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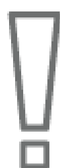

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New FATCA Proposed Regulations

On February 8, 2012 the Internal Revenue Services ("IRS") issued Proposed Regulations ("Proposed Regulations") regarding implementation of the Foreign Account Tax Compliance Act ("FATCA"). FATCA enacted sections 1471 through 1474 of the US Internal Revenue Code of 1986, as amended (the "Code"). Those provisions included a new and additional withholding tax compliance regime (statutorily effective in 2013).

FATCA withholding requires automatic withholding of 30% on "withholdable payments" to foreign financial institutions ("FFIs") that do not enter into an agreement with the IRS (an "FFI Agreement") and become a "participating" FFI ("PFFI") and nonfinancial foreign entities ("NFFEs") that do not comply with certain information reporting requirements. "Withholdable payments" include not only US-source payments such as dividends, interest, and other types of US-source payments, but also gross proceeds from the sale of assets that can produce US-source interest or dividends. Withholding is not necessary if certain information reporting requirements are satisfied. FATCA also sets forth a number of exceptions and exclusions from the withholding requirements.

FATCA's provisions left many details and definitions to regulations to be issued by the IRS. The IRS issued the first piece of guidance on August 27, 2010, in the form of Notice 2010-60. Notice 2010-60 addressed the new withholding tax requirements enacted in FATCA and provided preliminary guidance and requested comments on their implementation. This was followed on April 8, 2011 by Notice 2011-34, which provided additional guidance in response to several key issues identified following publication of Notice 2010-60. Finally, on July 14, 2011, Notice 2011-53 presented the initial phased implementation timeline of the various FATCA requirements.

With changes and amendments, the Proposed Regulations embody that previous guidance. These changes and amendments appear generally to relax some of the more onerous requirements of FATCA so as to make it more administrable for FFIs in particular. The IRS seeks comments regarding these Proposed Regulations, which will be effective only after they have been finalized.

This client alert focuses on changes and modifications of prior guidance as well as other key features of the Proposed Regulations, including:

- Intergovernmental Agreements
- Denial of Refund on Withholding for Nonparticipating FFI Beneficial Owners
- Definition of Financial Account

- Modification of Due Diligence Procedures for the Identification of Accounts
- Passthru Payments
- Compliance Verification
- Transitional Rules for Affiliates with Legal Prohibitions on Compliance
- Categories of Deemed-Compliant FFIs
- Definition of Substantial US Owner
- Extension of the Transition Period for the Scope of Information Reporting
- Expanded Scope of "Grandfathered Obligations"

Intergovernmental Agreements

Accompanying the publication of the Proposed Regulations was a Joint Statement from the United States, France, Germany, Italy, Spain and the United Kingdom regarding an alternative intergovernmental approach to Implementing FATCA (the "Joint Statement"). The IRS elaborated on the substantive aspects of this initiative in the Preamble to the Proposed Regulations. It generally described the intergovernmental alternative approach under consideration as one where an FFI could satisfy the reporting requirements of FATCA if:

(1) the FFI collects the information required under FATCA and reports this information to its residence country government; and
(2) the residence country government 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 United States.

Not surprisingly, the Preamble to the Proposed Regulations reiterates the potential use of agreements with foreign governments each time it discusses alternative approaches to passthru payment withholding, a subject many consider the most unworkable part of FATCA.

Denial of Refund on Withholding for Nonparticipating FFI Beneficial Owners

The Preamble to the Proposed Regulations highlights that FFIs that are not PFFIs cannot obtain refunds of or credits with respect to over-withheld amounts on payments as to which the FFI is the beneficial owner unless required by a treaty obligation of the United States. If a credit or refund is required by a treaty, it will be granted but no interest will be paid. In contrast, other beneficial owners are entitled to a refund of any overpayment of tax without regard to any treaty obligations.

Definition of Financial Account

Prior guidance left the definition of "financial account" ambiguous for FATCA purposes. The Proposed Regulations narrow the statutory definition of financial accounts to focus on bank, brokerage and money market accounts and interests in investment vehicles, including certain insurance contracts. Most debt and equity securities issued by banks and brokerage firms are excluded from the definition of financial accounts.

