March 5, 2012

FATCA Proposed Regulations Unveiled by Treasury

Highly anticipated proposed Treasury regulations provide comprehensive guidance on FATCA implementation.

On February 8, Treasury released nearly 400 pages of highly detailed proposed regulations[1] (the Proposed Regulations) relating to the implementation of the Foreign Account Tax Compliance Act (FATCA). In drafting the Proposed Regulations, Treasury has attempted to address hundreds of comments from industry stakeholders and practitioners regarding earlier guidance on FATCA.[2] As a result, while industry participants and practitioners continue to have concerns regarding FATCA, the Proposed Regulations appear to resolve a number of issues left open by previous guidance.

Along with the Proposed Regulations, Treasury announced a new information-exchange program with France, Germany, Italy, Spain, and the United Kingdom that is intended to help banks overcome local law impediments to disclosure of bank account information to the IRS. Treasury has indicated that such intergovernmental information sharing may serve as the basis for an alternative means of implementing the reporting requirements under FATCA.

Background

FATCA added a set of anti-tax evasion provisions to the Internal Revenue Code that are designed to encourage "foreign financial institutions" (FFIs) such as non-U.S. banks and offshore investment funds, as well as certain other non-U.S. entities, to provide information to the IRS with respect to their U.S. accounts[3] and, in some cases, to withhold tax on certain payments made to FFIs and other non-U.S. entities that fail to comply with the reporting and other requirements under FATCA.

Certain FFIs that enter into formal agreements with Treasury and the IRS (FFI Agreements) to provide client/investor information will be known as "participating FFIs." If participating FFIs are required to provide (and do provide) appropriate withholding certificates and all required documentation to a withholding agent, such participating FFIs may be exempt from FATCA's 30% withholding tax on certain payments in respect of U.S. securities, such as dividends, interest, and gross disposition proceeds (withholdable payments).[4] On the other hand, FFIs not entering into such agreements (nonparticipating FFIs), or that do enter into such agreements but fail to provide appropriate certificates and all of the required documentation, may be subject to the 30%

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1. View the proposed regulations at http://www.irs.gov/pub/newsroom/reg-121647-10.pdf.

2. For information on earlier IRS Notices providing guidance on FATCA implementation, please see our August 26, 2011, LawFlash, "Recent IRS Notices Provide Supplemental FATCA Guidance and Phased-in Implementation," available at http://www.morganlewis.com/pubs/Tax_LF_FATCAGuidancePhased-inImplementation_26aug11.pdf.

3. For this purpose, a "U.S. account" is a financial "account" (a term that is broadly defined to include not only standard bank accounts but also equity interests in offshore investment funds) that is owned by a "specified U.S. person." Importantly, those excluded from the definition of "specified U.S. person" include U.S. tax-exempt organizations and corporations the stock of which is regularly traded on an established securities market.

4. The Proposed Regulations retain the original implementation schedule for withholding on withholdable payments, with payments of U.S. source "FDAP"-type income (e.g., dividends, interest, rents and royalties) paid on or after January 1, 2014, and gross proceeds from the disposition of property that gives rise to dividends and interest paid after January 1, 2015, subject to withholding under FATCA.

withholding tax on such withholdable payments. If the 30% withholding tax is not imposed on withholdable payments received by a participating FFI, the participating FFI will nevertheless be obligated under its agreement with the IRS to withhold the 30% tax on so-called "passthru payments"[5] that it makes to its account holders/investors that are either nonparticipating FFIs or others that do not cooperate with certain documentation requests by the participating FFI (a recalcitrant account holder). Nonfinancial foreign entities, or NFFEs, are subject to less stringent requirements in order to avoid withholding on withholdable payments they receive.[6]

Selected Highlights of the Proposed Regulations

The Proposed Regulations streamline the compliance process and in several cases relieve some of the compliance burden under FATCA by, among other things, extending several key implementation dates and expanding exemptions to the FATCA reporting and withholding regime. Below is a summary of some of the key features of the Proposed Regulations.

Extension of certain implementation dates

1. GRADUAL "RAMP-UP" IN REPORTING BETWEEN 2014 AND 2017. The Proposed Regulations provide a phase-in period for the type of information that FFIs are required to report with respect to U.S. accounts. During 2014 and 2015 (for reporting with respect to calendar years 2013 and 2014, respectively), an FFI satisfies its reporting obligations by providing only basic information regarding U.S. accounts, such as the accountholder's name, address, and taxpayer identification number, and the account number and account balance or value. Beginning in 2016 (for reporting with respect to calendar year 2015), FFIs must begin reporting income paid or credited to the account in addition to the basic information described above. Finally, beginning in 2017 (for reporting with respect to calendar years 2016 and later), full disclosure of U.S. accounts by FFIs is required, including basic identifying information, income paid or credited to the account, and gross proceeds from the sale or redemption of property paid to the account. This phase-in period is designed to provide FFIs with additional time to make necessary changes to computer systems to facilitate expanded reporting.

