E-ALERT | Financial Institutions & Tax

February 13, 2012

IRS AND TREASURY RELEASE PROPOSED FATCA REGULATIONS

On February 8, 2012, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued lengthy and detailed Proposed Regulations for implementing the Foreign Account Tax Compliance Act ("FATCA"), legislation adopted in 2010 to combat offshore tax evasion by U.S. taxpayers.

The Proposed Regulations clarify and expand on prior FATCA guidance. They generally postpone and phase-in the effective dates for the implementation of FATCA and reflect various attempts to limit the initial compliance burden on foreign financial institutions ("FFIs"). The Proposed Regulations invite additional taxpayer comments in a variety of areas, subject to a relatively tight, April 30, 2012 deadline for receipt of the comments.

Simultaneous with the release of the Proposed Regulations, Treasury published a joint statement with France, Germany, Italy, Spain, and the United Kingdom (the "Joint Statement") expressing their collective interest in an intergovernmental approach to information exchange as an alternative to the unilateral approach of FATCA. Further developments are expected in this area.

This E-Alert provides an overview of the Proposed Regulations, highlights certain key technical issues addressed by them, and considers the next steps to be taken in the coming months.

OVERVIEW

According to the Proposed Regulations, the purpose of FATCA is to apply to the international financial activities of U.S. citizens and residents the same type of information reporting that applies to their domestic financial activities. U.S. financial institutions have long been required to report to the IRS comprehensive tax information about their U.S. customers, and the Proposed Regulations indicate that the IRS and Treasury are seeking the same types of information from FFIs as a way to combat U.S. tax evasion through offshore accounts.

Recognizing that the burden of the new reporting regime falls heavily on FFIs, and to a lesser extent on non-financial foreign entities ("NFFEs") with U.S. owners, the Proposed Regulations attempt to moderate the initial impact of the new regime. For example, they delay the effective date of the FATCA withholding tax and limit the initial scope of the withholding obligations imposed on FFIs for so-called "passthru payments" they make to non-compliant FFIs and account holders ("recalcitrant" account holders). The Proposed Regulations thus show that the IRS and Treasury are paying attention to the concerns expressed by commenters and stakeholders during the rulemaking process. In particular, they show a willingness on the part of the U.S. government to be flexible as to *when* FFIs implement FATCA—although not *whether* they implement it.

The Proposed Regulations formalize the guidance provided in Notices 2010-60, 2011-34, and 2011-53 (the "FATCA Notices") on several major topics. First, the Proposed Regulations define the key terms used in the statute. Second, they provide for the imposition of the FATCA withholding tax and

carve out certain exemptions from withholding. Third, they provide detailed rules that withholding agents can use to categorize the recipient of a payment to determine whether the FATCA withholding tax must be imposed. These rules include documentation requirements and presumptions for classifying the recipient. Fourth, the Proposed Regulations specify the duties that will be imposed on an FFI for it to be exempt from the FATCA withholding tax (that is, to be a "participating FFI"). These duties include searching for U.S. beneficial ownership of financial assets, reporting information to the IRS, and withholding on passthru payments. Fifth, the Proposed Regulations impose the FATCA tax on certain NFFEs unless they report to the IRS information about their U.S. owners (or lack thereof). Finally, the Proposed Regulations provide mechanisms for seeking a refund of the FATCA tax, rules for coordinating the FATCA tax with existing U.S. income withholding taxes, and other technical rules.

Released concurrently with the Proposed Regulations, the Joint Statement announced the possibility of bilateral agreements between the United States on the one hand and France, Germany, Italy, Spain, and the United Kingdom on the other. Under these bilateral agreements, the foreign government would enact legislation requiring FFIs subject to its requirements to collect the information required by FATCA and to deliver that information to the foreign government. The foreign government would then automatically send the information to the IRS. In exchange, FFIs subject to this reporting regime would be exempt from FATCA withholding and would not be required (1) to report the information directly to the IRS, (2) to withhold on passthru payments to FFIs organized in the same jurisdiction (or other jurisdictions with a similar agreement), (3) to withhold on passthru payments to recalcitrant account holders, or (4) to terminate the accounts of recalcitrant account holders. The main purpose of these agreements would be to address legal restrictions in those countries that would prevent FFIs from reporting confidential account information to the IRS, withholding a tax on behalf of the IRS, and complying with the requirement in FATCA that the FFI must close the accounts of certain recalcitrant account holders.

