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New Proposed Regulations Provide Some Welcome Relief for Foreign Financial Institutions under FATCA

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The Foreign Account Tax Compliance Act ("FATCA") initially threatened to create significant obstacles to fund managers. Recently published regulations have clarified the obligations imposed by the Act. The following article seeks to provide a brief analysis of FATCA and its impact.

I. Introduction

On February 8, 2012, the Treasury Department issued proposed regulations concerning the Foreign Account Tax Compliance Act ("FATCA") provisions found in Sections 1471 through 1474 of the Code.[1] FATCA was originally enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147), in order to promote compliance with US laws requiring US persons to report income from offshore accounts. The newly proposed regulations build upon several previous Notices from the Internal Revenue Service (the "IRS") in limiting the scope of FATCA and clarifying the reporting obligations of foreign financial institutions ("FFIs") and non-financial foreign entities ("NFFEs"). This article will generally focus on how the proposed regulations affect the responsibilities of FFIs under FATCA.

FATCA essentially forces many FFIs and other foreign entities to disclose to the IRS information about their US account holders and owners. Since the IRS has little direct power over most foreign entities, Congress chose to accomplish its goal indirectly. The penalty for a foreign person's non-compliance with FATCA is generally a 30 percent withholding tax on payments to the foreign person of any US-sourced "FDAP" income (such as interest, dividend, rent, royalty, and annuity payments) and any gross proceeds from the disposition of property that produces US-sourced interest or dividends, even if a treaty or statutory exemption (such as the portfolio interest exemption) from withholding tax would otherwise be applicable.[2] The tax is imposed on the person making the payment to the foreign person, and this payor is often a US financial institution; the payor/withholding agent has personal liability for any amounts required to be withheld.[3]

An FFI is generally subject to the withholding tax unless it becomes a "participating FFI" by entering into an agreement (an "FFI Agreement") with the IRS, which requires the FFI to implement due diligence procedures identifying financial accounts belonging to US persons or to foreign persons with US owners, to comply with certain annual informational reporting requirements, and to withhold 30 percent of any “passthru payments” (of the above FDAP income or gross proceed amounts, and certain other amounts) made by the participating FFI to non-participating FFIs or to “recalcitrant” account holders who refuse to provide information regarding their US status. An “FFI” is defined broadly as any foreign entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the accounts of others, as a substantial portion of its business, or (iii) is engaged (or holds itself as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnerships interests, or commodities, or interests in such assets.[4] In addition to mutual funds and hedge funds, an entity may be an FFI under the last category even if its investing activities do not rise to the level of a “trade or business” under Code section 162 or other Code provisions, such as certain trusts and family holding companies.[5]

NFFEs are defined as all foreign entities that are not financial institutions.[6] NFFEs are generally subject to the 30 percent withholding tax when they receive withholdable payments, unless they certify the identity of certain of their US owners. Most NFFEs are required to disclose only the identities of US persons that own 10 percent or more of the interests in the NFFE, but some NFFEs are required to disclose all of their direct and indirect US owners, no matter how small their interest.

In Notice 2011-53, the IRS delayed certain effective dates for the FATCA withholding rules, which would otherwise be effective for payments made after December 31, 2012. The Notice provided that the 30 percent withholding tax will be imposed after January 1, 2014 for US-source FDAP income and after January 1, 2015 for US-sourced gross proceeds, that are paid to non-participating FFIs.

If the 30 percent withholding tax results in an overpayment by the beneficial owner (such as a US person with an account at a non-participating FFI) of its US tax liability, the beneficial owner can obtain a refund or credit from the IRS.[7] However, if the beneficial owner is an entity, it can only obtain a refund or credit if it provides information about its US ownership to the IRS.[8]

II. The Regulations

The proposed regulations make many welcomed changes to the rules announced earlier in Notices 2010-60, 2011-34, and 2011-53. Among the many changes in the proposed regulations are:

A. Extension of cut-off date for “grandfathered obligations”

The FATCA statute provides that its withholding rules do not apply to obligations issued by March 18, 2012. The proposed regulations extend the date through all of 2012, thus excluding from FATCA all payments made under obligations outstanding on January 1, 2013, as well as any gross proceeds from the disposition of such obligations. The term ‘obligation’ generally includes “any legal agreement that produces or could produce withholdable payments,” such as debt, fixed-term annuities, and life insurance contracts, but it does not include stock, other equity instruments, or instruments that lack a “stated expiration or term,” such as a savings deposit or demand loan. An obligation is considered ‘outstanding’ on January 1, 2013 if (i) in the case of obligations characterised as debt for US income tax purposes, it has an issue date that is before

January 1, 2013, or (ii) in the case of other obligations, a legally binding agreement establishing the obligation was executed between the parties to the agreement before January 1, 2013. A material modification of a grandfathered debt instrument after December 31, 2012 would cause that instrument to be treated as newly issued on the modification date and to lose its grandfathered status.

