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International Tax ALERT ■

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# Final FATCA Regulations Are Finally Here

On January 17, 2013, the U.S. Treasury and the IRS issued long-awaited final regulations under the Foreign Account Tax Compliance Act (FATCA) provisions in Code Sections 1471 to 1474 (also known as "Chapter 4"). Enacted as part of the Hiring Incentives to Restore Employment Act of 2010, FATCA generally requires foreign financial institutions (FFIs) to agree to report information on their U.S. account holders or else be subject to a 30-percent withholding tax on "withholdable payments" made to them—i.e., certain U.S. source income and payments of gross proceeds from the disposition of assets generating U.S. source dividends and interest. FFIs themselves must withhold 30 percent on "passthru" payments (i.e., withholdable payments and "foreign passthru" payments) made to nonparticipating FFIs and recalcitrant account holders. FATCA also imposes a 30-percent withholding tax on withholdable payments to nonfinancial foreign entities (NFFEs) that do not disclose their substantial U.S. owners. In addition to clarifying aspects of the proposed regulations, the final rules reflect a targeted, risk-based approach to limit Chapter 4's scope and ease compliance burdens, while serving FATCA's policy goal to combat international tax evasion by U.S. taxpayers through improved information reporting.

## Background

The Treasury and the IRS issued proposed regulations under Chapter 4 in February 2012, offering a decent roadmap for affected FFIs to start developing or enhancing their systems and policies to comply with FATCA. The IRS also released other preliminary guidance, including Notices 2010-60, 2011-34 and 2011-53, as well as Announcement 2012-42, to clarify and modify the requirements under the Code and later the proposed rules. Meanwhile, Treasury has promulgated the intergovernmental agreement (IGA) regime as an alternative to the regulatory provisions to facilitate FATCA implementation through governmental cooperation. (Previous advisories covered the basic aspects of the proposed regulations, preliminary administrative guidance and the IGAs.)

## The Final Regulations

While the final regulations incorporate many of the provisions in the proposed regulations and preliminary guidance, they also provide additional details and other modifications. Some key features of the final rules include postponed compliance timeframes, updated procedural guidelines, expanded grandfathering rules, revised definitions affecting the scope of Chapter 4 rules and simplified administrative burdens. The final regulations also reflect greater harmonization with the burgeoning IGA regime.

## Postponed Effective Dates and Transitional Relief

The final regulations modify the effective dates for a number of requirements, in large part conforming to the phased-in or postponed timelines in the IGAs and Announcement 2012-42:

Generally, U.S. withholding agents and FFIs must withhold on U.S.-source fixed and determinable, annual and periodic (FDAP) income starting January 1, 2014, unless they have proper documentation. However, the final rules offer relief from withholding for payments made before January 1, 2016, with respect to certain preexisting obligations (obligations outstanding on January 1, 2014) held by an FFI except to payees that are prima facie FFIs or nonparticipating FFIs. Withholding on payments with respect to preexisting obligations to a prima facie FFI must start on July 1, 2014, if the FFI has not indicated that it is a participating FFI. The final regulations also provide relief from withholding on payments made before January 1, 2015, with respect to preexisting obligations held by an NFFE if there is no documentation indicating the NFFE's status as a "passive" NFFE with "substantial U.S. owners."

While FFIs must withhold on "passthru payments" as described above, the regulations reserve on the definition of "foreign passthru payment." An obligation will not give rise to a foreign passthru payment if executed on or before the date six months after regulations defining that term are published. Further, no withholding will be required on gross proceeds from sales or dispositions of property that occur before January 1, 2017. Reporting with respect to gross proceeds of U.S. accounts starts in 2017, with respect to the 2016 calendar year.

Participating FFIs have until December 31, 2015, to document all preexisting account holders (that are not prima facie FFIs) and may report on U.S. accounts maintained during both 2013 and 2014 by March 31, 2015.

