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TaxTalk

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Editor's Note

In 2012 Q1 the U.S. government finally released the Foreign Account Tax Compliance Act ("FATCA") guidance the market had been anticipating for some time. This had two different components: on February 15 the government released FATCA "withholdable payment" proposed regulations; and on March 7, 2012, it issued Notice 2012-20 which, among other things, addresses the circumstances under which "immobilized" debt instruments are treated as being issued in registered form for U.S. federal income tax purposes. Notice 2012-20 was released just in time for the March 18, 2012 effective date for FATCA's repeal of the "bearer bond" exception to the long-standing federal income tax requirement that debt be issued in registered form—another "highlight" of 2012 Q1. Both the proposed regulations and the Notice can be found in Knowfatca.com. In Q1, the Internal Revenue Service ("IRS") also released a Field Attorney Advice (i.e., from an IRS counsel in Atlanta, reviewed by the IRS National Office, to an IRS agent in the field) disallowing the benefits of a dividends-received deduction transaction and a Technical Advice Memorandum applying the modification principles of section 1001 (which we normally see applied only to debt modifications) to a call option. This issue of Tax Talk also covers the Second Circuit's *Castle Harbour* decision, the next chapter in a decade-long dispute between GE Capital and the IRS. Finally, we have our regular feature, *MoFo in the News*.

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IRS Issues Tech Advice Addressing Restructured Call Options

In late October 2011, the IRS released a technical advice memorandum[1] addressing whether written call options continued to be options for federal income tax purposes after being restructured, whether such restructuring of the options resulted in a Section[2] 1001 event, whether the restructured options were hedging transactions, and lastly whether the taxpayer was permitted to realize the options' losses upon closing.

The taxpayer ("Taxpayer") at issue was a commodity producer that entered into a strategic hedge, but did not hedge as a general matter. When the price of Taxpayer's commodity dropped in year 1, Taxpayer entered into a short prepaid forward contract to protect its downside exposure and used the proceeds to reduce its long-term debt. In addition, Taxpayer purchased European-style put options to protect against further price declines; these subsequently expired. Taxpayer also sold call options, which relinquished some of its upside opportunity associated with future sales of its commodities. The calls were not treated as hedges for financial accounting purposes and were marked-to-market periodically through Taxpayer's income statement. After the puts expired worthless, in year 3, Taxpayer restructured its call options.[3] The restructured call options differed from the original calls by requiring physical settlement, extending certain exercise dates, and adding a spot price delivery feature. Taxpayer did not treat the restructuring of the call options as an exchange under Section 1001 on its originally filed tax returns. In year 9, Taxpayer terminated its remaining delivery obligations under the restructured contracts and paid the relevant counterparties to close out the contracts while claiming an ordinary loss for tax purposes.

In its analysis, the IRS addressed several issues, including whether the call options continued to be options for tax purposes after they were restructured, such that the losses from the closing of those transactions were capital losses under Section 1234(b) and whether the restructuring of the call options caused those contracts to be materially modified under Section 1001, resulting in an exchange or deemed exchange at the time of the restructuring.

Taxpayer argued that Section 1234(b), which provides a character rule for closing transactions involving options on certain property, including commodities, and that, in the case of the grantor of the option, provides that gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property shall be treated as a gain or loss from the sale or exchange of a capital asset held for not more than one year, is inapplicable as the contracts were not options following the restructuring. In addition, Taxpayer argued as a result of the restructuring, the call options were exchanged for bilateral contracts due to the addition of the spot price delivery feature which eliminated the counterparty's "optionality."

The IRS ruled that, even after the contracts' restructuring, the contracts continued to have the key option elements, i.e., the counterparties had the right to acquire specified property (the commodity) at specified dates and for a specified price and the premium paid by the counterparties in year 1 was not reduced or refunded in any way. Thus, in form at least, the restructured contracts continued to have the essential elements of an option on property. As for the spot price delivery feature, the IRS determined it had little or no economic impact. The added feature did not upset or alter the apportionment of pricing risks that was established by the original call options. The IRS stated the fact that delivery was "required" should not preclude option treatment. The key distinction is not whether performance is legally required (as delivery is being assumed herein to have been if the contracts were not closed out in advance of expiration); it is whether the option holder was obligated to perform at that fixed price or suffer exposure or damages comparable to that which would be borne if it had committed to buying or selling at a fixed price. Unlike forwards or other bilateral property contracts, an option holder is not exposed to damages measured by the difference between the underlying option property's value and the fixed option price. Since the counterparties involved were not obligated to take delivery under the restructured contracts at a fixed price (the only "obligation" was to take delivery at a spot price if the spot price was less than the fixed strike price), the restructured contracts continued to be options and their closing gave rise to capital losses under Section 1234(b).

A second issue addressed by the ruling was whether the restructuring of the call options caused those contracts to be materially modified under Section 1001, resulting in an exchange or deemed exchange at the time of the restructuring. The Tech Advice observes that there is limited formal guidance addressing the exchange or modification of non-debt instruments. However, the Tech Advice concludes that, as described above, Taxpayer's modifications did not change the nature of the original call contracts. The IRS concluded that the addition of a physical delivery requirement was not a material change and that for fungible property that is readily traded, the obligation to take delivery does not generally constitute a meaningful right or obligation. The IRS also concluded that the nominal reduction in the strike

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[1] TAM 201142020.

