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IRS Provides Guidance on New Withholding and Reporting Provisions

On August 27, 2010, the Internal Revenue Service issued Notice 2010-60 (the "Notice"), which outlines proposals regarding the implementation of the new withholding and reporting provisions in the Hiring Incentives to Restore Employment Act of 2010 (the "Act"), codified as sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended (the "Code"). New section 1471 requires a foreign financial institution ("FFI") to report the identity of its "United States accounts" and new section 1472 requires a nonfinancial foreign entity ("NFFE") to report its direct or indirect "substantial United States owners." FFIs and NFFEs that fail to comply with the reporting requirements will be subject to a 30 percent U.S. withholding tax on certain "withholdable payments" made to them by U.S. persons after December 31, 2012.

Overview

The Notice states that the Treasury Department and the Internal Revenue Service (collectively, "Treasury") intend to issue guidance in advance of the December 31, 2012, effective date, including proposed regulations incorporating the guidance provided in the Notice and addressing other matters necessary to implement the new reporting and withholding rules. The Notice also

states that Treasury expects to publish a draft FFI agreement and draft information reporting and certifications forms.

In addition, the Notice provides preliminary guidance regarding certain "priority issues" in connection with the implementation of the new rules. Those issues include the mechanics of grandfathered obligations and the scope of obligations exempt from the new withholding and reporting rules, the definition of an FFI, requirements for identifying and reporting U.S. accounts and the information that must be reported by FFIs. The Notice focuses primarily on the application of the new rules to FFIs and does not address directly the application of those rules to NFFEs.

Grandfathered Obligations

Under the Act, no amount is required to be deducted or withheld from any payment under any obligation outstanding on March 18, 2012, or from the gross proceeds from any disposition of such an obligation. Treasury intends to issue regulations providing that the term "obligation" means any legal agreement that produces or could produce withholdable payments. Instruments treated as equity for U.S. tax purposes and agreements that lack a definitive expiration or term (such as savings deposits, demand

deposits and other similar accounts) will not be obligations for purposes of the Act. An obligation entered into on or before March 18, 2012, will be treated as outstanding on March 18, 2012, and any significant modification of an obligation will result in the issuance of a new obligation as of the effective date of such modification.

NFFEs

An NFFE is any foreign entity that is not a financial institution (defined below). NFFEs are subject to the documentation and reporting requirements set forth in section 1472, unless an exception applies. The Notice provides that the following NFFEs are excepted NFFEs and not subject to section 1472: (1) any corporation the stock of which is regularly traded on an established securities market, (2) any corporation that is a member of the same expanded affiliated group as a corporation the stock of which is regularly traded on an established securities market, (3) any entity that is organized under the laws of a U.S. territory and which is wholly owned by one or more bona fide residents (as defined in section 937(a)) of such U.S. territory, (4) any foreign government, any political subdivision of a foreign government or any wholly owned agency or instrumentality of the foregoing, (5) any international organization or any wholly owned agency or instrumentality thereof, (6) any foreign central bank of issue and (7) any other class of persons identified by the Secretary.

FFIs

An FFI generally is "any financial institution which is a foreign entity." A "financial institution" includes, but is

not limited to, an entity that falls within one (or more) of three categories:

- entities that would qualify as banks under specific Code provisions, savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions;
- broker-dealers, clearing organizations, trust companies, custodial banks and entities acting as custodians with respect to the assets of employee benefit plans; and
- mutual funds (or their foreign equivalent), funds of funds (and other similar investments), exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools and other investment vehicles.

The Notice also identifies certain types of foreign entities, such as offshore holding companies for operating businesses, that are excluded from the FFI definition. Significantly, Treasury acknowledges an exception for small investment funds with identified owners that meet certain documentation requirements (these entities will be treated as deemed-compliant FFIs) and those entities identified as posing a low risk of tax evasion, such as certain foreign retirement plans.

FFI Identification and Reporting Requirements

Under new section 1471, an FFI must enter into an FFI agreement, in which an FFI agrees to undertake certain due diligence, reporting and withholding obligations (a "participating

FFI"), to avoid the 30 percent withholding tax. Participating FFIs will first determine (1) whether individual account holders are U.S. persons or other persons and (2) whether nonindividual account holders are U.S. persons, FFIs or NFFEs.

