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Proposed Regulations Provide FATCA Compliance Guidance for Foreign Financial Institutions, Other Foreign Entities and U.S. Withholding Agents

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The U.S. Department of the Treasury and the Internal Revenue Service recently issued proposed regulations under Sections 1471–1474 of the Internal Revenue Code. The proposed regulations provide updated guidance on information reporting requirements for foreign financial institutions and non-financial foreign entities and the related withholding regime under FATCA. The proposed regulations effectively delay reporting and withholding in large part by providing for expanded categories of "grandfathered obligations." The proposed regulations also delay compliance procedures for foreign passthru payments until 2017 at the earliest and request comments on a number of items.

On February 8, 2012, the U.S. Department of the Treasury and the Internal Revenue Service (IRS) issued proposed regulations to implement certain provisions of Internal Revenue Code (IRC) Sections 1471-1474 (enacted as part of the Hiring Incentives to Restore Employment Act of 2010, or the HIRE Act). Sections 1471-1474 are commonly referred to as "FATCA" (as a holdover from the earlier Foreign Account Tax Compliance Act pursuant to which the provisions were originally proposed).

The proposed regulations follow a series of three IRS Notices that provided tranches of initial interpretive and implementing guidance. The proposed regulations incorporate much of the prior guidance and modify and expand the guidance provided in the Notices in a number of important respects. The proposed regulations indicate the drafters of the provisions considered the numerous comments received by the IRS and Treasury in response to the Notices.

The proposed regulations will generally become effective upon the publication of the final regulations. Comments to the proposed regulations must be received by April 30, 2012.

This newsletter provides a brief overview of the general FATCA provisions and summarizes the most significant modifications the proposed regulations make to the prior IRS Notices as well as certain other provisions of the proposed regulations.

Statutory Background

Reporting and Withholding Obligations for Foreign Financial Institutions

Chapter 4 of the IRC (Sections 1471-1474) requires foreign financial institutions (FFIs) to provide information to the IRS regarding certain "U.S. accounts." An FFI includes any foreign entity that accepts deposits in the ordinary course of a business engaged in banking or other similar business; that, as a substantial portion of its business, holds financial assets for the account of others; or that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities. Section 1471(d)(1) defines a U.S. account as a "financial account" held by specified U.S. persons and includes 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.

FATCA imposes a withholding tax on certain payments made to FFIs that fail to comply with certain obligations. Under Section 1471(a), a withholding agent must withhold tax at the rate of 30 percent from any "withholdable payment" made to an FFI to the extent the FFI does not meet the requirements of Section 1471(b). Subject to certain exceptions, a withholdable payment is defined in Section 1473(1) as including any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income (*e.g.*, FDAP income), if such payment is from sources within the United States, and any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from sources within the United States.

An FFI meets the requirements of Section 1471(b) if it enters into an agreement (an "FFI agreement") with the IRS pursuant to Section 1471(b)(1) or is otherwise deemed to comply with the requirements of Section 1471(b) pursuant to Treasury or IRS guidance. An FFI that enters into an FFI agreement (a "participating FFI") is required to report certain information on an annual basis to the IRS with respect to each U.S. account it maintains and to comply with requests for additional information made by the Secretary with respect to any U.S. account. The information that must be reported with respect to each U.S. account includes the name, address, and taxpayer identifying number ("TIN") of each account holder who is a specified U.S. person (or, in the case of an account holder that is a U.S. owned foreign entity, the name, address, and TIN of each specified U.S. person that is a "substantial U.S. owner" of such entity), the account number, the account balance or value, and, except to the extent provided by the Secretary, the gross receipts and gross withdrawals or payments from the account (determined for such period and in such manner as the Secretary may provide).

If foreign law would prevent the FFI from reporting the required information absent a waiver from the account holder, and the account holder fails to provide a waiver within a reasonable period of time, the FFI is required under Section 1471(b)(1)(F) to close the account.