The announced bilateral agreements offer the potential for reduced administrative burden on FFIs and appropriate sovereign oversight over the exchange of tax information. However, several obstacles remain to their successful implementation. For example, foreign requests for reciprocity could delay implementation of bilateral FATCA agreements. The IRS does not currently have the legal authority to collect automatically the same types of information the bilateral agreements would require the foreign country to send to the IRS. Significant opposition has been expressed to proposed regulations (REG-146097-09, 76 Fed. Reg. 1105 (Jan. 7, 2011)) requiring the collection of one such type of information, interest on U.S. bank deposits of nonresident alien individuals, from U.S. financial institutions. In addition, the bilateral agreements described in the Joint Statement would not appear to exempt FFIs from the obligation to withhold on passthru payments to non-participating FFIs located in third countries. Because the Joint Statement would not require an FFI to enter into a direct agreement with the IRS, however, it is unclear how this withholding requirement would be enforced. More generally, the foreign implementing legislation and FATCA would need to be closely coordinated to avoid subjecting FFIs to two reporting regimes instead of one.

TECHNICAL HIGHLIGHTS

Below we highlight some of the more significant technical provisions contained in the Proposed Regulations.

Phased Implementation of Reporting and Withholding Requirements

Relative to the prior FATCA Notices, the Proposed Regulations provide extended phase-in periods for the FATCA requirements that typically have presented the greatest problems for FFIs.

- Information reporting will be phased in. In 2014 and 2015, FFIs will need to report only identifying information and account balance or value of U.S. accounts (for the 2013 and 2014 calendar years, respectively). Income reporting will be phased in starting in 2016 (for the 2015 calendar year). Information on gross proceeds will need to be collected and reported starting in 2017 (for the 2016 calendar year).
- FATCA does not require withholding on payments made with respect to grandfathered debt obligations, including any payments of income or gross proceeds. Previously, any obligation outstanding on March 18, 2012, was eligible for the grandfather rule. The Proposed Regulations extend the grandfather rule to any obligation outstanding on January 1, 2013. The Proposed Regulations also request comments on whether or how to apply this rule to equity interests in securitization vehicles holding debt obligations.
- If a grandfathered obligation is "substantially modified" (within the meaning of Treasury Regulation § 1.1001–3) on or after January 1, 2013, it will no longer be eligible for the exception.
- In general, the requirements of FATCA apply to all members of an affiliated group of FFIs (including FFIs with branches in other jurisdictions). This rule has presented the risk that an FFI otherwise ready to meet its FATCA obligations on time would be disqualified if one of its affiliates were subject to foreign laws prohibiting compliance with the FATCA reporting requirements. The Proposed Regulations offer temporary relief in this situation. During a transition period, a nonparticipating FFI branch or affiliate that is subject to local laws that prohibit compliance with FATCA reporting requirements will not disqualify the remaining members of the affiliated group.
- The relief offered on the scope of an expanded affiliated group is limited. It is only available until January 1, 2016. In addition, the FFI branch or affiliate that is unable to become compliant due to local laws remains subject to the due diligence procedures and record maintenance imposed on participating FFIs and to FATCA withholding by other members of the group.

Modest Relaxation of Compliance Requirements

The Proposed Regulations show responsiveness to comments from stakeholders about the severity of the administrative burden imposed on participating FFIs. The following are some of the resulting adjustments:

Due diligence

- In determining whether it must review a pre-existing individual account for indicia of U.S. ownership, an FFI would not be required to distinguish between private banking and other accounts, as suggested by Notice 2011-34. Instead, only account balances are relevant.
- Pre-existing individual accounts with a balance below $50,000 are exempt from review. Accounts with a balance between $50,000 and $1 million are subject only to review of electronic data for certain specified indicia of U.S. ownership. Accounts with a balance above $1 million are subject to electronic review, a paper review to the extent the electronic review does not contain sufficient information, and an inquiry of the actual knowledge of any relationship manager associated with the account.
- For new individual accounts, an FFI can rely on documentation collected at the opening of the account, including information collected under anti–money laundering and "know your customer" ("AML/KYC") rules. The FFI needs to obtain additional information only if indicia of U.S. ownership are identified during the initial review.
- For pre-existing entity accounts, accounts with a balance of $250,000 or less are exempt from review until the account balance exceeds $1 million. Other accounts are exempt if the FFI's

records indicate that the entity is engaged in a nonfinancial trade or business. Accounts of passive investment entities with a balance of $1 million or less are reviewed for indicia of U.S. ownership based on the FFI's AML/KYC file. For accounts with a balance of greater than $1 million, the FFI must obtain information on all "substantial" U.S. owners or a certification that the entity has no substantial U.S. owners.

