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State and Local Tax Considerations of Federal Reserve Proposed IHC Rules

By Dale Kim and Dave Turzewski, KPMG LLP

Our last International Bank Tax News Flash discussed certain federal tax impacts of the proposed Federal Reserve rules issued in December 2012. In this issue, we discuss state and local tax considerations raised by the Federal Reserve's proposed U.S intermediate holding company requirements.

The proposed rules prescribe the legal entity structure in which certain foreign banking organizations (FBOs) must operate in the United States. A FBO with both $50 billion or more in consolidated global assets and U.S. subsidiaries with $10 billion or more in total assets as of July 1, 2014 would be required to reorganize its U.S. subsidiaries under a single U.S. intermediate holding company (IHC) by July 1, 2015. The purpose of the required structure is to promote the consistent supervision and regulation of the U.S. businesses of a foreign banking organization and to facilitate the orderly resolution of failing U.S. operations if needed. A FBO's U.S. branch and agency operations would remain part of the parent organization and would not be required to be moved under the IHC structure.

For many FBOs, these rules represent a significant change to their current U.S. organizational legal structure. Our last News Flash addressed several U.S. income tax issues that FBOs need to consider in planning to restructure their U.S. entities to comply with these rules. In addition, FBOs will face a number of significant state and local issues that will arise in moving to their new U.S. structures.

Unitary Combined Filing Group Composition

FBOs that restructure to a single IHC structure will generally file a single consolidated U.S. corporation income tax return (Form 1120), including the IHC and all affiliated corporations, in addition to a separate U.S. federal income tax return of a foreign corporation (From 1120-F) for the U.S. branch and/or agency. Under the new, single IHC structure, FBOs should also reconsider state income tax combined filing requirements (and options). We expect that states with mandatory unitary combined filing will assert that the new IHC structure is a single unitary group and expect to see a combined return

that includes the IHC and all affiliated corporations. FBOs that currently file separate combined returns, or combined returns that include less than every U.S. corporation, should begin to analyze the impact of potentially moving to a single combined return in unitary combined filing states.

New York Article 32 vs. Article 9A Classifications and Filing Implications

As a result of reorganizing under the IHC structure, FBOs may also want to reexamine the filing status of their U.S. entities for purposes of New York State and City corporate taxation. FBOs and their U.S. entities are generally taxed either as a general taxpayer under Article 9A (Corporation Franchise Tax) or as a bank under Article 32 (Bank Franchise Tax). Classification of financial organizations and their subsidiaries under either Article is subject to a complex series of rules and may affect an entity's nexus in New York, its tax base, apportionment methodology, and eligibility for combination with other related entities. (Note that New York has discussed potential tax reform that would include combining Article 9A and 32 into a single tax regime. At this time, tax reform legislation has not been proposed.)

Classification of Subsidiaries as General Taxpayers or Financial Organizations

A number of other state and local jurisdictions provide for separate tax regimes for general taxpayers and financial organizations. State definitions of financial organization vary, and may depend upon the ownership structure and whether or not a parent entity is also a financial organization or a bank holding company. Like New York state and city, classification as a general taxpayer or financial organization may affect an entities tax base, apportionment methodology, nexus rules, and combined filing status. FBOs that restructure under IHCs should review the filing status of their U.S. entities in jurisdictions with separate rules for financial organizations.

Effective State Tax Rate Considerations and Impact on Deferred Taxes

FBOs that will restructure under IHCs should consider the impact of the state tax issues noted above on the organization's overall state effective tax rate. Changes to filing methodologies (separate to combined, different filing groups) or entity classifications (general taxpayer or financial organization) discussed above may impact tax rate, apportionment, and combinations, resulting in a change to the overall state effective tax rate. A change in the state effective tax rate would be reflected in the financial statements through the state deferred tax asset or liability balances. In addition, FBOs should consider the impact of any legal entity reorganization on existing state net operating loss (NOL) carryforwards as NOLs in some jurisdictions may be lost or limited in certain reorganization transactions. Finally, FBOs should consider the need for changes to any valuation allowances on state deferred tax assets after the reorganization to the IHC structure.

Other State Tax Considerations

Other state and local tax issues should be considered in any legal entity reorganization including:

Net worth tax liabilities. Certain structures could increase taxable net worth in certain jurisdictions.

Short tax years. Mid-year reorganizations (the IHC structure is required to be implemented by July 1, 2015) may trigger a short tax year, which would accelerate the potential expiration of any NOL or credit carryforwards, and potentially trigger other tax attributes that are being phased-in over time.

Other existing state tax planning and filing positions. FBOs should consider the impact of moving to an IHC structure on any other state and local filing positions and planning currently in place. In addition to assessing the ongoing viability of existing planning, FBOs should consider the future impact of any reorganization on any existing FIN 48 reserves as well as the need for potential new FIN 48 reserves. Any restructuring plan also should take into account the potential impact on nexus and filing obligations, income tax base (e.g., expense disallowance, net operating losses, etc.), apportionment factors, credit and incentives, as well as non-income taxes such as net-worth based taxes, sales and use taxes, real property transfer taxes, etc.

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Affected FBOs should begin to review the impact these new IHC rules will have on their existing state and local tax planning, filing positions, and potential liabilities. In addition, FBOs may want to use these rules as an opportunity to create a more efficient federal and state tax structure and to develop and document future filing positions.

