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HEADLINE: #3 2012 TNT 93-3 ABA MEETING: BANKING COMMITTEE CONSIDERS COMPLIANCE QUESTIONS. (Section 1471 -- Foreign Financial Institution Withholding) (Release Date: MAY 11, 2012) (Doc 2012-10192)

TEXT:

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At its May meeting in Washington, the American Bar Association Section of Taxation Banking Committee discussed the Foreign Account Tax Compliance Act, withholding on total return dividend swaps, and the existential question of whether being a bank is worth the candle. The new laws are full employment not just for our readers, but also for systems administrators at financial intermediaries. Many complaints relate to the time required to build new systems to comply.

FATCA

Tara N. Ferris and Danielle Nishida, both of branch 2 of the IRS Office of Associate Chief Counsel (International), were on hand May 11 to defend the proposed FATCA regulations. (For REG-121647-10, see *Doc 2012-2485* or *2012 TNT 27-7*.)

Nishida noted that while the IRS is not planning any new W-8 forms, it is planning to "dummy-proof" existing forms, which will have to be long because of the numerous FATCA categories of payees. The IRS is also thinking about allowing financial institutions to use their own forms.

Eyeball tests for account holder identification will not be allowed, Nishida explained. If a payee does not want to be withheld on, documentation must be provided to the financial intermediary. She invited participants to send comments on what documentation would be appropriate.

Is it possible to delegate withholding responsibility? It certainly is possible to elect to be withheld upon (*section 1471(b)(3)*). Ferris explained that when chapter 3 withholding applies, chapter 4 withholding does not. Nonetheless, FATCA reporting responsibility still applies. But the IRS is looking for ways to coordinate withholding and reporting responsibility, according to Ferris.

Who is a payee? Here the new regulations conveniently ignore the beneficial owner and concentrate on the direct payee (*reg. section 1.1471-3(a)(1)*). That means that foreign financial institutions will want to become participation foreign financial institutions, especially if they want to be able to use customer securities in their regular business, Mark H. Leeds of Greenberg Traurig LLP commented.

The passthrough payment definition, which is the key to the whole FATCA scheme, has not been developed in regulations (*section 1471(d)(7)*). But the principle of withholding on a passthrough percentage has been established in *Notice 2011-53, 2011-32 IRB 124* (*Doc 2011-16103* or *2011 TNT 143-8*).

A participant asked whether there is a passthrough payment, such that the percentages would apply, if a nonfinancial issuer of securities makes a lump interest payment to a paying agent, which would then pay it on to holders of the securities (in real life, there are many more layers between issuers and holders). Nishida responded that the IRS is thinking about this question in developing the passthrough rules.

Total Return Swaps

Some commentators on the proposed and temporary *section 871(m)* regulations wanted the IRS to effectively repeal the statute. Another commentator said that withholding on everything would be easier, but there is still a cascading problem. (For REG-120282-10, see *Doc 2012-1100* or *2012 TNT 13-7*. For T.D. 9572, see *Doc 2012-1099* or *2012 TNT 13-6*.)

Mark Erwin, branch 5 senior technical reviewer, IRS Office of Associate Chief Counsel (International), said that the IRS is working on the cascading problem, but that it may not be resolved in the final regulations, which he expects will be issued soon so that banks can build computer systems.

Equity derivatives on broad-based indexes that are traded are exempt from withholding. Does the broad-based index have to be traded? Yes. Banks can't escape withholding using their own custom-made indexes. Plus it must be broad; each component of a narrowly based index would have to be analyzed. Mark Perwien, special counsel to the IRS associate chief counsel (financial institutions and products), explained that the IRS is considering permitting exemption for published broad-based indexes.

Taxpayer representatives fussed about the new rules' use of the concept "in the market" instead of the fuzzier statutory term "in connection with." If the long party (hedge fund) or a related party is in the market when the swap is put on, the short party (bank or a related party) must withhold.

Bankers complain that this rule means that they have to know everything that the hedge fund, its affiliates, and their own affiliates are doing in the market, which is impossible. They argue that the analysis should be confined to the Delta 1 (perfect correlation) desk. They urge the IRS to back off the long-standing "reason to know" standard of the withholding rules.

Perwien responded that the IRS will not back down on the reason to know standard. But Perwien recognizes that despite their statutory status as foreign taxpayers, the hedge funds that are the long parties in these deals are run out of Greenwich (or New York, or Boston). And these hedge funds are in possession of all the necessary information about who was in the market when, and other relevant actions. So, in his view, hedge funds should essentially be able to self-assess, and the bank on the other side should be allowed to rely on the hedge fund's representations about its positions.

What Is a Bank?

One would think that in the wake of the Dodd-Frank Act, a financial intermediary would not want to be regulated as a bank -- free money at the Fed window notwithstanding. But the tax law is very generous to banks, since it dates from a bygone age when the government propped up little community banks, so some small financial operations might want bank status.

Chief among the goodies available to banks as defined in *section 581* is *section 166*, which permits an ordinary deduction for bad debts -- which can include real estate mortgage investment conduit interests and shares of affiliates. Moreover, *reg. section 1.166-2* establishes a presumption of worthlessness for debts when a regulator has ordered a write-down, or the bank has a conformity election in place.

Regulators have ordered insurance companies to write down some of their debt holdings, so they are getting into arguments with the IRS about whether they are entitled to *section 166* deductions, according to Viva Hammer of KPMG LLP. *Section 581* requires that the entity be regulated by a state or federal regulator, but does not literally require that the regulator be a bank regulator. Moreover, ancient case law interpreting banking laws holds that deposit-taking need not be a huge component of the business.

Banks must be corporations, and they can be S corporations, but they are prohibited from using the *section 585* reserve method. There are a few S corporation private banks, according to Jonathan Goldstein of Simpson Thacher & Bartlett LLP.

Robert Martin, branch 1 senior technical reviewer, IRS Office of Associate Chief Counsel (Financial Institutions and Products), noted that the IRS recently lost a case against an S corporation bank on whether the *section 291* haircut applied to carrying costs covered by *section 265(b)*. (*Vainisi v. Commissioner, 132 T.C. 1 (2009), Doc 2009-968* or *2009 TNT 10-11*.)