[2] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

[3] The call options were restructured for financial accounting purposes (so Taxpayer could take the position on its financials that the transactions were "normal sales" under FAS 138, thereby avoiding the application of FAS 133 and the recognition of unrealized losses under that standard's mark-to-market rules).

Tech Advice on Restructured Call Options

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price was not a material modification and that the strike price was not significantly reduced (the reduction percentage was redacted in the ruling) and was substantially greater than the market price at the time of modification. While the alteration of the delivery or expiration dates can have great significance, according to the IRS there were several mitigating factors on the impact of the expiration date changes, including that the contracts were nowhere near expiring and that the change of expiration date differed nominally from the prior relevant exercise date. In addition, most of the extensions were inside the taxable year of the original exercise dates. Based on the totality of the changes, the Tech Advice concludes that most of the restructured contracts did not materially differ in kind or extent from the original written options, so they were not deemed exchanged under Section 1001. However, there was one group of restructured contracts that were altered so that the original exercise dates were extended by a greater period of time. Although these call options still had the same number of years remaining, the Tech Advice concludes that the extension of the exercise period by an amount greater than a specified percentage (also redacted) and beyond the taxable year end of the original options is a material change in and of itself, resulting in an exchange under Section 1001.

In addition, Taxpayer also argued that the restructured calls were not hedging transactions under Section 1.1221-2 because they (i) were "primarily" entered into to "finance" the purchased puts or obtain favorable accounting treatment; (ii) did not substantially reduce pricing risk or risk of loss; and (iii) did not hedge the commodity it presently held. The IRS rejected Taxpayer's assertions on the grounds that the restructured calls were entered into for the purpose of reducing risk, and the calls were a hedge of Taxpayer's inventory. Finally, the IRS held that Taxpayer was not permitted to take losses on the restructured calls upon termination (during the year 9 closing transactions). Rather, in order to clearly reflect income under the Section 1.446-4 hedge matching rules, those losses should be taken into account during the same taxable year that the applicable calls were scheduled to expire.

Second Circuit Rejects GE Capital Deal, Again

For the second time in six years, the U.S. Court of Appeals for the Second Circuit (the "Second Circuit") rejected a GE Capital Corporation ("GECC") transaction involving allocation of aircraft lease income to two Dutch banks. On January 24, 2012, the Second Circuit unanimously held that the IRS properly assessed additional tax and a substantial understatement penalty against a GECC subsidiary for its 1997 and 1998 tax years.

The case involved a 1993 transaction in which the GECC subsidiary (TIFD III-E, Inc.) created an LLC (Castle Harbour) that was treated as a partnership for federal income tax purposes with two Dutch banks as partners. GE contributed cash, fully tax depreciated airplanes and rents due on the airplanes. The Dutch partners contributed $67.5 million to Castle Harbour and purchased $50 million of GE's interest in Castle Harbour, bringing the total Dutch contribution to $117.5 million, representing 18% of Castle Harbour's capital. The partnership agreement allocated 98% of Castle Harbour's operating income to the Dutch partners and provided that over eight years, the Dutch banks' interest would be almost entirely bought out by partnership income, giving the Dutch partners a 9% return on their investment. Since the aircraft were fully depreciated for tax purposes, the taxable income allocated to the Dutch banks was greater than their book allocation by the amount of book depreciation. (The Dutch partners were insensitive to this book/tax difference since they paid no U.S. taxes.) The IRS challenged this transaction on three grounds. First, the IRS argued that the transaction should be disregarded as a sham. Second, the IRS argued that the Dutch banks were not really partners for tax purposes and should not be allocated any partnership income. Finally, the IRS argued that the partnership allocations violated the "overall tax effect" rule of Code Section 704(b).

In 2004, the Federal District Court in Connecticut found that the banks were valid partners and rejected each of these arguments. In particular, the court found that the transaction had both a non-tax economic effect (since the Dutch partners had a direct stake in the partnership's fortunes and participated in economic upside) as well as a non-tax business purpose (including GE's need to raise capital).

The Second Circuit reversed and remanded the District Court's ruling for the first time in 2006. The Second Circuit considered the transaction a sham and held that the Dutch banks were not partners under common law partnership tax principles. The Second Circuit, however, remanded the case to the District Court for consideration in the first instance of the taxpayer's argument that the banks qualified as partners under Section 704(e)(1).

In 2009, on remand, the IRS argued to the District Court that the Second Circuit's holding that the banks' interest was not a bona fide equity participation precluded the court from finding, on the same factual record, that the banks qualified as partners. The District Court rejected this argument and found that the banks met the requirements of the "family partnership" rules[4] in Section 704(e)(1) because (i)

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[4] Section 704(e)(1), although entitled "Family Partnerships," provides that "[a] person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."

