

Client Alert.

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Treasury Publishes Highly Anticipated “Withholdable Payment” FATCA Regulations and Outlines International Cooperation Alternative

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After months of waiting, the Treasury Department (“Treasury”) released proposed Foreign Account Tax Compliance Act (“FATCA”) “withholdable payment” regulations¹ on February 8, 2012. FATCA, contained in Sections² 1471 through 1474 of the Code, was originally enacted as part of the Hiring Incentives to Restore Employment Act (the “HIRE Act”) in 2010. Within the past two years, Treasury and the Internal Revenue Service (the “IRS”) have issued preliminary FATCA guidance in the form of three Notices (collectively, the “FATCA Notices”),³ with the repeated promise of proposed regulations. The newly issued proposed regulations incorporate the guidance provided in the FATCA Notices in a revised and refined manner. While the proposed regulations go into excruciating detail on the many facets of FATCA, this client alert highlights the significant modifications and additions to prior FATCA guidance. The text of the proposed regulations, along with Treasury’s joint statement from the U.S., France, Germany, Italy, Spain, and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA, can be found on our FATCA website, [KNOWFatca.com](http://www.knowfatca.com).

GRANDFATHERED OBLIGATIONS

As originally enacted in the HIRE Act, “obligations” outstanding on March 18, 2012 were grandfathered and not subject to FATCA reporting and withholding. An “obligation” for purposes of the grandfather provision is 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 definition of a grandfathered obligation to include obligations outstanding on January 1, 2013. Withholding is not required with respect to any payment under a grandfathered obligation or from the gross proceeds from any disposition of such an obligation.

Despite grandfathered obligations being exempt from FATCA reporting and withholding, 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 an obligation that is a debt instrument for U.S. tax purposes, a material modification means a significant modification pursuant to Treasury regulations.⁴ In all other cases, whether a modification of an obligation is material will be determined based upon all relevant facts and circumstances.

¹ REG-121647-10.

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

³ Notice 2010-60, 2010-37 I.R.B. 329, Notice 2011-34, 2011-19 I.R.B. 765, and Notice 2011-53, 2011-32 I.R.B. 124. See our prior client alerts on Notice 2010-60, <http://www.mofo.com/files/Uploads/Images/100910FACTA.pdf>, Notice 2011-34, <http://www.mofo.com/files/Uploads/Images/110420-IRS-Guidance-FATCA.pdf>, and Notice 2011-53, <http://www.mofo.com/files/Uploads/Images/110719-IRS-Announces-Phased-Implementation-of-FATCA.pdf>.

⁴ Section 1.1001-3.

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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. According to the preamble, Treasury and the IRS are considering whether to treat as grandfathered obligations certain equity interests in vehicles that invest solely in debt and similar instruments, if certain requirements are satisfied.

PASSTHRU PAYMENTS

Under Section 1471(d)(7), a passthru payment is defined as any withholdable payment or other payment to the extent attributable to a withholdable payment. Foreign financial institutions ("FFIs") that are participating FFIs ("PFFIs") must withhold on passthru payments made to non-participating FFIs and recalcitrant account holders. When Treasury released FATCA's phased implementation approach in the summer of 2011, Notice 2011-53 stated that PFFIs will not be obligated to withhold on passthru payments that are not withholdable payments (e.g., foreign passthru payments) made before January 1, 2015. The proposed regulations define a passthru payment to mean any withholdable payment and any foreign passthru payment.⁵ After receiving numerous comments with regard to the costs, administrative complexity, and legal impediments associated with identifying and withholding on passthru payments, the proposed regulations further provide that withholding will not be required with respect to foreign passthru payments before January 1, 2017. Instead, until withholding applies, the proposed regulations require PFFIs to report annually to the IRS the aggregate amount of certain payments made to each non-participating FFI. The proposed regulations reserve on the definition of a foreign passthru payment, presumably due to the fact that withholding does not apply before January 1, 2017.

If the proposed regulations are finalized in their current form, withholding and reporting on passthru payments would be implemented as follows: (i) (a) beginning on January 1, 2014, FFIs will be required to withhold on passthru payments that are withholdable payments and (b) FFIs will also be required to report annually on the aggregate amount of certain payments to each non-participating FFI for the 2015 and 2016 calendar years; and (ii) beginning no earlier than January 1, 2017, the scope of passthru payments will be expanded beyond withholdable payments and FFIs will be required to withhold on such payments pursuant to and in accordance with future guidance.

According to the preamble, Treasury and the IRS are considering modifications to passthru payment withholding, including whether to allow certain FFIs to rely upon a safe harbor passthru percentage if the FFI does not elect to calculate its exact passthru percentage.

In addition, the proposed regulations provide a special rule for dormant accounts, under which a PFFI that withholds on passthru payments made to a recalcitrant account holder of a dormant account may, in lieu of depositing the tax withheld, set aside the amount withheld in escrow until the date that the account ceases to be a dormant account.

