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Proposed Treasury Regulations Implementing the Foreign Account Tax Compliance Act ("FATCA")

On February 8, 2012, the Internal Revenue Service ("IRS") announced the release of proposed regulations (the "Proposed Regulations") for the next phase of implementing reporting and withholding provisions of the HIRE Act (commonly known as the Foreign Account Tax Compliance Act, or FATCA, provisions) that target noncompliance by U.S. taxpayers using foreign accounts. Concurrently with the issuance of the Proposed Regulations, the United States, France, Germany, Italy, Spain, and the United Kingdom issued a joint statement outlining a potential intergovernmental framework for FATCA. Under the framework, much of the information required by FATCA would be collected directly by foreign governments and shared with the United States pursuant to existing bilateral tax treaties. Such an approach, if adopted, could eliminate withholding obligations and the requirement to enter into a separate disclosure compliance agreement for foreign financial institutions ("FFIs") organized in partner countries.

In support of this approach, Treasury released final regulations on April 17, 2012, that require the reporting of U.S. bank deposit interest paid to nonresident aliens. These final regulations will facilitate intergovernmental cooperation on FATCA implementation by better enabling the IRS, in appropriate circumstances, to reciprocate by exchanging information with foreign governments for tax administration purposes. The preamble to the final regulations notes that a foreign jurisdiction's willingness to share information with the IRS to combat offshore tax evasion by U.S. taxpayers depends, in large part, on the ability of the IRS to exchange information that will assist that jurisdiction in combating offshore tax evasion by its own residents. The reporting requirement under the final regulations is effective for payments of U.S.-source deposit interest made on or after January 1, 2013, and is separate from reporting requirements imposed under the FATCA regime. Information sharing under the regulations is limited to countries with which the United States has a tax information exchange agreement (a "TIEA"), implying that Treasury may not enter into a FATCA intergovernmental agreement with a country that does not have in effect a TIEA. The IRS released Revenue Procedure 2012-24 with the final regulations, which includes a list of countries with which the United States has TIEAs.

Additionally, other countries have already begun to adopt laws similar to FATCA. For example, legislation passed by the French Parliament in July 2011 imposes far-reaching tax and disclosure obligations on trusts that have a connection to France.

FATCA imposes a new 30% withholding tax on (i) U.S. source fixed or determinable annual or periodic income that is described in applicable U.S. Treasury Regulations (*e.g.*, interest, dividends, rents, salaries, wages), and (ii) gross proceeds from the disposition of any property of a type that can produce any of the foregoing types of income or profits. In order to avoid this withholding tax, a foreign financial institution ("FFI") will need either to become a so-called "participating FFI" by entering into a disclosure compliance agreement with the IRS or otherwise to meet certain requirements set out in the Proposed Regulations to qualify as a so-called "deemed-compliant FFI." Any FFI that (a) is not a deemed-compliant FFI and (b) fails to qualify as a participating FFI will be subject to the 30% withholding tax beginning January 1, 2014.

Since FATCA's enactment in March 2010, the IRS has issued several rounds of guidance and the proposed implementing rules are evolving considerably as the Treasury and the IRS continue to consider comments received from various stakeholders. However, the Proposed Regulations have been much anticipated by taxpayers that may be affected by the FATCA withholding tax regime and they provide a clearer insight into the possible contours of final regulations to be adopted, as well as some welcome relief in certain areas. This alert addresses the following key provisions of the Proposed Regulations and certain operational considerations:

I. Effective dates: FATCA reporting and withholding will be required on withholdable payments (other than gross proceeds) starting in 2014, and on gross proceeds starting in 2015. For passthru payments, participating FFIs will be required to withhold on withholdable payments starting in 2014, and on all other passthru payments starting in 2017.

II. Grandfathered obligations: FATCA reporting and withholding will not apply to a payment under any "obligation" (as defined in the Proposed Regulations) outstanding on January 1, 2013, or to the gross proceeds from any disposition of such an obligation. The Proposed Regulations clarify that the term "obligation" includes a line of credit or a revolving credit facility.

III. Deemed compliant entities: The categories of deemed-compliant FFIs described in the Proposed Regulations are broader than the categories of deemed-compliant FFIs described in prior guidance.

IV. Coordination of withholding regimes: The Proposed Regulations provide for the coordination of FATCA with other existing U.S. federal withholding tax regimes and propose the use of modified IRS Forms W-8 and W-9 for certain certification requirements under FATCA.