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Castle Harbour Decision

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they, as opposed to some other entity, truly owned their interest in Castle Harbour; (ii) their interest was a capital interest; and (iii) capital, in the form of aircraft, was a material income-producing factor for Castle Harbour. Lastly, the District Court also concluded that, even if its ruling that the banks qualified as partners under Section 704(e) was ultimately overturned, the government could not impose a penalty pursuant to Section 6662(d) on the taxpayer for substantial understatement of income or negligent underpayment of tax in the years 1997 and 1998, because "substantial authority" supported the treatment of the banks' interest as equity for tax purposes.

In reversing the District Court again in January of this year, the Second Circuit held that the Dutch banks were not partners under Section 704(e)(1) and that a substantial understatement penalty could be imposed. The Second Circuit found that the banks' interest was not a capital interest under Section 704(e)(1). The court concluded that holding a debt, the nature of the banks' interest, does not result in ownership of a capital interest in a partnership to qualify that person as a partner under Section 704(e)(1). Thus, the Second Circuit rejected the District Court's finding that Section 704(e)(1) changed the law to allow debt to be considered a partnership interest after the Supreme Court's decision in *Commissioner v. Culbertson*. The Second Circuit also disagreed with the District Court that there was substantial authority for treatment of the banks as partners, finding that no substantial authority was provided for the tax treatment and that the IRS properly assessed a penalty for substantial understatement of income.

IRS Releases Field Attorney Advice Disallowing Benefits of a Dividends-Received Deduction Transaction

In our last issue of Tax Talk, we highlighted a Chief Counsel Advice Memorandum in which the IRS argued that cumulative preferred stock was Section 1504(a)(4) preferred stock because a payment of unpaid accumulated dividends upon redemption at maturity was not an "unreasonable redemption premium."[5] On March 23, 2012, the IRS released a second ruling in a short period of time that attacks a dividends-received deduction transaction; Field Attorney Advice 20121201F denies the dividends-received deduction on the grounds that the taxpayer had diminished its risk of loss.

The taxpayer ("Taxpayer") at issue purchased preferred shares from the issuer ("Issuer") which paid dividends for which Taxpayer claimed a dividends-received deduction. The dividend rates associates with these shares were fixed for a period of months and then reset. The dividend rates were reset to an agreed upon rate; however, if the parties could not agree, then the shares were remarketed. Upon a successful remarketing, Taxpayer would receive its purchase price for the shares. If the shares were not successfully remarketed, the dividend rate was reset at a higher rate, which would economically compel the shares to be redeemed at least according to the IRS. Upon a redemption, Taxpayer would receive its purchase price plus a redemption premium. If Issuer liquidated, Taxpayer also received its purchase price.

A corporation is entitled to a dividends-received deduction on preferred shares if it holds the shares for a specified period of time (in the case of preferred stock for 90 days or less during the 181-day period beginning on the date that is 90 days before the date on which such share becomes ex-dividend with respect to such dividend). A taxpayer's holding period is reduced where the taxpayer (i) is obligated to sell, or has made (and not closed) a short sale of, substantially identical stock or securities, (ii) is the grantor of an option to buy substantially identical stock or securities, or (iii) has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property.

In the Field Attorney Advice, the IRS concluded that Taxpayer's ability to receive its purchase price for the shares upon a redemption, liquidation and after a period of months, upon a remarketing, was essentially a put option to sell the shares for their purchase price, which reduced Taxpayer's holding period. Additionally, Taxpayer was the beneficiary of certain guarantee agreements which, in the IRS's view, diminished the taxpayer's risk of loss. Taken together, the IRS held that these transaction features were all implemented simultaneously with each other and with Taxpayer's acquisition of the preferred shares. Because these features diminished Taxpayer's risk of loss, Taxpayer's holding period for the preferred shares was reduced to zero. As a result, the Field Attorney Advice found Taxpayer was ineligible for a dividends-received deduction for dividends attributable to the preferred shares of Issuer.

[5] See "IRS Technical Advice: Cumulative Preferred Stock that Pays Accumulated Dividends at Redemption is Section 1504(a)(4) Preferred Stock" in MoFo Tax Talk 4.4 at http://www.mofo.com/files/Uploads/Images/120130-Tax-Talk.pdf.

Treasury Publishes Highly Anticipated "Withholdable Payment" FATCA Regulations and Outlines International Cooperation Alternative

After months of waiting, the Treasury released proposed Foreign Account Tax Compliance Act ("FATCA") "withholdable payment" regulations[6] on February 8, 2012. FATCA, contained in Sections 1471 through 1474 of the Code, was originally enacted as part of the Hiring Incentives to Restore Employment Act (the "HIRE Act") in 2010. Within the past two years, Treasury and the IRS have issued preliminary FATCA guidance in the form of three Notices (collectively, the "FATCA Notices"),[7] with the repeated promise of proposed regulations. The newly issued proposed regulations incorporate the guidance provided in the FATCA Notices in a revised and refined manner. While the proposed regulations go into excruciating detail on the many facets of FATCA, this client alert highlights the significant modifications and additions to prior FATCA guidance. The text of the proposed regulations, along with Treasury's joint statement from the U.S., France, Germany, Italy, Spain, and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA, can be found on our FATCA website, KNOWFatca.com.

[6] REG-121647-10.

