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Client Memorandum
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Supplemental IRS Guidance on Upcoming Compliance Obligations of Non-US Banks, Financial Intermediaries and Investment Vehicles

The US Internal Revenue Service (the "**IRS**") recently published Notice 2011-34 (the "**Supplemental Notice**"), which supplements guidance set forth in Notice 2010-60 (the "**Notice**" and, together with the Supplemental Notice, the "**Notices**") on how the IRS will apply new US tax compliance rules beginning in 2013 to non-US banks, financial intermediaries and investment vehicles.

These rules were enacted as part of the Hiring Incentives to Restore Employment Act of 2010 (the "**HIRE Act**"). They generally will impose a 30% withholding tax on proceeds (including a return of original investment) from investments in US financial assets ("**Withholdable Payments**") paid to non-US banks, financial intermediaries and investment vehicles ("**Foreign Financial Institutions**" or "**FFIs**"). However, the withholding tax does not apply if an FFI ("**Participating FFI**") enters into a form agreement with the IRS covering the FFI (a "**FFI Agreement**"), or complies with certain other procedures to ensure that the FFI has no account holders that are US persons.[1] The purpose of the HIRE Act provisions is to force all FFIs with meaningful direct or indirect US investments to become Participating FFIs. *The provisions essentially outsource to Participating FFIs, at their expense, the IRS role of identifying US persons who invest in non-US financial accounts*.[2]

The Supplemental Notice modifies and expands the guidance contained in the Notice. Among other things, the Supplemental Notice:

- Provides limited exceptions from the general requirement that a FFI enter into an FFI Agreement to avoid withholding tax on Withholdable Payments;
- Provides that "qualified intermediaries" ("**QIs**") generally will be required to become Participating FFIs;
- Provides that an FFI generally may become a Participating FFI only if all affiliated FFIs become Participating FFIs, and provides for a coordinated application process for all affiliated FFIs;
- Provides an expanded due diligence procedure for pre-existing individual accounts that are private banking accounts or have a value exceeding $500,000;
- Clarifies that if a Participating FFI makes payments on its own behalf (and not as a custodian) to a non-compliant account holders, the Participating FFI must withhold tax based on the proportion that the Participating FFI's US assets bears to its total assets; and

Key Issues

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[1] Certain transition procedures would permit withholding agents to delay withholding until 2015, as discussed below. However, withholding agents may elect to impose the withholding early.

[2] US persons who invest in non-US financial accounts are required to report those accounts to the IRS. The HIRE Act provisions reflect a concern that some US persons with non-US financial accounts are failing to comply with their reporting obligations.

- Clarifies that if a Participating FFI receives payments from another Participating FFI as a custodian for a non-compliant account holder, the Participating FFI generally must withhold tax based on the proportion that the lower-tier Participating FFI's assets bear to its total assets.[3]

The guidance is extensive and this memorandum provides only a general overview.

The guidance in the Notices will help FFIs evaluate their options for avoiding the new 30% withholding tax on Withholdable Payments. In determining whether to enter into an FFI Agreement, an FFI must consider not only the scope of the obligations, but whether the FFI will be permitted to take such measures under its local law and whether affiliated FFIs are also able to comply. The options for FFIs, as we see them, are as follows:

1. FFI Agreement. An FFI can avoid the new 30% withholding tax by entering into an FFI Agreement to (a) identify and report to the IRS its account holders that are US persons, whether or not they invest in US financial assets, and (b) withhold tax on any account holders that themselves are FFIs that do not either enter into an FFI Agreement with the IRS or comply with other procedures to ensure that the FFI has no account holders that are US persons (**"Non-Participating FFIs"**) or that refuse to provide identifying information or waive the benefit of customer privacy laws that would prevent reporting to the IRS under an FFI Agreement ("**Recalcitrant Account Holders**").

   The withholding obligation will extend not simply to payments that are directly traceable to US financial assets, but also will extent to payments that the Participating FFI makes on its own behalf (such as payments of principal and interest on deposits) based on the ratio that the Participating FFI's US assets bears to its total assets. Such a withholding obligation may conflict with local laws and may significantly affect capital flows to Participating FFIs. Accordingly, a FFI must consider whether assuming an obligation to withhold tax on payments to Non-Participating FFIs and Recalcitrant Account Holders will cause it to become uncompetitive (or require the FFI to absorb the withholding tax cost through gross-up payments).

   For example, a Participating FFI that is a bank would be required to withhold tax on payments of principal and interest made in respect of a deposit held by a Non-Participating FFI, based on the ratio of the Participating FFI's US assets to its total assets on specific testing dates. Even if the ratio is small, a Non-Participating FFI would almost certainly move its deposit to a Non-Participating FFI (or a Participating FFI with no US assets) to avoid the imposition of a confiscatory withholding tax.

2. Agreement to Undertake Form 1099 Reporting. Alternatively, an FFI can avoid the new 30% withholding tax by entering into an FFI Agreement with the IRS to undertake Form 1099 information reporting with respect to its account holders that are US persons. The Notices provides only limited information about how this option will apply. However, the FFI generally would be required to maintain and report information regarding income and proceeds received from financial assets and their tax basis, applying US tax principles.