V. Definition of "financial account": The Proposed Regulations refine the definition of a "financial account" (in the case of an FFI, an account with respect to which FATCA applies) to focus on traditional bank accounts, brokerage accounts, 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.

I. Effective Dates

Activity	Effective Date
Grandfathering of obligations not subject to FATCA ends	December 31, 2012
Withholding on U.S. source interest/ investment income	January 1, 2014
Withholding on gross sale, redemption and retirement proceeds of assets of type that produce U.S. source interest/investment income	January 1, 2015
Withholding on passthru payments	January 1, 2017

FATCA withholding was originally scheduled to apply beginning on January 1, 2013. However, in light of the significant practical difficulties for market participants to develop compliance, reporting, and withholding systems necessary to comply with this highly complex regime in such a short time frame, the IRS decided to delay the original effective date and provide for a phased implementation. Generally, under the Proposed Regulations, the rules relating to the requirement to withhold U.S. tax on certain payments apply principally to U.S. financial institutions or withholding agents, and participating FFIs, other than FFIs serving as intermediaries with respect to withholdable payments, generally will not be required to withhold tax on payments made to account holders or nonparticipating FFIs before January 1, 2017. More specifically, withholding agents will be required to withhold on withholdable payments (other than gross proceeds) starting January 1, 2014, and on gross proceeds starting January 1, 2015. For payments made to nonparticipating FFIs and recalcitrant account holders, participating FFIs will be required to withhold on withholdable payments starting in 2014 (which will include gross proceeds starting January 1, 2015) and on all other passthru payments ("foreign passthru payments") starting in 2017.

The term "withholdable payment" means (1) any payment of U.S. source FDAP income; and (2) 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. The term "U.S. source FDAP income" means fixed or determinable annual or periodic income (as described in Treasury Regulations sections 1.1441-2(b)(1) or 1.1441-2(c)) that is derived from sources within the United States, including (but not limited to) original issue discount, excess inclusions on REMIC residual interests, and certain FATCA withholding tax gross-ups. Except for certain payments (specifically, (i) a payment of interest or original issue discount on short-term obligations; (ii) effectively connected income; (iii) payments made in the ordinary course of the withholding agent's business for nonfinancial services, goods, and the use of property; (iv) gross proceeds from the sale or other disposition of any property that can produce U.S. source FDAP income excluded under (i) through (iii); and (v) certain sales of fractional shares), no exception to withholding on U.S. source FDAP income applies for purposes of determining whether a payment of such income is a withholdable payment. Thus, an exclusion from withholding under Treasury Regulations section 1.1441-2(a), an exclusion from taxation under section 881, or an exemption from the imposition

of withholding tax pursuant to an applicable tax treaty with the United States shall not apply for purposes of determining whether income is U.S. source FDAP income constituting a withholdable payment under FATCA, (for example, interest excluded from gross income under section 103(a) or portfolio interest). Generally, a payment is derived from sources within the United States if it is income treated as derived from sources within the United States under sections 861 through 865 and other relevant provisions of the Code. In the case of a payment of FDAP income for which the source of the payment cannot be determined at the time the payment is made, the payment shall be treated by a withholding agent as being from sources within the United States for purposes of FATCA.

The term "sale or other disposition" means any sale, exchange, or disposition of property of a type that can produce interest or dividends that are U.S. source FDAP income that requires recognition of gain or loss under section 1001, without regard to whether the owner of such property is a foreign person that is not subject to U.S. federal income tax with respect to such sale, exchange, or disposition. The term sale or other disposition includes (but is not limited to) a sale of securities, a redemption of stock, a retirement and redemption of indebtedness, and entering into a short sale and a closing transaction in a forward contract, option or other instrument that is otherwise a sale. Such term further includes a distribution from a corporation to the extent the distribution is a return of capital or a capital gain to the beneficial owner of the payment. Such term does not include a grant or purchase of an option, an exercise of a call option for physical delivery, or a mere execution of a contract that requires delivery of personal property or an interest therein. For this purpose, neither a constructive sale under section 1259 nor a mark to fair market value under sections 475 or 1296 is a sale or disposition.

