

International Tax ADVISORY

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Summary of the Proposed FATCA Regulations

On February 8, 2012, the IRS issued proposed regulations under the Foreign Account Tax Compliance Act (FATCA) that build upon prior FATCA notices issued by the IRS. The proposed regulations provide substantial additional guidance regarding due diligence, withholding and reporting obligations and additional carve-outs from—and exceptions to—FATCA's applicability, as well as a new timeline for implementation.

General Background

FATCA, enacted in 2010 as part of the Hiring Incentives to Restore Employment Act of 2010, added Sections 1471 through 1474 to the Code. Those sections impose rules that are intended to result in disclosure of U.S. persons who may be evading U.S. tax by holding income-producing assets through accounts at foreign financial institutions (FFIs)¹ or through other foreign entities (non-financial foreign entities or NFFEs). FATCA impacts both payors and recipients of affected income and requires steps to be taken as soon as possible to achieve compliance with the FATCA regime.

Section 1471 imposes a 30-percent withholding tax on “withholdable payments” made to FFIs that do not enter into “FFI Agreements” (and who are not “excepted” FFIs or “deemed-compliant” FFIs). Withholdable payments are defined as payments of i) interest, dividends, rents and other fixed or determinable annual or periodical gains, profits and income (FDAP income), if such payment is from sources within the United States; and ii) gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from sources within the United States.²

Under an “FFI Agreement,” a participating FFI will be obligated to undertake customer account due diligence, report annually to the IRS on its account holders who are U.S. persons or foreign entities with substantial U.S.

¹ FFIs are broadly defined to mean any entity that (a) accepts deposits in the ordinary course of a banking or similar business; (b) holds financial assets for the account of others as a substantial portion of its business; or (c) is engaged (or holds itself out as engaged) primarily in the business of investing, re-investing or trading in securities, partnership interests, commodities, notional principal contracts (e.g., swaps), insurance or annuity contracts, or any interest (including a futures or forward contract or option) in such securities, partnership interests, commodities, notional principal contracts, or insurance or annuity contracts. An FFI also includes an insurance company obligated to make payments with respect to a cash value insurance policy or an annuity contract.

² Payments that are excluded from the definition of “withholdable payments” include original issue discount from certain short-term obligations, income that is taken into account as effectively connected with the conduct of a trade or business in the United States, certain payments in the ordinary course of the withholding agent’s business, gross proceeds from the sale of property that can produce income that is excluded from the definition of withholdable payments and certain broker transactions that involve the sale of fractional shares.

ownership and, in certain cases, withhold and pay over to the IRS a 30 percent tax on “passthru payments.”³

The FFI Agreement will also provide a verification process for determining a participating FFI’s compliance with its FFI Agreement. This will require, among other things, that a participating FFI i) adopt written policies and procedures governing the participating FFI’s compliance with its responsibilities under the FFI Agreement; ii) conduct periodic internal reviews of its compliance (rather than periodic external audits, as are required for many Qualified Intermediaries);⁴ and iii) periodically provide the IRS with a certification and certain other information that will allow the IRS to determine whether the participating FFI has met its obligations under the FFI Agreement. However, repetitive or systematic failures of the participating FFI’s processes relating to its compliance with the FFI Agreement may result in enhanced compliance verification requirements, such as an external audit of one or more issues identified by the IRS.

Section 1472 provides for a 30 percent withholding tax on withholdable payments to NFFEs that do not comply with certain reporting requirements. In general, in order to avoid 30 percent FATCA withholding, an NFFE (other than an excepted NFFE) must provide the withholding agent with a certification that the NFFE (or another NFFE) is a beneficial owner that does not have any “substantial U.S. owners,”⁵ or the name, address and U.S. Taxpayer Identification Number (TIN) of each substantial U.S. owner, along with other information about the account and the NFFE, which must be reported to the IRS by the withholding agent.

