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After Months of Anticipation, Final FATCA Regulations Released

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BACKGROUND

On January 17, 2013, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued final regulations[1] implementing the Foreign Account Tax Compliance Act ("FATCA").

Congress enacted FATCA in 2010 as part of the Hiring Incentives to Restore Employment Act (the "HIRE Act"), and it is housed in Sections 1471 through 1474 of the Code.[2]

As described in the final regulations, the purpose of FATCA is broadly to buttress the existing U.S. information reporting regime by imposing reporting requirements on certain foreign financial institutions ("FFIs"), as well as other nonfinancial foreign entities ("NFFEs") with substantial U.S. ownership.[3]

The mechanism laid out in the final FATCA regulations to facilitate the flow of this information is complex, and the failure to comply carries a hefty price. In short, a 30% withholding tax will be levied on any "withholdable payment" to an FFI, or NFFE, that does not agree to report certain information—spelled out in great detail in the final regulations—about their U.S. account holders or substantial U.S. owners to the IRS.

Consuming more than 500 pages, these long-awaited final regulations are comprehensive and lengthy. In fact, they are anything but light reading, and the casual reader should be cautioned about their soporific effects. They do, however, (helpfully) refine and clarify many of the information reporting and withholding tax provisions of the proposed regulations, which were issued in February 2012, and we bring you just a few of the most relevant high points.

If you are a glutton for punishment, you can digest the final FATCA regulations in their entirety by visiting our FATCA website, KNOWFATCA.com. There, you will find a complete text of the final regulations, along with a host of other important FATCA-related guidance.

GRANDFATHERED OBLIGATIONS

Perhaps the best news in the short run is the extension of the grandfathering provisions, which were set to expire under the proposed regulations on January 1, 2013.

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[1] TD 9610 (January 17, 2013). The proposed FATCA regulations were released on February 8, 2012. For pertinent information on FATCA and the proposed regulations, in general, please see our previous Client Alert, which we released on Valentine's Day last year. As you will see, our passion for FATCA has not waned, and we hope to provide you with FATCA updates in the future as further guidance is released.

[2] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury regulations promulgated thereunder.

[3] Although FATCA withholding does not replace the existing U.S. tax withholding and reporting regimes, it has added complexity and increased the administrative compliance burden. The preamble to the final regulations asserts that the IRS has attempted to streamline the final FATCA regulations to enable businesses and foreign governments to implement FATCA effectively.

By carving out a special exception for certain grandfathered obligations from the definition of a “withholdable payment,” the final FATCA regulations extend grandfathering treatment to certain obligations outstanding as of January 1, 2014. As explained in the final FATCA regulations, the extension of the grandfathering dates was motivated by the government’s altruistic desire to ease potential administrative burdens and facilitate an orderly implementation of FATCA. As a result, FATCA withholding will not be required for any payment under any obligation outstanding on January 1, 2014.

To determine whether the grandfathering provisions apply in the first place, it is important to identify those obligations given special treatment under the final FATCA regulations. As a threshold matter, for purposes of the grandfathering provisions, the final regulations define an obligation to include any legally binding agreement or instrument, illustrated by the following five examples:

(1) a debt instrument;

(2) an agreement to extend credit for a fixed term (e.g., a line of credit or a revolving credit facility) provided that the agreement fixes the material terms at the issue date;

(3) a derivatives transaction between counterparties under an ISDA Master Agreement that is evidenced by a confirmation;

(4) a life insurance contract that provides that the entire contract value is payable no later than upon death of the insured; and

(5) an immediate annuity contract payable for a period certain or for the life of the annuitant.

With respect to debt obligations, the final regulations determine the date the obligation is outstanding based on the issue date of the debt. Thus, whether debt issued in a qualified reopening will be treated as a grandfathered obligation depends on the original issue date of the reopened issue. The final regulations provide that a withholding agent (other than the issuer or an agent of the issuer) may, absent actual knowledge, rely on a statement by the issuer of an obligation in determining whether such obligation is grandfathered.

Consistent with the proposed regulations, in the case of an obligation treated as debt for U.S. federal income tax purposes, a material modification is any significant modification of the debt instrument.[4] In all other cases, whether a modification of an obligation is material is a fact-specific inquiry. Thus, a grandfathered obligation that is materially modified after the extended grandfathering period expires would be subject to FATCA withholding, unless another, independent exception applies. In addition, the final regulations provide that a withholding agent is required to treat a modification as material only if the withholding agent knows or has reason to know that the modification is material. A withholding agent is treated as having “reason to know” for these purposes if the agent receives a disclosure of the material modification from the issuer of the obligation.

By contrast, an obligation does not include any legal agreement or instrument that is treated as equity for U.S. tax purposes, lacks a stated expiration or term,[5] or constitutes a brokerage or custodial agreement.

[4] *See* Treas. Reg. section 1.1001-3.

[5] For example, a savings deposit or demand deposit, a deferred annuity contract, or a life insurance contract or annuity contract that permits a substitution of a new individual as the insured or as the annuitant under the contract. *See* Treas. Reg. section 1.1471-2(b)(2)(ii)(B)(2).

The final regulations also address obligations that would be subject to FATCA solely because they give rise to U.S. source dividend equivalent payments under Section 871(m). These obligations are grandfathered if they are issued or executed on or before the date that is six months after the date on which obligations of that type become subject to dividend equivalent treatment.

The final regulations similarly exempt from FATCA withholding any agreement requiring a secured party to make a payment with respect to, or to repay, collateral posted to secure a grandfathered obligation.