KPMG's State and Local Tax professionals work directly with our Bank Tax Practice and have the industry experience, technical knowledge, and practical tax planning insights to help FBOs navigate the state and local tax issues and opportunities presented by the new Federal Reserve IHC requirements.

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An Analysis of TAM 201325012, Treatment of Debt Instruments Pledged to the Fed

By Rowan Liu and Anthony Marsicovetere, KPMG LLP

On June 24, 2013, the IRS released Technical Advice Memorandum ("TAM") 201325012 addressing whether income from certain debt securities must be allocated between income effectively connected with a U.S. banking business ("ECI") and non-ECI under a special "10% Rule."[1] In the TAM, the IRS applies a narrow reading of when a security is acquired to satisfy reserve or similar requirements for purposes of treating the security as an asset that generates ECI. Such a reading offers planning opportunities for non-U.S. banks engaged in a banking business in the United States.

Facts

The TAM describes the taxpayer as a non-U.S. corporation operating through a branch in the United States ("Branch") that is engaged in a banking business in the United States as defined in Treas. Reg. § 1.864-4(c)(5)(i) (e.g., making loans to the public). Branch holds a banking license, and taxpayer is subject to reserve requirements under the Federal Reserve Board's Regulation D. Branch wrote liquidity and credit-support commitments (the "Commitments") in the regular course of its banking business. The Commitments exposed taxpayer to significant liquidity risk. Taxpayer's internal policy required Branch to maintain access to the Federal Reserve Bank Discount Window for an amount sufficient to cover any liquidity risk. Federal Reserve Board's Regulation A requires Branch to post 100% collateral for such access.

Taxpayer, with material participation from Branch, acquired medium-term notes with at least one year maturity remaining (the "MTNs") solely to pledge as collateral with the Discount Window. The MTNs were acquired through brokers/dealers on the interbank market; some were purchased on or after their issue date, and others were subscribed to prior to their issue date. All MTNs were held for seven days or less prior to being pledged to the Discount Window as collateral.

Analysis

Generally, any U.S. source interest income from a security, and any U.S. source capital gain (or loss) from the sale of a security derived by a non-U.S. corporation in the active conduct of a banking business in the United States is treated as ECI only if the security giving rise to such income, gain or loss is attributable to the U.S. office through which such business is carried on and falls within one of the following categories:[2]

(1) Is acquired as a result of, or in the course of making loans to the public;

(2) Is acquired in the course of distributing such stocks or securities to the public;

(3) Is acquired for the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the U.S.;

(4) Is payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition;

(5) Is issued by the United States, or any agency or instrumentality therefore; or

(6) Is not described in (1) through (5).[3]

If the security falls within categories 1 through 5, any income generated from such security is taxable as ECI in its entirety. However, if a security falls within category 6, any income generated is allocated between ECI and non-ECI based on a proportion calculated under the "10% Rule."[4] Having ruled out categories 2, 4, and 5 on the face of the facts, the IRS focused on categories 1 and 3 in its analysis and found that the MTNs did not fall within either of these two categories, and were subject to the 10% Rule.

The IRS applied a narrow reading of the regulations to hold that category 1 securities include primarily debt securities a non-U.S. bank originates as loans to its customers in the course of its U.S. banking business. Although the taxpayer acquired the MTNs for the sole purpose of ensuring liquidity to fund the Commitments, which could be viewed as directly related to taxpayer's U.S. banking business, the IRS found that the MTNs failed to meet the "to the public" element required by the regulations.[5] As support, the IRS cited to another part of the regulations, which provides that securities acquired on an exchange or an OTC market is not considered to have been acquired as a result of, or in the course of, making loans to the public.[6] Since taxpayer acquired the MTNs from the interbank market (i.e., an OTC market), the IRS stated that the acquisitions did not take place in the course of making loans to the public. Accordingly, the IRS concluded the MTNs are not category 1 securities.

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[1] Treas. Reg. § 1.864-4(c)(5)(ii)(b)(3). Under the 10% Rule, the portion of income treated as ECI is determined by a fraction with a numerator of 10% and a denominator equaling to the ratio the monthly average book value of category (6) securities bears to the monthly average book value of total U.S. banking assets.

[2] Treas. Reg. § 1.864-4(c)(5)(ii).

[3] Treas. Reg. §§ 1.864-4(c)(5)(ii)(a) and (b).

[4] Treas. Reg. § 1.864-4(c)(5)(ii), flush language.

[5] Treas. Reg. § 1.864-4(c)(5)(ii)(a)(1).

[6] Treas. Reg. § 1.864-4(c)(5)(iv)(c).

Regulation D promulgated by the Federal Reserve Board, which is banking authority that establishes reserve requirements in the United States, prohibits a bank from using stock and securities to satisfy its minimum reserve requirements. However, the MTNs could fall within category 3 if the collateral requirements constitute "other requirements similar to reserve requirements."[7] The IRS concluded that while both the collateral requirements under Regulation A and the reserve requirements under Regulation D serve to stabilize demand for Federal Reserve balances, the collateral requirements also provide liquidity for banks. The collateral requirements are more akin to collateralization arrangements in commercial secured lending agreements, and the fact the counterparty setting the requirement is the Federal Reserve Bank should not make the requirement similar to a reserve requirement. Furthermore, the IRS looked at the history of banking regulations, and determined that the "similar to reserve requirements" language was intended to cover the broad variety of requirements established by state banking authorities at the time, and not to broaden the scope of the regulations to include requirements not directly related to a reserve requirement. Accordingly, the IRS concluded that the MTNs are not category 3 securities thereby resulting in the MTNs falling within category 6. As outlined above, interest, gain and/or loss from category 6 securities may be treated in part as ECI and in part as non-ECI under the 10% Rule.