The Proposed Regulations define a "financial account" as any (1) depository account or custodial account held at a financial institution, (2) equity or debt interest (other than interests which are regularly traded on an established

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securities market) in a financial institution, or (3) cash value insurance contract or annuity contract issued or maintained by a financial institution.

A depository account includes savings and checking accounts, certificates of deposit, and any amount held with an insurance company under an agreement to pay interest.

A custodial account includes accounts holding financial instruments or contracts on behalf of another person.

Debt or equity interests include: (i) a capital or profits interest in a partnership, (ii) an ownership or beneficial ownership interest in a trust that is a financial institution, and (iii) an interest in a financial institution primarily engaged in the business of investing or trading securities.

Insurance contracts that include an investment component, such as cash value insurance contracts or annuity contracts, are also included in the definition of financial accounts. However, insurance contracts providing pure insurance protection, e.g., term life insurance, are excluded from the definition of a financial account.

The definition of financial account also specifically excludes certain savings accounts, including retirement and pension accounts, and certain nonretirement savings accounts. The Proposed Regulations further state that these exclusions also apply in defining a "foreign financial asset" for purposes of the new foreign financial asset reporting provisions of section 6038D.

Modification of Due Diligence Procedures for the Identification of Accounts

Notice 2010-60 and Notice 2011-34 both addressed the due diligence procedures that PFFIs will be required to undertake to identify their US accounts. The Proposed Regulations relax those requirements, in particular, by increasing the $500,000 threshold to $1 million and eliminating certain provisions that would have applied to private banking departments. However, the knowledge and role of the "relationship manager" have become critical factors in the identification procedure rules (in respect of non-electronic due diligence and aggregation of accounts).

<u>Preexisting Individual Accounts</u>

Preexisting individual accounts with a balance or value of $50,000 or less and cash value insurance contracts with a value of $250,000 or less are exempt from review.

After completing electronic searches on preexisting individual accounts, a PFFI must manually review paper records only for accounts with a balance or value over $1,000,000. Even in this case, manual review is not required if the electronically searched information contains all of the following information:

(1) The account holder's nationality and/or residence status;
(2) The account holder's current residence address and mailing address;
(3) The account holder's current telephone number(s);
(4) Whether or not there are standing instructions to transfer funds in the account to an account at another branch of the PFFI or another financial institution;
(5) Whether or not there is a current "in care of" address or "hold mail" address for the account holder if no other residence or mailing address is found for the account; and

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(6) Whether or not there is any power of attorney or signatory authority for the account.

If a manual review of paper records is required, then the PFFI must manually review the records contained in the current customer master file and specifically:

(1) The most recent documentary evidence on file;
(2) The most recent account opening contract or documentation;
(3) The most recent documentation obtained by the PFFI for purposes of anti-money laundering ("AML") due diligence or for other regulatory purposes;
(4) Any power of attorney or signature authority forms currently in effect; and
(5) Any standing instructions to transfer funds currently in effect.

Preexisting Entity Accounts

Entity accounts of $250,000 or less existing on the date the FFI enters into the FFI Agreement ("pre-existing entity accounts") are exempt from review. However, at such time as those accounts reach a balance exceeding $1,000,000, they must be reviewed. For the remaining pre-existing entity accounts, FFIs can generally rely on AML or know your customer ("KYC") records and other existing account information to determine whether the entity is either an FFI, a US person, an entity excepted from the requirement to document its substantial US owners (for example, because it is engaged in a nonfinancial trade or business), or an entity that is not a financial institution and that is not a publicly-traded corporation, qualifying securities exchange, "withholding partnership," or "withholding trust" (referred to in the regulations as a "passive NFFE").

In the case of pre-existing accounts of a passive NFFE with account balances that do not exceed $1,000,000, FFIs may rely on information collected for AML/KYC due diligence purposes to identify substantial US owners, unless the FFI knows that such information is not correct.

In the case of pre-existing entity accounts of passive NFFEs with account balances that exceed $1,000,000, FFIs must obtain information regarding all substantial US owners or a certification from the passive investment entity that the entity does not have substantial US owners.