The proposed regulations describe entities that are treated as excepted NFFEs (for which the 30 percent withholding is not required) if the withholding agent can treat the payment as beneficially owned by such entity. These entities include certain corporations that are regularly traded on an established securities market, certain affiliated entities related to a publicly traded corporation, certain entities owned by one or more individual residents of a U.S. possession and organized under the laws of the same U.S. possession, exempt beneficial owner entities, active NFFEs (referring to an NFFE if less than 50 percent of its gross income is passive income and less than 50 percent of the NFFE’s assets produce passive income), certain nonfinancial holding companies, certain start-up companies (but this classification expires 24 months after the initial organization of such entity), nonfinancial entities that are liquidating or emerging from reorganization or bankruptcy, hedging/financing centers of a nonfinancial group and entities described in Section 501(c).

The recently issued proposed regulations under FATCA contain rules and preliminary guidance regarding the

³ A “passthru payment” is defined as a withholdable payment, as well as a payment attributable to a withholdable payment if such payment is made to a non-participating FFI or to a “recalcitrant” individual account holder who fails to provide sufficient information to determine whether or not he or she is a U.S. person (or a foreign entity account holder that fails to provide sufficient information about the identify of its substantial U.S. owners), or who fails to provide waivers of foreign law prohibiting such information reporting by the FFI.

⁴ Generally, a Qualified Intermediary is a person that is a party to a withholding agreement with the IRS and otherwise satisfies the requirements of Reg. § 1.441-1(e)(ii).

⁵ A substantial U.S. owner includes (a) “specified U.S. persons” who directly or indirectly own more than 10 percent of the stock (by vote or value) of a foreign corporation; (b) specified U.S. persons who directly or indirectly own more than 10 percent of a profits or capital interest in a foreign partnership; (c) specified U.S. persons who are treated as the owner of a grantor trust or who directly or indirectly hold more than 10 percent of the beneficial interests in a trust; and (d) specified U.S. persons who own any percentage of certain insurance companies or investment vehicles that are primarily engaged in an investing or trading business. A “specified U.S. person” is any U.S. person but the term excludes certain categories of U.S. persons, including real estate investment trusts, regulated investment companies and entities registered with the SEC under the Investment Company Act of 1940. The entire list of excluded U.S. persons is provided in Prop. Treas. Reg. § 1.1473-1(c).

implementation of FATCA, which had been outlined in three previous IRS Notices. Notice 2010-60, released on August 29, 2010, contained descriptions of a number of detailed rules and definitions forming much of the FATCA framework, including the definition of an FFI, the scope of collection of information and identification of U.S. account holders by FFIs, and exemptions from the withholding requirements. Notice 2011-34, released on April 8, 2011, modified several of the rules in Notice 2010-60 and provided detailed procedures for identifying U.S. accounts of participating FFIs, guidance on the concept of a “passthru” payment, categories of FFIs that may be treated as deemed-compliant FFIs and an explanation of the rules for expanded affiliated groups. Notice 2011-53, released on July 14, 2011, provided for a timeline for the phased implementation of key aspects of FATCA. The proposed regulations not only incorporate the guidance described in the FATCA Notices but also revise and refine those rules to provide exemptions and carve-outs from FATCA where there is a low risk of tax evasion, staggered timelines for implementing the various components of the rules and guidance on topics that were not addressed in the Notices.

Highlights of the proposed regulations are discussed in the following paragraphs:

“Grandfathered Obligations” Expanded

Originally, any obligation outstanding on March 18, 2012, was grandfathered and not subject to FATCA reporting and withholding. An “obligation” for this purpose is any legal agreement that produces or could produce a withholdable payment or “passthru payment,” other than an instrument treated as equity for U.S. tax purposes or lacking a stated expiration or term, such as a savings deposit or demand deposit. However, “obligation” does not include an agreement to hold financial assets for the account of others and to make and receive payments of income and other amounts with respect to such assets (e.g., brokerage or custodial agreements) or an agreement that merely set forth general and standard terms and conditions and that does not set forth all of the specific terms necessary to conclude a particular contract.