3. Comply with Procedures to Avoid Having US Account Holders. An FFI can avoid the new 30% withholding tax by complying with certain procedures, which are still to be defined, to ensure that the FFI has no account holders that are US persons. The Notices provide no guidance on this option.

4. Divest of Most US Investments. An FFI that does not take any of the foregoing steps can avoid the new 30% withholding tax by divesting of US investments, other than certain obligations that were outstanding on March 18, 2012, and interests in Participating FFIs that hold US assets. Notice 2010-60 provides important guidance regarding the scope of the exclusion for proceeds from obligations that are outstanding on March 18, 2012.

5. Refund Under an Applicable Income Tax Treaty. If an FFI receives payments on which the new 30% withholding tax has been imposed, and the FFI qualifies for the benefit of an income tax treaty, the FFI may apply for a refund, to the extent that the withholding tax exceeds the tax allowed under the treaty. No interest will accrue on the overwithheld tax. The Notices provide no guidance about the refund procedures.

Foreign Financial Institutions Subject to the New Provisions

In General

The Notices describe the activities that generally will cause a non-US person to be treated as an FFI and provide certain exceptions. The activities that will cause a non-US person to be an FFI include:

[3] On a number of issues, the Notices request comments from interested parties.

1. Taking Deposits in a Banking or Similar Business: This includes commercial banks, building societies and other savings and banking institutions. The fact that an institution is subject to banking or credit laws or to supervision and examination by a banking regulator is relevant to, but not determinative of, the determination whether an institution engages in this type of activity.
2. Holding Financial Assets for the Account of Others as a Substantial Portion of the Institution's Business: This includes, for example, broker-dealers, clearing organizations, trust companies, custodial banks, and entities acting as custodians with respect to the assets of employee benefit plans. Again, the regulatory treatment of the institution is relevant to, but not determinative of, the determination whether the institution engages in this type of activity.
3. Engaging Primarily in the Business of Investing or Trading in Financial Assets or Derivatives: This generally includes, but is not limited to, mutual funds, funds of funds, exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools and investment vehicles. The determination whether an entity is engaged primarily in the business of investing or trading in financial assets or derivatives will be based on all relevant facts and circumstances. The fact that an entity makes isolated transactions in financial assets may cause it to be engaged primarily in the business of investing or trading in such assets depending on such factors as the magnitude and importance of the transaction in comparison to the entity's other activities.

The HIRE Act provisions will apply even if a financial institution has entered into a Qualified Intermediary (**"QI"**) agreement with the IRS to report and withhold tax on payments made with respect to US securities. The Supplemental Notice states that all FFIs acting as QIs on and after January 1, 2013, will be required to become Participating FFIs unless they qualify to be treated as deemed compliant with the HIRE Act provisions without having concluded an FFI Agreement ("**Deemed Compliant FFIs**").[4]

The Notice clarifies that neither an FFI receiving Withholdable Payments solely through its US branch nor a controlled foreign corporation (i.e., a non-US corporation meeting certain thresholds of US ownership) will be excluded from the definition of FFI.[5]

Exceptions

The Notices identify a number of entities that will be excluded from FFI treatment. Certain such entities will be treated as "**Non-Financial Foreign Entities**" or ("**NFFEs**") that are exempted from withholding ("**Excepted NFFEs**"),[6] others will be treated as Deemed Compliant FFIs, and others will be treated as entities that are exempt from withholding because they pose a low risk of tax evasion ("**Low Risk Entities**"). The most significant exclusions include:

1. Active non-financial business entities;[7]
2. Property and casualty insurance companies and reinsurers;[8]
3. Certain local banks;[9]

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[4] "Foreign withholding partnerships" and "foreign withholding trusts" likewise will be required to become Participating FFIs unless they qualify as Deemed Compliant FFIs.

[5] Payments received by a US branch for its own account that are effectively connected with the conduct of a trade or business in the United States will be excluded from the definition of Withholdable Payment, as discussed below.

[6] Other Excepted NFFEs include certain publicly traded non-financial corporations and their subsidiaries, certain entities organized in a US territory and wholly owned by residents of the US territory, non-US governments, international organizations and non-US central banks of issue.

[7] This category includes holding companies for a subsidiary or group of subsidiaries, start-up non-financial companies during the first 24 months following their organization, non-financial companies that are liquidating or emerging from reorganization or bankruptcy, and hedging/financial centers of a non-financial group of companies (but not private equity funds, venture capital funds, or other investment-type vehicles). These entities will be treated as Excepted NFFEs.

[8] This category includes insurance companies whose business consists *solely* of issuing insurance or reinsurance contracts without cash value, such as typical property and casualty insurance or reinsurance contracts and term life insurance. It appears that such entities will be treated as Excepted NFFEs.