2. EXTENDED PERIOD FOR GRANDFATHERED OBLIGATIONS. The Proposed Regulations provide for an extended period of time during which certain debt obligations may be issued and exempt from FATCA. Previously, debt obligations issued prior to March 18, 2012, and not "materially modified" (as determined under existing Treasury Regulations) after such date were "grandfathered" and therefore no FATCA withholding was required on interest paid with respect to such instruments. If finalized in their current form, the Proposed Regulations will provide that debt obligations issued before January 1, 2013 (and not "materially modified" after that date), will be grandfathered and exempt from FATCA withholding.

3. WITHHOLDING ON "FOREIGN PASSTHRU PAYMENTS" DELAYED UNTIL 2017. The Proposed Regulations also delay the obligation of a participating FFI to withhold tax with respect to "foreign passthru payments" until 2017. As discussed above, a participating FFI is obligated to withhold a 30% tax on "passthru payments" (a component of which is foreign passthru payments) paid to account holders that are either nonparticipating FFIs or recalcitrant account holders. In the preamble to the Proposed Regulations, Treasury notes that it has received numerous comments expressing concern regarding the costs, administrative complexities, and legal impediments associated with identifying and withholding on passthru payments. Treasury seeks comments on approaches to reduce burdens relating to passthru payments, indicating that possible solutions include simplified computational methods, safe harbor rules, or *de minimis* exceptions.

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5. "Passthru payments" include withholdable payments plus certain *non*-U.S. source payments known as "foreign passthru payments," which are determined by reference to the percentage of U.S. assets held by the FFI. The computation of "foreign passthru payments" is detailed in IRS Notice 2011-34.

6. An NFFE is generally subject to the 30% withholding tax unless (i) it is the beneficial owner of the payment in question, (ii) the withholding agent determines that the NFFE has no "substantial U.S. owners" or that all such owners have been disclosed to the withholding agent, and (iii) the withholding agent reports information relating to the NFFE's substantial U.S. owners, if any. A "substantial U.S. owner" for this purpose generally includes direct or indirect owners of more than 10% of the NFFE's equity.

4. "ALL OR NOTHING" RULE WITH RESPECT TO EXPANDED AFFILIATED GROUPS TEMPORARILY RELAXED. As noted in prior IRS guidance, the Proposed Regulations contain the general rule that for any member of an "expanded affiliated group"[7] to be a participating FFI or registered deemed-compliant FFI, each other member of the group that is an FFI must also be a participating FFI or registered deemed-compliant FFI. The Proposed Regulations provide a temporary exception to this "all or nothing" rule by providing that until December 31, 2015, an FFI may qualify as a participating FFI notwithstanding the fact that another member of such FFI's affiliated group is located in a jurisdiction the laws of which prevent such affiliated FFI from qualifying as a participating FFI. Through the end of 2015, FFI group members in such jurisdictions are referred to as limited FFIs. Group members that are limited FFIs must engage in due diligence to identify U.S. accounts, and will be treated as nonparticipating FFIs (and therefore subject to withholding tax on any withholdable payments they receive).

Certain due diligence procedures simplified

The Proposed Regulations contain due diligence obligations of participating FFIs with respect to preexisting U.S. accounts, distinguishing between individual and entity accounts as well as between preexisting and new accounts. Account balances or values can also affect the type of diligence that needs to be undertaken. The preamble to the Proposed Regulations indicates that the diligence procedures are intended to provide certainty and minimize costs and burdens in a manner consistent with policy goals, and the Proposed Regulations do scale back from prior IRS guidance to some extent. For instance, a participating FFI's due diligence obligations with respect to accounts with balances of less than $1 million may be satisfied solely through electronic searches. Also, if an FFI is unable to determine the status of a "high-value account" (e.g., an account with a balance of more than $1 million) via electronic searches, a search of particular paper files is then required (i.e., the customer's master file and certain other documents). Notably, the scope of required paper file diligence under the Proposed Regulations is less extensive than that provided for under prior IRS guidance. No search is required with respect to preexisting U.S. individual accounts with balances of less than $50,000, certain cash value insurance and annuity contracts held by individuals with values or balances of $250,000 or less, and preexisting entity accounts with balances of $250,000 or less.

In performing its diligence with respect to both preexisting and newly opened accounts, FFIs may rely on information gathered in connection with compliance with "know your customer" and anti-money laundering rules, and other existing account information, to identify the status of an account and the account holder for FATCA purposes. To determine the status of new individual accounts as U.S. accounts, the FFI will be required to review information obtained as part of its standard account-opening procedures to identify whether the account has U.S. indicia (e.g., a U.S. address, telephone number), and if the FFI identifies such U.S. indicia as part of that review, the FFI will be required to obtain additional information from the account holder, including a Form W-9, or else treat that account as being held by a recalcitrant account holder. For new entity accounts, the participating FFI generally need not review the substantial owners of (i) accounts of other FFIs and (ii) accounts of entities engaged in active, nonfinancial trade or business. The participating FFI will, however, need to obtain certification from other types of entities to determine whether such entity has substantial U.S. owners (generally, a more than 10% equity interest in such entity held by a specified U.S. person).