Finally, the final regulations provide that, for purposes of "foreign passthru payments," a grandfathered obligation includes an obligation that is executed on or before the date that is six months after the date on which the term "foreign passthru payment" is defined. The final regulations have opted to punt on the definition of a foreign passthru payment for now.[6] Consistent with the proposed regulations, an FFI is not required to withhold on foreign passthru payments until January 1, 2017.

FATCA GROSS PROCEEDS WITHHOLDING POSTPONED UNTIL 2017

Although the final FATCA regulations did not extend the withholding date for standard FDAP-type payments, such as U.S. source interest and dividends, which begins January 1, 2014, the IRS did modify the rule set forth in the proposed regulations concerning withholding of gross proceeds.

The final regulations now provide that the term "withholdable payment" includes gross proceeds from any sale or other disposition of property that can produce interest or dividends that would be U.S. source FDAP income, but only if those sales and dispositions occur after December 31, 2016. This two-year extension means that gross proceeds from the disposition of property that can produce U.S. source FDAP-type income will be exempt from withholding until 2017.

The statutory definition of a "withholdable payment,"[7] which was maintained in the proposed regulations, has been retained, virtually without change.[8] The final regulations did, however, broaden the scope of a withholdable payment in the context of dispositions to include any contract producing dividend equivalent payments, as defined in Section 871(m) and the regulations thereunder. The final regulations clarify that these contracts will be treated as property that can produce U.S. source FDAP income, when sold or exchanged.[9]

Furthermore, the final regulations also clarified that withholdable payments include payments in connection with a securities lending transaction, as well as a forward, future, option or swap, or any other similar financial instrument.[10]

By contrast, the final regulations confirm that payments of interest or original issue discount on certain short-term obligations will not be treated as a withholdable payment; the same goes for accrued interest on the date of a sale or exchange of an interest-bearing debt obligation if the sale occurs between two interest payment dates.[11]

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[6] *See* Treas. Reg. section 1.1471-5(h)(2).

[7] 26 U.S.C. section 1473(1) (defining "withholdable payment").

[8] Treas. Reg. section 1.1473-1(a) (defining "withholdable payment").

[9] Treas. Reg. section 1.1473-1(a)(3)(ii)(A), (B). In contrast, the proposed regulations appeared to have targeted only terminations of a specified notional principal contract. *See* Prop. Treas. Reg. section 1.1473-1(a)(3)(ii)(B).

[10] Treas. Reg. section 1.1473-1(a)(4)(iii).

[11] Treas. Reg. section 1.1473-1(a)(2)(vi).

Likewise, any payment that gives rise to effectively connected income will not be treated as a withholdable payment.

SUMMARY OF RELEVANT DATES

FATCA Withholding Dates	
Withholdable Payments:	**Withholding begins on:**
Any payment of U.S. source FDAP income, such as U.S. source interest (including OID) and dividends	January 1, 2014
Gross proceeds from the disposition of property producing FDAP-type income	January 1, 2017
Foreign passthru payments	January 1, 2017
Grandfathered Obligations:	**Obligation must be outstanding[12] on:**
All Obligations	January 1, 2014
Obligations giving rise to Withholdable Payments solely because they are subject to dividend equivalent treatment	***Later of:*** (i) January 1, 2014 **OR** (ii) 6 months after Section 871(m) dividend equivalent treatment applies to such instrument
Obligations giving rise to foreign passthru payments	***Later of:*** (i) January 1, 2014 **OR** (ii) 6 months after the regulations defining foreign passthru payment are finalized

INTERGOVERNMENTAL AGREEMENTS PROVIDE FATCA COMPLIANCE ALTERNATIVE

Since the proposed regulations were issued last February, Treasury has been busy trying to make good on its promise to provide an alternative to FATCA compliance for those FFIs residing in countries that have entered into information sharing agreements with the U.S.

[12] The final regulations provide that debt obligations are considered outstanding on a date if it has an issue date before such date. Non-debt obligations are outstanding on a date if a legally binding agreement establishing the obligation was executed between the parties to the agreement before such date. Treas. Reg. 1471-2(b)(2)(iii).

As detailed in our previous client alerts[13] and issues of Tax Talk,[14] Treasury has issued two model intergovernmental agreements ("IGAs"). Technically, the IGAs do not offer a FATCA exemption, but merely offer an information sharing framework. For a complete list of FATCA partner countries to date, please see KNOWFATCA.com.

The first model IGA ("Model 1 IGA"), released on July 26, 2012, requires a partner FATCA country to collect information from resident FFIs about its U.S. account holders. The required information generally will mirror the information reporting framework laid out in the final FATCA regulations. The FATCA partner country then automatically provides this information to the IRS.

The second model IGA ("Model 2 IGA"), released on November 12, 2012, operates in a similar fashion, but with one significant difference. FFIs residing in a FATCA partner country that is a party to a Model 2 IGA are still required to register with the IRS and report information about their U.S. accounts directly to the IRS.

A major benefit to FFIs covered by a Model 1 IGA—aside from the promised reduction of compliance burdens—is that they will be deemed to have satisfied FATCA's due diligence and reporting requirements. In short, these FFIs will avoid FATCA withholding altogether. FFIs covered by a Model 2 IGA, on the other hand, are still required to comply with FATCA, except as provided in their respective IGA.

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[13] http://www.mofo.com/files/Uploads/Images/120807-Treasury-Releases-FATCA-Intergovernmental-Model-Agreements.pdf.

[14] http://www.mofo.com/files/Uploads/Images/130125-MoFo-Tax-Talk.pdf.