund) is considered to be "purchased outside the United States." In the absence of more detailed guidance, the wording used in the Final Regulations will be sufficiently unclear that, in many cases, it may be difficult to conclude with confidence that equity is an offshore obligation.

We believe that the broker information reporting regulations under Section 6045, which provide exemptions from reporting for certain sales of securities effected by a broker at an office outside the United States, provide a useful analogy. Under those rules, a broker generally must perform the actions necessary to effect the sale at an office located outside the United States, in accordance with instructions transmitted directly to such office by the broker's customer from outside the United States.[82] We believe that a similar rule can be adopted under the Final Regulations, providing that equity issued by a foreign entity will be an offshore obligation if the owner purchased the equity in a sale where both the seller and the purchaser each acted from offices outside the United States.

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79 *See* Treas. Reg. § 1.1471-3(c), (d).

80 *See* Treas. Reg. §§ 1.1471-4(c)(2)(ii)(A), (c)(3)(i).

81 Treas. Reg. § 1.1471-1(b)(82).

82 Treas. Reg. §§ 1.6045-1(g)(1), (g)(3)(iii).