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International Tax ADVISORY ■

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Notice Announces FATCA Enforcement Relief for 2014 and 2015 and Regulatory Amendments to Ease Implementation

On May 2, 2014, the IRS released Notice 2014-33, setting out additional guidance on the implementation of the Foreign Account Tax Compliance Act ("FATCA" or "Chapter 4 of the Code"). Significantly, the notice provides that calendar years 2014 and 2015 will be considered transitional for IRS enforcement and administration purposes with respect to FATCA compliance. The notice also announces several amendments to the FATCA regulations, which are intended to facilitate compliance.

Enacted by the 2010 HIRE Act, FATCA generally requires FFIs and non-financial foreign entities (NFFEs) to report certain information about their U.S. account holders and substantial U.S. owners, respectively, or be subject to a 30 percent withholding tax. The effective date for FATCA withholding still stands at July 1, 2014. This notice is the latest in the ongoing flurry of FATCA guidance issued by the U.S. Treasury and IRS to cover all the bases for implementation before July 1.

Transition Period for 2014 and 2015

The notice offers a welcome announcement that 2014 and 2015 will be regarded as transitional for IRS enforcement of the diligence, reporting and withholding provisions of FATCA, as well as provisions under Chapter 3, Chapter 61 and Section 3406, to the extent modified by temporary coordination regulations. During the transition period, the IRS will take into account the extent to which a participating or deemed-compliant FFI, direct reporting NFFE, sponsoring entity, sponsored FFI or direct reporting NFFE, or withholding agent had made good faith efforts to comply with Chapter 4 and the coordination regulations. Absent good faith efforts at compliance, an entity will not receive relief from the IRS. Moreover, the IRS will not regard 2014 and 2015 as transitional with respect to obligations of Chapters 3 and 61 and Section 3406 that were not affected by the coordination regulations issued on February 20, 2014.

Treatment of Entity Obligations Issued, Opened or Executed On or After July 1, 2014

The Chapter 4 regulations currently require withholding agents (other than participating or deemed-compliant FFIs) to implement new, FATCA-compliant account opening procedures beginning July 1, 2014. Participating and registered deemed-compliant FFIs are to implement such procedures on the later of July 1, 2014, or the effective date of their FFI agreement or FATCA registration, respectively. In consideration of comments citing the late release dates of final Forms W-8 and instructions, the regulations will be amended to allow a withholding agent or FFI to treat an obligation held by an entity that is issued, opened or executed on or after July 1, 2014, and before January 1, 2015, as preexisting for purposes of Chapter 4. This change generally means that withholding agents and FFIs will have more time to document an entity payee or accountholder to determine whether Chapter 4 withholding applies.

The notice also states that future FATCA intergovernmental agreements (IGAs), specifically Annex 1 thereof, will incorporate updated diligence procedures and timelines consistent with the notice. Partner jurisdictions that have already signed IGAs may still benefit from these updates under the "most favored nation" provision in their respective IGAs. Further, given that IGAs permit reliance on the regulations' procedures for identifying U.S. reportable accounts or accounts of NPFFIs, Model 1 and reporting Model 2 FFIs are entitled to rely on the notice prior to the publication of amendments to such regulations.

Modified Standard of Knowledge under Chapter 3 and Reasonable Explanation under Chapter 4

The notice announces that the temporary coordination regulations will be amended to mesh withholding agents' new reason to know standard, relating to U.S. telephone number and U.S. place of birth, under Chapter 4 with the regulations' transition rules for Chapter 3. Additionally, the notice states that the definition of reasonable explanation of foreign status, as defined in the Chapter 4 regulations, will be modified to conform to the scope described for Chapter 3 purposes in the coordination regulations.

Limited FFIs and Limited Branches

Under the regulations, for any member of an "expanded affiliated group" (EAG) to have participating or registered deemed-compliant FFI status, each FFI member of the EAG must be a participating GGI, deemed-compliant FFI, exempt beneficial owner, or limited FFI. Additionally, the Chapter 4 rules provide that an FFI or branch of a participating FFI can be treated as a limited FFI or limited branch if it registers with the IRS and agrees to certain conditions (e.g., the FFI or branch does not open accounts required to be treated as U.S. accounts or accounts held by nonparticipating FFIs). Stakeholders have expressed concern that the Chapter 4 restrictions on a limited FFI or limited branch may conflict with provisions of local law in non-IGA jurisdictions (e.g., requirements to provide access to resident individuals). In response (and consistent with the terms of the model IGAs), the Chapter 4 regulations will be amended to allow a limited FFI or limited branch to open U.S. accounts for individuals and nonparticipating FFIs resident in the jurisdiction where the FFI or branch is located—provided that the limited FFI or limited branch does not solicit U.S. accounts from persons not resident in its jurisdiction and the FFI or branch is not used by other FFIs in its EAG to circumvent FATCA. Additionally, the regulations will be amended to provide that, if any FFI is prohibited by local law from registering with the IRS as a limited FFI, such prohibition will not prevent members of its EAG from obtaining participating or registered deemed-compliant status—provided that the FFI is identified as a limited FFI on the FATCA registration website by a member of the EAG that is a U.S. financial institution or a participating, reporting Model 2 or Model 1 FFI.

IRS Announces Tightened "Killer B" Regulations

In Notice 2014-32, the IRS announced modifications and clarifications to be made to the "Killer B" regulations under Section 367(b), as finalized in 2011. The amendments, effective for triangular reorganizations completed on or after April 25, 2014, will eliminate the deemed contribution rule, modify provisions exempting certain triangular reorganizations and "clarify" the anti-abuse rule. These changes reflect the IRS' belief that taxpayers have been misinterpreting, if not exploiting, the Killer B regulations in ways that are inconsistent with their policy. However, it is debatable whether the changes themselves are founded in sound tax policy—or simply the IRS' exalting ends above means.