No equity interest in an entity can be a grandfathered obligation, even if such entity owns only grandfathered obligations. The Treasury Department and the IRS are requesting comments as to whether grandfathered obligations should include certain self-liquidating equity interests in securitisation vehicles that invest solely in debt and similar instruments.

If an investor holds stocks of US companies in a brokerage account with an FFI, the FATCA reporting and withholding obligations apply to all dividends, regardless of when the stocks were acquired. However, if the investor were to enter into an equity swap before 2013 for a fixed term, the swap might not be considered equity under certain circumstances and could qualify as a grandfathered obligation.

B. Delay in reporting

All participating FFIs must report to the IRS some information about their US account holders. According to Notice 2011-53, in 2014 (with respect to the 2013 calendar year), a participating FFI is required to only provide identifying information (name, address, TIN, and account number) and account balance or value of US accounts. Thereafter, the participating FFI will be required to report the US-sourced FDAP income, and later, the gross proceeds, of the US account. The proposed regulations further delay reporting requirements by providing that reporting on income will be phased in beginning in 2016 (with respect to the 2015 calendar year) and reporting on gross proceeds will be phased in beginning in 2017 (with respect to the 2016 calendar year). Thus, only identifying information and account balance or value are required to be reported in 2014 and 2015 (with respect to the 2013 and 2014 calendar years).

C. Delay in withholding on passthru payments that are not withholdable payments

As previously stated, an FFI that enters into an FFI Agreement with the IRS is not subject to withholding on payments made to it. However, Code section 1471(b)(1)(D) requires such participating FFIs to withhold on “passthru” payments that it makes itself to nonparticipating FFIs and recalcitrant account holders. A passthru payment is any withholdable payment or other payment to the extent attributable to a withholdable payment, and in some circumstances a passthru payment might not itself be a withholdable payment (based on a complex percentage formula).

A passthru payment that is a withholdable payment would be subject to FATCA withholding after January 1, 2014 (for US-sourced FDAP income) and after January 1, 2015 (for gross proceeds), if the participating FFI is paying it to a nonparticipating FFI or recalcitrant account holder, even though the participating FFI is subject to the simpler reporting rules for 2014, as described above.

Notice 2011-53 had provided that withholding on passthru payments that are not withholdable payments would generally apply to payments made after January 1, 2015. The proposed regulations extend the date further so that withholding would not apply to such payments made before January 1, 2017. Instead, participating FFIs would only need to report annually to the IRS the aggregate amount of certain payments made to each nonparticipating FFI.

D. Delay in application of affiliated group rules

Section 1471(e) of the Code provides that the requirements of any FFI Agreement would apply to the accounts of the participating FFI and also to the accounts of any other FFI that is a member of the same expanded affiliated group (generally, 50 percent common ownership). The proposed regulations recognize that some jurisdictions prohibit compliance with FATCA, so during a two-year transitional period (until January 1, 2016), an FFI can be a participating FFI even if branches or other FFIs in the expanded affiliated group are prohibited by law from complying with the FFI Agreement of the participating FFI, as long as the FFIs and branches in the restrictive jurisdictions meet certain requirements.

E. Expansion of Exempt Foreign Owners

Many entities are exempt from FATCA withholding for payments that they receive: foreign governments and their wholly owned agencies or instrumentalities, international organisations, and foreign central banks. The proposed regulations expand these categories of exempt foreign owners posing a “low risk of tax evasion” by adding certain foreign retirement funds and investment entities wholly owned by one or more exempt foreign owners. Additional rules apply to controlled entities of a foreign government.

F. Deemed-compliant FFIs

The proposed regulations provide for two kinds of deemed-compliant FFIs that are exempt from the withholding and reporting requirements of FATCA: registered deemed-compliant FFIs and certified deemed-compliant FFIs. Registered deemed-compliant FFIs include local FFIs (generally local banks that operate within only one foreign country and at least 98 percent of whose accounts are with residents of that country); non-reporting members of participating FFI groups (FFIs that essentially transfer all of their current and future US accounts to other members of its group that are participating FFIs); certain investment funds owned only by participating FFIs, deemed-compliant FFIs, and certain exempt persons; certain investment funds that restrict their ownership by US persons; and FFIs covered by an agreement between the United States and a foreign government. Registered deemed-complaint FFIs must register with the IRS and renew their deemed-compliant status every three years. Certified deemed-compliant FFIs, in contrast, do not have to register with the IRS and need only certify to any payor / withholding agent that they met the certified deemed-compliant FFI requirements. Certified deemed-complaint FFIs include non-registering local banks with less than $175 million in assets (and less than $500 million in assets for its expanded affiliated group), various retirement funds, non-profit organisations, certain “owner-documented” FFIs, and FFIs that have less than USD 50 million in assets and maintain no financial account with a balance in excess of USD 50,000.

G. Narrowing of the definition of “financial account”

Code section 1471(d)(2) defines a financial account to mean any depository account, any custodial account, and any non-publicly-traded equity or debt interest in an FFI. The proposed regulations refine the definition of financial accounts to focus on traditional bank, brokerage, and money market accounts, and interests in investment vehicles, and to exclude most debt and equity securities issued by banks and brokerage firms.