To facilitate implementation of FATCA, the proposed regulations exclude from the definition of withholdable payment and passthru payment any payment made under an obligation outstanding on January 1, 2013, and any gross proceeds from the disposition from such obligation. However, although grandfathered obligations are exempt from FATCA reporting and withholding, a material modification of a grandfathered obligation will result in its being treated as newly issued on the date of the material modification, based on all relevant facts and circumstances.⁶

Due Diligence Requirements

In order to comply with FATCA reporting requirements, participating FFIs must identify and report U.S. accounts in accordance with detailed due diligence procedures. The account identification and documentation requirements provided in the proposed regulations generally follow the procedures described in Notice 2011-34, but with certain modifications made in response to comments to reduce the administrative burden on FFIs. The due diligence procedures require participating FFIs to identify U.S. accounts, recalcitrant account holders and accounts held by nonparticipating FFIs. Those procedures also delineate additional requirements for participating FFIs to be treated as compliant under their FFI Agreements and avoid strict liability, and distinguish between the diligence expected with respect to individual accounts and entity accounts and with respect to preexisting accounts and new accounts.

⁶ For this purpose, a “material modification” of an obligation that is treated as a debt instrument for U.S. tax purposes is any “significant modification” of the terms of the instrument (as defined under Reg. §1.1001-3). For all other non-debt instruments, whether a modification is a “material modification” is determined based on all of the relevant facts and circumstances.

For preexisting individual accounts, the following guidelines apply:

- Accounts with a balance or value not exceeding \$50,000 are exempt from documentation.
- Documentation exceptions and aggregation rules apply for certain accounts that are offshore obligations (other than cash value insurance or annuity contracts) with a balance or value of \$50,000 or less and for cash value insurance or annuity contracts with a balance or value of \$250,000 or less.
- Accounts that are offshore obligations with a balance or value that exceeds \$50,000 but that do not exceed \$1 million are subject only to review of electronically searchable data for indicia of U.S. status.
- Accounts with a balance exceeding \$1 million are subject to review of electronic files (and non-electronic files to the extent that electronic files do not contain sufficient information about the account holder) for U.S. indicia, including an inquiry of the actual knowledge of any relationship manager associated with the account.

For preexisting entity accounts, the following guidelines apply:

- Accounts with a balance or value not exceeding \$250,000 are exempt from documentation requirements until the balance exceeds \$1 million.
- For remaining entities, anti-money laundering (AML) and Know-Your-Customer (KYC) records and other existing account information can be relied upon to determine the type of entity to which the account belongs (e.g., whether the entity is an FFI, a U.S. person or a passive investment entity). Depending on the account balance and type of entity, different identification procedures of substantial U.S. owners are required.

For new individual accounts (opened after the effective date of an FFI's agreement), review of the information provided at the time the account is opened is required, and if U.S. indicia are identified, additional documentation must be obtained or the FFI must treat the account as held by a recalcitrant account holder.

For new entity accounts, the following guidelines apply:

- Accounts of another FFI (other than an owner-documented FFI for which the participating FFI has agreed to perform reporting) are exempt from documentation of substantial U.S. owners.
- Accounts of an entity engaged in an active nonfinancial trade or business are excepted from documentation requirements.
- For remaining passive investment entities, FFIs will be required to determine whether the entity has any substantial U.S. owners upon opening a new account.

The proposed regulations reduce the compliance burden for FFIs, while continuing to target accounts that may be connected to tax evasion, by eliminating the private banking test provided in Notice 2011-34 and instead focusing on high-value accounts. Specifically, an enhanced review of high-value accounts is required (i.e., an enhanced review of an account with a balance or value that exceeds \$1 million at the end of the calendar year applying certain aggregation rules). The enhanced review includes the requirement of a relationship

manager inquiry to identify those high-value accounts for which the manager has actual knowledge that the account holder is a U.S. person. For such accounts, the participating FFI must obtain certain documentation, including Form W-9, within one year of the FFI agreement effective date or treat the account as a recalcitrant account. As part of this inquiry, a manager is required to identify any change in circumstance with the account.

For those accounts that are not identified as U.S. accounts as part of the relationship manager inquiry, and to the extent sufficient information is not available in electronic form, a participating FFI must perform a review of the current customer master file and the documents associated with the account that were obtained by the participating FFI in order to look for U.S. indicia and obtain documentation to establish that the account is a U.S. account. A responsible officer of a participating FFI must make certain certifications to the IRS, including a certification that it has completed the review of its high-value accounts as required under the rules, as well as a certification that the participating FFI has not had, since August 6, 2011, any practices or procedures in place to assist account holders in avoiding FATCA.