New Individual Accounts

For individual accounts opened after the FFI Agreement enters into effect, the FFI will be required to review the information provided at the opening of the account, including identification and any documentation collected under applicable AML/KYC rules. If any US indicia are identified as part of that review, the FFI must obtain additional documentation or treat the account as held by a "recalcitrant account holder." The IRS believes that FFIs will generally not need to make significant changes to the information collected during the account opening process to identify US accounts, except where US indicia are identified.

New Entity Accounts

FFIs will be required to determine whether the entity has any substantial US owners upon opening a new account by obtaining a certification from the account holder. This certification is not required, where the account is opened by another FFI (except where the other FFI was "self-documented," see below), or by an entity engaged in an active nonfinancial trade or business, or

an entity otherwise excepted from documentation requirements by the Proposed Regulations. As a practical matter, this will tend to limit certification to accounts of passive NFFEs.

Passthru Payments

Notice 2011-53 stated that PFFIs will not be obligated to withhold on passthru payments that are not withholdable payments (foreign passthru payments) made before January 1, 2015. The Proposed Regulations further postpone this by providing that withholding will not be required with respect to foreign passthru payments before January 1, 2017. Until withholding with respect to foreign passthru payments applies, the Proposed Regulations require PFFIs to report annually to the IRS the aggregate amount of US-source, nonbusiness income and other financial payments (not yet defined) made to each non-participating FFI.

As noted above, the IRS would like to discuss with foreign governments practical alternative approaches to passthru payment withholding, which alternative would be embodied in a bilateral agreement with the foreign government. If the agreement provides for the foreign government to report to the IRS information regarding US accounts and recalcitrant account holders, FFIs in such jurisdictions may not be required to withhold on any foreign passthru payments to recalcitrant account holders. However, there will doubtless be reporting requirements placed upon them by their government to permit the government to comply with the agreement.

Definition of Substantial US Owner of an NFFE

PFFIs must also report to the IRS information on accounts held by NFFEs that have a “substantial United States owner.” Accordingly, NFFEs must provide to the PFFI information regarding any specified USUS person that owns/holds, directly or indirectly, more than 10% of

- the stock of an NFFE corporation,
- the profits interests or capital interests in an NFFE partnership, or
- the value of the beneficial interests in a so-called non-grantor trust.

The Proposed Regulations clarify that holding of a beneficial interest in a non-US trust means either the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or the possibility to receive, directly or indirectly, a discretionary distribution from the trust.

In the case of *discretionary distributions*, the value of the beneficial interest equals the fair market value of the currency and other property distributed from the non-US trust to the specified USUS person during the prior calendar year. The 10% test is met if such value is both more than $5,000 and more than 10% of the value of all distributions made by the trust during that year.

Whether a person has a right to a *mandatory distribution* is determined taking into account all facts and circumstances. The value of such right during the year is calculated based on specific valuation tables provided under the Code. The 10% test is met if such value is both more than $50,000 and more than 10% of the value of all of the assets held by the trust during that year.

With respect to a so-called grantor trust, the determination is relatively simple because a substantial US owner is any specified USUS person that is treated as an “owner” of such trust for US federal income tax purposes.

Compliance Verification

In providing initial guidance on compliance verification procedures, Notice 2010-60 sets forth the concerns of the IRS regarding balancing compliance gains with the compliance costs of such procedures. Notice 2010-60 suggested that the verification procedure could include reporting by officers of FFIs and solicited comments. The Proposed Regulations follow that initial guidance and rely primarily on internal, rather than external, procedures to verify compliance.

The Proposed Regulations provide the basics of the verification process for a participating FFI to show compliance with its FFI Agreement. A model FFI Agreement, which will contain further details, will be set forth in a future Revenue Procedure. The Proposed Regulations include requirements that (i) the FFI adopt written policies and procedures for complying with its obligations; (ii) the FFI conduct periodic internal reviews of its compliance; and (iii) the FFI periodically provide certification of its compliance by its responsible officers. The participating FFI may at times be required to provide certain other information not specified in the regulations. Third-party audits will not be required on a regular basis to verify compliance.

If the IRS has concerns about the PFFI's compliance based on the above reporting and certification, or if the PFFI repeatedly fails to comply, additional verification requirements may be imposed. This could include external audits of the PFFI's compliance by IRS-approved third-party auditors. Under especially egregious circumstances, the PFFI could be determined to have defaulted on its FFI Agreement. The precise conditions of a default will be set forth in the FFI Agreement.

