

Final FATCA Regulations Can Have an Impact on Canadian Entities

The US Internal Revenue Service (IRS) has issued long-awaited final regulations (the Final Regulations) under the Foreign Account Tax Compliance Act (FATCA). FATCA, designed to police non-US investments, accounts and trust interests held by certain US persons, was initially enacted in March 2010 but is only beginning to take effect this year. FATCA has significant impact on Canadian and other non-US financial institutions, including Canadian banks and investment funds, as well as on certain other Canadian entities. The Final Regulations set forth steps that must be taken by covered entities so as to avoid potential US withholding tax under FATCA, and include provisions coordinating FATCA compliance under certain intergovernmental agreements as an alternative to compliance under the Final Regulations, all as discussed below.

Many believe that FATCA simply is yet another layer of compliance being added to the US tax regime in order to combat the abuses of certain US taxpayers “hiding” assets in foreign accounts and foreign entities. However, despite its complexity, FATCA does provide the US Treasury with a highly effective tool in the crusade against foreign intermediaries aiding in, or ignoring obvious evidence of, such tax evasion.

Any Canadian or other non-US entity earning any income from US sources likely will be impacted by FATCA to some degree, and should immediately begin taking steps to ensure timely compliance with these rules.

Overview

Certain foreign financial institutions (FFIs) are required under FATCA to enter into an agreement (an FFI Agreement) with the US Treasury to (a) identify, through established due diligence procedures, any financial account held by specified US taxpayers or US-owned foreign entities (so-called “US accounts”), (b) report information about each US account, and (c) withhold taxes on certain payments made to (i) financial account owners that fail to submit information to the FFI and (ii) FFIs that do not enter into an agreement with the US Treasury (so-called “nonparticipating FFIs”). FFIs that enter into an FFI Agreement are referred to as “participating FFIs.”

FFIs that fail to enter into an FFI agreement may be subject to a 30 percent US withholding tax on certain US source payments (so-called “withholdable payments”), including US-source interest, dividends, rents, salaries, wages and similar fixed and determinable annual or periodical (FDAP) payments, as well as gross proceeds from the sale or other disposition of property that can produce US-source interest or dividends.

Other non-financial, foreign entities (so-called “non-financial foreign entities,” or NFFE) are subject to the same 30 percent FATCA withholding tax if they do not report information on certain US owners or certify that they have no “substantial” (generally over 10 percent) US owners.

The IRS had issued preliminary guidance on FATCA prior to the Final Regulations, including several notices (the Notices), as well as proposed regulations (the Proposed Regulations) that incorporated, refined and expanded upon the guidance set forth in the Notices. In addition, the US Treasury recently issued two model intergovernmental agreements, the Model 1 IGA and Model 2 IGA (collectively, the Model IGAs), which provide FFIs resident in jurisdictions that enter into such agreements with an alternative approach to satisfy FATCA requirements. Please see our prior [FATCA client alerts](#), which describe the Notices, Proposed Regulations, and Model IGAs.

The Final Regulations make certain modifications to the above-described preliminary guidance, designed to reduce the burden of implementing FATCA. The Final Regulations also clarify certain aspects of the preliminary guidance. **The Final Regulations ultimately do little, however, to reduce the complexity and compliance burden inherent in the application of FATCA.**

Foreign Financial Institutions

An FFI is defined as any financial institution that is a non-US entity. The term financial institution generally includes any entity that (i) accepts deposits in the ordinary course of a banking or similar business (Depository Institution), (ii) holds, as a substantial portion of its business, financial assets for the benefit of one or more other persons, (iii) is an investment entity (Investment Entity), (iv) is an insurance company that makes payments with respect to a cash value insurance or annuity contract, or (v) is a “holding company” or “treasury center” (defined below) that meets certain conditions.