[7] Notice 2010-60, 2010-37 I.R.B. 329, Notice 2011-34, 2011-19 I.R.B. 765, and Notice 2011-53, 2011-32 I.R.B. 124. See our prior client alerts on Notice 2010-60, http://www.mofo.com/files/Uploads/Images/100910FACTA.pdf, Notice 2011-34, http://www.mofo.com/files/Uploads/Images/110420-IRS-Guidance-FATCA.pdf, and Notice 2011-53, http://www.mofo.com/files/Uploads/Images/110719-IRS-Announces-Phased-Implementation-of-FATCA.pdf.

Grandfathered Obligations

As originally enacted in the HIRE Act, "obligations" outstanding on March 18, 2012 were grandfathered and not subject to FATCA reporting and withholding. An "obligation" for purposes of the grandfather provision is any legal agreement that produces or could produce a withholdable payment or "passthru payment," other than an instrument that is treated as equity for U.S. tax purposes or that lacks a stated expiration or term. The proposed regulations expand the definition of a grandfathered obligation to include obligations outstanding on January 1, 2013. Withholding is not required with respect to any payment under a grandfathered obligation or from the gross proceeds from any disposition of such an obligation.

Despite grandfathered obligations being exempt from FATCA reporting and withholding, any material modification of a grandfathered obligation will result in such obligation being treated as newly issued on the date of the material modification. In the case of an obligation that is a debt instrument for U.S. tax purposes, a material modification means a significant modification pursuant to Treasury regulations.[8] In all other cases, whether a modification of an obligation is material will be determined based upon all relevant facts and circumstances.

The proposed regulations do not include in the definition of a grandfathered obligation any interest in an entity that is treated as equity for U.S. tax purposes, regardless of whether such entity holds assets that give rise to grandfathered payments. According to the preamble, Treasury and the IRS are considering whether to treat as grandfathered obligations certain equity interests in vehicles that invest solely in debt and similar instruments, if certain requirements are satisfied.

[8] Section 1.1001-3.

Passthru Payments

Under Section 1471(d)(7), a passthru payment is defined as any withholdable payment or other payment to the extent attributable to a withholdable payment. Foreign financial institutions ("FFIs") that are participating FFIs ("PFFIs") must withhold on passthru payments made to non-participating FFIs and recalcitrant account holders. When Treasury released FATCA's phased implementation approach in the summer of 2011, Notice 2011-53 stated that PFFIs will not be obligated to withhold on passthru payments that are not withholdable payments (e.g., foreign passthru payments) made before January 1, 2015. The proposed regulations define a passthru payment to mean any withholdable payment and any foreign passthru payment.[9] After receiving numerous comments with regard to the costs, administrative complexity, and legal impediments associated with identifying and withholding on passthru payments, the proposed regulations further provide that withholding will not be required with respect to foreign passthru payments before January 1, 2017. Instead, until withholding applies, the proposed regulations require PFFIs to report annually to the IRS the aggregate amount of certain payments made to each non-participating FFI. The proposed regulations reserve on the definition of a foreign passthru payment, presumably due to the fact that withholding does not apply before January 1, 2017.

If the proposed regulations are finalized in their current form, withholding and reporting on passthru payments would be implemented as follows: (i) (a) beginning on January 1, 2014, FFIs will be required to withhold on passthru payments that are withholdable payments and (b) FFIs will also be required to report annually on the aggregate amount of certain payments to each non-participating FFI for the 2015 and 2016 calendar years; and (ii) beginning no earlier than January 1, 2017, the scope of passthru payments will be expanded beyond withholdable payments and FFIs will be required to withhold on such payments pursuant to and in

[9] Prop. Reg. Section 1.1471-5(h).

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accordance with future guidance.

According to the preamble, Treasury and the IRS are considering modifications to passthru payment withholding, including whether to allow certain FFIs to rely upon a safe harbor passthru percentage if the FFI does not elect to calculate its exact passthru percentage.

In addition, the proposed regulations provide a special rule for dormant accounts, under which a PFFI that withholds on passthru payments made to a recalcitrant account holder of a dormant account may, in lieu of depositing the tax withheld, set aside the amount withheld in escrow until the date that the account ceases to be a dormant account.

Financial Accounts

Pursuant to FATCA, FFIs that enter into an FFI Agreement[10] are required to identify their "U.S. accounts" and comply with verification and due diligence procedures prescribed by Treasury. A U.S. account is defined under Section 1471(d)(1) as any "financial account" held by one or more specified United States persons or United States owned foreign entities, subject to certain exceptions.

As originally enacted, a "financial account" is any depository account, custodial account, or equity or debt interest in an FFI, other than interests that are regularly traded on an established securities market.[11] However, the proposed regulations refine the definition of financial accounts to focus on traditional bank, brokerage, money market accounts, and interests in investment vehicles, and to exclude most debt and equity securities issued by banks and brokerage firms, subject to an anti-abuse rule.