Section 1471(e)(7) introduces the concept of a "passthru" payment (with that unique spelling). Under that section, it is any withholdable payment or other payment to the extent attributable to a withholding payment. The Proposed Regulations define a "passthru payment" as any withholdable payment and any foreign passthru payment; however, they reserve on the definition of a foreign passthru payment. Thus, any payment made by a participating FFI on its own behalf to a non-participating FFI would be a passthru payment based on the ratio of U.S. assets to total assets held by the participating FFI. This means a payment can be subject to withholding even if there is no direct connection to U.S. source income (so long as the FFI making the payment or from which the payment originates has a positive passthru percentage, i.e., it owns U.S. assets). The Proposed Regulations provide that withholding on passthru payments will begin no sooner than January 1, 2017, and note that Treasury is considering ways to ease the compliance burdens associated with passthru payment withholding. Among the alternatives being considered is 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, and whether (and to what extent) to allow rounding conventions to limit the number of possible passthru percentages that could apply. In addition, it is expected that future guidance will prevent U.S. (and U.S. territory) financial institutions from serving as "blockers" with respect to foreign passthru payment reporting and withholding. Because a U.S. withholding agent currently is required to withhold only with respect to withholdable payments, while a participating FFI is generally required to withhold on all foreign passthru payments, this creates the potential for FFIs to use U.S. withholding agents as "blockers" for foreign passthru payments made to nonparticipating FFIs. Treasury is assessing various options to address this issue, including

expanding the definition of withholdable payments, or requiring FFIs to perform withholding on foreign passthru payments made to U.S. withholding agents acting as intermediaries.

II. Grandfathered Obligations

The Proposed Regulations provide that a withholdable payment or passthru payment does not include any payment made under a "grandfathered obligation" or any gross proceeds from the disposition of such an obligation. Consequently, FATCA withholding generally will not apply to any payment under any obligation outstanding on January 1, 2013, or from the gross proceeds from any disposition of such an obligation. The term "obligation" means any legal agreement that produces or could produce a passthru payment. An obligation does not, however, include any legal agreement or instrument that is treated as equity for U.S. tax purposes or any legal agreement that lacks a stated expiration or term, such as a savings deposit or demand deposit. In addition, it does not include any brokerage agreement, custodial agreement, or other similar agreement 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. An obligation also does not include a master agreement that merely sets forth general and standard terms and conditions that are intended to apply to a series of transactions between parties and that does not set forth all of the specific terms necessary to conclude a particular contract.

The Proposed Regulations provide examples of an obligation for purposes of this provision, including: (1) a debt instrument (such as a bond, guaranteed investment certificate, or term deposit); (2) a binding agreement to extend credit for a fixed term (for example, a line of credit or a revolving credit facility), provided that on the agreement's issue date the agreement fixes the material terms (including a stated maturity date) under which the credit will be provided; (3) a life insurance contract payable upon the earlier of attaining a stated age or death; (4) a term certain annuity contract; and (5) a derivatives transaction entered into between counterparties under an ISDA master agreement and evidenced by a confirmation.

An obligation that constitutes indebtedness for U.S. federal income tax purposes is outstanding on January 1, 2013, if it has an issue date before January 1, 2013. In all other cases, an obligation is outstanding on January 1, 2013, if a legally binding agreement establishing the obligation was executed between the parties to the agreement before January 1, 2013. Any material modification of an outstanding obligation will result in the obligation being treated as newly issued or executed as of the effective date of such modification. In the case of an obligation that constitutes indebtedness for U.S. tax purposes, a material modification is any significant modification of the debt instrument as defined in Treasury Regulations section 1.1001-3. In all other cases, whether a modification of an obligation is material will be determined based upon all relevant facts and circumstances.

A payment made under a grandfathered obligation includes a payment made to a partnership with respect to such obligation, including a payment made with respect to a partnership's disposition of such obligation. A payment made under a grandfathered obligation further includes the income from such obligation that is includible in the gross income of a partner with respect to a capital or profits interest in the partnership and the gross proceeds allocated to a partner from the disposition of such obligation.

A payment made under a grandfathered obligation also includes a payment made to a simple trust or a grantor trust with respect to such obligation, including a payment made with respect to a trust's disposition of such obligation. A payment made under a grandfathered obligation further includes income from such obligation that (1) with respect to a simple trust, is includible in the income of a beneficiary and further includes a beneficiary's share of the gross proceeds from a disposition of such obligation, and (2) with respect to a grantor trust, is includible in the gross income of a person that is treated as an owner of the trust and the gross proceeds from the disposition of such obligation to the extent such owner is treated as owning the portion of the trust that consists of the obligation.