## FATCA Procedural Guidelines

Although formal procedures are not fully finalized, the preamble to the final regulations announces a web-based FATCA Registration Portal for FFIs to register with the IRS, manage their registration information and acknowledge their agreement to comply with the FATCA requirements applicable to their status (e.g., participating FFI or deemed-compliant FFI). Registration will begin no later than July 15, 2013. After approval of the registration, the IRS will assign a Global Intermediary Identification Number (GIIN) to each registered participating or deemed-compliant FFI starting October 15, 2013. The IRS will electronically publish a list of participating FFIs and registered deemed-compliant FFIs on December 2, 2013, updating the list on a monthly basis thereafter. To make the December 2013 list, FFIs must register by October 25, 2013. IRS has said that a formal Revenue Procedure setting out these and other terms consistent with the final rules is forthcoming. The Revenue Procedure would also address coordination of FFIs' obligations under Chapter 4, the regular withholding tax rules under Chapter 3 of the Code (e.g., Sections 1441 and 1442) and any applicable IGAs.

## Expanded Grandfathered Obligations

The final regulations widen the scope of grandfathered obligations not subject to FATCA withholding. Under the final regulations, a grandfathered obligation now includes (1) any obligation outstanding on January 1, 2014; (2) any obligation that gives rise to a dividend equivalent payment under Code Section 871(m), if executed on or before the date six months after the date the obligation is treated as producing a dividend equivalent payment under final regulations; (3) any obligation that gives rise to foreign passthru payments, if executed on or before the date six months after the regulations defining "foreign passthru payment" are published; and (4) any agreement that requires collateral to secure a grandfathered obligation (even if the collateral itself is not grandfathered). Collateral securing both grandfathered and non-grandfathered obligations must be allocated. Under the regulations, a withholding

agent that is not the issuer may rely on a written statement of the issuer to determine whether an obligation is grandfathered and treat a modification of the obligation as material only if it has reason to know (i.e., the issuer provides the agent with a disclosure statement).

## Coordination with Intergovernmental Agreements

A significant aspect of the final regulations is coordination with the IGA regime that the Treasury has developed in the last year. The IGA framework reflects international cooperation in combating tax evasion by addressing jurisdictional legal impediments to FATCA compliance. In July and November of last year, the Treasury released the Model 1 IGA and the Model 2 IGA, respectively. In the Model 1 IGA (in reciprocal and nonreciprocal versions), FFIs report all appropriate information to the partner country, and the partner country then automatically exchanges the information with the IRS. Under the Model 2 IGA, partner countries enable their FFIs to register with and report directly to the IRS, with certain information on recalcitrant account holders reported on an aggregate basis and supplemented by Competent Authority exchange of information requests.

To date, several IGAs have been signed or initialed (including Denmark, Ireland, Mexico, Norway, Spain, Switzerland and the United Kingdom), and many more are being negotiated and considered. The final regulations provide that FFIs covered by and compliant with a Model 1 IGA will be treated as deemed-compliant with FATCA and need not apply the regulations themselves (though under some agreements, the regulatory regime may be electively applied). In contrast, FFIs governed by a Model 2 IGA generally must comply with the final regulations, unless the IGA expressly provides otherwise. The final rules have also revised certain terms in the proposed regulations to be consistent with the IGAs (e.g., the definition of "investment entity" discussed below).

## Revised Definitions and Provisions Affecting the Scope of FATCA

The final regulations modify several definitions that affect the scope of the Chapter 4 rules. The final rules, for instance, change the definitions relating to certain types of "financial accounts." The term "depository account," a financial account for placing money with an entity engaged in banking or similar business, now includes credit balances with credit card companies (subject to additional rules) and amounts held with an insurance company under a guaranteed investment contract or similar agreement to pay interest. However, certain escrow accounts for commercial transactions, certain negotiable debt instruments and certain advance premiums received by an insurance company are not depository accounts.

Under the final rules, FFIs generally include the following four types of institutions: depository institutions, custodial institutions, investment entities and specified insurance companies. Aside from changes relating to investment entity and insurance company FFIs (discussed more below), the final rules also expand certain favorable classifications under FATCA, such as exceptions to passive income, excepted FFIs, deemed-compliant FFIs and exempt beneficial owners. For example, under the regulations, passive income does not include (1) dividends, interest, rents or royalties from a related person if the income is allocable to nonpassive income of the payor, or (2) certain income of dealers earned in the ordinary course of their business. Certain entities that provide financial services only within a group of nonfinancial businesses may be considered excepted NFFEs rather than FFIs (e.g., treasury centers, holding companies and captive finance companies), unless formed or availed of by private equity type funds. The regulations also broaden the exception for nonfinancial start-up companies to include all active NFFEs entering a new line of business (other than investment funds or vehicles) and add the category "excepted inter-affiliate FFIs" (helpful for dormant entities or special purpose entities of a group). The final rules extend exempt beneficial owner status to persons treated as such under an IGA and to more types of non-U.S. pension funds. However, the regulations restrict exempt status for other