- First, as provided in Section 1471(d)(2)(C), debt or equity that is regularly traded on an established securities market is not a financial account.
- Second, the proposed regulations provide that an equity interest includes a capital or profits interest in a partnership and, in the case of a trust that is a financial institution, the interest of an owner under the "grantor trust" rules of Sections 671 through 679 and a beneficial interest in a trust.
- Third, the proposed regulations provide that an equity or debt interest in a financial institution is a financial account if it is an equity or debt interest in a financial institution that is engaged primarily in the business of investing, reinvesting, or trading securities.[12] In addition, in the case of a financial institution that is engaged in banking or similar business, holds financial assets for the account of others, or is an insurance company, equity or debt instruments in such financial institution will constitute financial accounts only if the value of those interests is determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments. This represents a significant cutback in the broad statutory definition.

Transition Rules

The proposed regulations incorporate a number of transition rules with regards to FATCA compliance. One is a transition rule with respect to affiliates with legal prohibitions on compliance. Under FATCA, when an FFI enters into an FFI Agreement, such FFI Agreement not only applies to the U.S. accounts of the PFFI, but applies to the U.S. accounts of each additional FFI that is a member of the same expanded affiliated group. Notice 2011-34 states that Treasury intends to require that each FFI that is a member of an expanded affiliated group be a PFFI or deemed-compliant FFI in order for any FFI in the expanded affiliated group to become a PFFI. Recognizing that certain jurisdictions prohibit an FFI from fully complying with the FATCA requirements, the proposed regulations provide a two-year transition period, until January 1, 2016, for the full implementation of this requirement. During this transitional period, an FFI affiliate in a jurisdiction that prohibits the reporting or withholding required by FATCA will not prevent other FFIs within the same expanded affiliated group from entering into an FFI Agreement, provided that the FFI in the restrictive jurisdiction agrees to perform due diligence to identify its U.S. accounts, maintain certain records, and meet certain other requirements.

The proposed regulations also provide for an extension of the transition period for the scope of information reporting. Notice 2011-53 provided a phased implementation of the FATCA reporting requirements, where only identifying information (name, address, TIN, and account number) and account balance or value of U.S. accounts would be required to be reported in 2014 (with respect to 2013). The proposed regulations postpone certain reporting requirements and provide that reporting on income will be phased in beginning in 2016 (with respect to the 2015 calendar year), and reporting on gross proceeds will begin in 2017 (with respect to the 2016 calendar year). If the proposed regulations are finalized in their current form, the phase-in of reporting obligations is as follows:

- For reporting in 2014 and 2015 (with respect to calendar years 2013 and 2014), PFFIs are required to report only name, address, TIN, account number, and account balance with respect to U.S. accounts.
- Beginning with reporting in 2016 (with respect to calendar year 2015), in addition to the aforementioned information, income associated with U.S. accounts must be reported.

[10] The preamble states that Treasury intends to publish a draft model FFI agreement in early 2012 and a final model FFI agreement in the fall of 2012. Prop. Reg. Section 1.1471-4 sets forth the general requirements that will apply to an FFI under an FFI agreement.

[11] Section 1471(d)(2).

[12] The regulations provide guidance with respect to the circumstances under which an entity is engaged primarily in the business of investing, reinvesting, or trading securities and other relevant assets. See Prop. Reg. Sections 1.1471-5(e)(1) and (e)(4).

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- Beginning with reporting in 2017 (with respect to calendar year 2016), full reporting, including information on the gross proceeds from broker transactions, will be required.

Deemed-Compliant FFIs

Section 1471(b)(2) provides that an FFI may be deemed to comply with FATCA's reporting requirements if it meets certain requirements. Notice 2011-34 provided initial guidance regarding certain categories of FFIs that will be deemed-compliant. The proposed regulations implement the exclusions provided in Notice 2011-34, and expand the categories of deemed-compliant FFIs to include certain banks and investment funds conducting business only with local clients, low-risk entities, or PFFIs, subject to restrictions designed to prevent the FFIs from being used for U.S. tax evasion.

One interesting note on the expansion of the deemed-compliant FFI category is that the proposed regulations include as a deemed-compliant FFI an FFI regulated as an investment fund under the law of its country of organization and for which each distributor of the investment fund's interests is a PFFI, a registered deemed-compliant FFI, a nonregistering local bank, or a restricted distributor.[13] The proposed regulations require that each agreement that governs the distribution of the investment fund's debt or equity interests (other than interests which are both distributed by and held through a PFFI) prohibit sales of debt or equity interests in the fund to U.S. persons, non-participating FFIs, or passive non-financial foreign entities ("NFFEs") with one or more substantial U.S. owners, and its prospectus must indicate that sales to U.S. persons, passive NFFEs, and non-participating FFIs (other than interests which are both distributed by and held through a PFFI) are prohibited. The FFI must also establish procedures to review preexisting direct accounts and ensure proper treatment of new direct accounts.

Due Diligence Procedures for the Identification of Accounts

In order to comply with FATCA reporting requirements, FFIs are required to identify their U.S. accounts.[14] Notices 2010-60 and 2011-34 provide guidance regarding the due diligence procedures that PFFIs will be required to undertake to identify their U.S. accounts. Treasury received numerous comments to reduce the administrative burden on FFIs regarding such due diligence procedures. The due diligence procedures were modified and the proposed regulations outline the procedures required to be undertaken by FFIs to identify their U.S. accounts. For this purpose, the proposed regulations distinguish between the diligence expected with respect to individual accounts and entity accounts and between preexisting accounts and new accounts. According to the preamble, it is intended that FFIs that adhere to the diligence guidelines outlined in the proposed regulations will be treated as compliant with the requirement to identify U.S. accounts and will not be held to a strict liability standard.

