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Treasury Issues Proposed FATCA Regulations, Seeks to Respond to Market Concerns

Treasury has issued proposed regulations interpreting the segment of the Internal Revenue Code commonly referred to as "FATCA." These proposed regulations would take a number of important steps toward simplifying the regime and minimizing the compliance burden on market participants. For example, the proposed regulations would extend several "grandfathering" periods, would expand the universe of entities that are not subject to the regime or are subject to materially reduced burdens, and would streamline the compliance process for "participating" foreign financial institutions in a variety of ways. Below are selected highlights of the proposed regulations. We will follow up in the near future with a more detailed analysis of the regime and its implications for market participants.

Background

In order to prevent U.S. persons from using offshore accounts to evade U.S. federal income tax, FATCA imposes a 30% U.S. withholding tax on any "withholdable payment" or "passthru payment" made to a foreign entity unless that entity complies with specified U.S. reporting requirements or otherwise qualifies for an exemption. Separate rules apply to foreign financial institutions ("FFIs") and to non-financial foreign entities ("NFFEs"), with FFIs generally being subject to a much higher compliance burden in order to avoid the imposition of the 30% FATCA tax. An FFI will be subject to the 30% FATCA tax unless it either qualifies for a specific exemption or becomes a "participating FFI" (a "PFFI") by entering into an agreement with Treasury (an "FFI Agreement") pursuant to which it agrees to perform specified due diligence, reporting and withholding functions. Specifically, a PFFI will be required to obtain and report certain information with respect to "financial accounts" held by "specified U.S. persons" or "U.S.-owned foreign entities" ("U.S. accounts") and will be required to withhold FATCA tax from "passthru payments" (that is, withholdable payments or payments that are "attributable to" withholdable payments) that it makes to "recalcitrant" accountholders or to non-participating FFIs.

In three Notices issued over the past two years, Treasury and the IRS have provided indications of their plans for the implementation of FATCA. They have received many comments on these Notices, and the proposed regulations reflect an effort to address various defects and complexities that market participants have identified in the FATCA regime in general, including the preliminary guidance provided in those Notices.

Highlights of the Proposed Regulations and Related Announcement

The proposed regulations generally contain provisions broadly consistent with the approach set out in the earlier Notices, but with significant and helpful modifications and refinements. In addition, they provide guidance on a number of issues that the Notices did not address. See the proposed regulations.

Separately from the proposed FATCA regulations, Treasury issued a joint statement with France, Germany, Italy, Spain and the United Kingdom expressing a mutual intent to pursue a government-to-government framework for FATCA implementation. Under this potential framework, if a country enters an agreement with the United States, FFIs in that country would be required by local law to collect information identifying U.S. accounts and report it to that country's tax authority, which would provide the information to the IRS. FFIs in those countries would not be (i) required to enter an FFI Agreement, (ii) subject to FATCA tax (on payments to or by them) or (iii) required to terminate the accounts of "recalcitrant" accountholders. See the joint statement.

Highlights from the proposed regulations include the following:

- In general, FATCA withholding tax will apply to U.S.-source "fixed or determinable annual or periodical income" ("FDAP") payments beginning on January 1, 2014, and otherwise will apply beginning on January 1, 2015.
  - However, no FATCA withholding tax will apply to payments (including "passthru payments") made with respect to any "obligations" that are outstanding on **January 1, 2013** (the original proposed grandfathering date was March 18, 2012).
  - PFFIs will not be required to withhold FATCA tax from "foreign passthru payments" (passthru payments that are attributable to withholdable payments, but are not themselves withholdable payments, such as interest on a PFFI's bank accounts or distributions to shareholders by certain PFFIs that are foreign investment vehicles) until **January 1, 2017** (the original proposed effective date was January 1, 2015). Prior to January 1, 2017, however, PFFIs will be required to report to the IRS the aggregate amount of certain payments they make to non-participating FFIs. The proposed regulations reserve on the precise rules for withholding on foreign passthru payments.
- An earlier Notice identified certain FFIs that Treasury and the IRS contemplated would be treated as "deemed compliant" FFIs that would not be required to enter into FFI Agreements in order to avoid FATCA tax. The proposed regulations would expand the universe of deemed compliant FFIs to include "local" banks, certain mutual funds and members of a PFFI's affiliated group that, in each case, register with the IRS and meet various criteria, as well as small and/or "local" banks, charities and pension funds that meet various criteria and that certify their qualification as deemed compliant FFIs.
- The proposed regulations would expand the categories of entities that will be exempt from FATCA reporting altogether, to include holding companies and intercompany financing companies for non-financial groups, certain bankrupt and start-up entities and certain tax-exempt entities, as well as "active" NFFEs, which would very generally mean those less than half of whose assets or income for the previous year were considered "passive."
- The statute provides that an FFI will generally not be permitted to be a PFFI unless every other FFI that is a member of its affiliated group is either a PFFI or deemed compliant. The proposed regulations would loosen this requirement, however, by providing that until January 1, 2016, an FFI may become a PFFI even if it is affiliated with one or more other FFIs that are not either PFFIs or deemed compliant, provided that those other FFIs (i) are in jurisdictions that prohibit FATCA reporting and withholding and (ii) agree to comply with certain requirements, including due diligence requirements.
- The definition of a "financial account" would be narrowed among other things to exclude:
  - debt or equity interests in an FFI that is not an investment vehicle if the value of the debt or equity is not determined primarily by reference to assets that give rise to "withholdable payments;"
  - retirement accounts, pension accounts and non-retirement savings accounts that meet certain requirements; and
  - certain accounts held solely by or on behalf of certain exempt owners.
- The proposed regulations outline in detail the due diligence that would be required to be undertaken by FFIs to identify U.S. accounts. These requirements would rely in significant respects on FFIs' existing procedures, including "know your customer" and anti-money-laundering

rules, and would take a number of steps to minimize the burden previous Notices would have imposed relating to existing accounts.

- The reporting obligations of PFFIs with respect to U.S. accounts would be phased in. Reporting on income associated with U.S. accounts would commence in 2016 (with respect to the 2015 calendar year), while reporting on gross proceeds would begin in 2017 (with respect to the 2016 calendar year). For 2014 and 2015 (with respect to calendar years 2013 and 2014, respectively), PFFIs would be required to report only the name, address, taxpayer identification number and account balance of each of their U.S. accounts.
- The proposed regulations would require every withholding agent (including a PFFI, unless its FFI Agreement provides otherwise) to file a Form 1042 (and send information reports to "recipients" on Forms 1042-S) describing all FDAP paid on or after January 1, 2014 and all gross proceeds and passthru payments subject to FATCA tax (in each case, whether or not actually taxed) that have been paid by the withholding agent during a year ("foreign reportable payments"). While not entirely clear, "recipients" would appear to include very generally (i) any PFFI that receives a foreign reportable payment (unless it is acting as an intermediary and provides information to enable the payor to report the foreign reportable payment to its beneficial owners) and (ii) any other person or entity that is considered under the proposed regulations to be a beneficial owner of a foreign reportable payment (including through intermediaries). However, "recipients" would not include, very generally, U.S. persons and recalcitrant accountholders. There would be a special rule for reportable foreign payments made by PFFIs to non-participating FFIs during 2015 and 2016.

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