IRS Publishes FATCA Guidance

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BACKGROUND

The Hiring Incentives to Restore Employment ("HIRE") Act, enacted earlier this year, includes a provision known as the Foreign Account Tax Compliance Act ("FATCA"), which is designed to police offshore investments, accounts and trust interests held by certain US persons. Although FATCA does not come into effect until 2013, it has already been the subject of rather intense attention and concern on the part of foreign entities — including banks, hedge funds and others — that must determine how to comply so as to avoid a potential new US withholding tax. In response thereto, the US Internal Revenue Service (the "IRS") recently issued a Notice (described below) containing some preliminary guidance in respect of the provisions.

Under FATCA, "foreign financial institutions" ("FFIs") that do not certify that they have no US account holders are required to enter into an agreement (an "FFI Agreement") with the US Treasury to obtain and report identifying and other account-related information with respect to US holders. Failure to comply will result in FFIs being subject to a 30 percent US withholding tax on US-source interest, dividends, rents, salaries and similar ("fixed and determinable annual or periodical") payments, as well as on gross proceeds from the sale or other disposition of property that can produce US-source interest or dividends (all of such payments being referred to as "withholdable payments"). Income treated as effectively connected with the conduct by the foreign person of a US trade or business ("ECI") and already subject to US income tax would, however, not be subject to this withholding tax.

If the FFI is itself the beneficial owner of a payment with respect to which tax has been withheld, and is entitled to a reduced rate of tax on the payment under a tax treaty, the FFI can claim a credit or refund of over-withheld tax, but no interest is allowed with respect thereto.

The FFI Agreement also would require FFIs themselves to withhold on payments attributable to "withholdable payments" made to an account holder who does not itself furnish required information, or who is itself an FFI not in compliance with the new provisions, unless an election is made to subject such amounts to the withholding tax described above, without reduction pursuant to any treaty provision.

FFIs include not only foreign banks, but also other foreign entities engaged in investing, or trading in securities, *e.g.*, foreign hedge funds. In addition, other non-financial, foreign entities (so-called "non-financial foreign entity" or "NFFEs") are subject to the same withholding tax on certain US-source payments if they do not report information on US owners, unless they can certify that they have no "substantial" (generally over 10 percent) US owner, with certain exceptions for, *inter alia*, publicly-traded corporations, foreign governments, or agencies or instrumentalities thereof, and foreign central banks.

As noted above, the new rules apply to payments made after December 31, 2012. There is, however, a "grandfathering" rule in respect of (i) payments on any obligation outstanding on the date that is two years after the date of enactment or (ii) the gross proceeds from any disposition of such an obligation. Such payments or proceeds are not subject to the new withholding tax.

IRS NOTICE 2010-60

On August 27, 2010, the IRS issued Notice 2010-60 (the "Notice"), which provides preliminary guidance regarding certain "priority issues" involving the implementation of FATCA, including (1) the scope of obligations exempt from withholding, (2) the definition of an FFI, (3) the scope of the required collection of information and identification of persons by FFIs and US financial institutions and (4) the specific information that FFIs must report to the IRS pursuant to an FFI Agreement with respect to their US accounts. The IRS intends that most of this guidance ultimately will be formalized in regulations to be issued at a later date. A summary of key aspects of the Notice follows.

Grandfathered Obligations

Although FATCA generally is effective for payments made after December 31, 2012, "obligations" outstanding on March 18, 2012 (*i.e.*, two years after enactment) are generally not subject to the FATCA withholding regime. The Notice provides that, for this purpose, the term "obligations" generally does not include stock or other equity interests or agreements that lack a definitive expiration or term (the latter including deposit accounts or brokerage agreements). Any material modification of an obligation will, however, result in the obligation being treated as newly issued for purposes of FATCA, thus potentially taking it out of the "grandfathering" protection.

Definition of FFI

FATCA requires withholding of 30 percent from any "withholdable payment" to an FFI that does not meet certain requirements. To meet such requirements, an FFI generally must enter into an FFI Agreement with the IRS, pursuant to which the FFI must agree to undertake certain due diligence, reporting and withholding responsibilities. An NFFE is excluded from the definition of an FFI and subject to separate documentation and reporting requirements, unless an exception applies.

An FFI generally is defined as a foreign entity that (1) accepts deposits in the ordinary course of a banking or similar business, such as a bank or credit union, (2) holds financial assets for the account of others as a substantial portion of its business, such as a broker-dealer or custodial bank, or (3) is engaged primarily in the business of investing, reinvesting or trading, directly or indirectly, in securities, partnership interests or commodities, such as a mutual fund, hedge fund, private equity fund or venture capital fund. The Notice provides that the concept of "business" for this purpose is highly factual and generally will be broader than the concept of "trade or business" as used elsewhere for US tax purposes (*e.g.*, in determining whether a foreign entity is engaged in a US trade or business and therefore subject to US net income taxation). As such, isolated transactions that might not in general rise to the level of a trade or business may cause an entity to be treated as FFI for purposes of FATCA.

A. *Entities Excluded from the Definition of FFI*

The Notice states that future IRS guidance will provide that the following types of foreign entities engaged primarily in the business of investing, reinvestment or trading, directly or indirectly, in securities will not be treated as a FFIs and, therefore, will not be subject to the FATCA withholding regime: (1) holding companies for a group of subsidiaries that primarily engage in a trade or business other than that of a financial institution[1]; (2) "start-up" companies (*i.e.*, companies not yet operating a business) for the first 24 months following their organization; (3) non-financial entities in the process of liquidating or reorganizing; and (4) entities engaging in financing and hedging transactions solely with, or for, certain related entities (assuming such members are not themselves FFIs).