Coordination with preexisting U.S. withholding tax rules

The Internal Revenue Code has long contained rules requiring withholding with respect to certain types of U.S. income, such as interest, dividends, and royalties paid to non-U.S. residents. To a large extent, the withholding rules under FATCA overlap these preexisting rules. The Proposed Regulations remove the overlap by providing that to the extent there has been withholding under FATCA, a withholding agent may credit the amount withheld against the withholding liability due under such preexisting rules. In addition, the Proposed Regulations clarify that if withholding is required with respect to the disposition of real property in the United States (or with respect to the

7. The "expanded affiliated group" concept in this context is similar to the concept of a consolidated group generally applicable to domestic "C" corporations, whereby a group of entities is under common control (the common ownership threshold for an expanded affiliated group is 50%). A similar rule applies for determining whether a partnership is part of the "expanded affiliated group" for these purposes.

stock of certain “U.S. Real Property Holding Corporations”) by a non-U.S. resident (so-called FIRPTA withholding), withholding will be governed by preexisting rules relating to FIRPTA withholding and not by the FATCA rules.

Guidance on “deemed-compliant FFIs” and other exempt entities

As indicated in prior IRS guidance, certain FFIs will be deemed to be compliant with FATCA and therefore be relieved of the due diligence and other obligations that would otherwise apply to such FFIs, provided that certain procedures and requirements are satisfied. Under the Proposed Regulations, guidance is provided relating to several categories of FFIs that are “deemed compliant” with FATCA, on account of the relatively low risk of tax evasion posed by such FFIs. The categories of “deemed-compliant FFIs” are somewhat narrow, and include entities such as “local banks” (i.e., banks doing business solely in their home jurisdictions), nonprofit organizations, and certain retirement funds.

The Proposed Regulations also outline rules relating to other types of entities that are generally exempt from withholding under FATCA on payments they beneficially own. These entities include “active” NFFEs (i.e., an NFFE with less than 50% of its gross income, or less than 50% of its assets, characterized as “passive” in nature) as well as NFFEs that are publicly traded on one or more established securities markets.

Intergovernmental information-exchange agreement

As noted above, Treasury unveiled a new bank account information-exchange program in which the United States, France, Germany, Italy, Spain, and the United Kingdom would participate. The preamble to the Proposed Regulations indicates that in order to minimize the compliance burden resulting from, and to help FFIs overcome legal obstacles associated with, FATCA compliance, Treasury is considering an alternative approach whereby an FFI can satisfy its FATCA-related reporting obligations by collecting the required information on its U.S. accounts and reporting such information to its residence country government. The residence country government would then agree to annually report such information to the IRS, pursuant to a tax treaty, tax information-exchange agreement, or other agreement with the United States. For its part, the United States would likewise collect and share with the other five countries information on U.S. bank accounts held by residents of those countries.

This bilateral information-exchange program, if implemented, would relieve banks and other FFIs in these countries of the need to enter into separate FFI Agreements with the IRS. This program does not remove the need for FFIs located in non-U.S. countries other than those five listed above from having to enter into FFI Agreements with the IRS to obtain participating FFI status.

Impact on offshore investment funds

Although the Proposed Regulations provide more visibility on what is likely to be expected of offshore investment funds under FATCA, little to no relief was provided to such funds. Offshore investment funds should anticipate entering into FFI Agreements with the IRS prior to July 1, 2013, and obtaining additional information from their investors, including new IRS Forms W-8 and W-9 once they are available in revised form (see below). It is recommended that any offshore investment funds launching between now and the finalization of the Proposed Regulations and the revised IRS Forms W-8 and W-9 require their investors to provide such information and certifications as may be required to satisfy these FATCA provisions. Care should also be taken to ensure that any burden imposed on offshore investment funds as a result of recalcitrant investors is borne by such investors. Finally, advisers to offshore investment funds should be thinking about which employees will be designated as the “responsible FFI officers,” who will be expected to certify that the offshore investment funds, as FFIs, have complied with the terms of their respective FFI Agreements.

Next Steps

As the Proposed Regulations are currently in proposed form, they are subject to further revision. Treasury has set a deadline of April 30, 2012, for additional comments and will hold a hearing on May 15, 2012, to discuss the

Proposed Regulations. Treasury expects to release a draft of the FFI Agreement in early 2012, as well as modified IRS Forms W-8 and W-9, which will facilitate the determination of status of a payee for purposes of both FATCA and preexisting withholding rules. Treasury has indicated that it expects to issue final regulations by the end of summer 2012.

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