LATHAM & WATKINS

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Client Alert

Latham & Watkins Tax Department

IRS Releases Final FATCA Regulations

Summary

On January 17, 2013, the Internal Revenue Service (IRS) released final Treasury regulations (the Regulations) under sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended (the Code), commonly referred to as the Foreign Account Tax Compliance Act (FATCA). The Regulations reflect comments submitted in response to the proposed regulations issued in February 2012, interim guidance issued by the IRS and the development of intergovernmental agreements between the United States and various non-US jurisdictions (IGAs). IGAs provide an alternative to, or otherwise supplement, the Regulations in implementing FATCA.[1]

This *Alert* highlights some of the key differences between the Regulations and the proposed regulations, and discusses the interaction between the Regulations and the IGAs.

"The Regulations represent a significant step towards FATCA implementation, yet considerable uncertainties remain, including the extent to which intergovernmental agreements will become the preferred route to achieve FATCA compliance."

Background

FATCA was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010 to uncover US persons who may be evading US taxes by investing through non-US financial institutions or other non-US entities. To accomplish this goal, FATCA creates a new information reporting and withholding regime, in addition to existing US information reporting and withholding rules. Although the FATCA legislation is generally effective beginning January 1, 2013, the Regulations phase in the implementation of FATCA over the next several years.

FATCA generally requires withholding agents to withhold 30 percent on certain payments made to any (i) foreign financial institution (FFI), if the FFI does not enter into an agreement with the IRS to report certain information about its US accounts to the IRS, and (ii) nonfinancial foreign entity (NFFE), if the NFFE (or its beneficial owner, as applicable) does not provide to the withholding agent certain information about its substantial US owners (generally a US person that owns directly or indirectly more than 10 percent of the NFFE). Foreign governments, international organizations, foreign central banks of issue and other entities identified by the IRS as posing a low risk of tax evasion are exempt from withholding under FATCA.

Under the statute, an FFI generally is a non-US entity that accepts deposits in the ordinary course of a banking or similar business, holds financial assets for the account of others, or is engaged in the business of investing or trading financial instruments. As discussed below, the Regulations supplement the statutory definition. Examples of FFIs include many hedge funds, private equity funds and issuers of collateralized debt obligations.

An FFI can avoid withholding under FATCA by entering into an agreement with the IRS (an FFI Agreement) that requires the FFI to (i) conduct due diligence to determine whether the FFI has any US accounts, (ii) report various information with respect to each US account, including the identity of the account holder, the account balance or value and the amount of payments made on the account, and (iii) withhold under FATCA on payments made to non-compliant FFIs and account holders who fail to establish their FATCA status. Certain categories of FFIs are deemed to comply with FATCA (deemed-compliant FFIs) and are not required to enter into an FFI Agreement to avoid withholding under FATCA. Examples of deemed-compliant FFIs include "local FFIs" (generally, an FFI whose activities are limited to the FFI's country of organization), qualified collective investment vehicles, certain retirement plans and FFIs that are deemed compliant under an applicable IGA.

An NFFE is any non-US entity that is not a financial institution, with exceptions for publicly traded corporations, non-publicly traded corporations that are members of the same expanded affiliated group as a publicly traded corporation, foreign governments, international organizations, "active NFFEs" (generally NFFEs with less than 50 percent passive income or assets) and other entities designated by the IRS. For an NFFE to avoid withholding under FATCA, although it is not required to enter into an agreement with the IRS, the NFFE (or, if applicable, its beneficial owner) must certify to the withholding agent that it does not have any substantial US owners, or, if it does, it must disclose the identities of such owners to the withholding agent.

Withholding under FATCA applies to "withholdable payments" and "foreign passthru payments." "Withholdable payments" generally are payments of US-source dividends, interest and other fixed or determinable annual or periodic income (FDAP income), and gross proceeds from the disposition of property of a type that can produce US-source dividends or interest. Payments that are effectively connected with a US trade or business of the recipient are not considered withholdable payments. The term "foreign passthru payment" (*i.e.*, a payment made by an FFI that is attributable to a withholdable payment) is not yet defined. Once the IRS issues final regulations defining "foreign passthru payment," they may become subject to withholding under FATCA as well, but such withholding will apply no earlier than January 1, 2017.