[9] This category applies only if (i) each affiliated FFI is licensed and regulated as a bank or similar deposit-taking institution and is not an investment vehicle; (ii) all of the affiliated FFIs are organized in the same country; (iii) no affiliated FFI maintains operations outside its country of organization; (iv) no affiliated FFI solicits account holders outside its country of organization; and (v) each affiliated FFI

4. Certain local FFIs that are members of a group including a Participating FFI;[10]
5. Certain investment vehicles that are held exclusively by Participating FFIs, Deemed Compliant FFIs or Low Risk Entities;[11]
6. Small investment vehicles outsourcing compliance to a withholding agent;[12]
7. Certain retirement plans;[13] and
8. Foreign governments, international organizations, central banks of issue, and certain controlled entities.[14]

In addition, the Supplemental Notice indicates that the IRS is considering under what circumstances exchange-traded funds and other entities all the interests in which are regularly traded on an established securities market could be Deemed Compliant FFIs.[15] The IRS also is considering whether there may be a category of funds that may be treated as Deemed Compliant FFIs because of limitations on the identity of direct interest holders and corresponding sales restrictions.

FFIs Maintaining No US Accounts

An entity will be treated as a Deemed Compliant FFI if it complies with procedures specified by the IRS to ensure that it does not maintain US Accounts (as defined below). The Notices do not set forth the procedures that will apply for this purpose.

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implements policies and procedures to ensure that it does not open or maintain accounts for non-residents, non-participating FFIs, or NFFEs other than excepted NFFEs that are organized and operating in the relevant jurisdiction. Such entities will be treated as Deemed Compliant FFIs.

[10] This category applies if (i) the FFI maintains no operations outside its country of organization; (ii) the FFI does not solicit account holders outside its country of organization; (iii) the FFI implements the pre-existing account and customer identification procedures required of Participating FFIs to identify "US Accounts" (as defined below), accounts of "Non-Participating FFIs" (as defined above) and accounts of NFFEs that are not Excepted NFFEs that are organized and operating in the jurisdiction where the FFI maintains the account; and (iv) the FFI agrees that, if any of the foregoing types of accounts are found, it will enter into an FFI Agreement, transfer such accounts to an affiliated Participating FFI, or close the account. Such entities will be treated as Deemed Compliant FFIs.

[11] This category applies only if (i) all holders of record of direct interests in the fund are Participating FFIs or Deemed Compliant FFIs holding on behalf of other investors or Low Risk Entities; (ii) the fund prohibits the subscription for or acquisition of any interests in the fund by any person that is not a Participating FFI, a Deemed Compliant FFI or a Low Risk Entity; and (iii) the fund certifies that any Passthru Payment Percentages (as defined below) that it calculates and publishes will be done in accordance with the relevant guidance. Such entities will be treated as Deemed Compliant FFIs.

[12] This category includes certain small investment vehicles that do not take deposits or hold financial assets for the account of others. This exclusion is likely to apply only if (i) the entity has only a small number of direct or indirect owners, all of whom are individuals or Excepted NFFEs, and (ii) the withholding agent specifically identifies each relevant direct or indirect owner of the entity, collects required documentation, and reports the US owners of the entities as if they were direct account holders. Such entities will be treated as Deemed Compliant FFIs;

[13] This exclusion is likely to apply only if the retirement plan (i) qualifies as a retirement plan under the law of the country in which it is established, (ii) is sponsored by a non-US employer, and (iii) does not allow US participants or beneficiaries other than employees that worked for the non-US employer in the country in which such retirement plan is established during the period in which benefits accrued. Such entities will be treated as Low Risk Entities. The Supplemental Notice states that the IRS intends to provide further guidance on the types of foreign retirement plans that may qualify for treatment as Low Risk Entities, or that may be treated as Deemed Compliant FFIs.

[14] Such entities will be treated as Low Risk Entities.

[15] Such entities do not maintain US Accounts (as defined below). However, they will be required to enter into FFI Agreements, withhold on Passthru Payments made to Non-Participating FFIs, and certify that any Passthru Payment Percentage that they publish will comply with the relevant guidance.

Payments Covered By the New Withholding Tax

In General

The definition of Withholdable Payment generally includes (i) any US source payment of interest, dividends, rents, salaries, and other fixed or determinable annual or periodical gains, profits, and income, and (ii) gross proceeds from the sale or disposition of property of a type that can produce US source interest or dividends. Excluded from the definition of Withholdable Payments are payments effectively connected with the conduct of a trade or business in the United States.

Grandfathered Obligations

Payments made on and the proceeds from the disposition of any obligation outstanding on March 18, 2012 are excluded from the definition of Withholdable Payment and, therefore, such payments and proceeds are not subject to the 30% withholding tax imposed under the HIRE Act. For these purposes, Notice 2010-60 clarifies the definition of "obligation" to include any legal agreement that produces or could produce Withholdable Payments, except for (i) instruments that are treated as equity for US federal income tax purposes, (ii) legal agreements that lack a definitive expiration or term (e.g., deposit type agreements), and (iii) brokerage, custodial and similar agreements to hold financial assets for the account of others and to make and receive payments of income and other amounts with respect to such assets.