III. <u>Deemed-Compliant Entities</u>

Withholding under FATCA is not required for certain FFIs that are deemed compliant by Treasury. IRS Notice 2011-34 provided guidance on initial categories of FFIs that would be deemed compliant for purposes of FATCA, and therefore would not be subject to withholding, including (1) certain local banks, (2) local FFI members of participating FFI groups, and (3) certain collective investment vehicles and other investment funds. The Proposed Regulations retain these exclusions 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 participating FFIs, subject to restrictions designed to prevent the FFIs from being used for U.S. tax evasion. In addition, the Proposed Regulations expand the category of retirement plans that are treated as posing a low risk of tax evasion, and which are excepted from the FATCA requirements. The expansion of categories of deemed-compliant institutions is intended to focus the application of FATCA on financial institutions that provide services to the global investment community and reduce or eliminate burdens on truly local entities and other entities for which entering into an FFI agreement is not necessary to carry out the purposes of FATCA.

Specifically, the Proposed Regulations provide for two general types of deemed-compliant FFIs: registered deemed-compliant FFIs and certified deemed-compliant FFIs.

Registered Deemed Compliant FFIs

The categories of registered deemed-compliant FFIs are (1) local FFIs, (2) non-reporting members of participating FFI groups, (3) qualified investment vehicles, (4) restricted funds, and (5) FFIs that comply with the requirements of Section 1471(b) under an agreement between the United States and a non-U.S. government. A registered deemed-compliant FFI generally is required to register with the IRS to declare its status as deemed-compliant and to attest to the IRS that it satisfies certain procedural requirements.

To qualify as a local FFI, generally, the FFI (or each FFI in a group) must meet certain licensing and regulation requirements. It must have no fixed place of business outside its country of organization and must not solicit account holders outside its country of organization. In addition, 98% of the accounts maintained by the FFI must be held by residents of the FFI's country of organization, and the FFI must be subject to reporting or withholding requirements in its country of organization with respect to resident accounts. For this purpose, an FFI that is

organized in a European Union ("EU") member state may treat account holders that are residents of other EU member states as residents of the country in which the FFI is organized. This rule for FFIs established in EU member states was included because financial institutions in EU member states have common tax reporting or withholding obligations with respect to EU residents. A local FFI must also establish policies and procedures to ensure that it does not open or maintain accounts for specified U.S. persons that are not residents in the country in which the FFI is organized, for nonparticipating FFIs, or for entities controlled or beneficially owned by specified U.S. persons, and must perform due diligence with respect to its entity accounts and certain individual accounts.

The registered deemed-compliant category for non-reporting members of participating FFI groups permits an FFI that is a member of an expanded affiliated group that includes at least one participating FFI to become a deemed-compliant FFI if it transfers any pre-existing accounts that are identified under specified procedures as U.S. accounts or accounts held by non-participating FFIs to an affiliate that is a participating FFI or U.S. financial institution. The non-reporting member is also required to implement policies and procedures to ensure that if it opens or maintains any U.S. accounts or accounts held by non-participating FFIs, it either transfers any such accounts to an affiliate that is a participating FFI or U.S. financial institution or becomes a participating FFI itself, in either case within 90 days of having opened the account or of having knowledge or reason to know of a change in circumstances resulting in an account becoming a U.S. account or an account held by a nonparticipating FFI. This type of deemed-compliant FFI is not limited to those FFIs that operate within a single country and that solicit account holders in such country, as was required under Notice 2011-34.

In general, a collective investment vehicle is a qualified investment vehicle if it is regulated as an investment fund and all holders of record of a direct interest in the FFI are participating FFIs, registered deemed-compliant FFIs, specified U.S. persons, or exempt beneficial owners. Separately, restricted funds includes an FFI that is 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 participating FFI, a registered deemed-compliant FFI, a non-registering local bank, or a restricted distributor (as defined in Treasury Regulations section 1.1471-5(f)(4)). Each agreement that governs the distribution of the restricted fund's debt or equity interests (other than interests which are both distributed by and held through a participating FFI) must prohibit sales of debt or equity interests in the fund to U.S. persons, non-participating FFIs, or passive NFFEs with any substantial U.S. owners, and its prospectus must indicate that sales to U.S. persons, passive NFFEs, and nonparticipating FFIs (other than interests which are both distributed by and held through a participating FFI) are prohibited. The restricted fund must also establish procedures to review pre-existing direct accounts and ensure proper treatment of new direct accounts.

A registered deemed-compliant FFI must (1) certify to the IRS that it meets the requirements of its applicable deemed-compliant category, (2) obtain a confirmation of its registration as a deemed-compliant FFI and an FFI identification number (an "FFI-EIN") from the IRS; (3) agree to the conditions for deemed-compliant status; and (4) renew its certification every three years (or earlier if there is a change in circumstance).