Final Regulations

Implementation Dates

The Regulations alter the original implementation timeline for FATCA and defer many of the dates provided under the proposed regulations.

As in the proposed regulations, withholding under FATCA on US-source FDAP income (*e.g.*, US-source dividends and interest) will generally begin on January 1, 2014. However, withholding under FATCA on gross proceeds from the disposition of property of a type that can produce US-source dividends or interest will begin on dispositions that occur on or after January 1, 2017, instead of January 1, 2015 in the proposed regulations. The Regulations further provide that FATCA withholding on US-source FDAP income with respect to certain limited payments on "offshore obligations" or "preexisting obligations" will not be required during an additional transitional period.

The text of the FFI Agreement has not yet been published, but the Regulations detail much of what the FFI Agreement will contain. The Regulations delay the effective date of FFI Agreements entered into in 2013 to December 31, 2013 (from July 1, 2013 in the proposed regulations). Any FFI Agreement entered into on or after January 1, 2014 will be effective as of the date the IRS issues a global intermediary identification number (GIIN) to the FFI. FFIs that have agreed to comply with the requirements of an FFI Agreement are designated as participating FFIs (PFFIs).

FFIs will enter into FFI Agreements by registering with the IRS through an online registration portal (the Portal), which the IRS announced will be available no later than July 15, 2013. In addition to FFIs that enter into an FFI Agreement, certain deemed-compliant FFIs, sponsoring entities, limited FFIs and FFIs subject to an IGA will also need to register through the Portal to establish their FATCA status. The IRS will issue GIINs to registering FFIs and electronically post a list of such entities (the IRS FFI List). Withholding agents may generally rely on this list (which will be updated monthly by the IRS) to verify the GIIN and FATCA status of an FFI. The first IRS FFI List will be posted on December 2, 2013, to be used by withholding agents when the first phase of withholding under FATCA begins on January 1, 2014. To ensure that it appears on the December 2, 2013 list, an FFI must register through the Portal by October 25, 2013. A withholding agent may accept a payee's claim of PFFI or registered deemed-compliant FFI status for 90 calendar days, even if the FFI is not yet included on the IRS FFI List. However, it may be advisable for FFIs to register for the IRS FFI List by October 25, 2013 to avoid disputes with withholding agents and to mitigate the impact of unexpected delays in getting on the IRS FFI List within the 90 calendar day grace period.

The Regulations also provide that the initial information reporting with respect to US accounts is due March 31, 2015 (with respect to both calendar years 2013 and 2014), instead of September 30, 2014 (with respect to calendar year 2013) as per the proposed regulations.

Attached to the end of this *Client Alert* is a timeline detailing the important implementation dates of FATCA.

Grandfathered Obligations

Withholding under FATCA does not apply to certain obligations. Specifically, a withholdable payment does not include any payment made under a grandfathered obligation, or any gross proceeds from the disposition of such an obligation. A "grandfathered obligation" is any:

- obligation outstanding on January 1, 2014 (an extension of the January 1, 2013 date in the proposed regulations),
- obligation that produces withholdable payments solely because the obligation is treated as giving rise to a dividend equivalent under section 871(m) of the Code and the Treasury regulations thereunder, provided that the obligation is executed on or before the date that is six months after the date on which obligations of its type are first treated as giving rise to dividend equivalents (not in the proposed regulations), or

- agreement requiring a secured party to make payments with respect to collateral securing one or more grandfathered obligations, even if the collateral is not itself a grandfathered obligation (*e.g.*, a Credit Support Annex to an ISDA Master Agreement that is a grandfathered obligation) (not in the proposed regulations).

With respect to withholding on a foreign passthru payment, a grandfathered obligation also includes an obligation that is executed on or before the date that is six months after the date on which final regulations defining the term foreign passthru payment are filed.