Significantly, the Final Regulations modify the definition of an Investment Entity contained in the Proposed Regulations. Under the Proposed Regulations, an Investment Entity generally included any entity that had at least 50 percent of its total gross income over a period of three years from investing, reinvesting, or trading in financial assets. **The Final Regulations narrow this definition generally by limiting the category of Investment Entities to (i) commercial entities (i.e., entities that undertake business activities on behalf of customers) and (ii) entities that are professionally managed.**

Specifically, an Investment Entity under the Final Regulations includes any of the following entities:

- An entity that primarily conducts as a business on behalf of customers: (i) trading in certain enumerated financial instruments; (ii) individual or collective portfolio management; or (iii) otherwise investing, administering, or managing funds, money or financial assets on behalf of others.
- An entity whose gross income is primarily attributable to investing, reinvesting or trading in financial assets, but generally only if the entity is managed by another FFI that primarily conducts a business on behalf of customers.
- An entity that “holds itself out” as a mutual fund, hedge fund or similar investment vehicle with an investment strategy of investing, reinvesting or trading in financial assets. (It is not clear what “holds itself out” means in this context.)

An entity will be treated as primarily conducting a business on behalf of customers, and an entity’s gross income will be treated as primarily attributable to investing, reinvesting or trading, if the entity’s gross income from such activities is at least 50 percent of the entity’s total gross income over the prior three years (or, with respect to a start-up entity, if the entity anticipates meeting the 50 percent gross income threshold).

The Final Regulations limit the circumstances under which a “holding company” or a “treasury center” (generally including an entity whose purpose is to hold the stock of, or engage in investment and financing transactions with, members of its “expanded affiliated group,” as defined below) will be treated as an FFI by providing that such an entity generally may be so treated only if (i) its “expanded affiliated group” includes another FFI, or (ii) such entity is formed in connection with, or used by, a mutual fund, hedge fund, or similar investment vehicle. In general, an “expanded affiliated group” means a chain or group of corporations related by at least 50 percent common ownership (by vote and value). A partnership or other non-corporate entity is treated as a member of an expanded affiliated group if such entity is more than 50 percent owned (by value) by members of such group. The provision described above reduces the instances in which parent companies will be treated as FFIs and subject to FATCA.

US Accounts

FATCA defines the term “US account” (subject to FATCA reporting) as any “financial account” held by one or more “specified US persons” or “US-owned foreign entities,” with certain exceptions. Under FATCA, a “financial account” generally is defined to mean any depository account, custodial account, or equity or debt interest in an FFI, other than interests that are regularly traded on an established securities market.

The Final Regulations refine the statutory definition of financial account so as to focus generally on traditional bank, brokerage, money market accounts, and interests in investment vehicles, and to exclude most debt and equity securities issued by banks and brokerage firms, subject to certain anti-abuse rules. In addition, the Final Regulations provide that debt or equity that is “regularly traded” on an “established securities market” will not be treated as a financial account. The Final Regulations fill a gap in the Proposed Regulations by providing a special rule for determining whether the “regularly trading” requirement is met with respect to newly issued interests.

The Final Regulations provide that the term “specified US person” generally means any US person, *excluding*, however, (a) a corporation whose stock is regularly traded on one or more established securities markets, and any corporation within the same expanded affiliated group as such a corporation; (b) a real estate investment trust (REIT); (c) the United States or any wholly owned agency or instrumentality thereof; and (d) a US tax-exempt organization (including charities and certain pension funds). A “US-owned foreign entity” is defined as any foreign entity that has one or more substantial (generally more than 10 percent, directly or indirectly) US owners.

FATCA Withholding on Withholdable Payments

FATCA requires withholding of 30 percent from any withholdable payment made to an FFI or NFFE that does not meet certain requirements.

To meet such requirements, an FFI generally must enter into an FFI Agreement with the IRS by registering online through what the Final Regulations refer to as the FATCA Registration Portal (the Portal) and agreeing to undertake certain due diligence, reporting and withholding responsibilities. Once an FFI’s registration is approved, the IRS will issue the FFI a Global Intermediary Identification Number (GIIN).