Significance

The IRS' holdings in TAM 201325012 are significant on several levels. First, they provide guidance in identifying securities that are eligible for the 10% Rule by clarifying the proper treatment with respect to securities acquired in the interbank market. Second, they clarify that a security acquired on the interbank market, regardless of whether through pre-subscription or purchased after issuance, should not be treated as acquired as a result of, or in the course of, making loans to the public; instead, such a security should be tested under the other categories of the applicable regulation to determine whether all or a portion of the income, gain or loss from the security should be considered ECI. Third, the IRS adoptes a narrow definition of reserve requirement, distinguishing voluntary liquidity requirements from the compulsory reserve requirements contemplated by the regulations.

Non-U.S. banks should consider how any of these holdings affect their U.S. tax positions. For example, they should review their current treatment of securities acquired for regulatory purposes and determine whether the securities should be treated as satisfying the reserve requirement (under Regulation D) or collateral requirement (under Regulation A) to assess whether the income from the securities would be subject to the 10% Rule. On a broader note, it may be possible for a non-U.S. bank to structure a portion of its investments to reduce the amount of its taxable ECI (i.e., purchase or pre-subscribe to debt on the interbank market instead of originating debt directly with customers).

[8] Treas. Reg. § 1.864-4(c)(5)(ii)(a)(3).

Certain Payments Related to an ADR Program Treated as US Source FDAP Income

By Rowan Liu and Anthony Marsicovetere, KPMG LLP

On July 3, 2013, the IRS issued Generic Legal Advice Memorandum ("GLAM") 2013-003 addressing the source and character of certain payments made to foreign corporations in exchange for exclusive right to offer American Depositary Receipts ("ADRs"), and the whether such payments are subject to a 30% withholding tax imposed on non-effectively connected, U.S. source fixed or determinable annual or periodical ("FDAP") income paid by a U.S. withholding agent to a foreign corporation.

Under an ADR program, a U.S. financial institution, referred to as a Depositary Institution ("DI"), will acquire stock in a foreign corporation ("Issuer"), and offer interests in such stock to U.S. investors in the form of ADRs. The DI passes on any dividends paid on Issuer's stock by making dividend equivalent payments to ADR holders. In exchange, the DI receives compensation in the form of various service charges related to the administration of the ADR program. ADRs are priced in U.S. dollars, and can be traded on U.S stock exchanges and over-the-counter markets. Although ADRs are subject to SEC oversight, they offer foreign corporations convenient access to U.S. capital without becoming listed on a securities exchange in the United States. Additionally, ADRs allow U.S. investors to invest in foreign companies without engaging in cross-border or foreign currency transactions.

Generally, any DI may acquire Issuer's stock and offer ADRs to U.S. investors through unsponsored ADR programs, unless Issuer grants a specific DI the exclusive right to set up an ADR program with respect to Issuer's stock (i.e., a sponsored ADR program). Often, a DI in a sponsored ADR program will reimburse Issuer for a portion of the expense incurred in instituting the program. The reimbursement may be in the form of payments made directly to Issuer, or payments to third parties made on behalf of Issuer. Generally, only expenses that would not have been incurred but for the ADR program are eligible for reimbursement; Issuer's operating costs are not reimbursed. These reimbursement payments (the "Payments") are the subject of GLAM 2013-003.

The IRS first concluded that the Payments are consideration for the exclusive distribution right of ADRs with respect to Issuer's stock, because similar payments are not made in unsponsored programs. Then, relying on holdings in *Sebatini v. Commissioner*,[1] the IRS found the Payments are consideration for the transfer of a property interest in the United States. In *Sebatini*, a foreign author granted a U.S. publisher the right to publish certain books in the United States that were not copyrighted; although no copyright was granted, the court nonetheless found that the payments compensated the author for foregoing his right to authorize another party to publish the books, which was an interest in property in the United States.[2] Since the Payments similarly compensated Issuer for foregoing the right to authorize another financial institution to offer ADRs with respect to Issuer's stock in the United States, the IRS concluded that the reasoning in *Sebatini* should apply to the Payments as well. Accordingly, the IRS concluded that the Payments, as non-effectively connected, U.S. source FDAP income, are subject to withholding tax, absent relief under an applicable income tax treaty.[3] A DI may therefore be obligated to withhold on the Payments, absent relief under an income tax treaty.[4]

Whether the Payments are eligible for income tax treaty benefits depends on their characterization under the applicable treaty. While the results may differ depending on the language of each treaty, the GLAM addressed the characterization of the Payments under the United State Model Income Tax Convention of November 15, 2006 ("U.S. Model") and the OECD Model Tax Convention on Income and on Capital (July 2010) ("OECD Model") (collectively, the "Model treaties"). The IRS found that under the language of both Model treaties, the Payments should be treated as "Other Income." In reaching this conclusion, the IRS first eliminated "royalties" as a possible characterization. The technical explanations to the Model treaties define "royalties" as payments for the use of a specified list of properties.[5] Reading the language of the Model treaties strictly, the IRS concluded that the Payments do not compensate Issuer for the transfer of a property identified under the Model treaties, and therefore are

[1] 98 F.2d 753 (2d Cir. 1938).