In general, an "obligation" for this purpose is any legally binding agreement or instrument, which includes, among others, a debt instrument, an agreement to extend credit for a fixed term (provided the material terms are fixed as of its issue date, including a stated maturity date), and a derivatives transaction entered into between counterparties under an ISDA Master Agreement that is evidenced by a confirmation. However, an "obligation" does not include, among others, any legal agreement or instrument that is treated as equity for US tax purposes, lacks a stated expiration or term, or is a master agreement that does not set forth all the necessary terms of a specific transaction.

The Regulations clarify that a debt obligation is considered outstanding on January 1, 2014 if it has an issue date for US tax purposes (which, for a qualified reopening under applicable Treasury regulations, would mean the issue date of the original issuance) prior to January 1, 2014. A non-debt obligation is considered outstanding on a date if a legally binding agreement with respect to that obligation was executed prior to that date. Any obligation exempt from withholding under FATCA pursuant to the foregoing rules that undergoes a material modification (which, for a debt instrument, is a "significant modification" as defined in applicable Treasury regulations) may lose the grandfathered status if the date of such material modification is after the applicable grandfathering date.

FATCA Withholding Procedure

In response to comments to the proposed regulations, the Regulations generally coordinate the procedure for withholding under FATCA with the procedure for existing US withholding on US-source FDAP income. The preamble to the Regulations states that IRS Forms W-8 relied on for existing US withholding will be modified to facilitate FATCA withholding along with existing US withholding. The procedure for withholding under FATCA on payments of gross proceeds is currently reserved.

The Regulations also clarify and provide additional guidance on the scope of a withholding agent's duty. Withholding under FATCA does not apply if a withholding agent lacks control, custody or knowledge of a payment. If the source or character of a payment is unknown, a withholding agent must treat the payment generally as a withholdable payment or elect to withhold 30 percent of the payment in escrow for a year pending a determination of the relevant facts. In determining the grandfathered status of an obligation, a withholding agent generally may rely on a written statement by the issuer of the obligation.

Definition of Financial Institution

Under the proposed regulations, the term "financial institution" (which is important, as a foreign financial institution has significantly more burdensome compliance requirements than other foreign entities) included a depository institution, a custodial institution, an investment entity and an insurance company. The

Regulations make a few important changes and clarifications to this definition, including the following.

First, the Regulations clarify that an entity is a depository institution only if it accepts deposits and engages in the ordinary course of a banking or similar business.

Second, the definition of an investment entity has been generally expanded from the prior definition under the proposed regulations. The proposed regulations provided that entities that primarily invest or trade in various financial assets are investment entities. The Regulations now provide that investment entities also include those that (i) hold themselves out as engaging in such activities, (ii) engage in certain trading activities on behalf of others or (iii) manage portfolios or invest, manage or administer money or financial assets on behalf of others. On the other hand, the Regulations generally exclude from the definition of investment entities passive funds that are not managed by entities engaged in investment, trading or management activities on behalf of others.

Third, the Regulations also treat an entity as a financial institution if it is a holding company or treasury center that is (i) a part of an expanded affiliated group including a depository institution, custodial institution, insurance company or investment entity, or (ii) formed in connection with or availed of by a private equity fund, hedge fund, venture capital fund, leveraged buyout fund or other similar investment vehicle.

However, even if an entity otherwise meets the definition of a financial institution, it is excluded from the definition if, among other rules, it is a non-US member of a nonfinancial group (generally a group with passive income of the group not exceeding 25 percent of its gross income, passive assets of the group not exceeding 25 percent of its gross assets, and gross income of FFIs in the group not exceeding 5 percent of the group's gross income) and acts as a holding company, treasury center or captive finance company for the group.

Due Diligence Under FFI Agreements

The Regulations make a number of improvements with respect to an FFI's due diligence obligations. The Regulations revise the definition of "financial accounts," which are the primary focus of an FFI's due diligence obligations. For example, the Regulations now include exceptions from the definition of financial accounts for certain traded negotiable debt instruments, certain escrow accounts, and certain debt and equity issued by holding companies or treasury centers. In addition, in circumstances viewed by the IRS as low risk for tax evasion, FFIs are no longer required to refresh documentation from account holders every three years.