Except as otherwise provided by the Secretary, an FFI agreement applies to the U.S. accounts of each FFI that is a member of the same "expanded affiliated group," as defined in Section 1471(e)(2).

A participating FFI is required to withhold 30 percent of any "passthru payment" to a "recalcitrant account holder" or to a non-participating FFI. A passthru payment is defined in Section 1471(d)(7) as any withholdable payment or other payment to the extent attributable to a withholdable payment. A recalcitrant account holder is defined as any account holder that fails to provide the information required to determine whether the account is a U.S. account, that fails to provide the information required to be reported by the FFI, or that fails to provide a waiver of a foreign law that would prevent reporting. This regime prevents non-participating FFIs from using participating FFIs as intermediary blockers in order to avoid the FATCA rules on their U.S. investments.

Reporting and Withholding Obligations for Non-Financial Foreign Entities

FATCA also requires certain non-financial foreign entities (NFFEs) to provide information to withholding agents on their "substantial U.S. owners." Withholdable payments made to an NFFE are also subject to 30 percent withholding if the payment is beneficially owned by the NFFE or another NFFE, unless the requirements of Section 1472(b) are met with respect to the beneficial owner of the payment. An NFFE is any foreign entity that is not an FFI.

The requirements of Section 1472(b) are met with respect to the beneficial owner of a payment if: the beneficial owner or payee provides the withholding agent with either a certification that such beneficial owner does not have any substantial U.S. owners, or the name, address, and TIN of each substantial U.S. owner; the withholding agent does not know or have reason to know that any information provided by the beneficial owner or payee is incorrect; and the withholding agent reports the information provided to the Secretary.

Certain classes of persons identified by Treasury as posing a low risk of tax evasion are exempt from the withholding provisions applicable to NFFEs.

Significant Provisions of the Proposed Regulations

Definition of Financial Account. The proposed regulations refine the definition of financial accounts to focus on traditional bank, brokerage, money market accounts and interests in investment vehicles, and excludes most debt and equity securities issued by banks and brokerage firms. Importantly, this exception does not apply to interests in investment funds. The proposed regulations also exclude from the definition of financial account certain savings accounts (including retirement and pension accounts) that meet certain requirements with respect to tax treatment and the type and amount of contributions.

Expanded Scope of "Grandfathered Obligations." As originally enacted in the HIRE Act, "obligations" outstanding as of March 18, 2012 were not subject to FATCA reporting and withholding. For purposes of this "grandfathered obligations" provision, an "obligation" includes any legal agreement that produces or could produce a withholdable payment or passthru payment, other than an instrument that is treated as equity for U.S. tax purposes or that lacks a stated expiration or term. The proposed regulations expand the grandfathered obligations provision to include obligations outstanding as of January 1, 2013. Thus, any payments made under or any gross proceeds resulting from the disposition of an obligation outstanding as of January 1, 2013 will generally not be subject to FATCA information reporting and withholding requirements. The proposed regulations provide, however, that any material modification of a grandfathered obligation will result in such obligation being treated as newly issued on the date of the material modification. In the case of a debt instrument for U.S. tax purposes, a material modification includes a significant modification pursuant to Treasury regulation section 1.1001-3. In other cases, whether a modification of an obligation is material will be determined based upon all relevant facts and circumstances. The proposed regulations do not include in the definition of a grandfathered obligation any interest in an entity that is treated as equity for U.S. tax purposes, regardless of whether such entity holds assets that give rise to grandfathered payments. The Treasury and IRS are requesting comments on whether it is appropriate to treat as grandfathered obligations certain equity interests in securitization vehicles that invest solely in debt and similar instruments if such vehicles will liquidate within a specified time frame and if certain requirements are satisfied.

Extended Transition Period for Reporting. The proposed regulations extend the transition period for the reporting obligations of participating FFIs. For reporting in 2014 and 2015, participating FFIs need only report the name, address, TIN, account number and account balance with respect to each U.S. account (under the Notices, full reporting would have commenced during 2014).