Notice 2010-60 also clarifies that any material modification of an obligation will result in the obligation being treated as newly issued as of the effective date of the modification. Existing US tax regulations will apply for purposes of determining whether there is a material modification of a debt obligation; in the case of other obligations, the determination will be based on all the relevant facts and circumstances. For example, if a US borrower and its lenders agree to materially restructure a debt obligation that was outstanding on March 18, 2012, and the restructuring occurs after that date, the restructured obligation will generate Withholdable Payments. This may impede negotiated debt restructurings after March 18, 2012.

FFI Agreements

Under an FFI Agreement, a Participating FFI generally must:

- Obtain information regarding each holder of each account maintained by the FFI as is necessary to identify accounts ("**US Accounts**") that are held by certain US persons ("**Specified US Persons**")[16] or by non-US entities with one or more owners that are Specified US Persons and whose ownership exceeds certain thresholds ("**US Owned Foreign Entities**");
- Comply with specified due diligence procedures for identifying US Accounts;
- Report certain information with respect to US Accounts maintained by the Participating FFI;
- Withhold tax on certain payments to account holders that are Non-Participating FFIs or Recalcitrant Account Holders;[17] and
- Close the account of a customer that fails within a reasonable period of time to waive the benefit of an applicable customer privacy law that prevents reporting to the IRS under the FFI Agreement.

The HIRE Act provides that if an FFI enters into an FFI Agreement with the IRS, each other affiliated financial institution (other than any FFI that also enters into an agreement with the IRS) must comply with the procedures of such FFI Agreement. The Supplemental Notice states that each FFI that is affiliated with a Participating FFI must itself be a Participating FFI or a Deemed Compliant FFI, and describes a coordinated application process for affiliated FFIs, led by a designated member of the affiliated group of FFIs. That member generally would serve as a central point of contact for the entire group with the IRS regarding HIRE Act issues. The Supplemental Notice also states that the IRS intends to provide

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[16] Specified US Persons do not include certain publicly traded corporations and their subsidiaries, tax exempt organizations, charitable trusts, retirement plans, federal, state and local governments, banks, real estate investment trusts, regulated investment companies and common trust funds.

[17] The Notices state that the IRS is considering measures for dealing with long-term Recalcitrant Account Holders, including terminating FFI Agreements when an FFI has numerous long-term Recalcitrant Account Holders remaining after a reasonable amount of time.

affiliated groups of FFIs an option whereby a designated FFI would assume an oversight role with respect to the compliance by other members of the group. A similar procedure is being considered for managers or agents of a group of funds.

An FFI may be prohibited under its local law from complying with certain requirements of an FFI Agreement, such as disclosing the identity of account holders, withholding US tax on payments to account holders, or closing accounts. The IRS has asked for comments on how to resolve conflicts between the requirements of the FFI Agreement and local law.

Identification of US Accounts

The Notices set forth procedures that Participating FFIs must apply to identify US Accounts. Those procedures are different depending on whether the accounts are held by individuals, or by entities, and whether the accounts are pre-existing or established after the date that the Participating FFI's FFI Agreement becomes effective. The Supplemental Notice provides new procedures for pre-existing individual accounts.

The procedures for pre-existing entity accounts generally allow a Participating FFI to initially rely on electronically searchable information maintained by the Participating FFI and associated with the account, with a reexamination of certain accounts as if they were newly-established accounts over certain transition periods.

The procedures for newly-established accounts generally require the Participating FFI to examine all information collected in connection with the account (e.g., for purposes of opening and maintaining the account, corresponding with the account holder, and complying with regulatory requirements, including anti-money laundering/know-your-customer requirements), regardless of whether such information is available in electronically searchable files, with a reexamination required in certain circumstances. A Participating FFI will be entitled to rely on the documentation received from account holders under the procedures set forth below unless it knows or has reason to know that the information contained in such documentation is unreliable or incorrect.

Accounts Held by Individuals

The procedures for pre-existing accounts held by individuals, the Supplemental Notice prescribes a complex review process that depends on whether the account:

- has previously been documented as a US Account;
- has a balance as of the end of the calendar year preceding the effective date of the Participating FFI's FFI Agreement that does not exceed $50,000 (or the equivalent in foreign currency);
- is a private banking account, in which case the Participating FFI must ensure that relationship managers, among other things:
  - identify clients they know are US persons;
  - review client files to identify clients who are US persons or have indicia of US connections; and
  - request clients identified as US persons or having US connections to provide specific types of documentation;
- has indicia of US status in its electronically searchable information (in which case the Participating FFI must request specific types of documentation from the clients); or
- has a balance at the end of the calendar year preceding the effective date of the Participating FFI's FFI Agreement or on subsequent annual testing dates of $500,000 or more (or the equivalent in foreign currency), in which case the Participating FFI must review client files to identify clients who are US persons or have indicia of US connections.