[2] *Id.*

[3] *See* §§ 861(a)(4) and 894(a).

[4] *See, generally*, §§ 1442 and 1461 and the treasury regulations promulgated thereunder.

[5] The properties identified are "rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience." The OECD Commentary on OECD Model Article 12, ¶8. For definition of "royalty," *see* OECD Model Article 12, ¶2; U.S. Model Article 12, ¶ 2.

not "royalties" for this purpose.[6] Similarly, "business profits" was also eliminated as a possible characterization. The IRS reasoned that because the Payments are consideration for the transfer of an interest in property in the United States, and neither the DI nor Issuer is engaged in the business of making such transfers, the Payments cannot be properly classified as "business profits." In the absence of another applicable article, an item of income is characterized as "other income." The "Other Income" articles under both Model treaties limit the taxation of income within its scope to the country of residence. Accordingly, the Payments would not be subject to U.S. withholding tax under both Model treaties.[7]

Financial institution clients who offer sponsored ADR programs should review their withholding procedures and make sure they properly account for withholding on payments of ADR program expenses to or on behalf of an Issuer. Special attention should be given to Issuers claiming treaty benefits, in order to ensure that the Payments are properly characterized under the specific treaty.

[6] The IRS concluded in a previous GLAM that the Payments qualify as royalties within § 861(a)(4), because they are consideration for the use of "other like property" similar to franchises rights. *See* GLAM 2010-006 (December 8, 2010). However, the IRS found here that as an explicitly defined term, "royalties" for purposes of the Model treaties should not be interpreted by reference to domestic law. Furthermore, the IRS concluded that the addition of the "other like rights or property" language alone would not qualify the Payments as "royalties" under the U.S. Model, because the Payments are not for intellectual property.

[7] It must be noted that some U.S. income tax treaties currently in force allow the source state to tax "other income" derived by a resident of the other contracting state, including the income tax treaties currently in force with Australia and Canada.

Eaton Corp. v Comm. – Tax Court Review of APA Cancellation

By Julie Damore and Robert Rizzo, KPMG LLP

United States – Tax Court's review of APA cancellations

The U.S. Tax Court recently issued an opinion addressing its jurisdiction to review the cancellation of an advance pricing agreement (APA) by the IRS. *Eaton Corp. v. Commissioner*, 140 T.C. No. 18 (June 26, 2013). The fundamental disagreement related to the manner in which the APAs at issue limit the IRS's authority to administer and enforce transfer pricing regulations under IRC Section 482. The taxpayer's position was that the APAs were enforceable contracts and that the IRS must show that the cancellations were appropriate under contract law. The IRS disagreed and the Tax Court concurred that the cancellations were administrative determinations.

The Tax Court held it has jurisdiction to review an APA cancellation because this action is an administrative determination necessary to ascertain the merits of deficiency determinations, and that such review is on an abuse-of-discretion basis. No conclusion was reached as of yet with regard to whether the IRS abused its discretion in canceling the APAs at issue and to the merits of the deficiency determinations. A trial is still to be scheduled.

Background of the Case

The taxpayer and the IRS entered into two APAs establishing a transfer pricing methodology for "covered transactions" between the taxpayer and its subsidiaries. The first APA covered the taxpayer's 2001 through 2005 tax years (Original APA), and the second APA covered the taxpayer's 2006 through 2010 tax years (Renewal APA). The IRS's administration of the APAs was governed by certain revenue procedures.[1]

Subsequently, charging that the taxpayer had misrepresented material facts during the APA process, the IRS cancelled the Original APA for the 2005 tax year, and revoked the Renewal APA effective January 1, 2006. The IRS then issued a deficiency notice and in applying an alternative transfer pricing methodology increased the taxpayer's income under section 482 by over $102 million for 2005 and over $266 million for 2006.

The IRS has entered into more than 1,000 APAs since the APA program was established in 1991. The IRS has canceled or revoked only nine other APAs from 1991 through 2011. However, Eaton is the first taxpayer to challenge a cancellation or revocation in court and appears to present a unique situation.[2]

The taxpayer filed a petition with the Tax Court. The taxpayer alleged that it did comply with the terms and conditions of the APAs, and demonstrated that compliance to the IRS by disclosing errors in its data in 2010 and rectifying those errors.

The taxpayer and IRS filed cross-motions for partial summary judgment, with the taxpayer claiming that the APAs were enforceable contracts, and that the IRS must show that it was entitled to cancel the APAs.

The IRS countered that it canceled the APAs under revenue procedures that reserve certain discretion to the Commissioner of the IRS and that the cancellations were administrative determinations. As such, the IRS claimed that the Tax Court's deficiency jurisdiction only permits review for abuse of discretion of the administrative determinations necessary to resolve the merits of a deficiency determination.