To summarize the modified due diligence procedures, for preexisting individual accounts that are offshore obligations, manual review of paper records is limited to accounts with a balance or value that exceeds $1,000,000. In addition, the proposed regulations provide detailed guidance on the precise scope of paper records required to be searched. Additionally, with respect to preexisting accounts, individual accounts with a balance or value of $50,000 or less, and certain cash value insurance contracts with a value of $250,000 or less, are excluded from the due diligence procedure. With respect to preexisting entity accounts, the following measures are proposed: (i) accounts of $250,000 or less are exempt from review until the account balance exceeds $1,000,000; (ii) extended reliance on information gathered in the context of the due diligence required to comply with anti-money laundering/"know your customer" rules; and (iii) simplified procedures to identify the status of preexisting entity accounts. With respect to new accounts, the proposed due diligence procedures rely extensively on an FFI's existing customer intake procedures. According to Treasury, the proposed regulations generally do not require an FFI to make significant modifications to the information likely collected on customer intake, other than with respect to account holders identified as FFIs, as passive investment entities, or as having U.S. indicia.

Withholdable Payments and Source

A withholdable payment is defined in Section 1473(1) to mean, subject to certain exceptions: (i) any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income (FDAP income), if such payment is from sources within the United States; and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States. The proposed regulations refine the definition of a withholdable payment as any payment of U.S. source FDAP income and, for any sales or other dispositions occurring after December 31, 2014, any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends that are U.S. source FDAP income.[15]

The proposed regulations clarify that an exclusion from Chapter 3[16] withholding or an exclusion from taxation under Section 881 does not exclude such amount from the definition of U.S. source FDAP for the purpose of determining whether a payment is a withholdable payment under

[13] See Prop. Reg. Section 1.1471-5(f)(1)(i)(D).

[14] Section 1471(b).

[15] Prop. Reg. Section 1.1473-1(a).

[16] Comprised of Sections 1441 through 1464.

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FATCA.[17] While bank deposit interest with respect to offshore accounts is ordinarily treated as foreign source income,[18] such interest is treated as income from sources within the United States for purposes of the definition of a withholdable payment. Similar to the rule that applies for purposes of withholding under Chapter 3, if a withholding agent cannot determine the source of a payment at the time the payment is made, the payment is treated as U.S. source. The proposed regulations also provide a list of payments that are excluded from the definition of withholdable payments. This list includes original issue discount from certain short-term obligations, income that is taken into account as effectively connected with the conduct of a trade or business in the U.S., certain payments in the ordinary course of the withholding agent's business, gross proceeds from the sale of property that can produce income that is excluded from the definition of withholdable payment, and certain broker transactions that involve the sale of fractional shares.

Effective Date

The proposed regulations would be effective on the date Treasury adopts these rules as final regulations and, as noted above, other dates for specific provisions.

Intergovernmental Cooperation as an Alternative to FATCA

According to the preamble, Treasury and the IRS have consulted with foreign governments on the relationship between coordination with local law and complying with FATCA reporting. The preamble states that Treasury and the IRS are considering, in consultation with foreign governments, an alternative approach to implementation, whereby an FFI could satisfy the reporting requirements if: (i) the FFI collects the information required and reports this information to the government of its country of residence; and (ii) the government of its country of residence enters into an agreement to report this information annually to the IRS, pursuant to an income tax treaty, tax information exchange agreement, or other agreement with the U.S.

At the same time it released the proposed regulations, Treasury released a joint statement from the U.S., France, Germany, Italy, Spain, and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA. The joint statement notes that the U.S. is open to adopting an intergovernmental approach to implement FATCA and improve international tax compliance and is willing to reciprocate in collecting and exchanging on an automatic basis information on accounts held in U.S. financial institutions by residents of France, Germany, Italy, Spain, and the United Kingdom. In light of these considerations, the U.S., France, Germany, Italy, Spain, and the United Kingdom have agreed to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchange based on existing bilateral tax treaties.

[17] Prop. Reg. Section 1.1473-1(a)(2)(i)(B).

[18] See Section 861(a)(1)(A).

IRS Issues Guidance on Registered Bonds Days Before Repeal of Bearer Bond Exception

FATCA ends the practice by U.S. issuers (and controlled foreign corporations) of selling bearer debt to foreign investors under "TEFRA C" and "TEFRA D" after March 18, 2012.[19] As a result, debt issued after that date must be issued by U.S. issuers in registered form. FATCA codified IRS Notice 2006-99, providing that debt obligations cleared through dematerialized book-entry systems would be treated as being issued in registered form. On March 7, 2012, the IRS released Notice 2012-20 (the "Notice"), which addresses, among others, (i) the circumstances under which certain bonds are treated as in registered form, and (ii) a temporary relief from the requirement to collect IRS Forms W-8 in order to qualify for the portfolio interest exemption from U.S. withholding tax on interest. The U.S. Treasury Department said it intends to issue regulations implementing the provisions included in the Notice.