H. Due diligence

Participating FFIs must undertake due diligence procedures to identify their US accounts. The proposed regulations allow electronic reviews of most preexisting accounts. For preexisting individual accounts, manual review of paper records is generally limited to accounts with a balance or value of more than USD 1,000,000 (unless the electronic searches meet certain requirements, in which case manual review for even such large accounts is not required). In addition, individual accounts with a balance or value of $50,000 or less, entity accounts with a balance or value of $250,000 or less, and certain cash value insurance contracts valued at $250,000 or less, are excluded from the due diligence procedure. A number of other burden-reducing measures are proposed, such as extended reliance on information gathered in the context of the due diligence required to comply with anti-money laundering / “know your customer” rules. For new accounts, FFIs may generally rely on their existing customer intake procedures; FFIs are generally not required to significantly modify their intake procedures, other than with respect to account holders identified as FFIs, as passive investment entities, or as having indicia of US status.

J. Self-certification allowed

A participating FFI can have its responsible officers self-certify that it has complied with the terms of its FFI Agreement. Third party audits are not required.

K. Definition of withholdable payment

As described above, a withholdable payment is defined in Code section 1473(1) to mean any payment of US-sourced FDAP income, and any gross proceeds from the sale or disposition of any property of a type which can produce US-sourced interest or dividends. The proposed regulations provide a list of exclusions from the definition of withholdable payments, such as original issue discount from certain short-term obligations, income that is effectively connected with the conduct of a US trade or business, certain payments made in the ordinary course of the withholding agent’s business, and certain broker transactions that involve the sale of fractional shares. The proposed regulations clarify that an exclusion from withholding or an exclusion from taxation under section 881, such as the portfolio interest exemption, does not exclude such amount from the definition of US-sourced FDAP income for FATCA purposes. In addition, while normally bank deposit interest with respect to offshore accounts is treated as foreign-source income under section 861(a)(1)(A), such as for foreign tax credit purposes, such interest is treated as US-sourced income for purposes of the definition of a withholdable payment under FATCA.

If a withholding agent cannot determine the source of a payment at the time the payment is made, the payment is treated as US-sourced.

L. Identification of Payee

The documentation requirements with respect to the payee of a payment subject to FATCA are similar to those under the other withholding requirements of the Code, but are expanded in order to determine whether the payee is an FFI and whether it is acting as an agent or intermediary. The proposed regulations list specific situations in which further documentation or verification is required, beyond the payee's information provided on a Form W-8 or W-9.

Generally, the "payee" is the person to whom a payment is made, regardless of whether the person is the beneficial owner of the account. However, the direct recipient of a payment will not automatically be considered the 'payee' if the payment is made to certain entities, such as foreign agents, intermediaries, or flow-through entities; a US person that is known to be acting as an intermediary or agent of a foreign person, unless the US person is a financial institution and certain other conditions apply; disregarded entities or branches; US branches of certain foreign banks and foreign insurance companies; and foreign branches of US financial institutions.

III. Future

The Treasury Department expects to introduce by January 1, 2013 an online process for FFIs to register as participating FFIs or deemed-compliant FFIs. The online process would allow FFIs to enter into an FFI Agreement, complete a required certification, and perform other tasks. Notice 2001-53 stated that FFIs will need to sign FFI Agreements by June 30, 2013 in order for the FFI to be considered a participating FFI on January 1, 2014, which is when the first FATCA withholding would begin to occur (on US-source FDAP income).

In addition to the proposed regulations, there may in the future be a special rule for FFIs in jurisdictions that enter into information-sharing agreements with the United States, according to a statement issued by the Treasury Department jointly with France, Germany, Italy, Spain, and the United Kingdom. Such FFIs would perform the due diligence necessary to identify US accounts and report the information to the FATCA partner government, which would then transmit that information to the United States automatically pursuant to a tax treaty or tax information exchange agreement.

The Treasury Department is requesting comments on the proposed regulations by April 30, 2012, and it scheduled a public hearing on the proposed regulations for May 15, 2012. The Treasury Department has previously stated that its goal is to issue final, or perhaps temporary, regulations later this summer, at which point the regulations would become effective.

The regulations are not the only FATCA matter that the Treasury Department is working on. The Treasury Department is planning to release a draft model FFI Agreement in the first half of 2012, followed by the release of a final model FFI Agreement in the fall of 2012, for use by FFIs to become participating FFIs. The Treasury Department also intendeds to release draft forms for reporting the information required by FATCA, as well as changes to other withholding regulations and existing forms (such as Forms W-8 and W-9) to make them FATCA compliant. The next few years should prove to be interesting and busy times for all parties involved.

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[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.
[2] Code section 1473(1).
[3] Code section 1474(a).
[4] Code section 1471(d)(5).
[5] Notice 2010-60, II.A.2.

[6] Code section 1472(d).
[7] Code section 1474(b)(1).
[8] Code section 1474(b)(3).