The procedures for newly-established accounts held by individuals generally require a Participating FFI to apply a five-step process:

1. Exclusion of Small Accounts: The Participating FFI may exclude an account if the average of the month-end balances or values during certain testing periods of all depository accounts held by the account holder at such Participating FFI was less than $50,000 (or the equivalent in foreign currency).
2. Previously Identified US Accounts: From all accounts not excluded in step 1, all account holders that are already documented as US persons for other US tax purposes will be treated as Specified US Persons and their accounts will be treated as US Accounts.
3. Documentation of US or Non-US Status: For newly-established accounts, or pre-existing accounts that are subject to reexamination, from all accounts that are not addressed in steps 1 and 2, the Participating FFI must obtain and examine documentary evidence establishing US or non-US status. In the case of US Account holders, the

Participating FFI must obtain IRS Forms W-9. Accounts that are not established as US Accounts are subject to steps 4 and 5 below, regardless of the documentation received.

4. Accounts Without Indicia of US Status: From all accounts not addressed in steps 1 and 2, and not documented as a US Account under step 3, the Participating FFI shall exclude an account if the information required to be examined does not include any of the following indicia of potential US status: (i) identification of an account holder as a US resident or US citizen; (ii) a US address associated with an account holder; (iii) a US place of birth for an account holder; (iv) an "in care of" address, a "hold mail" address, or a post office address that is the sole address on file with respect to the account holder; (v) a power of attorney or signatory authority granted to a person with a US address; (vi) standing instructions to transfer funds to an account maintained in the US, or directions received from a US address; and (vii) in the case of a newly-established account or an account subject to re-examination, any other indicia of potential US status.

5. Accounts With Indicia of US Status: For all accounts identified as containing indicia of potential US status in step 4, the Participating FFI will be required to obtain certain documentation to establish whether the account is a US Account. In particular, the Participating FFI must obtain IRS Form W-9 from an account holder who is identified as a US resident or citizen in item 4(i). If the account information includes any of the US indicia identified in item 4(ii) or (iii), the Participating FFI must obtain IRS Form W-9 establishing the US status, or IRS Form W-8BEN and documentary evidence establishing the non-US status, of the account holder. For an account holder to establish non-US status, the account holder must present a non-US passport or other similar evidence of non-US citizenship. If the account is identified as containing only indicia of potential US status described in items 4(iv)-(vii), the Participating FFI shall obtain IRS Form W-9 establishing US status, or Form W-8BEN or other documentary evidence establishing non-US status, from the account holder. Account holders that do not provide appropriate documentation generally will be classified as Recalcitrant Account Holders until appropriate documentation is provided to the Participating FFI by the account holder.

Accounts Held by Entities

The procedures for accounts held by entities generally require a Participating FFI to determine whether such accounts are treated as falling within one of the following classifications: (i) US Accounts, (ii) accounts of Participating FFIs, (iii) accounts of Deemed Compliant FFIs, (iv) accounts of Non-Participating FFIs, (v) accounts of Low Risk Entities, (vi) accounts of Excepted NFFEs, (vii) accounts of other NFFEs, or (viii) accounts of Recalcitrant Account Holder, applying the following steps.

1. Previously Identified US Accounts: The Participating FFI will treat all account holders already identified as US persons for other US tax purposes as US persons for purposes of the FFI Agreement. Participating FFIs will permit such entities to provide documentation establishing that they are not Specified US Persons. Any US person that does not provide such documentation within a specified period will be classified as a Specified US Person until such documentation is received.

2. Accounts With Indicia of US Status: Of the remaining account holders, the FFI will identify any entities for which information maintained by the Participating FFI indicates that the account holder is a US entity (e.g., a place of incorporation in the United States). Such entities will be presumed to be US entities. Participating FFIs will permit such entities to present documentation establishing that they are not US persons, or, if they are US persons, that they are not Specified US Persons. The Participating FFI will be required to request such documentation within one year of the effective date of the relevant FFI Agreement. Any such entity that has not presented such documentation within a specified period will be classified as a Specified US Person until such documentation is received. An account holder treated as a Specified US Person under this step 2 shall be treated as a Recalcitrant Account Holder until the Participating FFI receives the information it is required to report with respect to such account holder.

3. Accounts Without Indicia of US Status: All account holders not treated as US persons in steps 1 or 2 will be presumed to be non-US entities, and will be subject to further classification as follows:

    a. Accounts With Indicia of FFI Status: The Participating FFI will determine whether the entity's name (or other information readily available to the Participating FFI regarding the account holder) clearly indicates that the entity is an FFI. If so, the Participating FFI will tentatively classify the entity as an FFI.

    b. Account Holder Tentatively Classified as an FFI: If an account holder is tentatively classified as an FFI in step 3(a), the Participating FFI will request that the entity provide the Participating FFI with the entity's FFI identification number assigned by the IRS ("**FFI EIN**") and certification of its Participating FFI status, and upon receipt of the FFI EIN and certification of Participating FFI status, treat the entity as a Participating FFI, subject to confirmation with the IRS that the FFI EIN is valid.

c. Account Holder Not Providing an FFI EIN and Certification of FFI Status: If an account holder tentatively classified as an FFI in step 3(a) does not provide a valid FFI EIN and certification of Participating FFI status within a specified period, the Participating FFI will request documentation from the entity indicating whether the entity is a Participating FFI, a Deemed Compliant FFI, a Non-Participating FFI, a Low Risk Entity, or an NFFE. An account holder that does not present such documentation within a specified period will be treated as a Non-Participating FFI until the date on which appropriate documentation is received from the account holder by the Participating FFI. During the interim period (i.e., prior to the time that the account holder is treated as a Non-Participating FFI), the account holder will be considered an Excepted NFFE, and its account will be treated as other than a US Account, unless the entity is otherwise identified by the IRS on a published list. If the entity is so identified, the entity will be treated as a Non-Participating FFI.

