

FATCA Proposed Regulations Released

On February 8, 2012, the IRS released proposed regulations under Code §§ 1471-74 (generally referred to as the FATCA provisions). The proposed regulations clarify, expand, and relax the requirements of the earlier FATCA Notices. This Client Alert briefly summarizes the most significant changes.

On the same day, a joint statement was released by the United States, France, Germany, Italy, Spain, and the United Kingdom announcing an intent to explore a common approach to FATCA through automatic information exchange based upon information-exchange provisions in tax treaties. If such an approach is adopted, the United States would agree to waive some of the more onerous FATCA requirements.

Background: The FATCA Requirements

The FATCA regime was enacted in the United States in 2010 as a way to encourage tax reporting and compliance with respect to ownership of assets by US persons through foreign accounts. Under FATCA, a new 30 percent withholding is required on payments to non-US entities unless they comply with the information gathering and reporting requirements of FATCA. This withholding “tax” is generally called FATCA withholding. FATCA withholding has two major parts: withholdable payments to foreign financial institutions (FFIs) and payments to non-financial foreign entities (NFFEs).

- Payments to FFIs will be subject to FATCA withholding unless the FFI enters into an agreement with the IRS to determine whether the entity has any direct or indirect US account holders. The agreement will also obligate FFIs to withhold on passthru payments made by the FFI.
- Payments to NFFEs will be subject to the new FATCA withholding unless the NFFE certifies that it has no direct or indirect US owners of more than 10 percent of the NFFE’s equity (or provides information about those that it has).

In 2010 and 2011 the IRS issued several notices giving detailed explanations of the FATCA requirements.

Significant Changes to the FATCA Notices

Significant changes were made to the provisions of the earlier FATCA Notices in the following areas:

- Expanded Scope of Grandfathered Obligations
- Transitional Rules for Affiliates with Legal Prohibitions on Compliance
- Additional Categories of Deemed-Compliant FFIs
- Modification of Due Diligence Procedures for the Identification of Accounts
- Guidance on Procedures to Verify Compliance
- Refinement of the Definition of Financial Account
- Extension of Transition Period for the Scope of Information Reporting
- Passthru Payments

This Client Alert will summarize briefly the changes in the above categories. Many additional changes were also made by the proposed regulations.

Expanded Scope of Grandfathered Obligations

Section 501(d)(2) of the HIRE Act (which included FATCA) provides that no amount needs to be deducted or withheld from any payment on any obligation outstanding on March 18, 2012, or from the gross proceeds from the disposition of such an obligation. The proposed regulations extend the definition of a grandfathered obligation, the payments on which are exempt from FATCA withholding, to those obligations outstanding on January 1, 2013.

Transitional Rules for Affiliates with Legal Prohibitions on Compliance

If an FFI enters into an agreement with the IRS to comply with the FATCA requirements, every other FFI in the expanded affiliated group of the compliant FFI is also required to be compliant. The proposed regulations allow a two-year transition period, until January 1, 2016, for the full implementation of this requirement. During this transition period, an FFI that is prohibited from complying with the FATCA requirements under the laws of its jurisdiction will not prevent other members of the affiliated group from being treated as complying provided certain requirements are met.

Additional Categories of Deemed-Compliant FFIs

The proposed regulations provide additional categories of deemed-compliant FFIs. The proposed regulations would create two categories 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 to attest to the IRS that it satisfies certain procedural requirements. The categories of registered deemed-compliant FFIs are local FFIs, nonreporting members of participating FFI groups, qualified investment vehicles, restricted funds, and FFIs that comply with the FATCA requirements under an agreement between the United States and a foreign government.

The certified categories of deemed-compliant FFIs are nonregistering local banks, nonprofit organizations, certain owner-documented FFIs, and FFIs with only low-value accounts. Institutions 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.

Modification of Due Diligence Procedures for the Identification of Accounts

The proposed regulations rely primarily on electronic reviews of preexisting accounts. For preexisting accounts that are offshore obligations, manual review of paper records is limited to accounts with a balance or value that exceeds \$1 million (unless the electronic searches meet certain requirements, in which case manual review is not required). Additionally, with respect to preexisting accounts, 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 excluded from the due diligence procedures. The proposed regulations also have extended reliance on information gathered in anti-money-laundering and know-your-customer due diligence.

Guidance on Procedures Required to Verify Compliance

The proposed regulations modify and supplement the procedures required to verify compliance described in the Notices. The proposed regulations provide that responsible FFI officers will be expected to certify that the FFI has complied with the terms of the FFI agreement. Verification of such compliance through third-party audits is not required. If an FFI complies with its obligations under an FFI agreement with the IRS, it will not be held strictly liable for failure to identify a US account.

Refinement of the 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 to exclude most debt and equity securities issued by banks and brokerage firms, subject to an anti-abuse rule.