Beginning in 2016 (with respect to calendar year 2015), reporting is expanded to include income paid and credited to U.S. accounts. Beginning in 2017 (with respect to calendar year 2016), the reporting obligation is expanded again to include gross proceeds.

Extended Transition Period for Withholding and Phase-In on Scope for Passthru Payments. The proposed regulations extend the transition period for withholding obligations by U.S. withholding agents on payments made to non-participating FFIs and by participating FFIs with respect to passthru payments. In general, FATCA withholding on U.S.-source FDAP will apply to passthru payments made on or after January 1, 2014. FATCA withholding on "gross proceeds" from the sale or disposition of property that can produce U.S.-source interest or dividends is required for sales or dispositions occurring on or after January 1, 2015.

In addition, the proposed regulations also delay FATCA withholding by participating FFIs with respect to "foreign passthru payments" (passthru payments that are attributable to withholdable payments but are not themselves withholdable payments) until January 1, 2017 at the earliest, pending further guidance. The proposed regulations also reserve on the definition of foreign passthru payment. In the interim, the proposed regulations require participating FFIs to report annually to the IRS the aggregate amount of certain payments made to each nonparticipating FFI. The proposed regulations indicate the delay in implementing FATCA to passthru payments is the result of numerous comments received expressing concern about the costs, administrative complexity, and legal impediments associated with identifying and withholding on passthru payments. The proposed regulations request comments on numerous proposed approaches to reduce these burdens.

The proposed regulations also indicate a concern with and request comments regarding possible approaches to prevent the potential use of U.S. entities as "blockers" to avoid foreign passthru payment reporting and withholding.

Transitional Rules for Expanded Affiliated Group Members with Legal Prohibitions on Compliance ("Limited" FFI Affiliates and Branches). Under Section 1471, an FFI agreement must disclose account information concerning the U.S. accounts of each FFI within the same "expanded affiliated group." A prior IRS Notice stated that the Treasury and IRS intended to require each FFI that is a member of an expanded affiliated group to be a participating FFI or deemed-compliant FFI in order for *any* FFI in the expanded affiliated group to become a participating FFI. In recognition of the fact that some jurisdictions may have laws that prohibit an FFI's compliance with certain of FATCA's requirements, the proposed regulations provide a two-year transition period until January 1, 2016, for the full implementation of this requirement. During this transition period, an FFI affiliate in a jurisdiction that prevents compliance with FATCA will be treated as a "limited FFI" and will be exempt from the general rules for members of an expanded affiliated group. However, the limited FFI must comply with certain other requirements (*e.g.*, the limited FFI must perform due diligence to identify U.S. accounts and maintain certain records). Importantly, if a limited FFI affiliate or branch does not comply with the general rules by January 1, 2016, the entire expanded affiliated group's status as a participating FFI could be jeopardized.

Updated Diligence Procedures for FFIs. The proposed regulations provide updated guidance regarding the due diligence procedures FFIs must undertake in order to identify U.S. accounts. In order to reduce the administrative burden on FFIs, the proposed regulations allow FFIs to rely primarily on electronic reviews of pre-existing accounts. For pre-existing *individual* accounts that are offshore obligations, manual review of paper records is limited to accounts with a balance or value that exceeds $1,000,000. Pre-existing individual accounts with a balance or value of $50,000 or less and certain cash value insurance contracts with a value of $250,000 or less are also excluded from the due diligence procedure, as are pre-existing *entity* accounts with a value of $250,000 or less. Finally, with respect to pre-existing entity accounts not below the $250,000 threshold, the rules extend the reliance on information gathered with respect to the existing "anti-money laundering" (AML) and "know your customer" (KYC) rules.

Active Entity Accounts Excluded from Certain Documentation Requirements. The proposed regulations exempt new entity accounts of an entity engaged in an active nonfinancial trade or business from the requirement that the FFI document the entity's substantial U.S. owners. Also, FFIs will not need to document the substantial U.S. owners of the accounts of another FFI. Passive investment entities, on the other hand, are excluded from this exemption and FFIs will be required to determine whether the entity has any substantial U.S. owners upon opening a new account.

