# IRS Publishes FATCA Guidance

The Hiring Incentives to Restore Employment ("HIRE") Act, enacted in March 2010, 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 U.S. persons. *See* our Client Alert, published on March 25, 2010, "Revenue Offsets in Jobs Act Impact U.S. Persons with Offshore Investments and Certain Non-U.S. Investors."

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 U.S. withholding tax. In response thereto, on August 27, 2010, the U.S. Internal Revenue Service (the "IRS") issued Notice 2010-60 (the "2010 Notice"), which provided preliminary guidance regarding certain "priority issues" involving the implementation of FATCA, including:

(1) the scope of obligations exempt from withholding;

(2) the definition of a "foreign financial institution" (an "FFI");

(3) the scope of the required collection of information and identification of persons by FFIs and U.S. financial institutions; and

(4) the specific information that FFIs must report to the IRS with respect to their U.S. accounts pursuant to an "FFI Agreement" entered into with the U.S. Treasury.

On April 8, 2011, the IRS issued Notice 2011-34 (the "2011 Notice"), which provides additional guidance regarding the implementation of FATCA, including:

(1) procedures to be followed by participating FFIs in identifying their U.S. accounts among their preexisting individual accounts;

(2) guidance with respect to withholding on indirect investments in the United States (so-called "passthru payments");

(3) guidance on certain categories of FFIs that will be deemed compliant with FATCA;

(4) further guidance regarding the obligation of participating FFIs to report with respect to U.S. accounts;

(5) the treatment of "qualified intermediaries" under FATCA; and

(6) the application of FATCA to affiliated groups of FFIs.

The IRS intends that most of this guidance ultimately will be formalized in regulations to be issued at a later date. A summary of certain key aspects of the 2010 Notice and the 2011 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), generally are not subject to the FATCA withholding regime. The 2010 Notice provides that, for this purpose, the term "obligations" generally does not, however, include stock or other equity interests or agreements that lack a definitive expiration or term (the latter including deposit accounts or brokerage agreements). Moreover, any material modification of an obligation will 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% 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 (so-called "participating FFIs"). In addition, other non-financial, foreign entities (so-called "non-financial foreign entity" or "NFFEs") are subject to the same withholding tax on certain U.S.-source payments if they do not report information on U.S. owners, unless they can certify that they have no "substantial" (generally over 10%) U.S. owner, with certain exceptions for, *inter alia*, publicly traded corporations, foreign governments or agencies or instrumentalities thereof, and foreign central banks.

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 2010 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 U.S. tax purposes (*e.g.*, in determining whether a foreign entity is engaged in a U.S. trade or business and therefore subject to U.S. 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.

The 2011 Notice provides that the IRS intends to require all FFIs that are affiliates of participating FFIs to also be participating FFIs or deemed-complaint FFIs (discussed below). However, the IRS has implemented a centralized compliance approach that will require (or, in certain cases, permit) an affiliated group of FFIs to designate a lead FFI to handle communications with the IRS and assume an oversight role with respect to compliance by the affiliate group with the FATCA regime. This should alleviate some of the compliance burden on affiliated groups of FFIs.

### Entities Excluded from the Definition of FFI

The 2010 Notice provides 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 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).

In addition, entities whose business consists solely of issuing insurance or reinsurance contracts will not be treated as FFIs for purposes of FATCA.[2] Furthermore, 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 U.S. territories, although generally treated as "foreign" for U.S. tax purposes, will be treated as domestic for purposes of FATCA.

### "Deemed Compliant" FFIs

The 2011 Notice describes certain categories of FFIs that will be treated as "deemed compliant" under FATCA and, as a result, will not be required to enter into an FFI Agreement with the IRS in order to avoid the 30% withholding tax. Such FFIs will be required to apply for deemed-compliant status with the IRS, and thereafter certify such status to the IRS every three years.

FFIs eligible for such status include:

(1) local banks (and affiliated entities) that employ certain procedures to ensure they do not open or maintain accounts for non-participating FFIs, NFFEs, and persons resident outside their local jurisdiction;

(2) certain affiliates of participating FFIs that implement procedures designed to avoid having any U.S. accounts; and

(3) certain collective investment vehicles if all holders of record are participating FFIs or deemed-compliant FFIs.

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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 However, 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.

### 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 2010 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 U.S. 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.

### "Passthru" Payments

The 2011 Notice provides rules on when payments made by participating FFIs will be treated as attributable to "withholdable payments" received by the FFI. Under FATCA, a participating FFI must, under certain circumstances, itself withhold 30% of such payments. In general, this "passthru" payment calculation will need to be made on a quarterly basis, based on the relative percentage of the FFI's U.S. assets to total assets (a so-called "passthru payment percentage"). Participating FFIs will be required to make their passthru payment percentage available to the public on a website or other publicly accessible database. Grandfathered obligations generally are not treated as U.S. assets for purposes of determining an FFI's passthru payment percentage.

### Treatment of U.S. Branches and CFCs

A payment to an FFI that is considered effectively connected with the conduct by the FFI of a U.S. trade or business ("ECI") and already subject to U.S. income tax is not be subject to the FATCA withholding regime. This ECI exclusion, however, does not cover all payments that may be made to an FFI's U.S. branch, such as payments received on behalf of the FFI's account holders rather than for its own account. In the 2010 Notice, the IRS has affirmed its intention not to exempt an FFI from FATCA even if the FFI receives withholdable payments solely through its U.S. branch.

A controlled foreign corporation (a "CFC") (*i.e.*, a foreign corporation more than 50% of the vote or value of which is held by certain U.S. 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 2010 Notice its intention not to exempt CFCs from the FATCA rules.

### Qualified Intermediaries

In the 2011 Notice, the IRS stated its intention to require all FFIs currently acting as qualified intermediaries, foreign withholding partnerships and foreign withholding trusts to become participating FFIs unless they qualify as deemed-compliant FFIs.

### Scope of Collection of Information, Identification of Persons, and Reporting by FFIs

FATCA generally requires FFIs to enter into an FFI Agreement with the IRS in order to avoid the 30% withholding tax noted above. An FFI Agreement generally provides that the participating FFI must identify all "U.S. accounts" maintained by the FFI (*i.e.*, financial accounts held by specified U.S. persons or U.S.-owned foreign entities), comply with IRS-specified due diligence procedures, and report to the IRS certain information with respect to each U.S. 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 U.S. financial institution or other withholding agent, subject to certain exceptions, to withhold tax on certain withholdable payments made to an NFFE and to report certain information regarding the "substantial U.S. owners" (generally, more than 10% owners) of the NFFE. NFFEs excepted from these rules include:

(1) publicly traded corporations and certain related entities;

(2) entities organized under the laws of a U.S. territory and wholly owned by *bona fide* residents thereof;

(3) foreign governments, including political subdivisions or wholly owned agencies or instrumentalities thereof;

(4) certain international organizations or any wholly owned agencies or instrumentalities thereof; and

(5) foreign central banks of issue.

The 2010 and 2011 Notices provide specific procedures to be applied by participating FFIs and U.S. financial institutions to make these determinations with respect to the status of account holders required to comply with the above-described provisions of FATCA. Most notably, the Notices provide certain presumptions that may be applied by an FFI or a U.S. financial institution in determining the status of an account, based on information gathered for other purposes (including other U.S. tax purposes). In addition, the Notices provide that an FFI (but not a U.S. financial institution) can treat certain depository accounts with average balances of less than $50,000 as other than a U.S. account without further inquiry.

## Conclusion

Although there is still more than one and a half 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 U.S. payors of U.S.-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 U.S. withholding tax burden.

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