Interaction Between the Regulations and IGAs

In conjunction with the release of the proposed regulations, the US Treasury Department (Treasury) announced that it was working with several non-US jurisdictions to create and enter into IGAs to streamline the implementation of FATCA. Treasury has published two model IGAs, referred to as the Model 1 IGA (which has two versions: reciprocal and nonreciprocal) and the Model 2 IGA. As of January 17, 2013, the United States has signed or initialed IGAs with seven jurisdictions: the United Kingdom, Denmark, Mexico, Ireland, Spain, Switzerland and Norway. Furthermore, Treasury has announced that the United States is currently in various stages of negotiations with more than 50 other jurisdictions regarding entering into an IGA.

In general, under the Model 1 IGA, FFIs and FFI branches (*i.e.*, a branch of an FFI located in an IGA jurisdiction in which the FFI is not resident) in a Model 1 IGA jurisdiction would report information about US accounts to their local government without entering into FFI Agreements, which local government in turn would report such information to the IRS (and the United States would provide similar information to such local government under the reciprocal version of the Model 1 IGA). In contrast, a Model 2 IGA allows FFIs and FFI branches in the Model 2 IGA jurisdiction to comply with the Regulations, including entering into an FFI Agreement, as modified by the specific terms of the Model 2 IGA. FFIs and FFI branches that are in compliance with an applicable IGA generally will not be subject to withholding under FATCA.

Conclusion

The Regulations represent a significant step towards FATCA implementation and address many of the issues raised by stakeholders in response to the proposed regulations. Yet, considerable uncertainties remain on various aspects of FATCA, including the extent to which IGAs will become the preferred route to achieve FATCA compliance. FATCA remains a developing area of law that may take several years to work properly.

Endnote

[1] For related coverage, see Latham & Watkins *Client Alert* Number 1287, "IRS Releases Proposed FATCA Regulations," February 14, 2012, and *Client Alert* Number 1412, "FATCA: An Update From a European Loan Market Perspective," October 8, 2012.

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SELECTED DATES OF INTEREST

Information Reporting Dates
Withholding Dates
Other Key Dates

2013

January 1, 2013 – First date account information is subject to information reporting under FATCA. Initially, participating FFIs must report to the IRS only the name, address, TIN, account number and account balance with respect to US accounts. Reports with respect to calendar years 2013 and 2014 will be due on March 31, 2015. For subsequent calendar years, the report for any calendar year will be due March 31 following that calendar year.

July 15, 2013 – The Portal will be available no later than this date, and FFIs can begin entering into FFI Agreements and registering their FATCA status.

October 25, 2013 – Deadline for FFIs to register using the Portal to ensure inclusion on the first IRS FFI List.

December 2, 2013 – Publication of the first IRS FFI List to be used when FATCA withholding begins in 2014.

2014

January 1, 2014 – Obligations that are outstanding on this date (and not materially modified thereafter) are not subject to FATCA withholding (*i.e.*, grandfathered obligations).

January 1, 2014 – FATCA withholding generally begins on payments of US-source interest, dividends and other fixed or determinable annual or periodic income. Transitional exceptions to FATCA withholding will apply to such payments made on certain offshore obligations and certain preexisting obligations during 2014 and 2015.

2015

January 1, 2015 – Beginning on this date, in addition to the information previously subject to reporting, participating FFIs must also include the income associated with US accounts.

2016

January 1, 2016 – Beginning on this date, in addition to the information previously subject to reporting, participating FFIs must also include the gross proceeds associated with US accounts.

2017

January 1, 2017 – FATCA withholding begins on payments of gross proceeds from the disposition of property of a type that can produce US-source dividends or interest.

January 1, 2017 – Earliest possible date when FATCA withholding could apply to foreign passthru payments.

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Brussels
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