Tax Court's Ruling

The Tax Court held that:

- It has jurisdiction to review the cancellations of the APAs because they are administrative determinations necessary to ascertain the merits of the deficiency determinations.
- An APA cancellation is reviewed for abuse of discretion, and that the taxpayer must show that the APA cancellations by the IRS were arbitrary, capricious or without sound basis in fact.

The Tax Court granted the IRS's motion for partial summary judgment and concomitantly denied the taxpayer's motion for partial summary judgment.

[1] Rev. Proc. 96-53, 1996-2 C.B. 375 for the Original APA, and Rev. Proc. 2004-40, 2004-2 C.B. 50 for the Renewal APA.

[2] See comments made by the current APMA Director in "Setting an Ambitious Agenda for APMA, New Director Sees Perfectionism Conflicting with Goal of Increased Output," 21 TM TPR 330, 2012, and in an article by former APA Director Craig A. Sharon, "The Eaton Case: Testing the Finality of APAs," 21 TM TPR 591, 2012.

Revised Timeline and Other Guidance Regarding the Implementation of FATCA

By Daniele Nishida and Laurie Hatten-Boyd, KPMG LLP

Please find attached Notice 2013-43, which revises the timelines included in the final chapter 4 regulations for withholding agents and foreign financial institutions to begin their due diligence, withholding, and reporting requirements under sections 1471-1474 of the Code (commonly referred to as FATCA). **Specifically, this Notice provides a six-month extension for when withholding will begin (i.e., payments after June 30, 2014) and for implementing new account opening procedures as well as related requirements to comply with FATCA.** The timeline for foreign financial institutions to register as (among other things) participating foreign financial institutions is also extended under the Notice, with the registration portal expected to open on August 19, 2013. Finally, the Notice provides that financial institutions operating in jurisdictions that have signed an intergovernmental agreement (IGA) covering their financial institutions' compliance with FATCA will be treated as having an effective IGA

Notice 2013-43

I. PURPOSE

This notice provides: (i) revised timelines for implementation of the requirements of sections 1471 through 1474 of the Internal Revenue Code (Code), commonly referred to as the Foreign Account Tax Compliance Act, or FATCA; and (ii) additional guidance concerning the treatment of financial institutions located in jurisdictions that have signed intergovernmental agreements for the implementation of FATCA (IGAs) but have not yet brought those IGAs into force. The Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) intend to amend the regulations under sections 1471 through 1474 to adopt these rules. Prior to the issuance of those amendments, taxpayers may rely on the provisions of this notice regarding expected amendments to the regulations.

II. BACKGROUND

A. FATCA Regulations

On March 18, 2010, the Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111-147 (H.R. 2847), added chapter 4 (sections 1471 through 1474) to Subtitle A of the Code. Chapter 4 requires withholding agents to withhold 30 percent of certain payments to a foreign financial institution (FFI) unless the FFI has entered into an agreement (FFI agreement) with the IRS to, among other things, report certain information with respect to U.S. accounts. Chapter 4 also imposes on withholding agents certain withholding, documentation, and reporting requirements with respect to certain payments made to certain non-financial foreign entities (NFFEs).

On February 15, 2012, Treasury and the IRS published proposed regulations under chapter 4 in the Federal Register (REG-121647-10, 77 Fed. Reg. 9022) (proposed regulations). On January 17, 2013, Treasury and the IRS published final regulations under chapter 4 (TD 9610, 78 Fed. Reg. 5873) (final regulations). The final regulations provided for a phased implementation of the requirements of FATCA, beginning on January 1, 2014, and continuing through 2017. In particular, the final regulations provided that withholding agents (including participating FFIs (PFFIs), qualified intermediaries (QIs) that assume withholding responsibility, withholding foreign partnerships (WPs), and withholding foreign trusts (WTs)) would be required to begin withholding with respect to withholdable payments made after December 31, 2013 (with an exception for "grandfathered obligations" outstanding on January 1, 2014, and associated collateral). Due diligence for documenting payees and account holders by U.S. withholding agents and PFFIs would be phased in during 2014 and 2015. Annual reporting by PFFIs would be phased in starting in 2015 (with respect to information related to the 2013 and 2014 calendar years), with reporting of the full scope of FATCA information required beginning in 2017.

B. Model IGAs

On July 26, 2012, Treasury released a Model (Model 1) for bilateral agreements with other jurisdictions (in both reciprocal and nonreciprocal versions) under which FFIs (reporting Model 1 FFIs) would satisfy their chapter 4 requirements by reporting information about U.S. accounts to their respective tax authorities, followed by the automatic exchange of that information on a government-to-government basis with the United States. On November 14, 2012, Treasury released a second Model agreement (Model 2), under which FFIs (reporting Model 2 FFIs) would report specified information directly to the IRS in a manner consistent with the final regulations, supplemented by government-to-government exchange of information on request. Treasury has concluded a number of bilateral IGAs based on the Model agreements (Model 1 IGAs and Model 2 IGAs, respectively). Treasury has periodically updated the Model IGAs since their initial release, including an update to both Model IGAs on May 9, 2013, to incorporate certain modifications arrived at through intergovernmental discussions, as well as modifications to the due diligence procedures to reflect improvements adopted in the final regulations following the initial release of the model IGAs.