Certified Deemed-Compliant FFIs

A certified deemed-compliant FFI means an FFI that has certified as to its status as a deemed-compliant FFI by providing a withholding agent with certain required documentation applicable to the relevant deemed-compliant category. The categories of certified deemed-compliant FFIs are (1) non-registering local banks, (2) retirement plans, (3) non-profit organizations, (4) FFIs with only low-value accounts, and (5) certain owner-documented FFIs. Entities that satisfy the requirements of these categories are not required to register with the IRS, but each will certify to the withholding agent that it meets the requirements of its certified deemed-compliant category on a Form W-8.

To qualify as a non-registering local bank, generally, a bank must offer basic banking services, operate solely in its country of incorporation (or if it is a member of an expanded affiliated group, all members must operate in the same country), and the assets on each affiliated group member FFI's balance sheet must be no more than $175 million (with the entire expanded affiliated group having no more than $500 million on its combined balance sheet).

For retirement plans to qualify for certified deemed-compliant status, the FFI generally must be organized for the provision of retirement or pension benefits under the law of each country in which it is established or in which it operates. Contributions to the FFI must consist only of employer, government, or employee contributions and must be limited by reference to earned income. In addition, no single beneficiary may have a right to more than 5% of the FFI's assets. Finally, either (i) contributions to the FFI must be deductible or otherwise excluded from the income of the beneficiary under the law where the FFI is established or operates, (ii) taxation of investment income attributable to the beneficiary must be deferred under such law, or (iii) the FFI must receive 50% or more of its total contributions from the government or the employer. Alternative criteria are provided for FFIs that provide retirement or pension benefits and that have fewer than 20 participants and meet certain other requirements.

A non-profit organization will qualify for certified deemed-compliant status if it: (1) is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes; (2) is exempt from income tax in its country of residence; (3) has no shareholders or members that have a proprietary interest in its income or assets; and (4) is subject to restrictions preventing the private inurement of its income and assets.

An FFI with only low-value accounts will qualify for certified deemed-compliant status if: (1) the FFI is an FFI solely because it accepts deposits in the ordinary course of a banking or similar business or, as a substantial portion of its business, holds financial assets for the account of others; (2) no financial account maintained by the FFI (or, in the case of an FFI that is a member of an expanded affiliated group, by any member of the expanded affiliated group) has a balance or value in excess of $50,000; and (3) the FFI has no more than $50 million in assets on its balance sheet (and, in the case of an FFI that is a member of an expanded affiliated group, the entire expanded affiliated group has no more than $50 million in assets on its consolidated or combined balance sheet).

Generally, an owner-documented FFI is eligible for certified deemed-compliant status if (1) it is not an entity that (i) accepts deposits in the ordinary course of a banking or similar business or, as a substantial portion of its business, (ii) holds financial assets for the account of others or (iii) is an insurance company, and is not affiliated with another FFI that is such an entity; (2) it maintains no financial accounts for nonparticipating FFIs; (3) it does not issue debt that constitutes a financial account in excess of $50,000 to any person; (4) it provides a withholding agent with all required documentation regarding its owners; and (5) the withholding agent agrees to report to the IRS the information required with respect to any of the owners of the owner-documented FFI that are specified U.S. persons. Because an owner-documented FFI is required to provide each withholding agent with documentation and the withholding agent must agree to report on behalf of the owner-documented FFI, an owner-documented FFI may have certified deemed-compliant status only with respect to a specific withholding agent.

IV. Coordination of Withholding Regimes

The Proposed Regulations provide for the coordination of FATCA with other existing U.S. federal withholding tax regimes and propose the use of modified IRS Forms W-8 and W-9 for certain certification requirements under FATCA.

In general, in the case of a withholdable payment or passthru payment that is both subject to withholding under FATCA and is an amount subject to withholding under section 1441, a withholding agent may credit the amount withheld under FATCA against the withholding agent's liability under section 1441 (or section 1442 or 1443) on the same payment. For purposes of allowing an offset of withholding and allowing a credit to a withholding agent against its liability for such tax due, withholding is treated as applied for purposes of FATCA only when the withholding agent has actually withheld on a payment and has not made any adjustment for overwithheld tax applicable to the amount withheld that would be otherwise permitted with respect to the payment.