Registered Bonds

The Notice states that a debt obligation will be considered to be in registered form for U.S. federal income tax purposes if the obligation is issued through (i) a dematerialized book entry system in which beneficial interests are transferable only though a book entry system maintained by a clearing organization (or its agent), or (ii) a clearing system in which the obligation is effectively immobilized.

Pursuant to the Notice, an obligation will be treated as immobilized if (i) the obligation is represented by one or more global securities in physical form that are issued to and held by a clearing organization (or its custodian or depository acting as its agent) for the benefit of purchasers of interests in the obligation under arrangements that prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms, and (ii) beneficial interests in the underlying obligation are transferable only through a book entry system maintained by the clearing organization (or its agent).

According to the Notice, dematerialized or immobilized obligations are issued in registered form even if holders may receive bearer bonds in the following

[19] For further background with respect to the repeal of the bearer bond exception (and the potential sanctions resulting from non-compliance), please see our prior client alert at http://www.mofo.com//files//Uploads/Images/100322FATCA.pdf.

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Guidance on Registered Bonds

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circumstances: (i) termination of the clearing organization's business without a successor, (ii) default by the issuer, or (iii) issuance of definitive securities at the issuer's request upon a change in tax law that would be adverse to the issuer but for the issuance of physical securities in bearer form. The Notice provides that, if any such circumstance occurs, regardless of whether any option to obtain a physical certificate in bearer form has been exercised, any obligation as to which a holder has a right to obtain a physical certificate in bearer form will no longer be considered in registered form.

Temporary Relief from Collecting IRS Forms W-8

The IRS indicates in the Notice it has received comments that there may be difficulties in obtaining IRS Forms W-8 in certain non-U.S. markets in connection with the issuance of registered debt. Such forms are required to qualify for the portfolio interest exemption from 30% U.S. withholding tax on interest payments.

In response to these comments, the Notice provides that no IRS Forms W-8 are per se required for obligations issued in registered form after March 18, 2012 and before January 1, 2014, provided the obligations are issued in compliance with the "foreign-targeted registered obligation" rules.[20] However, to qualify for the portfolio interest exemption from the 30% U.S. withholding tax on interest payments, a U.S. withholding agent must receive either (i) IRS Form W-8, or (ii) documentary evidence certifying that the beneficial owner of the registered obligation is not a U.S. person. The "foreign-targeted registered obligation" rules generally require any registered obligations to only be sold to non-U.S. persons pursuant to procedures similar to TEFRA D but permit certain intermediaries to certify as to the holder's non-U.S. status.

[20] These rules were suspended by Notice 2006-99 and have now temporarily come back to life.

Short-Term Debt and Excise Tax

The Notice confirms that the TEFRA C and TEFRA D procedures will remain in existence for purposes of an exception from information reporting of interest with respect to certain short-term obligations (term of 183 days or less) and for purposes of avoiding the excise tax (equal to 1% of the principal amount of the obligations times the number of years to maturity) with respect to obligations that are not issued in registered form for U.S. federal income tax purposes.

MoFo in the News

On January 29-31, 2012, Henry Fields joined the panel "Director Liability Workshop: Exploring Board Liabilities Throughout the Deal Process" in the Bank Director Conference, "Acquire or Be Acquired." Bank Director's Acquire or Be Acquired conference has been widely regarded as the financial industry's premier M&A and growth event since 1995. Both bankers and financial executives have attended this three-day conference to network with peers and explore a variety of growth options through interactive sessions and presentations. With many predicting a massive wave of consolidation in the coming years, our 2012 event focused on both organic growth and M&A activity.

MoFo partners David Lynn and Anna Pinedo participated in a PLI Webcast titled "Private Offering Reform" on January 30, 2012. As attention in the United States has turned to job creation, the dialogue related to regulatory burdens and their effect on capital formation has taken on a new sense of urgency. The webcast discussed a number of the concerns that have been raised regarding the potentially chilling effect of certain regulations on capital raising by smaller or emerging companies. The webcast also discussed some of the changes in private offering requirements that are currently being debated.

IFLR sponsored a Webinar titled "Recovery and Resolution Planning: A U.S. and European View," on February 1, 2012, led by Peter Green, Jeremy Jennings-Mares and Dwight Smith. In an effort to ensure that no banking organization is too big to fail, U.S. and European regulators are requiring systemically important banking institutions to file plans that explain how they would recover from an economically distressed situation and how they could be resolved or liquidated safely in the event of failure. In developing these plans, globally important banks will have to deal with regulators in different countries and with different resolution tools. The panel reviewed the final resolution plan regulation in the U.S. and the emerging requirements in the UK and Europe.

During the February 2, 2012 MoFo Classics on Research Rules, led by Anna Pinedo and Nilene Evans, participants addressed the regulations affecting research coverage and research analyst independence.

Anna Pinedo participated in the 4th Annual SPA and MoFo Structured Products Legal, Regulatory & Compliance Update 2012, held on February 6, 2012. This presentation focused on critical developments in the legal-regulatory-compliance landscape. Topics included: FINRA's filing requirement and principal review of FWPs prior to broad dissemination; hybrids and Dodd-Frank legislation; litigation and arbitration review; regulation of internal communications; retail communications on an online, electronic forum; strategies for SEC/FINRA on-site inspections; and Jim Cotar's new white-paper on "Analysis of Structured Products in the Context of Historical Performance."