Active NFFEs Excluded from Withholding Requirements. The proposed regulations expand the types of NFFEs that are exempt from withholding under Section 1472. A withholding agent is not required to withhold on payments made to an entity that it may treat as an active NFFE. An active NFFE is any NFFE if less than 50 percent of its gross income for the calendar year is passive income and less than 50 percent of its assets are assets that produce or are held for the production of dividends, interest, rents and royalties (other than those derived in the active conduct of a trade or business), annuities, or other passive income.

Expanded Categories of Deemed-Compliant FFIs. The proposed regulations expand the previously announced categories of FFIs that will be "deemed-compliant" with FATCA. An FFI that is deemed-compliant may avoid withholding under FATCA without entering into an FFI agreement. The preamble to the proposed regulations explains that FATCA's compliance obligations are intended to focus on financial institutions that provide services to the global investment community and the proposed regulations attempt to eliminate or reduce the burden on truly local entities or other entities for which an FFI agreement is not necessary. The proposed regulations provide for two types of deemed-compliant FFIs: "registered deemed-compliant" FFIs" and "certified deemed-compliant FFIs".

A registered deemed-compliant FFI is required to register with the IRS to declare its status as deemed-compliant and must attest to the IRS that it satisfies certain requirements. The categories of registered deemed-compliant FFIs include local FFIs (*i.e.*, FFIs meeting certain licensing and regulation requirements and certain other requirements including having no fixed place of business outside its country of organization and having policies and procedures in place to ensure it does not maintain any U.S. accounts), non-reporting members of participating FFI groups, qualified investment vehicles (*e.g.*, certain collective investment vehicles in which each direct holder is a participating FFI, deemed-compliant FFI or an exempt beneficial owner), certain restricted funds (*e.g.*, foreign regulated investment funds that, among other requirements, prohibit the sale of debt or equity interests to U.S. persons, non-participating FFIs, and NFFEs with substantial U.S. owners) and FFIs that comply with the requirements under a bilateral agreement between the United States and a foreign government.

Proposed Model FFI Agreement. In the preamble to the proposed regulations, the Treasury and IRS announced their intention to publish a draft model FFI agreement in early 2012 and a final model FFI agreement, incorporating comments received on the draft model, by the fall of 2012.

Proposed Updates to Forms W-8 and W-9. The preamble to the proposed regulations indicates that Forms W-8 and W-9 will be revised to permit payees to indicate their tax status under FATCA on such forms used to indicate the payees' general withholding tax status under Chapter 3 of the Code (including status as an FFI, and certification of any substantial U.S. ownership).

Comments Requested. In addition to requesting comments on the provisions of the proposed regulations, the preamble to the proposed regulations requests comments on a variety of topics to be addressed in subsequent guidance, including:

- The treatment of passthru payments, including potentially providing a *de minimis* exception from foreign passthru payment withholding.
- The scope and content of the factual information and representations FFIs will be required to include as part of their periodic certification that they have met their obligations under an FFI agreement, as well as the scope and content of the periodic reviews the IRS may conduct relating to FFI agreements.
- Refund procedures for tax withheld on payments made to limited FFIs.
- Coordination of withholding under FATCA with backup withholding under IRC Section 3406.
- Whether there should be additional categories of deemed-compliant FFIs.
- Whether it is appropriate to treat certain equity interests in securitization vehicles that invest solely in debt and similar instruments as grandfathered obligations if such vehicles will liquidate within a specified timeframe given the types of investments they hold and the extent of their reinvestment in other assets.

The Treasury and IRS expect to issue additional guidance on the substantive and procedural issues not addressed in the proposed regulations, which guidance will be based, in part, on the comments received. IRS officials have reiterated that FATCA

legislation is “an ongoing process” and that comments from the public will be an essential component in developing additional guidance.

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