Importantly, if an FFI complies with the obligations set forth in its FFI Agreement, it will not be held strictly liable for failing to identify a US account.

Transitional Rules for Affiliates with Legal Prohibitions on Compliance

Notice 2011-34 stated that the Treasury Department and the IRS shall require that each FFI that is a member of an expanded affiliated group ("EAG") must be a PFFI or deemed-compliant FFI for any FFI in the expanded affiliated group to become a PFFI. The Proposed Regulations provide a two-year transition, until January 1, 2016, for the full implementation of this requirement.

During the transition period, a branch or affiliate of an FFI in a jurisdiction that prohibits the reporting or withholding required by FATCA will not prevent the other FFIs within the same EAG from entering into an FFI Agreement. The Proposed Regulations define these entities as limited branches and limited FFI affiliates. Existing qualified intermediaries ("QIs") that are unable to comply with the provisions of an FFI Agreement will be treated as limited FFIs during the transition. If its jurisdiction no longer prohibits it from complying with the requirements of the FFI Agreement, the branch or limited FFI must enter into an FFI Agreement before the beginning of the third calendar quarter following the date on which the prohibition ends. Regardless of such prohibition, on or before January 1, 2016, all members of an EAG must have entered into an FFI Agreement; otherwise, no member of the EAG will be treated as a PFFI.

In order to qualify for the transition rule for a limited branch, the FFI must, as part of its registration for FATCA:

(1) identify the relevant jurisdiction of each branch for which it seeks limited branch status;
(2) agree that each such branch will identify its account holders under the due diligence requirements applicable to participating FFIs;
(3) retain account holder documentation pertaining to those identification requirements for six years from the effective date of its FFI Agreement;
(4) report to the IRS with respect to its accounts that it is required to treat as US accounts to the extent permitted under the relevant laws pertaining to the branch;
(5) treat each such branch as a separate entity for purposes of withholding;
(6) agree that each such branch will not open new accounts that it is required to treat as US accounts or accounts held by non-participating FFIs; and
(7) agree that each such branch will identify itself to withholding agents (including affiliates of the FFI) as a non-participating FFI.

PFFIs are required to withhold on withholdable payments that are considered received on behalf of the limited branch.

To qualify for limited FFI affiliate status, the FFI must agree to (2), (3), (4), (6) and (7) above.

Categories of Deemed-Compliant FFIs

Notice 2011-34 provided initial guidance on categories of FFIs which would be considered deemed compliant, i.e., they would not need to enter into an FFI Agreement with the IRS to be relieved from FATCA withholding. While Notice 2011-34 described deemed-compliant status for certain local banks, local FFI members of participating FFI groups, and certain investment vehicles, the Proposed Regulations describe these in more detail. The Proposed Regulations also describe additional categories of deemed-compliant FFIs, including specifics concerning deemed-compliant foreign retirement plans.

The specific categories of deemed-compliant FFIs can be broken down into three major categories: registered, certified, and certain owner-documented FFIs.

<u>Registered Deemed-Compliant FFIs</u>

Registered deemed-compliant FFIs include:

(a) Local FFIs;
(b) Nonreporting members of participating FFI groups;
(c) Qualified investment vehicles;
(d) Restricted funds; and
(e) FFIs that comply under an agreement between the United States and a foreign government.

Registered deemed-compliant FFIs must, as a general rule, be registered or licensed in their home country. An FFI in this category is required to (i) certify to the IRS that it meets all the requirements of its claimed deemed-compliant FFI category, in a manner to be specified by the IRS at a later date; (ii) obtain confirmation of its registration from the IRS and obtain an FFI-EIN; (iii) renew its certification every three years; and (iv) agree to notify the IRS if it becomes ineligible for its deemed-compliant FFI status.