MoFo partners Anna Pinedo and Remmelt Reigersman led the February 7, 2012 MoFo Classics on Debt Repurchases & Exchanges. With many debt securities trading at discounted levels, this session discussed the structuring, documentation, securities law and tax consequences associated with debt repurchases, tenders and exchanges.

On February 7, 2012, Anna Pinedo participated in the GARP Webinar titled "How Basel III Will Change Risk Management in the U.S." The ink is barely dry on the final Basel III proposals, yet a number of implementation challenges

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MoFo in the News

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are coming to light. In the U.S., where financial institutions and risk practitioners are already struggling with the Dodd-Frank Act, incorporating Basel III raises a complex series of questions.

IFLR's Structured Products with Derivatives Forum 2012 was held on February 9, 2012, in which Peter Green, Jeremy Jennings-Mares and Anna Pinedo participated. IFLR's second annual Structured Products & Derivatives Forum in London discussed Mifid II, Dodd-Frank, Emir, Basel III, CRD 4 and how these regulations and laws work alongside each other. There was also a focus on retail structural products, how to protect collateral in restructurings and the future of documentation. The forum was in a panel format and featured legal industry leaders from banks, corporations and private practice.

MoFo partners Anna Pinedo and David Lynn led the February 16, 2012, MoFo Classics "Reg M Refresher." A discussion of Reg M issues related to stock buybacks; offerings; and M&A transactions, and a review of Rule 105.

Anna Pinedo presented the "Dodd-Frank: Progress Report?" on February 21, 2012, at Cardozo School of Law. The discussion provided a brief overview of the progress of rulemaking pursuant to the Dodd-Frank Act, with a focus on the provisions applicable to regulatory capital; the capital markets (securitization, Volcker); and derivatives. Following a status report on these areas, the discussion focused in on the ways in which the Act veered from its mission of addressing the root causes of the financial crisis and instead chose to address other areas that did not have a direct nexus to the financial crisis, and finally focused on the disconnect between the Act and the capital markets.

On February 21, 2012, David Kaufman and Dwight Smith spoke at The FENG Banking S.I.G. seminar about Dodd-Frank legislation and its impact on the banking sector, its far reaching regulatory consequences and potential spillover effects to the U.S. economy. The panel included Susan Lee from Promontory Capital and was moderated by Serge Sondak, Co-Chair Banking SIG.

Charles Horn spoke at the BBA Conference: Dodd-Frank Update Seminar, held on February 21, 2012.

MoFo partners Anna Pinedo and Nilene Evans led the March 1, 2012 MoFo Classics titled "FINRA & Offerings," which was a review of the regulations relevant to offerings (public and private).

The "Reg M Refresher" PLI Webcast was held on March 5, 2012, in which David Lynn and Anna Pinedo discussed Regulation M issues related to stock buybacks, offerings and M&A transactions, and also reviewed Rule 105.

The March 8, 2012 IFLR Webcast titled "Private Placement Reform," led by David Lynn and Anna Pinedo, provided an overview of the regulatory burdens that impact capital raising in the U.S. They also discussed proposed reforms to the IPO process and to the private offering process and how these may help U.S. and foreign companies to access the capital markets more easily.

Charles Horn and Dwight Smith discussed Basel III and the impact on financial institutions at a PLI Webcast on Basel III on March 12, 2012.

Anna Pinedo and Nilene Evans spoke at the March 13, 2012 West Legalworks Webinar on FINRA, which covered a review of the regulations relevant to offerings (public and private).

Also on March 13, 2012, a breakfast seminar led by Peter Green and Jeremy Jennings-Mares on MiFID II was held at MoFo London. This seminar discussed the main changes proposed by the MiFID II package, how they interact with other, related European and international initiatives and the impact that such changes will have on financial markets, services and products in Europe.

On March 20, 2012, the West Legalworks Webinar titled "Private Placements" was presented by Anna Pinedo and David Lynn.

Anna Pinedo spoke at a joint FENG and MoFo event titled "Using GRC (Governance, Regulatory, compliance) Issues to Gain a Competitive Advantage," on March 21, 2012.

On March 22, 2012, Anna Pinedo presented during a Tokyo Teleconference titled "Understanding Dodd-Frank."

Charles Horn, Oliver Ireland and Dwight Smith spoke at the Penn Program on Regulation on March 23, 2012. The Penn Program on Regulation was held in Washington, D.C., on March 23, 2012, and brought together leading scholars from the University of Pennsylvania's Law School and Wharton School for an interactive dialogue on core issues and implications of the Volcker Rule's implementation.

MoFo partner Anna Pinedo led the GARP Webinar titled "Basel III: Answering Your Risk Management Questions," on March 27, 2012.

On April 4, 2012, Peter Green and Lloyd Harmetz led the IFLR Webcast titled "Structured Products Developments." This program provided an update as to recent developments impacting structured product development and sales in the U.S. and Europe, based on recent regulatory initiatives from the SEC, FINRA, European Commission, ESMA and the FSA.

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