In order for an NFFE to avoid FATCA withholding, it generally must either certify to the payor of a withholdable payment that it does not have any “substantial” US owners, or provide the payor with the name, address, and tax ID number of each substantial US owner. Certain foreign entities, however, are exempt from FATCA withholding tax (so-called “excepted NFFEs”) and, as such, do not have to certify as to any US owners. Excepted NFFEs under the statute include (i) any publicly traded corporation (and any corporation within the same expanded affiliated group), (ii) foreign governments or agencies or instrumentalities thereof, (iii) international organizations, and (iv) foreign central banks. The Final Regulations expand the list of excepted NFFEs to include “active NFFEs,” defined as any NFFE if less than 50 percent of its gross income for the calendar year is passive income and less than 50 percent of the weighted average percentage of its assets (tested quarterly) are assets that produce, or are held for the production of, passive income. Subject to certain exceptions, passive income includes dividends, interest, rents and royalties (other than those derived in the active conduct of a trade or business), and annuities. **Accordingly, foreign entities involved in active operating businesses should not be viewed as NFFEs.**

Exempt Beneficial Owners

Payments made to FFIs are exempt from withholding when such payments are allocable to certain persons (so-called “exempt beneficial owners”). Under the Final Regulations, exempt beneficial owners generally include (i) a foreign government or an agency or instrumentality thereof, (ii) international organizations and (iii) foreign central banks, (iv) governments of US territories, (v) certain foreign retirement plans (the definition of which has been expanded under the Final Regulations) and (vi) any FFI that is an Investment Entity whose direct equity interest holders are exempt beneficial owners and whose direct debt interest holders generally are either Depository Institutions or exempt beneficial owners. Thus, payments made to an investment fund FFI that are allocable to, for example, a sovereign wealth fund or certain non-US retirement fund investors, would not be subject to FATCA withholding.

Withholding under an FFI Agreement

FATCA requires a participating FFI to withhold 30 percent of any “passthru payment” to a “recalcitrant account holder” or to another FFI that is a nonparticipating FFI. A “passthru payment” generally is defined as any (a) withholdable payment or (b) other payment made by a participating FFI to the extent attributable to a withholdable payment received by the FFI (“foreign passthru payment”). **The Final Regulations provide that the IRS is still considering rules for when a payment will be treated as a foreign passthru payment.** A “recalcitrant account holder” is any account holder that fails to provide the information required to determine whether the account is a US account, or the information required to be reported by the FFI, or that fails to provide a waiver of a foreign law that would prevent reporting. (A participating FFI may in certain cases elect not to withhold on passthru payments, and instead subject itself to FATCA withholding on payments it receives, to the extent those payments are allocable to recalcitrant account holders or nonparticipating FFIs.)

Deemed-Compliant FFIs

FATCA provides that certain categories of FFIs will be treated as “deemed compliant” and, as a result, will not be required to enter into an FFI Agreement with the IRS in order to avoid the 30 percent FATCA withholding tax. The Final Regulations expand upon prior guidance and provide additional categories of deemed-compliant FFIs.

Specifically, the Final Regulations provide for three general types of deemed-compliant FFIs: registered deemed compliant FFIs, certified deemed-compliant FFIs and owner-documented FFIs. A registered deemed-compliant FFI generally is required to register with the IRS through the Portal every three years in order to declare its status as deemed-compliant. A certified deemed-compliant FFI or owner-documented FFI generally is not required to register with the IRS, but will be required to certify to any withholding agent on an IRS Form W-8 that it meets the requirements of its deemed-compliant category.

- **Registered Deemed-Compliant FFIs**

Registered deemed-compliant FFIs include the categories of FFIs described below, as well as FFIs that are in compliance with a Model 1 IGA or that are treated as registered deemed-compliant under a Model 2 IGA.

Local FFIs. A local FFI generally is an FFI that, along with all members of its expanded affiliate group, is licensed and regulated as a financial institution in its home country. The FFI must have no fixed place of business, nor solicit account holders, outside its home country. In addition, 98 percent of the accounts (by value) maintained by the FFI must be held by residents of the FFI’s home country, and the FFI generally must implement policies and procedures to sustain this status. (For this purpose, an FFI that is organized in a European Union (EU) Member State is permitted to treat account holders that are residents of other EU Member States as residents of the FFI’s home country.)