FINANCIAL ACCOUNTS

Pursuant to FATCA, FFIs that enter into an FFI Agreement⁶ are required to identify their "U.S. accounts" and comply with verification and due diligence procedures prescribed by Treasury. A U.S. account is defined under Section 1471(d)(1) as any "financial account" held by one or more specified United States persons or United States owned foreign entities, subject to certain exceptions.

⁵ Prop. Reg. Section 1.1471-5(h).

⁶ The preamble states that Treasury intends to publish a draft model FFI agreement in early 2012 and a final model FFI agreement in the fall of 2012. Prop. Reg. Section 1.1471-4 sets forth the general requirements that will apply to an FFI under an FFI agreement.

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As originally enacted, a “financial account” is any depository account, custodial account, or equity or debt interest in an FFI, other than interests that are regularly traded on an established securities market.⁷ However, 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.

- First, as provided in Section 1471(d)(2)(C), debt or equity that is regularly traded on an established securities market is not a financial account.
- Second, the proposed regulations provide that an equity interest includes a capital or profits interest in a partnership and, in the case of a trust that is a financial institution, the interest of an owner under the “grantor trust” rules of Sections 671 through 679 and a beneficial interest in a trust.
- Third, the proposed regulations provide that an equity or debt interest in a financial institution is a financial account if it is an equity or debt interest in a financial institution that is engaged primarily in the business of investing, reinvesting, or trading securities.⁸ In addition, in the case of a financial institution that is engaged in banking or similar business, holds financial assets for the account of others, or is an insurance company, equity or debt instruments in such financial institution will constitute financial accounts only if the value of those interests is determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments. This represents a significant cutback in the broad statutory definition.

TRANSITION RULES

The proposed regulations incorporate a number of transition rules with regards to FATCA compliance. One is a transition rule with respect to affiliates with legal prohibitions on compliance. Under FATCA, when an FFI enters into an FFI Agreement, such FFI Agreement not only applies to the U.S. accounts of the PFFI, but applies to the U.S. accounts of each additional FFI that is a member of the same expanded affiliated group. Notice 2011-34 states that Treasury intends to require that each FFI that is a member of an expanded affiliated group be a PFFI or deemed-compliant FFI in order for any FFI in the expanded affiliated group to become a PFFI. Recognizing that certain jurisdictions prohibit an FFI from fully complying with the FATCA requirements, the proposed regulations provide a two-year transition period, until January 1, 2016, for the full implementation of this requirement. During this transitional period, an FFI affiliate in a jurisdiction that prohibits the reporting or withholding required by FATCA will not prevent other FFIs within the same expanded affiliated group from entering into an FFI Agreement, provided that the FFI in the restrictive jurisdiction agrees to perform due diligence to identify its U.S. accounts, maintain certain records, and meet certain other requirements.

The proposed regulations also provide for an extension of the transition period for the scope of information reporting. Notice 2011-53 provided a phased implementation of the FATCA reporting requirements, where only identifying information (name, address, TIN, and account number) and account balance or value of U.S. accounts would be required to be reported in 2014 (with respect to 2013). The proposed regulations postpone certain reporting requirements and 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). If the proposed regulations are finalized in their current form, the phase-in of reporting obligations is as follows:

⁷ Section 1471(d)(2).

⁸ The regulations provide guidance with respect to the circumstances under which an entity is engaged primarily in the business of investing, reinvesting, or trading securities and other relevant assets. See Prop. Reg. Section 1.1471-5(e)(1) and (e)(4).

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- For reporting in 2014 and 2015 (with respect to calendar years 2013 and 2014), PFFIs are required to report only name, address, TIN, account number, and account balance with respect to U.S. accounts.
- Beginning with reporting in 2016 (with respect to calendar year 2015), in addition to the aforementioned information, income associated with U.S. accounts must be reported.
- Beginning with reporting in 2017 (with respect to calendar year 2016), full reporting, including information on the gross proceeds from broker transactions, will be required.

DEEMED-COMPLIANT FFIS

Section 1471(b)(2) provides that an FFI may be deemed to comply with FATCA's reporting requirements if it meets certain requirements. Notice 2011-34 provided initial guidance regarding certain categories of FFIs that will be deemed-compliant. The proposed regulations implement the exclusions provided in Notice 2011-34, and expand the categories of deemed-compliant FFIs to include certain banks and investment funds conducting business only with local clients, low-risk entities, or PFFIs, subject to restrictions designed to prevent the FFIs from being used for U.S. tax evasion.

One interesting note on the expansion of the deemed-compliant FFI category is that the proposed regulations include as a deemed-compliant FFI an FFI regulated as an investment fund under the law of its country of organization and for which each distributor of the investment fund's interests is a PFFI, a registered deemed-compliant FFI, a nonregistering local bank, or a restricted distributor.⁹ The proposed regulations require that each agreement that governs the distribution of the investment fund's debt or equity interests (other than interests which are both distributed by and held through a PFFI) prohibit sales of debt or equity interests in the fund to U.S. persons, non-participating FFIs, or passive non-financial foreign entities ("NFFEs") with one or more substantial U.S. owners, and its prospectus must indicate that sales to U.S. persons, passive NFFEs, and non-participating FFIs (other than interests which are both distributed by and held through a PFFI) are prohibited. The FFI must also establish procedures to review preexisting direct accounts and ensure proper treatment of new direct accounts.