The Model IGAs outline time frames for FFIs in jurisdictions with IGAs in force (partner jurisdictions) to complete the necessary due diligence to identify U.S. accounts and to perform reporting on U.S. accounts that are identified. The timelines and other provisions contained in the Model IGAs interact with the final regulations in various ways. The Model IGAs, and all IGAs that have been concluded to date, contain a provision, colloquially referred to as the "most-favored nation" provision, providing that, with respect to certain terms of the IGA, including the due diligence rules

applicable to reporting Model 1 FFIs and reporting Model 2 FFIs, a partner jurisdiction is entitled to the benefit of any more favorable provision agreed to in a comparable IGA with another partner jurisdiction, subject to certain conditions. Model 1 IGAs and Model 2 IGAs also contain a coordination provision providing that a partner jurisdiction may permit its FFIs to use a definition in the relevant U.S. Treasury Regulations in lieu of a corresponding definition in the IGA, provided that such application would not frustrate the purposes of the IGA. With respect to the due diligence procedures, Model 1 IGAs and Model 2 IGAs provide that a partner jurisdiction may permit its FFIs to apply the due diligence procedures described in the relevant U.S. Treasury Regulations in lieu of the due diligence procedures in the IGA to establish the status of account holders and payees. In addition, paragraph 6 of Article 4 of the Model 1 IGA coordinates the time by which the parties must obtain and exchange information with the time by which PFFIs must report similar information to the IRS under the relevant U.S. Treasury Regulations.

C. Registration Process

In the preamble to the final regulations, Treasury and the IRS announced their intent to create a FATCA registration website, which would serve as the primary way for FFIs to interact with the IRS to complete the required registration, agreements, and certifications. The preamble stated that the FATCA registration website would be accessible to FFIs no later than July 15, 2013. After approval of its registration, each PFFI and registered deemed-compliant FFI would be assigned a global intermediary identification number (GIIN), which would be used both for reporting purposes and to identify the FFI's status to withholding agents. The preamble provided that the IRS would electronically post the first list of PFFIs and registered deemed-compliant FFIs (IRS FFI List) on December 2, 2013, and would update the list on a monthly basis. To ensure inclusion on the December 2013 IRS FFI List, FFIs would need to register by October 25, 2013.

D. Modification of Phased Timeline for Implementation

Comments have indicated that certain elements of the phased timeline for the implementation of FATCA present practical problems for both U.S. withholding agents and FFIs. In addition, while comments from FFIs overwhelmingly supported the development of IGAs as a solution to the legal conflicts that might otherwise impede compliance with FATCA and as a more effective and efficient way to implement cross-border tax information reporting, some comments noted that, in the short term, continued uncertainty about whether an IGA will be in effect in a particular jurisdiction hinders the ability of FFIs and withholding agents to complete due diligence and other implementation procedures. In consideration of these comments, and to allow for a more orderly implementation of FATCA, Treasury and the IRS intend to amend the final regulations to postpone by six months the start of FATCA withholding, and to make corresponding adjustments to various other time frames provided in the final regulations, as described in Section III below.

In addition, as described in Section IV below, Treasury and the IRS intend to provide a list of jurisdictions that will be treated as having in effect an IGA, even though that IGA may not have entered into force as of July 1, 2014.

Unless otherwise defined, terms used in this notice have the meanings set forth in the final regulations.

III. REVISED FATCA IMPLEMENTATION TIMELINE

A. Timeline for Withholding

Withholding agents generally will be required to begin withholding on withholdable payments made after June 30, 2014, to payees that are FFIs or NFFEs with respect to obligations that are not grandfathered obligations, unless the payments can be reliably associated with documentation on which the withholding agent can rely to treat the payments as exempt from withholding. The definition of grandfathered obligation will be revised to include obligations outstanding on July 1, 2014 (and associated collateral). This notice does not affect the timing provided in the final regulations for withholding on gross proceeds, passthru payments, and payments of U.S. source FDAP with respect to offshore obligations by persons not acting in an intermediary capacity.

B. Timeline for Implementing New Account Opening Procedures and the Definition of Preexisting Obligations

Withholding agents generally will be required to implement new account opening procedures by July 1, 2014, or, in the case of a PFFI, by the later of July 1, 2014 or the effective date of its FFI agreement. Accordingly, the definition of the term "preexisting obligation" will be modified to mean:

- **With respect to a withholding agent other than a PFFI or a registered deemed-compliant FFI:** any account, instrument, or contract maintained, executed, or issued by the withholding agent that is outstanding on June 30, 2014;
- **With respect to a PFFI:** any account, instrument, or contract maintained, executed, or issued by the PFFI that is outstanding on the effective date of the FFI agreement; and
- **With respect to a registered deemed-compliant FFI:** any account, instrument, or contract maintained, executed or issued by the FFI prior to the later of July 1, 2014, or the date on which the FFI registers as a deemed-compliant FFI and receives a GIIN.

Treasury intends to include a similar change to the definition of the term "Preexisting Account" in both Model IGAs. Thus, it is expected that future IGAs will define the term "Preexisting Account" to mean a Financial Account maintained as of June 30, 2014. For IGAs in force that contain the previous definition of the term "Preexisting Account," the partner

jurisdiction will be permitted under the coordination provision of the IGA to permit its FFIs to substitute the definition of the term "preexisting account" from the amended final regulations for the definition of the term "Preexisting Account" in the IGA. For IGAs concluded before the coordination provision was added, the coordination provision will apply through the operation of the most-favored nation provision once an IGA containing the coordination provision is in force.