- For new entity accounts, accounts of an FFI or an entity engaged in a nonfinancial trade or business are excluded from review. For all other new entity accounts, the FFI must obtain information on all substantial U.S. owners or a certification that the entity has no substantial U.S. owners.
- If an FFI adheres to the foregoing due diligence requirements, it will not be held strictly liable for a failure to identify U.S. accounts.
- The Proposed Regulations confirm that insurance contracts that do not include an investment component—such as term life, disability, health, and property and casualty insurance contracts—are not "financial accounts" subject to FATCA.

Reporting and withholding

- For accounts that are subject to reporting, information may be reported in the account currency or in U.S. dollars.
- The Proposed Regulations attempt to coordinate FATCA withholding with income tax withholding in several areas. For example, they propose to coordinate the election to be withheld upon under FATCA with the election to assume primary responsibility for withholding required elsewhere in the Internal Revenue Code. The Proposed Regulations would revise Forms W-8, W-9, and 1042-S to accommodate FATCA-related information and would apply documentation standards similar to the income tax withholding rules for establishing a recipient's FATCA status.
- A U.S. branch of a participating FFI that satisfies its backup withholding obligations with respect to accounts treated as held by U.S. non-exempt recipients will be deemed to satisfy its FATCA withholding responsibilities.
- It appears from the Proposed Regulations that an NFFE eligible for a reduction in U.S. withholding tax under a bilateral U.S. income tax treaty can obtain a refund of FATCA withholding without necessarily having to disclose the extent of its U.S. ownership. However, the NFFE may be required to obtain relief from withholding through a refund claim rather than an exemption from withholding. An NFFE not entitled to treaty benefits must disclose its ownership to obtain a refund of the FATCA tax.

FFI status

- The Proposed Regulations expand the categories of FFIs that can qualify as "deemed-compliant" and therefore exempt from FATCA withholding. Under Notice 2011-34, Treasury and the IRS considered treating only a narrow set of entities as "deemed-compliant" FFIs, including certain local banks, local FFI members of participating FFI groups, a narrow subset of investment vehicles, and certain foreign retirement plans. In general, the expansion under the Proposed Regulations covers certain types of investment vehicles and FFIs that exclusively serve local foreign markets. Other deemed-compliant FFIs include certain retirement plans, non-profit organizations, and FFIs with only low-value accounts.
- The Proposed Regulations provide additional detail on the types of retirement plans that qualify as deemed-compliant, including foreign pension funds that qualify for tax treaty benefits.
- Under the Proposed Regulations, an FFI that could be disqualified from deemed-compliant status because it has a limited number of U.S. accounts would be able to retain its favored status by

transferring all of its U.S. and noncompliant accounts (both new and pre-existing) to a participating FFI in its affiliated group. This type of deemed-compliant FFI is no longer limited to FFIs that operate in a single country and that solicit account holders only in that country.

- Treasury and the IRS intend to publish a draft model FFI agreement and draft reporting forms in early 2012, and to finalize the model agreement in the fall of 2012. The IRS also intends to make available an online process for FFI registration no later than January 1, 2013.
- No third-party verification of compliance with FFI agreements will be required. Internal certification will be permitted. "Repetitive or systematic" compliance failures may result in additional compliance measures, such as an external audit, and ultimately can result in termination of the FFI agreement in "egregious circumstances."