4. Accounts Without Indicia of US Status or FFI Status: All account holders that are not treated as US persons in steps 1 or 2, and are not treated as FFIs in step 3, will be subject to further classification as follows:

   a. Accounts With Indicia of an Active Trade or Business: The Participating FFI will examine the entity's account file for evidence that the entity is engaged in an active trade or business (other than a financial institution business). Appropriate evidence in this regard may include statements of business activities, physical assets used in business activities, persons employed in business activities, and receivables and payables related to business activities (such as may be shown on audited financial statements or other business records provided by the account holder). The IRS is also considering permitting FFIs to rely in part on information obtained from third-party credit databases. An account holder identified in this step as engaged in an active trade or business will be treated as an Excepted NFFE.

   b. Accounts Without Indicia of an Active Trade or Business: The participating FFI will permit an account holder, not treated in step 4(a) as engaged in an active trade or business, to present documentation showing or certifying that it is a Participating FFI (in which case the procedures of step 3(b) and (c) will apply), a Deemed Compliant FFI, a Non-Participating FFI, an NFFE, or a Low Risk Entity. The Participating FFI will be permitted to rely on existing documentary evidence in its account files for this purpose, unless the Participating FFI knows or has reason to know that the documentation is unreliable or incorrect. If the Participating FFI does not have existing documentary evidence on which it can rely for this purpose, the Participating FFI will request documentation as required to show or certify the status of the account holder within a specified period. If the account holder does not present the documentation required by this step, the account holder will be treated as a Non-Participating FFI until the date appropriate documentation is received from the account holder by the Participating FFI.

   c. Account Holder Treated as an NFFE: If the documentation provided by the account holder in step 4(b) above indicates that the account holder is an NFFE, the Participating FFI must either obtain documentary evidence (or rely on existing documentary evidence in its account files) that the NFFE is an Excepted NFFE, or the Participating FFI must (i) specifically identify each individual, and each other Specified US Person that has an interest in such entity, either directly or through ownership in one or more other entities, other than through ownership in an Excepted NFFE, a Participating FFI, a Deemed Compliant FFI, or a Low Risk Entity, and (ii) if the Participating FFI identifies a Specified US Person, treat the account as a US Account and obtain with respect to each such person the documentation that the Participating FFI would be required to obtain from such person if such person were a new account holder and report any such Specified US person to the IRS. If the Participating FFI is unable to obtain the required documentation with respect to the Specified US Person within a specified period, the account holder will be treated as a Recalcitrant Account Holder until the date appropriate documentation is received from the account holder by the Participating FFI.

Reporting of US Accounts

A Participating FFI generally must report the following information pursuant to an FFI Agreement with respect to each US Account:

- The name, address and taxpayer identification number ("**TIN**") of each account holder which is a Specified US Person;
- In the case of any account holder which is a US-Owned Foreign Entity, the name, address, and TIN of each substantial US owner of such entity;
- The account number;
- The account balance or value (generally, at year-end); and

- The gross receipts and gross withdrawals or payments from the account. For this purpose, gross receipts must be segregated into the gross amount of dividends, the gross amount of interest, other income, and gross proceeds from the sale or redemption of property.

Alternatively, a Participating FFI may elect to comply with the IRS Form 1099 information reporting provisions that would apply if such Participating FFI were a US person and each holder of a US Account that is a Specified US Person or US-Owned Foreign Entity were an individual and citizen of the United States.[18] The Notices provide guidance regarding various elements of these requirements.

Withholding on "Passthru Payments" to Recalcitrant Account Holders and Non-Participating FFIs

As part of an FFI Agreement, a Participating FFI must withhold tax at a 30% rate on (1) any "Passthru Payment" that is made to a Non-Participating FFI or Recalcitrant Account Holder, and (2) in the case of a Passthru Payment made by such institution to a Participating FFI that has elected to be withheld upon with respect to such payment, so much of such payment as is allocable to accounts held by Non-Participating FFIs or Recalcitrant Account Holders of that upper-tier Participating FFI. A "**Passthru Payment**" generally is any Withholdable Payment or other payment to the extent attributable to Withholdable Payments. As discussed below, the Supplemental Notice sets forth a method for identifying and calculating Passthru Payments that is likely to significantly affect capital flows to Participating FFIs.

For example, a Participating FFI that is a bank would be required to withhold tax on payments of principal and interest made in respect of a deposit held by a Non-Participating FFI, based on the ratio of the Participating FFI's US assets to its total assets on specific testing dates. Even if the ratio is small, a Non-Participating FFI would almost certainly move its deposit to a Non-Participating FFI (or a Participating FFI with no US assets) to avoid the imposition of a confiscatory withholding tax.