C. Transition Rules for Completing Due Diligence on Preexisting Obligations

The FFI Agreement of a PFFI that registers and receives a GIIN from the IRS on or before June 30, 2014, will have an effective date of June 30, 2014, effectively resulting in a six-month postponement of the deadlines for completing due diligence on preexisting obligations. For withholding agents other than PFFIs, the deadlines for completing due diligence on preexisting obligations will be postponed by six months. Thus, for example, a withholding agent other than a PFFI will be required to document payees that are prima facie FFIs by December 31, 2014, instead of by June 30, 2014.

Account balance or value will be measured initially as of June 30, 2014, for purposes of determining whether an account is exempt from review, subject only to an electronic search for indicia, or subject to enhanced review. An account with a balance or value that was initially $1,000,000 or below, and with respect to which there has been no change in circumstances, will not be subject to enhanced review unless the account balance or value exceeds $1,000,000 as of the end of 2015 or any subsequent calendar year. Thus, the obligation to monitor the account balance or value of preexisting accounts to determine whether enhanced review is required is deferred by one year.

Treasury intends to provide for a similar six-month delay in the due diligence procedures included in Annex I of IGAs concluded after the issuance of this notice, which will generally apply automatically to previously-signed IGAs through the operation of the most-favored nation provision in those IGAs once those later signed agreements are in force.

D. Due Date for First Report of a PFFI with respect to U.S. Accounts

The final regulations provide that a PFFI will be required to file information reports on its U.S. accounts with respect to the 2013 and 2014 calendar years no later than March 31, 2015. Treasury and the IRS intend to modify these rules to require reporting on March 31, 2015, only with respect to the 2014 calendar year (for U.S. accounts identified by December 31, 2014). Through the operation of paragraph 6 of Article 4 of the Model 1 IGAs, this modification to the required reporting will apply automatically in the context of Model 1 IGAs as well. For IGAs concluded before paragraph 6 of Article 4 was added, the rules of paragraph 6 of Article 4 will apply through the operation of the most-favored nation provision once an IGA containing paragraph 6 of Article 4 is in force. As a result, once an IGA containing paragraph 6 of Article 4 is in force, partner jurisdictions will not be obligated to obtain and exchange information with respect to the 2013 calendar year. Instead, the information exchanged by partner jurisdictions in 2015 will be required to include only information related to the 2014 calendar year.

E. Timeline For Registration

The FATCA registration website is projected to be accessible to financial institutions on August 19, 2013. Other key dates for registration, however, will be extended by six months. Thus, after the FATCA registration website opens, a financial institution will be able to begin the process of registering by creating an account and inputting the required information for itself, for its branch operations, and, if it serves as a "lead" financial institution, for other members of its expanded affiliated group. All input information will be saved automatically in the registration system and associated with the financial institution's account. For the period from the opening of the FATCA registration website through December 31, 2013, a financial institution will be able to access its account to modify or add registration information, including to indicate the appropriate registration status, as such status is established, for example, by the signing of an IGA. Prior to January 1, 2014, however, any information entered into the system, even if submitted as final, will not be regarded as a final submission, but will merely be stored until the information is submitted as final on or after January 1, 2014. Thus, financial institutions can use the remainder of 2013 to get familiar with the registration process, to input preliminary information, and to refine that information. On or after January 1, 2014, each financial institution will be expected to finalize its registration information by logging into its account on the FATCA registration website, making any necessary additional changes, and submitting the information as final.

Consistent with this 6-month extension, the IRS will not issue any GIINs in 2013. Instead it expects to begin issuing GIINs as registrations are finalized in 2014. The IRS will electronically post the first IRS FFI List by June 2, 2014, and will update the list on a monthly basis thereafter. To ensure inclusion in the June 2014 IRS FFI List, FFIs would need to finalize their registration by April 25, 2014.

As provided in the final regulations, subject to certain exceptions for preexisting obligations and for offshore obligations, a withholding agent generally may treat a payee as a PFFI or registered deemed-compliant FFI only if the withholding agent has a withholding certificate identifying the payee as a PFFI or registered deemed-compliant FFI and verifies the GIIN contained on that withholding certificate against the IRS FFI List. For payments made prior to January 1, 2015, however, verification of a GIIN is not required with respect to payees that are reporting Model 1 FFIs. This provision will continue to apply following the changes described in this notice. As a result, while

reporting Model 1 FFIs will be able to register and obtain GIINs beginning on January 1, 2014, they will have additional time beyond July 1, 2014, to register and obtain a GIIN in order to ensure that they are included on the IRS FFI list before January 1, 2015.

F. Treatment of Expiring Chapter 3 Documentation

For purposes of chapter 3 withholding, withholding certificates and documentary evidence generally expire on the last day of the third calendar year following the year in which the withholding certificate is signed or the documentary evidence is provided to the withholding agent. Withholding certificates and documentary evidence that would otherwise expire on December 31, 2013, will expire instead on June 30, 2014, unless a change in circumstances occurs that would otherwise render the withholding certificate or documentary evidence incorrect or unreliable.

G. Automatic Extension of Expiring QI, WP, and WT Agreements

All QI, WP, or WT agreements that would otherwise expire on December 31, 2013, will be automatically extended until June 30, 2014.