categories of exempt beneficial owners (e.g., foreign governments, international organizations, foreign central banks of issue and governments of U.S. territories) with respect to payments from certain commercial financial activities unless certain conditions are met.

New categories of registered and certified deemed-compliant FFIs have been added in the final regulations. Registered deemed-compliant FFIs must register with the IRS through the Registration Portal, certify compliance every three years and alert the IRS within six months if they no longer satisfy the criteria for registered deemed-compliant FFIs. This category now includes reporting FFIs under a Model 1 IGA, reporting FFIs under certain Model 2 IGAs, local FFIs, nonreporting members of participating FFI groups, qualified collective investment vehicles (CIVs), restricted funds, qualified credit card issuers, and sponsored investment entities and controlled foreign corporations. Certified deemed-compliant FFIs include nonregistering local banks of limited size, FFIs with only low-value accounts (less than $50,000 balance or value), sponsored closely-held investment vehicles and, prior to 2017, limited life debt investment entities.

***Provisions Relating to Banking Institutions***

The final regulations comprise a number of new provisions affecting banking institutions. For example, an FFI is a "depository institution" if it accepts deposits in the ordinary course of a banking business. Under the final regulations, "banking business" encompasses, among other activities, making loans or extending credit, buying or selling notes or obligations, issuing letters of credit, providing fiduciary services, financing foreign exchange transactions and buying or disposing finance leases or leased assets. (This definition is broader than the one under Section 581 of the Code.) An exception exists for entities that accept deposits solely as collateral pursuant to a sale or lease of property or a similar financing arrangement.

The regulations also provide special rules for some U.S. branches of participating FFIs. U.S. branches treated as U.S. persons have special due diligence, reporting and withholding requirements under FATCA similar to those of U.S. financial institutions, including filing a separate Form 1042 for FATCA. U.S. branches not treated as U.S. persons are subject to the general regulatory requirements.

***Provisions Relating to Insurance Companies***

In addition to insurance-related refinements to the definition of "depository account," the final rules simplify other terms such as "annuity contract," "life insurance contract" and "insurance company," using plain language and references to local law, and offer new definitions for certain annuity contracts, clarifying when certain insurance contracts qualify as financial accounts. Under the regulations, cash value insurance contracts (but not annuity contracts) with a value less than $50,000 at all times during the year, indemnity reinsurance agreements, certain annuities monetizing retirement or pension accounts, and certain term life insurance contracts are no longer considered financial accounts subject to FATCA. In contrast, preexisting cash value insurance or annuity contracts with a balance or value less than $250,000 are financial accounts, but exempted from certain documentation rules. "Local FFI" deemed-compliant status can now apply to insurance companies that meet certain requirements. The final rules also reduce some insurance-related due diligence and reporting burdens.

***Provisions Relating to Investment Entities and Funds***

The definition of FFI in the final rules includes "investment entities," an IGA concept imported, with significant changes, to the regulations. The IGA definition of "investment entity" includes an entity whose primary business is, on behalf of customers, (i) trading in financial instruments; (ii) providing individual or collective portfolio management; or (iii) otherwise investing, reinvesting, administering or managing funds, money or certain financial assets on behalf of

other persons. The final regulations broaden the definition to comprise two additional types of investment entities: (1) entities whose gross income is primarily attributable to investing, reinvesting or trading, based on a bright-line test (even if not on behalf of customers) if they are professionally managed by a depository or custodial institution, insurance company or another investment entity; and (2) entities that function or hold themselves out as a CIV, mutual fund, private equity fund, hedge fund or similar investment vehicle. (Passive, noncommercial investment vehicles, such as non-professionally managed trusts, are considered "passive NFFEs," rather than FFIs.) Generally, debt and equity interests in an investment entity constitute "financial accounts" subject to FATCA, unless the interests are regularly traded on an established securities market and provided that their value is not determined by assets that give rise to withholdable payments. Significantly, FFI includes investment entities that may not necessarily be custodial entities that actually hold the assets.