Transitional Rules for Affiliated Groups

In general, the FFI agreement applies to the U.S. accounts of the participating FFI and to the accounts of each other FFI that is a member of the same expanded affiliated group (referring to common ownership of more than 50 percent). Notice 2011-34 stated that each FFI that is a member of an expanded affiliated group must be a participating FFI or deemed-compliant FFI in order for any FFI in the expanded affiliated group to become a participating FFI. However, because some jurisdictions may have laws in place that prohibit an FFI's compliance under FATCA, the proposed regulations loosen this requirement through a two-year transition rule.

Thus, a transitional FFI agreement may apply to a participating FFI even if one or more of its branches or affiliates cannot, under local law, satisfy the requirements of the FFI Agreement, if such branches or affiliates qualify as "limited branches" or "limited FFIs" under which each member of the expanded affiliated group must register with the IRS and agree to comply with certain requirements as part of its registration process. As part of this rule, a participating FFI must withhold on certain withholdable payments that it is considered to receive on behalf of such limited branches or affiliates. In addition, the limited branch or limited FFI must hold itself out as a non-participating FFI with respect to payments it receives. The transitional relief expires the earlier of December 31, 2015, or the date the branch or affiliate is no longer prohibited from complying with the requirements of the FFI agreement.

Deemed-Compliant FFIs

Certain FFIs may be deemed compliant under FATCA and excepted from the reporting and withholding requirements of FATCA, provided that certain requirements are met. Notice 2011-34 identified certain FFIs that would be treated as excepted FFIs and not required to enter into FFI Agreements in order to avoid FATCA, subject to restrictions designed to prevent such FFIs from being used for U.S. tax evasion. The proposed regulations would expand the categories of deemed-compliant FFIs to include i) registered deemed-compliant "local" banks, non-reporting members of a participating FFI's affiliated group, qualified collective investment vehicles, restricted investment funds whose interests are sold through certain distributors and FFIs that comply with the requirements of an agreement between the U.S. and a foreign government that, in each case, register with the IRS, meet various requirements for their deemed-compliant status and renew their certification every three years; and ii) certified (but non-registering) deemed-compliant "local" banks, retirement funds, non-profit organizations, certain owner-documented FFIs and FFIs with only low-value accounts that meet various

criteria and that certify their qualification as deemed-compliant FFIs by providing certain documentation to a withholding agent.

Definition of Financial Account

The statute defines the term “financial account” as including depository accounts, custodial accounts and equity or debt interests in a financial institution (other than interests that are regularly traded on an established securities market). In addition to these three categories, the proposed regulations also include cash-value insurance contracts and annuity contracts issued by financial institutions. The proposed regulations exclude from the definition of financial account life insurance contracts that do not have a cash value, certain tax-favored retirement or pension fund-related savings accounts, and accounts held by exempt beneficial owners.

Phase-In of Scope of Passthru Payments

Participating FFIs must withhold with respect to a passthru payment that is a “withholdable payment” and an “amount attributable to a withholdable payment” made to recalcitrant account holders, nonparticipating FFIs and a participating FFI that has made an election to be withheld upon. Notice 2011-34 provided that a passthru payment made to a recalcitrant account holder or a non-participating FFI will be subject to 30-percent withholding to the extent of the amount of the payment that is a withholdable payment, plus the amount of the payment that is not a “withholdable payment” (i.e., the amount attributable to a withholdable payment) multiplied by a passthru payment percentage.

After the release of Notice 2011-34, commentators expressed concern about the cost and difficulty associated with identifying and withholding on passthru payments. In response to concerns about the passthru payment regime, the IRS has pushed back withholding on “amounts attributable to withholdable payments” (now referred to as “foreign passthru payments”) until 2017, but retained the requirement for participating FFIs to withhold on passthru payments that are “withholdable payments” beginning on January 1, 2014 (for FDAP payments) and January 1, 2015 (for gross proceeds). However, participating FFIs are required to report annually to the IRS the aggregate amount of certain payments made to each nonparticipating FFI during 2015 and 2016.

Refunds

The proposed regulations provide that a beneficial owner of a payment to which an amount of withheld tax is attributable may claim a refund or credit from the IRS for an overpayment of tax withheld. Under these rules, however, a non-participating FFI beneficial owner may claim a refund or credit only to the extent it is entitled to a reduced rate of withholding pursuant to an income tax treaty (although no interest will be allowed with respect to the credit or refund) and an NFFE that is a beneficial owner must certify that it does not have substantial U.S. owners or provide some documentation that withholding is not required in order to qualify for a refund or credit unless it is entitled to a reduced rate of withholding pursuant to an income tax treaty.