Local FFIs – Notice 2011-34 described a category of “local banks” which would be deemed compliant. The Proposed Regulations break this down into several distinct categories with different requirements. An FFI may qualify as a deemed-compliant local FFI if:

(1) The FFI is licensed and regulated under the laws of its country of organization as a bank or similar organization;
(2) The FFI has no fixed place of business outside of its country of organization;
(3) The FFI does not solicit account holders outside of its country of organization;
(4) The FFI is required under the laws of its country of organization to either report information or withhold tax on accounts of residents;
(5) At least 98% of the accounts of the FFI are held by residents;
(6) The FFI implements policies and procedures to ensure that it does not open or maintain accounts for any specified US person who is not a resident;
(7) Special review is made of accounts of non-residents opened after December 31, 2011, but before the policies and procedures described in (6) were implemented, to identify any US accounts or accounts held by non-participating FFIs and take appropriate action with respect to them (including transferring or closing the account, or withholding and reporting on it, as applicable); and
(8) In the case of an FFI that is a member of an expanded affiliated group, each member of the expanded affiliated group is organized in the same country and meets all of the foregoing requirements.

Nonreporting members of PFFI groups – FFIs that are part of a PFFI group must meet the following requirements:

(i) The FFI must review accounts opened before it implements the policies and procedures described below in (iii) to identify any US accounts or accounts held by non-participating FFIs;
(ii) If a US account or account held by non-participating FFI is identified, the FFI must enter into an FFI Agreement within 90 days and either transfer the account to a participating FFI or close the account;
(iii) The FFI must implement policies and procedures to ensure that it complies with (ii) above; and
(iv) The FFI must implement policies and procedures to ensure that it will identify any existing account which becomes a US account or account held by a non-participating FFI due to a change in circumstances.

The Proposed Regulations state that any FFI which is deemed to comply pursuant to an agreement between the United States and a foreign government will also be treated as a registered deemed-compliant FFI.

Certified Deemed-Compliant FFIs

The second category of deemed-compliant FFIs are certified deemed-compliant FFIs. Like registered deemed-compliant FFIs, they are generally required to be local in scope and their status relies in part on local registration, licensing or oversight by the country of residence. Certified deemed-compliant FFIs include:

(a) Nonregistering local banks;
(b) Retirement plans;
(c) Non-profit organizations; and
(d) FFIs with only low-value accounts.

Certified deemed-compliant FFIs must provide a withholding agent with certain documentation (including withholding certificates and financial statements), certifying their status as to the relevant deemed-compliant category.

Nonregistering local bank – The requirements for nonregistering local banks are similar to those for Local FFIs. However, the requirements focus more on the size of the institution and the value of accounts:

(i) The FFI must be licensed and regulated under the laws of its country of organization only as a bank;
(ii) The FFI must not have a fixed place of business outside of its country of organization;
(iii) (The FFI must not solicit account holders outside of its country of organization;
(iv) The FFI can have a maximum of $175 million in assets on its balance sheet; if the FFI is a member of an expanded affiliated group, the group may have no more than $500 million in total assets on its balance sheet;
(v) The FFI must be required under the laws of its country of organization to either report information or withhold tax on accounts of residents; the FFI will be considered to meet this requirement if it has no accounts with a total value of more than $50,000; and
(vi) In the case of an FFI that is a member of an expanded affiliated group, each member of the expanded affiliated group must be organized in the same country and must meet all of the foregoing requirements.

Retirement funds – The requirements for a foreign retirement fund to qualify as deemed-compliant include:

(i) All contributions must be employer, government or employee contributions;
(ii) No single beneficiary has a right to more than 5% of the FFI's assets; and
(iii) Contributions which would otherwise be taxable are deductible or excluded.

Owner Documented FFIs

Owner-documented FFIs are deemed-compliant only with respect to payments received by or accounts held with a withholding agent. Similarly to certified deemed-compliant FFIs, they are required to provide certain documentation of their status to withholding agents and they may not act as intermediaries.

Extension of the Transition Period for the Scope of Information Reporting

Notice 2011-53 provided for phased implementation of the reporting required under FATCA with respect to US accounts. The identifying information (name, address, TIN, and account number) and account balance or value of US accounts was required to be reported in 2014 (with respect to 2013 data). The Proposed Regulations extend this period and provide that reporting on income will begin in 2016 (with respect to 2015 data), and reporting on gross proceeds will begin in 2017 (with respect to 2016 data). In addition, the Proposed Regulations provide that FFIs may elect to report information either in the currency in which the account is maintained or in US dollars.