DUE DILIGENCE PROCEDURES FOR THE IDENTIFICATION OF ACCOUNTS

In order to comply with FATCA reporting requirements, FFIs are required to identify their U.S. accounts.¹⁰ Notices 2010-60 and 2011-34 provide guidance regarding the due diligence procedures that PFFIs will be required to undertake to identify their U.S. accounts. Treasury received numerous comments to reduce the administrative burden on FFIs regarding such due diligence procedures. The due diligence procedures were modified and the proposed regulations outline the procedures required to be undertaken by FFIs to identify their U.S. accounts. For this purpose, the proposed regulations distinguish between the diligence expected with respect to individual accounts and entity accounts and between preexisting accounts and new accounts. According to the preamble, it is intended that FFIs that adhere to the diligence guidelines outlined in the proposed regulations will be treated as compliant with the requirement to identify U.S. accounts and will not be held to a strict liability standard.

To summarize the modified due diligence procedures, for preexisting 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. In addition, the proposed regulations provide detailed guidance on the precise scope of paper records required to be searched.

⁹ See Prop. Reg. Section 1.1471-5(f)(1)(i)(D).

¹⁰ Section 1471(b).

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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 procedure. With respect to preexisting entity accounts, the following measures are proposed: (i) accounts of \$250,000 or less are exempt from review until the account balance exceeds \$1,000,000; (ii) extended reliance on information gathered in the context of the due diligence required to comply with anti-money laundering/"know your customer" rules; and (iii) simplified procedures to identify the status of preexisting entity accounts. With respect to new accounts, the proposed due diligence procedures rely extensively on an FFI's existing customer intake procedures. According to Treasury, the proposed regulations generally do not require an FFI to make significant modifications to the information likely collected on customer intake, other than with respect to account holders identified as FFIs, as passive investment entities, or as having U.S. indicia.

WITHHOLDABLE PAYMENTS AND SOURCE

A withholdable payment is defined in Section 1473(1) to mean, subject to certain exceptions: (i) 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 (FDAP income), if such payment is from sources within the United States; and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States. The proposed regulations refine the definition of a withholdable payment as any payment of U.S. source FDAP income and, for any sales or other dispositions occurring after December 31, 2014, any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends that are U.S. source FDAP income.¹¹

The proposed regulations clarify that an exclusion from Chapter 3¹² withholding or an exclusion from taxation under Section 881 does not exclude such amount from the definition of U.S. source FDAP for the purpose of determining whether a payment is a withholdable payment under FATCA.¹³ While bank deposit interest with respect to offshore accounts is ordinarily treated as foreign source income,¹⁴ such interest is treated as income from sources within the United States for purposes of the definition of a withholdable payment. Similar to the rule that applies for purposes of withholding under Chapter 3, if a withholding agent cannot determine the source of a payment at the time the payment is made, the payment is treated as U.S. source. The proposed regulations also provide a list of payments that are excluded from the definition of withholdable payments. This list includes original issue discount from certain short-term obligations, income that is taken into account as effectively connected with the conduct of a trade or business in the U.S., certain payments in the ordinary course of the withholding agent's business, gross proceeds from the sale of property that can produce income that is excluded from the definition of withholdable payment, and certain broker transactions that involve the sale of fractional shares.

EFFECTIVE DATE

The proposed regulations would be effective on the date Treasury adopts these rules as final regulations and, as noted above, other dates for specific provisions.

¹¹ Prop. Reg. Section 1.1473-1(a).

¹² Comprised of Sections 1441 through 1464.

¹³ Prop. Reg. Section 1.1473-1(a)(2)(i)(B).

¹⁴ See Section 861(a)(1)(A).

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INTERGOVERNMENTAL COOPERATION AS AN ALTERNATIVE TO FATCA

According to the preamble, Treasury and the IRS have consulted with foreign governments on the relationship between coordination with local law and complying with FATCA reporting. The preamble states that Treasury and the IRS are considering, in consultation with foreign governments, an alternative approach to implementation, whereby an FFI could satisfy the reporting requirements if: (i) the FFI collects the information required and reports this information to the government of its country of residence; and (ii) the government of its country of residence enters into an agreement to report this information annually to the IRS, pursuant to an income tax treaty, tax information exchange agreement, or other agreement with the U.S.

At the same time it released the proposed regulations, Treasury released a joint statement from the U.S., France, Germany, Italy, Spain, and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA. The joint statement notes that the U.S. is open to adopting an intergovernmental approach to implement FATCA and improve international tax compliance and is willing to reciprocate in collecting and exchanging on an automatic basis information on accounts held in U.S. financial institutions by residents of France, Germany, Italy, Spain, and the United Kingdom. In light of these considerations, the U.S., France, Germany, Italy, Spain, and the United Kingdom have agreed to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchange based on existing bilateral tax treaties.

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