A Participating FFI generally may elect to have a withholding agent withhold on Withholdable Payments or Passthru Payments made to it, rather than act as a withholding agent for Passthru Payments it makes to its account holders. If a Participating FFI so elects, it will be withheld upon to the extent Withholdable Payments or Passthru Payments made to it are allocable to accounts that are held by Recalcitrant Account Holders or by Non-Participating FFIs. As part of the election, a Participating FFI must agree to notify the withholding agent of its election to be withheld upon and provide such other information as may be necessary for the withholding agent to determine the appropriate amount to deduct and withhold from Withholdable Payments or Passthru Payments it makes to the Participating FFI. The Participating FFI also must agree to waive any right under any treaty of the United States with respect to any amount deducted and withheld pursuant to the election.

Defining Passthru Payments

The Supplemental Notice defines a Passthru Payment as any "payment" to the extent of (i) the amount of the payment that is a Withholdable Payment; plus (ii) the amount of the payment that is not a Withholdable Payment multipled by (A) in the case of a "**Custodial Payment**" (as defined below), the "**Passthru Payment Percentage**" (determined on quarterly testing dates and calculated as described below) of the entity that issued the interest or instrument, or (B) in the case of any other payment, the Passthru Payment Percentage of the Participating FFI making the payment. The effect of this definition is to:

- Impose withholding on payments that a Participating FFI receives from another FFI as custodian for a Non-Participating FFI or Recalcitrant Account Holder based on the Passthru Payment Percentage of the lower-tier FFI; and
- Impose withholding on payments that a Participating FFI makes to a Non-Participating FFI or Recalcitrant Account Holder in its own capacity (e.g., as a borrower or issuer of stock) based on the Participating FFI's own Passthru Payment Percentage.

The Supplemental Notice does not define the types of payments that may be treated as Passthru Payments. Therefore, it is unclear to what extent a Participating FFI would be required to withhold on a commercial payments made to Non-Participating FFIs or Recalcitrant Account Holders.

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[18] A Participating FFI that makes this election must still report the name, address, and TIN of each account holder which is a Specified US Person and, in the case of any account holder which is a US-Owned Foreign Entity, the name, address, and TIN of each substantial US owner of such entity, as well as the relevant account numbers; however, such an electing FFI will not have to report the account balance or value or the gross receipts and gross withdrawals of payments.

Calculating the Passthru Payment Percentage

The Supplemental Notice prescribes a method for calculating an FFI's Passthru Payment Percentage. The FFI generally must determine its total assets and US assets as of quarterly testing dates. The FFI's Passthru Payment Percentage will be determined by dividing the sum of the FFI's US assets held on each of the last four quarterly testing dates, by the sum of the FFI's total assets held on those dates. If a Participating FFI or Deemed Compliant FFI does not calculate and publish its Passthru Payment Percentage, that percentage will be deemed to be 100%.

For this purpose, the determination of an FFI's assets will be based on its financial statements, but future guidance may require the inclusion off-balance sheet transactions or positions. Assets held in a custodial account will be excluded. Assets will be included at their gross values, unreduced by liabilities or other associated obligations. This methodology will result in significant distortions in assigning liability for withholding tax on Non-Participating FFIs and Recalcitrant Account Holders.

Consider, for example, a Participating FFI with only two account holders, both of whom are Non-Participating FFIs. At a time when the US dollar equals the Swiss Franc, one Non-Participating FFI deposits $100, and the other Non-Participating FFI deposits SFR 100, with the Participating FFI. The Participating FFI in turn deposits $100 with the US Federal Reserve Bank, and deposits SFR with the Swiss Central Bank. The Participating FFI's Passthru Payment Percentage will be 50%, and therefore the Participating FFI will be required to withhold tax on 50% of the payments in respect of the US dollar deposit, and on 50% of the payments in respect of the Swiss Franc deposit. The Non-Participating FFI that deposited $100 with the Participating FFI obtains effectively a 50% reduction in the withholding tax compared to the withholding tax that would have been imposed if it had deposited the $100 directly with the US Federal Reserve Bank. The Non-Participating FFI that deposited SFR with the Participating FFI is subject to withholding tax that would not have been imposed if it had deposited the SFR 100 directly with the Swiss Central Bank.

A US asset will include any asset to the extent that it is a type that could give rise to a Passthru Payment, applying the following principles:

- A debt or equity interest in a US corporation (other than a grandfathered obligation as described above) will be treated as a US asset to the extent of 100% of its value;
- A debt or equity interest in a NFFE will not be treated as a US asset;
- An interest in, or non-custodial account with, a lower-tier Participating FFI or Deemed Compliant FFI constitutes a US asset in an amount equal to the value of the interest or account multiplied by the lower-tier FFI's Passthru Payment Percentage;
- An interest in, or non-custodial account with a lower-tier FFI that is not a Participating FFI or Deemed Compliant FFI will be presumed to have a Passthru Payment Percentage of zero.

The Supplemental Notice states that the IRS intends to issue guidance providing for an anti-avoidance rule that will disregard transactions with intent of manipulating a FFI's Passthru Payment Percentage.