Nonreporting Members of Participating FFI Groups. An FFI that is a member of a “participating FFI group” generally can become a registered deemed-compliant FFI as a “nonreporting member” if it closes certain preexisting and new accounts that are identified as US accounts (or accounts held by nonparticipating FFIs) or transfers such accounts to an affiliate in the group that is a participating FFI, US financial institution, or an FFI compliant with a Model 1 IGA. A “participating FFI group” generally is an expanded affiliated group where (i) at least one member is a participating FFI, or (ii) at least one member is an FFI in compliance with a Model 1 IGA and the other FFI members meet certain requirements.

Qualified Collective Investment Vehicles. A qualified collective investment vehicle is an FFI that is an Investment Entity, and that is regulated as an investment fund either in the FFI’s home country or in all the countries in which the FFI is registered and operates. Such an entity generally may qualify as a registered deemed-compliant FFI only if all holders of record of a direct interest in the FFI are participating FFIs, registered deemed-compliant FFIs, or other specified persons.

Restricted Funds. Similar to a qualified collective investment vehicle, a restricted fund is an FFI that is an Investment Entity and that is regulated as an investment fund either in the FFI's home country or in all the countries in which the FFI is registered and operates. However, in the case of a restricted fund, (i) interests therein issued directly by the FFI must be redeemed or transferred by the FFI, (ii) interests therein not issued directly by the FFI must be sold only through "distributors" (including underwriters, brokers and dealers) that are participating FFIs, registered deemed-compliant FFIs, nonregistering local banks, or restricted distributors, (iii) the FFI must have procedures in place to prohibit certain sales or transfers of interests therein to specified US persons, nonparticipating FFIs, or passive NFFEs with one or more substantial US owners, and (iv) the FFI must meet certain other requirements.

Qualified Credit Card Issuers. **The Final Regulations have added a new category of registered deemed-compliant FFIs designed to cover the vast majority of credit card issuers.** An FFI that issues credit cards generally can qualify as a registered deemed-compliant FFI if (i) it accepts deposits only when a customer pays more than the balance due on the card, and the overpayment is not immediately returned to the customer, and (ii) it limits such deposits to \$50,000.

Sponsored Entities. **The Final Regulations have added a new category of registered deemed-compliant FFIs designed generally to permit a so-called "sponsoring entity" to perform FATCA compliance on behalf of FFIs that are Investment Entities and that it manages on a consolidated basis.** The sponsoring entity is required to register with the IRS on behalf of itself and each Investment Entity for whom it is authorized to manage. A similar rule applies with respect to a non-US corporation controlled by a US financial institution if the owner shares a common electronic account system with the subsidiary and agrees to act as its sponsoring entity. **This new category of registered deemed-compliant FFIs should help significantly to reduce FATCA's administrative burden on Investment Entities and foreign subsidiaries of US banks and other US financial institutions.**

- **Certified Deemed-Compliant FFIs**

Certified deemed-compliant FFIs include the categories of FFIs described below, as well as FFIs treated as certified deemed-compliant under the Model IGAs.

Non-Registering Local Banks. A bank or credit union may qualify as a registered deemed-compliant FFI if its business consists primarily of receiving deposits from, and making loans to, unrelated retail customers; it does not have a fixed place of business, or solicit customers, outside its home country; and it has no more than \$175 million in assets on its balance sheet. Additional rules apply if the FFI is part of an expanded affiliated group. This category is narrower than that for local FFIs (a registered deemed-compliant FFI, discussed above) in that it is limited to banks and credit unions.

FFIs with Only Low-Value Accounts. An FFI generally is treated as having only low-value accounts if (i) the FFI is not an Investment Entity, (ii) no financial account maintained by the FFI (or by any member of its expanded affiliated group) has a balance or value in excess of \$50,000, and (iii) the FFI (and its entire expanded affiliated group) has no more than \$50 million in assets.

Sponsored Closely-Held Investment Vehicles. **The Final Regulations have added a new category of certified deemed-compliant FFIs designed to permit a "sponsoring entity" to perform FATCA compliance on behalf of FFIs that are Investment Entities and that it manages on a consolidated basis.** This category is similar to the Sponsored Investment Entity category of registered deemed-compliant FFIs (described above). However, under this certified deemed-compliant category (i) the sponsoring entity must be a participating FFI, a US financial institution, or an FFI compliant with a Model 1 IGA, (ii) the sponsored FFI must not hold itself out as an investment vehicle to unrelated parties, (iii) only 20 or fewer individuals generally may be permitted to own all the debt and equity interests in the sponsored FFI, and (iv) certain other conditions must be met.