Future IRS guidance also will provide that entities whose business consists solely of issuing insurance or reinsurance contracts will not be treated as FFIs for purposes of FATCA.[2] In addition, certain FFIs with only a small number of direct or indirect account holders, all of whom are individuals, will be exempt from the FATCA withholding regime if such FFIs comply with certain IRS documentation requirements. Finally, entities organized in US territories, although generally treated as "foreign" for US tax purposes, will be treated as domestic for purposes of FATCA.

B. *Retirement Plans*

FATCA provides the IRS with discretion to exclude certain classes of financial institutions from the FATCA withholding regime to the extent the IRS determines that such entities pose a low risk of tax evasion. Pursuant to the Notice, the IRS intends to exercise this discretion by providing that a foreign retirement plan is exempt from the withholding regime, provided that the plan (1) qualifies as a retirement plan under the relevant foreign law, (2) is sponsored by a foreign employer and (3) does not allow US participants or beneficiaries (other than employees that worked for the foreign employer in the country in which such plan is established during the period in which benefits accrued). This should be a welcome development for foreign pension plans.

C. *Treatment of US Branches and CFCs*

Under FATCA, a payment to an FFI that is considered ECI to such FFI is excluded from the FATCA withholding regime. This ECI exclusion, however, does not cover all payments that may be made to an FFI's US branch, such as payments received on behalf of the FFI's account holders rather than for its own account. In the Notice, the IRS has affirmed its intention not to exempt an FFI from FATCA even if the FFI receives withholdable payments solely through its US branch. However, where a US branch of an FFI receives a withholdable payment as an intermediary, the IRS may consider permitting the US branch to avoid withholding by complying with less stringent documentation requirements.

A controlled foreign corporation (a "CFC") (*i.e.*, a foreign corporation more than 50 percent of the vote or value of which is held by certain US persons) that qualifies as a financial institution is considered an FFI and subject to FATCA. Despite industry opposition to this rule, the IRS has affirmed in the Notice its intention not to exempt CFCs from the FATCA rules.

Scope of Collection of Information and Identification of Persons by FFIs

FATCA generally requires FFIs to enter into an FFI Agreement with the IRS in order to avoid the 30 percent withholding tax noted above. An FFI Agreement generally provides that the participating FFI (1) will obtain such information regarding each holder of each account maintained by the FFI as is necessary to determine which (if any) of such accounts are "US accounts,"[3] (2) comply with IRS-specified due diligence procedures and (3) report to the IRS certain information with respect to each US account. In addition, a participating FFI must agree to withhold tax on certain payments made to non-participating FFIs and certain "recalcitrant" account holders (including account holders that fail to comply with reasonable requests for information).

FATCA also requires a US financial institution or other withholding agent, subject to certain exceptions, (1) to withhold tax on certain withholdable payments made to an NFFE and (2) to report certain information regarding the "substantial US owners" (generally, more than 10 percent owners) of the NFFE. NFFEs excepted from these rules include (A) publicly-traded corporations and certain related entities (B) entities organized under the laws of a US territory and wholly-owned by bona fide residents thereof, (C) foreign governments, including political subdivisions or wholly-owned agencies or instrumentalities thereof, (D) certain international organizations or any wholly-owned agencies or instrumentalities thereof and (E) foreign central banks of issue.

The Notice provides specific procedures to be applied by participating FFIs and US financial institutions to make the determinations required to comply with the provisions of FATCA. Most notably, the Notice provides certain presumptions that may be applied by an FFI or a US financial institution in determining the status of an account, based on information gathered for other purposes (including other US tax purposes). In addition, the Notice provides that an FFI (but not a US financial institution) can treat certain depository accounts with average balances of less than $50,000 as other than a US account without further inquiry.

Information Required to be Reported Pursuant to an FFI Agreement

Under an FFI Agreement, FFIs are required annually to provide the IRS certain information with respect to their US accounts, including the name, address and taxpayer identification number of each US account holder, account balance or value, and the gross receipts and gross withdrawals or payments from the account. The Notice provides that the IRS is considering how best to implement these reporting requirements.

CONCLUSION

Although there are still two full years before the FATCA provisions become effective, once they come into play they will have a significant impact on foreign banks, funds and other foreign persons (as well as on US payors of US-source amounts to such foreign persons). Foreign entities subject to these new rules are well-advised to plan ahead by putting mechanisms into place that will enable them to comply with the various due diligence and reporting requirements so as to avoid an unnecessary US withholding tax burden. ★

1 This class of excepted entities will not, however, include investment funds, such as private equity funds, venture capital funds, leveraged buyout funds, or any investment vehicle whose purpose is to acquire, or fund the start up of, companies and hold them for investment purposes for a limited period of time.

2 The Notice provides, however, that life insurance contracts (other than term life insurance contracts without cash value) and annuity contracts generally include an investment component and, therefore, entities that issue such contracts likely will continue to be treated as financial institutions for purposes of FATCA.

3 US accounts are financial accounts held by one or more specified US persons or US-owned foreign entities.

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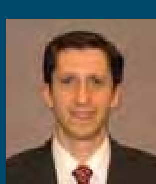

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