H. Extension of Foreign-Targeted Registered Obligation Rules

Notice 2012-20 provided as a limited transition rule that a withholding agent paying interest on an obligation issued in registered form after March 18, 2012, and before January 1, 2014, may apply the foreign-targeted registered obligation rules of §1.871-14(e) if the obligation satisfies the requirements of those rules. The end of this transition period was intended to coincide with the implementation of the chapter 4 rules. As a result, this transition rule will be extended to obligations issued in registered form after March 18, 2012 and before July 1, 2014.

IV. Treatment of Financial Institutions Operating in Jurisdictions That Have Signed an Intergovernmental Agreement to Implement FATCA

A jurisdiction will be treated as having in effect an IGA if the jurisdiction is listed on the Treasury website as a jurisdiction that is treated as having an IGA in effect. In general, Treasury and the IRS intend to include on this list jurisdictions that have signed but have not yet brought into force an IGA. The list of jurisdictions that are treated as having an IGA in effect is available at the following address:

http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx.

A financial institution resident in a jurisdiction that is treated as having an IGA in effect will be permitted to register on the FATCA registration website as a registered deemed-compliant FFI (which would include all reporting Model 1 FFIs) or PFFI (which would include all reporting Model 2 FFIs), as applicable. In addition, a financial institution may designate a branch located in such jurisdiction as not a limited branch. A jurisdiction may be removed from the list of jurisdictions that are treated as having an IGA in effect if the jurisdiction fails to perform the steps necessary to bring the IGA into force within a reasonable period of time. If a jurisdiction is removed from the list, financial institutions that are residents of that jurisdiction, and branches that are located in that jurisdiction, will no longer be entitled to the status that would be provided under the IGA, and must update their status on the FATCA registration website accordingly.

DRAFTING INFORMATION

The principal author of this notice is Tara Ferris of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact John Sweeney at (202) 622-3840 (not a toll-free call).

Treaty Update

By Anthony Marsicovetere,
KPMG LLP

As mentioned in our previous quarterly newsletter, a number of pending U.S. tax treaties and protocols to existing tax treaties have stalled with the U.S. Senate. In late 2011 Senator Rand Paul, R-Ky, placed a hold on Senate floor consideration of the pending Swiss and Luxembourg protocols as well as the pending treaty with Hungary. According to Tax Analysts, various sources stated Senator Paul placed this hold based on his objection to the treaty information sharing provisions contained in these agreements. These agreements contain updated information exchange provisions that implement the OECD standard on information exchange.

Under U.S. law the following steps generally must occur before a pending U.S. tax treaty or pending protocol to an existing tax treaty can enter into force:

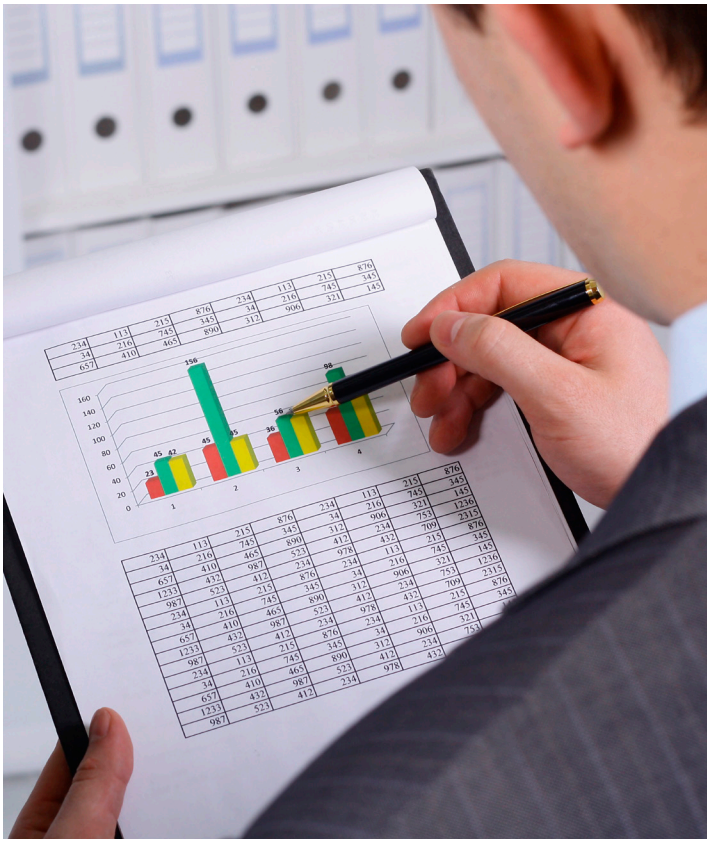
(i) The SFRC must consider and hold a public hearing addressing the pending tax treaty instrument;

(ii) The full U.S. Senate must unanimously approve the pending tax treaty instrument;

(iii) The U.S. President must sign a U.S. Instrument of Ratification; and

(iv) The U.S. government must formally notify the other contracting state through diplomatic channels that the U.S. ratification process has been completed.

In the interim, several Intergovernmental Agreements (FATCA IGAs) have been signed. The countries that have signed the IGAs are Germany, Japan, Norway and Spain. A number of countries continue to be in the process of negotiating their IGAs.



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