In the case of a passthru payment (including a withholdable payment) subject to withholding under FATCA that is a distribution with respect to the stock of a qualified investment entity or a United States real property holding corporation ("USRPHC"), withholding under FATCA does not apply when withholding under section 1445 applies to such amounts. With respect to the portion of such distribution that is not subject to withholding under section 1445 but is subject to withholding under section 1441 (or section 1442 or 1443) and FATCA, the coordination rule described in the previous paragraph applies. A withholding agent other than a USRPHC may, absent actual knowledge or reason to know otherwise, rely on the representations of the USRPHC making the distribution regarding the portion of the distribution that is estimated to be a dividend under Treasury Regulations section 1.1441-3(c)(2)(ii)(A) and in the case of a failure by the withholding agent to withhold under FATCA, the required amount shall be imputed to the USRPHC.

A withholdable payment or a foreign passthru payment subject to withholding under section 1446 generally is not subject to withholding under FATCA; however, the Proposed Regulations reserve on the coordination of withholding on distributions of gross proceeds subject to tax under section 1446.

The Proposed Regulations also reserve on the coordination of withholding under FATCA for payments subject to backup withholding under section 3406.

The Proposed Regulations do not provide coordination rules for withholding on substitute payments that are part of a chain of securities lending transactions using identical securities. Notice 2010-46 outlined a proposed withholding and reporting framework to reduce instances of potential excessive or cascading taxation and to properly account for the role of financial intermediaries in securities lending transactions. Notice 2010-46 also provided transitional rules that taxpayers may rely on prior to the publication of final regulations. The proposed framework and the transitional rules of Notice 2010-46 are limited to regular withholding on substitute dividend payments and do not address FATCA withholding.

V. <u>Definition of "Financial Account"</u>

Section 1471(d)(2) defines a "financial account" to mean, except as otherwise provided, any depository account, any custodial account, and any equity or debt interest in an FFI, other than interests that are regularly traded on an established securities market. The broad definition of financial account means that any time a foreign person owns an interest in a U.S. debt instrument, it will be the owner of a financial account and subject to FACTA compliance. On the other hand, if a foreign person owns an interest in a foreign borrower, it will not be subject to FACTA. However, if a lender holds a debt instrument in a foreign borrower, it may be subject to FACTA by virtue of the passthru payment rules.

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. Specifically, the Proposed Regulations define a depository account to include a commercial, checking, savings, time, or thrift account, an account evidenced by a certificate of deposit or similar instruments, and any amount held with an insurance company under an agreement to pay interest. A custodial account is defined to include an account that holds any financial instrument or contract held for investment for the benefit of another person. The Proposed Regulations exclude from the definition of a financial account certain savings accounts (including both retirement and pension accounts and nonretirement savings accounts) that meet certain requirements with respect to tax treatment and the type and amount of contributions. They also exclude any account that otherwise constitutes a financial account if it is held solely by one or more exempt beneficial owners (i.e., foreign governments, political subdivisions of a foreign government, and wholly-owned instrumentalities and agencies of a foreign government; international organizations and wholly owned agencies or instrumentalities of an international organization; foreign central banks of issue; governments of U.S. territories; and certain foreign retirement plans) or by nonparticipating FFIs that hold the account as intermediaries solely on behalf of one or more such owners. Thus, a participating FFI need not determine whether such an account is a U.S. account or held by a recalcitrant account holder.

The Proposed Regulations also provide guidance on the treatment of debt or equity as a financial account. First, debt or equity that is regularly traded on an established securities market

is not a financial account. For this purpose, debt or equity interests are considered regularly traded on an established securities market if trades in such interests are effected, other than in *de minimis* quantities, on such market or markets on at least 60 days during the prior year, and the aggregate number of such interests that are traded on such market or markets during the prior year is at least ten percent of the average number of such interests outstanding during the prior year. 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 sections 671 through 679 and a beneficial interest in a foreign trust if a specified U.S. person has the right to receive, directly or indirectly, a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the 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. In the case of a financial institution that is engaged in a 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.

Finally, to address the circumstances in which certain insurance or annuity contracts are financial accounts, the Proposed Regulations include in the definition of a financial account insurance contracts that include an investment component—namely cash value insurance contracts and annuity contracts, but exclude insurance contracts that provide pure insurance protection (such as term life, disability, health, and property and casualty insurance contracts).

The broad definition of financial account means that any time a foreign person owns an interest in a U.S. debt instrument, it will be the owner of a financial account and subject to FACTA compliance. On the other hand, if a foreign person owns an interest in a foreign borrower, it will not be subject to FACTA. However, if a lender holds a debt instrument in a foreign borrower, it may be subject to FACTA by virtue of the passthru payment rules.

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