Scope of Passthru Payments Narrowed—for Now

In Notice 2011-34, the IRS and Treasury indicated how they expected the passthru payment withholding mechanism would work. This aspect of the notice became controversial. For example, in certain cases the notice would have imposed the FATCA tax on passthru payments attributable to income from sources outside the United States, not just income attributable to "withholdable" U.S.-source payments. In addition, the notice would have required FFIs to determine the amount of withholding using a "passthru payment percentage," computed based on the relative proportions of the FFI's U.S. and foreign assets. Computation of this percentage was widely viewed as complex and burdensome. The Proposed Regulations acknowledge the controversy generated by Notice 2011-34 and defer the imposition of the broader form of withholding:

- Withholding on passthru payments attributable to withholdable U.S- source payments will be required beginning on January 1, 2014. Withholding on passthru payments not attributable to withholdable payments (that is, foreign passthru payments) will not be required any earlier than January 1, 2017.
- The Proposed Regulations thus do not require computation of a passthru payment percentage. They "reserve" on how foreign passthru payments will be computed. Among the alternatives under consideration are a *de minimis* exception from foreign passthru payment withholding, a safe harbor percentage if the FFI does not calculate one, or the use of rounding conventions to limit the number of percentages that could apply. Treasury and the IRS have requested comments on these and other possible approaches to reduce the administrative burden.
- Although withholding on foreign passthru payments has been delayed, in the interim the Proposed Regulations require participating FFIs to report to the IRS the aggregate amount of certain payments made to nonparticipating FFIs.
- Under the Proposed Regulations, U.S. financial institutions are required to withhold on withholdable U.S.-source payments only, while FFIs generally are required to withhold on all passthru payments. As a result, absent an anti-abuse rule, an FFI could use a U.S. financial institution as a FATCA "blocker" for foreign passthru payments made to nonparticipating FFIs. The Proposed Regulations indicate that future guidance will address this issue. Alternatives under consideration include expanding the withholding obligations imposed on U.S. financial institutions or requiring FFIs to impose passthru payment withholding on payments made to U.S. withholding agents acting as intermediaries.

NEXT STEPS

Many issues remain unaddressed under the Proposed Regulations, including the rules requiring withholding on foreign passthru payments; the substantiation requirements for entities seeking a refund of the FATCA withholding tax; the reporting requirements for participating FFIs that are also

qualified intermediaries ("QIs"); the reporting of "other financial payments" by FFIs; guidance on when gross proceeds are treated as paid to a partner, owner, or beneficiary of a flow-through entity; and specific details on the coordination of FATCA withholding with the withholding requirements applicable to the distribution of gross proceeds subject to tax under other Code provisions.

The IRS and Treasury have stated that they will continue to work with businesses and foreign governments to implement FATCA effectively. They have invited comments in several areas, including FATCA withholding on substitute dividend payments, the coordination of income tax withholding and FATCA withholding, the coordination of backup withholding and FATCA withholding, the treatment of equity interests in certain securitization vehicles holding debt instruments as grandfathered obligations, how the IRS should review FATCA compliance by FFIs, and whether there should be additional categories of deemed-compliant FFIs.

The IRS and Treasury have invited written comments on the Proposed Regulations by April 30, 2012. Unlike many IRS guidance projects, the due date for comments on the Proposed Regulations is likely to be adhered to more strictly due to the compressed timeframe for the IRS and Treasury to issue final regulations. A public hearing has been scheduled for May 15, 2012.

Additional developments can be expected on bilateral agreements. Press accounts indicate that FATCA has been a subject of concern to many countries, such as Canada, who are not co-signatories to the Joint Statement. The Proposed Regulations should facilitate these bilateral consultations: foreign governments now have a baseline set of U.S. rules to function as the starting point for negotiations. Recent public comments by Treasury officials also indicate that the United States will continue to pursue multilateral information exchange initiatives in the G-20 and the OECD. Although multilateral information exchange on a standardized basis is more difficult to achieve in the near term, it offers the promise of a more stable and less burdensome regime than the unilateral FATCA.

* * *

Under IRS standards of professional practice, certain tax advice must meet requirements as to form and substance. To assure compliance with these standards, we disclose to you that this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our financial institutions and tax practice groups:

Dirk Suringa	202.662.5436	dsuringa@cov.com
Edward Yingling	202.662.5029	eyingling@cov.com
Nicole Welch	202.662.5191	nwelch@cov.com
Gregory Frischmann	202.662.5256	gfrischmann@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.

© 2012 Covington & Burling LLP, 1201 Pennsylvania Avenue, NW, Washington, DC 20004-2401. All rights reserved.