Background

Section 367(a) treats a U.S. person's transfer of appreciated property to a foreign corporation in an exchange under Sections 332, 351, 354, 356 or 361 as a taxable transaction, unless an exception applies. Section 367(b) provides that a foreign corporation shall be treated as a corporation for purposes of these non-recognition exchange provisions unless the regulations provide otherwise to prevent tax avoidance. In 2011, the IRS finalized regulations under Section 367 applicable to triangular reorganizations in which a subsidiary (S) acquires stock of its parent (P) in exchange for property, S exchanges the P stock for stock or assets of a target (T), and S or P or both are foreign. The 2011 regulations, which culminated several years' of IRS guidance, were aimed at curbing the use of triangular reorganizations (in particular, "Killer B" reorganizations) to repatriate earnings with little or no tax consequence.

Elimination of the Deemed Contribution Rule

In the case of a triangular reorganization subject to Section 1.367(b)-10, the 2011 regulations require P and S to make adjustments consistent with those that would have been made had (i) S distributed property to P under Section 301 (the "deemed distribution") and (ii) P contributed property to S (the "deemed contribution"). The amount of the deemed distribution and deemed contribution is generally the amount of property transferred by S to acquire the P stock. These deemed transactions are generally treated as occurring separate from and prior to S's acquisition of the P stock, as well as before the triangular reorganization.

The notice provides that the IRS will eliminate the deemed contribution rule from the regulations (and make corresponding revisions). Moreover, the deemed distribution rule will be modified to provide that the adjustment to P's basis in its S stock will be determined as if P provided its stock or securities pursuant to the plan of reorganization, notwithstanding the fact that S in fact acquired the P stock or securities in exchange for property.

Clarification of the Exemption Rules

The 2011 regulations do not apply to a triangular reorganization if (i) P and S are foreign and neither is a controlled foreign corporation (CFC) immediately before or immediately after the reorganization; (ii) S is domestic, P's stock in S is not a "U.S. real property interest" (USRPI) under Section 897, and P would not be subject to U.S. tax on a dividend from S under either Section 881 or 882 (e.g., by application of a treaty or for lack of earnings and profits or "E&P") (the "no-U.S.-tax exception"); or (iii) in an exchange under Section 354 or 356, one or more U.S. persons exchange T stock or securities and the amount of gain recognized by such persons under Section 367(a) is equal to or greater than the sum of the amounts of the deemed distribution that would be treated by P as a dividend or gain from the sale or exchange of property under Section 301(c) ("Section 367(b) income") if the regulations otherwise applied (the "Section 367(a) priority rule"). As a corollary, the regulations provide that Section 367(a)(1) will not apply to a Section 354 or 356 exchange in connection with a triangular reorganization if the gain recognized under Section 367(a)(1) is less than the Section 367(b) income recognized under the regulations (the "Section 367(b) priority rule").

The notice indicates that the IRS is aware that the priority rules may enable transactions designed to avoid tax. For example, a foreign P forms S, a domestic subsidiary, which generates a small amount of E&P. S then acquires T, a domestic corporation, using P stock that S acquired in exchange for a note. The stock in S is not a USRPI, and P would not be subject to tax on a disposition of S stock. However, the transaction results in a small amount of dividend income due to S's E&P and significant Section 367(b) income in the form of Section 301(c)(3) gain. The taxpayer takes the position that the no-U.S.-tax exception does not apply due to the dividend income, and that the Section 367(b) priority rule applies because the income recognized by P by reason of Section 1.367(b)-10 exceeds the gain that would be recognized by the T shareholders with respect to their T stock—even though the Section 301(c) gain recognized by P would not be subject to U.S. tax. (The taxpayer also contends that the anti-abuse rule is inapplicable.)

The notice, citing underlying policy concerns, states that the priority rules will be modified to provide that Section 367(b) income only includes Section 301(c) dividends and gains that are subject to U.S. tax (or inclusion under subpart F). Additionally, the notice provides that the no-U.S.-tax exception will not be available if P is a CFC. Further, where P is not a CFC, S is a domestic corporation and the stock of S is not a USRPI, the regulations will clarify that the no-U.S.-tax exception will apply if the deemed distribution that would result under Section 1.367(b)-10 would not be treated as a Section 301(c) dividend that is subject to U.S. tax (e.g., by reason of a treaty or for lack of E&P).

Clarification of the Anti-Abuse Rule

The 2011 regulations require "appropriate adjustments" to be made if, in connection with a triangular reorganization, a transaction is engaged in to avoid the purpose of Section 1.367(b)-10 (the "anti-abuse rule").

The notice's "clarifications" to the anti-abuse rule clearly indicate that the IRS intends the rule to apply more broadly than taxpayers have so far believed. The notice provides that the anti-abuse rule will be clarified to provide that S's acquisition of P stock or securities in exchange for a note may trigger the anti-abuse rule. Moreover, the regulations will be clarified to provide that the E&P of a corporation (or successor) may be taken into account to determine the consequences of the adjustments required by the regulations, as modified by the notice, regardless whether such corporation is related to P or S prior to the triangular reorganization. For example, T's E&P may be considered. Lastly, the regulations will be clarified to provide that funding of S may occur after the reorganization and includes capital contributions, loans and distributions.

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