Participating FFIs then will determine (1) whether entities that are U.S. persons are specified U.S. persons or other U.S. persons, (2) whether FFIs are participating FFIs, deemed-compliant FFIs or nonparticipating FFIs and (3) whether NFFEs, other than excepted NFFEs, are U.S.-owned foreign entities. An NFFE will be treated as a U.S.-owned foreign entity if it is found to have substantial U.S. owners.

U.S. financial institutions ("USFIs"), as payors, must make determinations similar to those required of FFIs. Specifically, USFIs making withholdable payments must determine whether to treat the entities receiving those payments as U.S. persons, FFIs or NFFEs. USFIs then must determine (1) whether FFIs are participating FFIs, deemed-compliant FFIs or nonparticipating FFIs and (2) whether NFFEs other than excepted NFFEs are U.S.-owned.

The Notice sets forth detailed procedures for FFIs and USFIs to use in making the foregoing determinations. Those procedures contain separate rules for (1) pre-existing financial accounts held by individuals, (2) new financial accounts held by individuals, (3) pre-existing financial accounts held by persons other than individuals (*i.e.*, pre-existing entity accounts) and (4) new financial accounts held by persons other than individuals (*i.e.*, new entity accounts). Treasury

contemplates that it will issue employer identification numbers (“EINs”) to participating FFIs and those EINs will be used by FFIs to identify themselves to withholding agents. Treasury also contemplates requiring participating FFIs and USFIs to report certain information to Treasury regarding the identity of any entity that provides documentation indicating that it is a participating FFI but that does not provide a valid EIN. Participating FFIs and USFIs will generally be permitted to rely on Forms W-9 collected for other U.S. tax purposes in meeting requirements under the new law.

Information Required to be Reported Under an FFI Agreement

Treasury is developing a new form for reporting the required information. That information will include:

- the name, address and taxpayer identification number (“TIN”) of each account holder that is a specified U.S. person;
- in the case of any account holder that is a U.S.-owned foreign entity, the name, address and TIN of each substantial United States owner of such entity;
- the account number (or if no account number is used by the FFI, the serial number or other

unique number the FFI assigns to the account);

- the account balance or value in U.S. dollars (the Notice indicates Treasury will want to see the highest regularly calculated balance of the year and to have access to additional account-related information, such as copies of account statements and daily receipts and withdrawals); and
- the gross receipts and gross withdrawals or payments from the account (determined for such period and in such manner as the Secretary may provide).

Treasury wants the reporting FFI to be the FFI that is in a direct payment relationship with the account holder, and Treasury intends to issue regulations to eliminate duplicative reporting. Treasury also intends to require a participating FFI to report the number and aggregate value of its financial accounts held by recalcitrant account holders, as well as the number and aggregate value of its accounts held by related or unrelated nonparticipating FFIs.

Some Client Considerations

The new information and reporting rule burdens are likely to be substantial. One result of these new rules is to effectively deny the portfolio interest

exemption to FFIs and NFFEs who fail to comply with the prescribed reporting requirements. Clients who are, or sponsor the formation of, offshore investment vehicles or financial enterprises must monitor the development of these rules. In particular, clients whose offshore enterprises are not directed toward, and do not permit, U.S. persons as customers or investors should consider making an effort to assure that these rules ultimately will not apply to them. Also, it would be helpful if these rules made it clear that foreign entities, which are taxable entities for U.S. tax purposes and may have U.S. owners but maintain no U.S. accounts, should not be burdened by these new rules. Treasury has requested specific comments on various aspects of the implementation of the new withholding and reporting rules, including, in particular, the treatment of passthru payments, sanctions with respect to recalcitrant account holders, the application of the rules to FFIs subject to restrictions that prohibit U.S. account holders and possible modification to the reporting and withholding requirements based on availability of information from other sources.

[A copy of the Notice is available here.](#) If you would like to receive more information about the Notice, please contact our firm.