Custodial Payments

The Supplemental Notice defines a Custodial Payment as a payment with respect to which an FFI acts as a custodian, broker, nominee, or otherwise as an agent for another person. A Custodial Payment that is a Withholdable Payment will be treated as such, and the FFI must apply the appropriate withholding unless the withholding obligation has been satisfied by another withholding agent. If the Custodial Payment is made with respect to an interest or instrument issued by another FFI, then the Custodial Payment is a Passthru Payment in an amount equal to the amount of the payment multiplied by the Passthru Payment Percentage of that other FFI.

Establishing Compliance

As part of an FFI Agreement, a Participating FFI agrees to comply with such verification procedures as the IRS may require with respect to the identification of US Accounts. The Notice indicates that the IRS is considering whether some degree of reliance can be placed on verification procedures and reviews performed by financial auditors engaged by the Participating FFI or by its internal audit function.[19] In addition, the IRS is considering the possibility of relying in some circumstances on written certifications by high-level management employees of the Participating FFI regarding the steps taken to comply with the FFI Agreement.

[19] QI agreements generally require the QI to obtain an outside audit of its compliance.

The Supplemental Notice specifically provides that the Chief Compliance Officer or another equivalent-level officer of the Participating FFI must certify to the IRS when the Participating FFI has completed the procedures for testing pre-existing individual accounts as described above (other than the annual retesting of high value accounts). As part of the certifications, the responsible officer will be required to certify that:

- Between the publication date of the Supplemental Notice and the effective date of the Participating FFI's FFI Agreement, the Participating FFI's management personnel did not engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging, or assisting account holders with respect to strategies for avoiding identification of their accounts as US Accounts; and
- The Participating FFI had written policies and procedures in place as of the effective date of its FFI Agreement prohibiting its employees from advising US Account holders on how to avoid having their US Accounts identified.

The Supplemental Notice also provides that:

- Deemed Compliant FFIs that publish their Passthru Payment Percentages must certify the accuracy of such percentages to the IRS every three years;
- If a Participating FFI retains copies of statements sent to holders of US Accounts in the ordinary course of business, it must retain such statements for a period of five years, and must provide such statements to the IRS upon request; and
- A Deemed Compliant FFI may use an agent to perform the necessary due diligence and take any required action associated with maintaining deemed compliant status. Similarly, a Participating FFI may use an agent to perform its obligations under its FFI Agreement. In each case, the FFI remains responsible for ensuring that the relevant requirements or obligations are satisfied.

Obligations of US Financial Institutions and Other US Withholding Agents

A withholding agent generally must withhold tax at a 30% rate on Withholdable Payments made to an FFI that is not a Participating FFI or a Deemed Compliant FFI, or to a NFFE that is not an Excepted NFFE and that does not provide information regarding its substantial US owners. A withholding agent also is required to report certain information regarding the substantial US owners of NFFEs, other than Excepted NFFEs, that beneficially own Withholdable Payments.

In applying these obligations, a withholding agent must determine whether to treat entities to which it makes Withholdable Payments as US persons, Participating FFIs, Deemed Compliant FFIs, Non-Participating FFIs, Low Risk Entities, Excepted NFFEs, or other NFFEs. The Notice describes procedures for a US financial institution ("**USFI**") to make this determination that are similar to the procedures described above that a Participating FFI will apply to determine the classification of its account holders that are entities.[20] The Notice states that the IRS contemplates a less extensive procedure for US withholding agents that are not USFIs, whereby the withholding agent may rely on a non-US entity's certification as to its classification, absent reason to know that the certification is unreliable or incorrect.[21] The Notice also states that the IRS anticipates providing an exception from withholding on payments made to an NFFE engaged in an active trade or business by withholding agents other than financial institutions.

Treaty Refund Procedures

The 30% withholding tax imposed under the foreign account provisions of the HIRE Act will apply notwithstanding the FFI's eligibility for a reduced rate of withholding under an applicable income tax treaty. A refund generally can be obtained for the excess of the amount withheld under the provision over the amount permitted to be withheld under the applicable income tax treaty.[22] A Withholdable Payment attributable to a return of invested capital may not be treated as income that generally would be covered by an income tax treaty. As such, it is unclear whether this refund procedure would apply to tax withheld

[20] Under certain transition procedures described in the Notice, for financial accounts opened before January 1, 2013, a USFI may not be required to withhold on Withholdable Payments before January 1, 2015.

[21] These requirements would also apply with respect to Withholdable Payments made by FFIs and USFIs to NFFEs that are not holders of financial accounts maintained by the financial institution.

[22] As discussed above, if a Participating FFI elects to have a withholding agent withhold on Withholdable Payments or Passthru Payments made to it, rather than act as a withholding agent for Passthru Payments it makes to its account holders, the Participating FFI must agree to waive any right under any treaty of the United States with respect to any amount deducted and withheld pursuant to the election.

on such a Withholdable Payment. Additionally, no interest will accrue on a refund, which may result in an economic loss for the taxpayer claiming the refund.

The foregoing is not intended or written to be used, and cannot be used by any person, for the purposes of avoiding US federal income tax penalties or to promote or market the matters addressed herein.