Extension of Transition Period for the Scope of Information Reporting

The proposed regulations provide that reporting on income will be phased in beginning in 2016 (with respect to the 2015 calendar year) and reporting on gross proceeds will begin in 2017 (with respect to the 2016 calendar year).

Passthru Payments

The proposed regulations provide that withholding will not be required with respect to foreign passthru payments before January 1, 2017. Instead, the IRS is seeking industry comments on coordinating withholding on passthru payments with existing withholding rules. Until FATCA withholding on passthru payments applies, the proposed regulations require participating FFIs to report annually to the IRS the aggregate amount of certain payments made to each nonparticipating FFI.

Joint Statement from the US, France, Germany, Italy, Spain, and the UK

The United States, France, Germany, Italy, Spain, and the United Kingdom have agreed to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic information exchange based upon bilateral tax treaties.

Agreements of the Partner Countries

The United States and a partner country (a FATCA partner) would enter into an agreement pursuant to which, subject to certain terms and conditions, the FATCA partner would agree to:

- Pursue the necessary implementing legislation to require FFIs in its jurisdiction to collect and report to the authorities of the FATCA partner the required information;
- Enable FFIs established in the FATCA partner (other than FFIs that are excepted pursuant to the agreement or in US guidance) to apply the necessary due diligence to identify US accounts; and
- Transfer to the United States, on an automatic basis, the information reported by the FFIs.

Agreements of the United States

In consideration of the foregoing, the United States would agree to:

- Eliminate the obligation of each FFI established in the FATCA partner to enter into a separate comprehensive FFI agreement directly with the IRS, provided that each FFI registered with the IRS is excepted from registration pursuant to the agreement or IRS guidance;
- Allow FFIs established in the FATCA partner to comply with their reporting obligations under FATCA by reporting information to the FATCA partner rather than reporting it directly to the IRS;
- Eliminate US withholding under FATCA on payments to FFIs established in the FATCA partner;
- Identify in the agreement specific categories of FFIs established in the FATCA partner that would be treated, consistent with IRS guidelines, as deemed compliant or presenting a low risk of tax evasion; and

- Commit to reciprocity with respect to collecting and reporting on an automatic basis to the authorities of the FATCA partner information on the US account of residents of the FATCA partner.

Benefits to the FFIs

As a result of the above agreements, FFIs established in the FATCA partner would not be required to:

- Terminate the account of a recalcitrant account holder;
- Impose passthru payment withholding on payments to recalcitrant account holders; or
- Impose passthru payment withholding on payments to other FFIs organized in the FATCA partner or in another jurisdiction with which the United States has a FATCA implementation agreement.

Mutual Commitments

The United States, France, Germany, Italy, Spain, and the United Kingdom expressed the intent to work together to come to practical approaches to achieve the goals of passthru payment withholding. They also express the intent to work with the OECD and the EU to develop a common model for the automatic exchange of information, including the development of reporting and due diligence standards.

Conclusion

FATCA has been a moving target since its adoption. Fortunately, the proposed regulations and the joint announcement indicate a general intent to move the requirements in a direction that may be more practical for FFIs to comply with. There will still be many burdens in compliance, and we are quite likely to receive additional guidance in the future, so the proposed regulations may not be the final rules. Among the guidance yet to come is a proposed model FFI agreement; the preamble to the proposed regulations indicates that the IRS intends to release a draft "early" in 2012.

Key Terms

FATCA

Foreign Account Tax Compliance Act, enacted as Sections 1471 through 1474 of the Code, and included as part of the larger HIRE Act.

FDAP

FDAP payments include any payments of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic gains, profits, and income if such payments are from sources within the United States. The preamble to the proposed regulations indicates that interest on tax-exempt bonds (and gross proceeds from the sale of such bonds) is not intended to be included in withholdable payments.

FFI

Foreign financial institution. A financial institution is any entity which (1) accepts deposits in the ordinary course of a banking or similar business, (2) as a substantial portion of its business, holds financial assets for the account of others, or (3) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities. Thus, a financial institution would include a hedge fund, a private equity fund, or other collective investment vehicle, as well as a bank. An insurance company will not be a financial institution for these purposes if the insurance company only sells property or casualty insurance or reinsurance contracts.

HIRE Act

Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111-147 (H.R.2847).

Passthru Payment

The regulations reserve in part on the definition for passthru payments, but they are generally understood to refer to withholdable payments or other payments made by an intermediary or by a foreign pass thru entity to the extent attributable to a withholdable payment.

Withholdable Payment

A withholdable payment includes (1) any FDAP payment if such payment is from sources within the United States and (2) 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.

For more information, please contact Paul Carman (312-845-3443) or Melanie Gnazzo (415-278-9020). To the extent that any part of this summary is interpreted as being tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

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