Expanded Scope of "Grandfathered Obligations"

Notice 2010-60 had given a slight reprieve from FATCA withholding for any payments on obligations entered into before a certain date, so-called "grandfathered obligations." The Proposed Regulations push back the date for grandfathered obligations to January 1, 2013, from the prior date of March 18, 2012. This more practical date should allow for easier implementation and compliance by financial institutions.

Unresolved Issues

The Proposed Regulations and the Joint Statement leave a number of issues unresolved, and we can expect additional guidance to be issued within the next year to timely implement FATCA.

In the short term, the IRS will issue a draft model FFI Agreement and draft forms relating to FATCA reporting. While the Proposed Regulations provide the contours of the FFI Agreement, they are silent with respect to certain key details that will be fleshed out in the draft model FFI Agreement. For example, the draft model FFI Agreement will include more detail regarding the periodic internal review and certification a PFFI must undertake so that the IRS can determine whether the PFFI has met its obligations under the FFI Agreement. Treasury is interested in comments on the scope and content of the review, factual information and representations for the certification. Additionally, the draft model FFI Agreement will contain a list of "egregious circumstances" that will cause a PFFI to be in default. The draft model FFI Agreement may allow flexibility for FFIs in jurisdictions that are subject to a FATCA intergovernmental agreement as described in the Joint Statement.

There are multiple unresolved issues affecting the scope of withholding and definition of passthru payments. The Proposed Regulations do not fully define passthru payments. As discussed above, a passthru payment is any withholdable payment and any foreign passthru payment. Treasury deferred the definition and scope of foreign passthru payment for another day. A US withholding agent is required to withhold only on withholdable payments, while an FFI with an agreement is required to withhold on all foreign passthru payments. Until foreign passthru payment is defined, the scope of such withholding is uncertain. The Preamble states that future guidance will prevent US financial institutions ("USFIs") from serving as blockers for foreign passthru payment reporting and withholding. Could Treasury define foreign passthru payment to increase the scope of withholding for US withholding agents? Or will Treasury narrow the scope of foreign passthru payments in exchange for more robust information reporting? In any event, Treasury will continue to obtain comments from financial institutions and other governments to appropriately define the scope of foreign passthru payments and to prevent circumvention of the new reporting and withholding requirements.

Further guidance will be required to address refund requests. An NFFE may claim a refund if it provides information regarding the NFFE's substantial US owners or a certification that it does not have US owners. Treasury will need to issue guidance regarding the level of substantiation that an NFFE will need to meet to obtain a refund. Additionally, further guidance will be required regarding the refund procedures for a recalcitrant account holder who is ultimately not subject to US tax.

The Joint Statement raises many questions. For example, how will FATCA be implemented for FFIs in countries that enter into a FATCA Intergovernmental Agreement with the US? The Joint Statement and the Preamble state that various aspects of FATCA will be relaxed, including in particular passthru

payment withholding obligations, for such FFIs in exchange for intergovernmental cooperation. But the details and timing of these effects remain to be revealed. Also, what will USFIs be required to provide to foreign governments as part of this? Will USFIs be required to look through corporate and passthru entities to determine the ultimate beneficial owner and provide gross amounts of transactions to the IRS for transmission to foreign governments? Should USFIs apply FATCA-type rules to domestic accounts, and what is the transition for USFIs to apply FATCA-type rules to foreign account holders? Will USFIs be required to use the same forms as FFIs for reporting? The Joint Statement says the six countries are committed to working together "over the longer term" towards achieving common reporting and due diligence standards – does this mean that there will be a period during which different standards will have to be applied simultaneously to satisfy the requirements of the several governments? What will the process be for achieving the common standards, and how will the business community be able to provide input into that process? To what extent will governments entering into Intergovernmental Agreements need to enact enabling legislation? If so, how, and how soon, will FATCA-based reporting requirements be introduced into the legislation of the various countries? As welcome as the alternative intergovernmental approach to FATCA may be, much remains to be seen about how it will progress and work in practice.

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Pursuant to requirements relating to practice before the Internal Revenue Service, any tax advice in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties imposed under the United States Internal Revenue Code, or (ii) promoting, marketing, or recommending to another person any tax-related matter.

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