Foreign Government Cooperation to Develop Alternative Approach to Collecting and Reporting FATCA Information

Along with the proposed regulations, the U.S. Treasury also announced a groundbreaking framework under which the United States, France, Germany, Italy, Spain and the United Kingdom will develop an alternative approach to FATCA through automatic exchanges of information and addressing the objectives of passthru payment withholding. This intergovernmental approach is intended to help financial institutions deal with costs

(estimated to be \$100 million for each multinational bank), administrative burdens and legal impediments (e.g., data protection, reporting restrictions) in applying the FATCA provisions. The U.S. government is approaching more countries regarding this new approach to sharing information.

The intergovernmental framework outlines the following objectives:

- The U.S. would enter into an agreement with a partner country (FATCA partner) under which each FATCA partner would implement legislation to require FFIs in its jurisdiction to apply necessary diligence in order to collect and report to the tax authority of the FATCA partner the required information, which would be automatically transferred to the United States.
- The U.S. government would allow certain FFIs to avoid entering into an FFI Agreement with the IRS, and would establish categories of FFIs that would not be subject to U.S. withholding on payments to them and that would be allowed to report FATCA information to the FATCA partner jurisdiction rather than to the IRS.
- The U.S. government would commit to automatic reciprocal collection and reporting of information to FATCA partners.
- FFIs established in the FATCA partner would not be required to (i) terminate the accounts of recalcitrant account holders, (ii) impose passthru payment withholding on recalcitrant account holders or (iii) impose passthru payment withholding on payments to other FFIs organized in any FATCA partner jurisdiction.
- Each FATCA partner would commit to the development of alternative approaches to achieving the policy objectives of passthru payment withholding that would minimize any associated administrative burden and would work with appropriate partners to adapt FATCA to a common model for automatic exchange of information, including the development of reporting and due diligence standards.

Phase-In of Withholding and Reporting Obligations

The proposed regulations extend the phased implementation of the requirements for withholding and information reporting pertaining to U.S. accounts. Important dates related to the implementation of FATCA include:

January 1, 2013

- The IRS will begin accepting FFI Applications through its electronic submissions process. FFI agreements with respect to applications submitted before June 30, 2013, will be effective on July 1, 2013. FFI agreements with respect to applications submitted after June 30, 2013, will be effective as of the date entered into.
- Obligations outstanding on January 1, 2013, and gross proceeds from the sale of such obligations, are not subject to FATCA reporting and withholding.

January 1, 2014

- FATCA withholding on U.S. source FDAP payments (including passthru payments that are U.S. source FDAP withholdable payments) begins on January 1, 2014.

January 1, 2015

- FATCA withholding on payments of gross proceeds begins on January 1, 2015.

January 1, 2014

- FFI reporting of the name of account holders and account balances begins in 2014 and 2015 (with respect to the 2013 and 2014 years).

January 1, 2016

- FFI reporting of account holder income begins in 2016 (with respect to 2015).

January 1, 2017

- FFI reporting of gross proceeds begins in 2017 (with respect to 2016).

January 1, 2017

- FFI withholding on “foreign passthru” payments will begin no earlier than January 1, 2017.

Final Guidance

The Treasury is currently working to release a draft model FFI agreement in the first half of 2012. The proposed regulations will apply on the date the final regulations are published, which is expected to be in the summer of 2012. The Treasury intends to modify the existing Qualified Intermediary agreement, as well as the foreign Withholding Partnership and Foreign Withholding Trust agreements, and to amend other related documentation forms to incorporate the FATCA obligations.

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Alston & Bird LLP is pleased to assist you with respect to the matters covered in this Client Alert. Please contact Edward Tanenbaum (212-210-9425, edward.tanenbaum@alston.com), Jim Croker (202-239-3309, jim.croker@alston.com), Clay Littlefield (704-444-1440, clay.littlefield@alston.com) or Matthew Stevens (202-239-3553, matthew.stevens@alston.com).

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