Funds with certain structures may benefit from the final regulations' new category of certified deemed-compliant FFI, sponsored closely-held investment vehicles. These entities include an investment entity managed by a sponsoring entity that is a participating FFI, reporting Model 1 IGA FFI or U.S. financial institution that registers with the IRS and agrees to fulfill all participating FFI obligations on behalf of the investment vehicle. The final rules also permit qualified CIVs and restricted funds that are registered deemed-compliant FFIs to have bearer obligations issued prior to December 31, 2012, outstanding for a limited period.

## Relaxed Diligence and Documentation Requirements

Under the final rules, due diligence and documentation burdens for FFIs and other withholding agents have generally been reduced. For example, de minimis thresholds for preexisting individual ($50,000 or less) and entity accounts ($250,000 or less) are exempt from documentation and diligence obligations altogether. For preexisting individual accounts of $1 million or less, only an electronic search for U.S. indicia is required. The regulations further provide that, under certain conditions, a new account of a customer with a preexisting account can be treated as preexisting.

The rules also expand the types of documentary evidence on which withholding agents can rely. In certain circumstances, withholding agents can rely on previously recorded information, written statements or evidence from payees or certain third parties, substitute forms not in English, and even old Forms W-8 for some preexisting accounts. A withholding agent may even employ presumption rules in lieu of documentation in some instances. The regulations also permit withholding agents to rely on a payee's claimed status by cross-checking the payee's GIIN with the IRS' published list of participating and registered deemed-compliant FFIs. The final rules authorize electronic transmission of documentation and withholding certificates within regulatory guidelines.

## FFI Agreements

The final regulations claim to set forth all substantive obligations for a participating FFI under an FFI agreement, including provisions for verifying compliance, defining events of default and remedial measures and procedures to be followed in the event an FFI is legally prohibited from reporting or withholding under an FFI agreement. Additionally, the rules provide that participating FFIs may file collective refund claims on behalf of certain accountholders. Participating FFIs may also terminate FFI agreements without restriction under the regulations. As mentioned above, a forthcoming Revenue Procedure is expected to clarify further the substantive and administrative provisions applicable to FFIs.

Alterations to the due diligence rules for participating FFIs are generally intended to be consistent with the IGAs. For example, an FFI agreement will include the regulatory requirements and any modifications thereto set forth in a Model 2 IGA. Importantly, except as otherwise provided in applicable IGAs, the final regulations maintain the requirement that, in order for any FFI that is a member of an expanded affiliated group (EAG) to be a participating FFI, each FFI that is a member of the EAG must be a participating or registered deemed-compliant FFI. However, there is transitional relief for this requirement: until December 31, 2015, subject to certain conditions, a participating FFI may maintain "limited branches" and "limited FFI" affiliates that are not participating FFIs without jeopardizing the status of any member of the EAG as an otherwise valid participating FFI.

As discussed above, the final regulations relax several documentation and diligence requirements for certain preexisting and new accounts, but there are some heightened obligations for participating FFIs. The responsible officer, the individual in charge of a participating FFI's FATCA implementation, must confirm the FFI's compliance with diligence requirements. The responsible officer must also certify, after reasonable inquiry, that the FFI did not have formal or informal practices or policies in place at any time since August 6, 2011, to assist accountholders in avoiding FATCA.

## Conclusion

The final regulations overall provide welcome clarity and simplification of the FATCA regime, but the rules are still comprehensive and quite complex. Forthcoming guidance in the way of revenue procedures, updated certification forms and draft FFI agreements, as well as other materials, will shed more light on Chapter 4 and the new final regulations' application, but some issues remain unresolved (e.g., the definition of "foreign passthru payments"). Moreover, further coordination of FATCA provisions with Chapter 3 withholding and Chapter 61 information reporting is needed. As the Treasury, the IRS and affected stakeholders confront the practical realities of implementation and compliance, more issues will undoubtedly surface.

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