Limited Life Debt Investment Entities. **The Final Regulations have added a second new category of certified deemed-compliant FFIs designed to ease FATCA compliance for certain collective**

investment vehicles that are formed for the limited purpose of purchasing specific types of debt pursuant to a trust (or similar) agreement and that are required to liquidate on a set date. In many such cases, the trustee will not be able to comply with FATCA unless the trust agreement expressly permits the trustee to do so or the vehicle's investors unanimously amend the trust agreement. Recognizing that such vehicles need time to address these limitations, the Final Regulations permit them to qualify as certified deemed-compliant FFIs prior to January 1, 2017, provided certain conditions are met.

- **Owner-Documented FFIs**

In general, an "owner-documented FFI" is an FFI that (i) is an FFI solely by virtue of being an Investment Entity and is affiliated only with other similar FFIs, (ii) maintains no financial accounts for nonparticipating FFIs, (iii) provides a withholding agent with all required documentation regarding its owners and agrees to notify the withholding agent regarding any change in circumstances, and (iv) with respect to which the withholding agent agrees to report to the IRS (or, if the withholding agent is an FFI compliant with a Model 1 IGA, to the relevant foreign government) the information required with respect to any specified US persons that own a direct or indirect equity interest in the FFI (other than persons that hold such an interest through a participating FFI, certain deemed-compliant FFIs, a US person, an exempt beneficial owner, or an excepted NFFE). **Because an owner-documented FFI is required to provide each withholding agent with documentation and the withholding agent must agree to report on behalf of the owner-documented FFI, an owner-documented FFI may have deemed-compliant status only with respect to a specific withholding agent.**

Coordination between the Final Regulations and Model IGAs

As noted above, the US Treasury has released two Model IGAs. **FFIs operating in a jurisdiction that enters into a Model 1 IGA are not required to enter into an FFI Agreement.** Thus, such FFIs are not required to report information directly to the IRS. Instead, they must report information about their US accounts to their own governments which, in turn, will relay the information to the IRS. FFIs that are covered by, and in compliance with, a Model 1 IGA will be treated as compliant with FATCA (as a "registered deemed-compliant FFI," defined above) and will not be subject to FATCA withholding tax.

FFIs located in a jurisdiction that enters into a Model 2 IGA are required to enter into and comply with an FFI Agreement in accordance with the Final Regulations, as modified by the Model 2 IGA. Such FFIs generally are required to report directly to the IRS under the FFI Agreement. For purpose of applying the Final Regulations, FFIs covered by and in compliance with a Model 2 IGA generally are treated as participating FFIs, as defined above.

In general, the Model IGAs cover (i) any FFI that is a resident in a Model IGA jurisdiction, but excludes any branches of such FFI that are located outside the Model IGA jurisdiction, and (ii) any FFI branch that is located in a Model IGA jurisdiction, even if the FFI is not resident in the Model IGA jurisdiction. Thus, it generally is where the FFI operates that is relevant. A Model 2 IGA also covers any FFI that is organized under the laws of a Model 2 IGA jurisdiction. In addition, a non-US branch of a US financial institution that is located in a Model 1 IGA jurisdiction may have additional reporting obligations under local law as a result of the Model 1 IGA.

FFIs with branches in several countries may need to comply with both the Final Regulations (i.e., as to branches in jurisdictions lacking a Model IGA) and Model IGAs (in those jurisdictions that have them). For example, if an FFI operates in a Model 1 IGA jurisdiction but has branches in a Model 2 IGA jurisdiction or non-IGA jurisdiction, the FFI will be required to comply with the Model 1 IGA and to enter into an FFI Agreement on behalf of the branches in the Model 2 IGA and non-IGA jurisdictions.

The Model IGAs simplify FATCA implementation, minimize compliance burdens, and are favored by the IRS. The agreements resolve the conflicts between the implementation of FATCA and the local

law of many countries. To date, the United Kingdom, Denmark, Mexico, Ireland, Switzerland, Norway and Spain have entered into or initialed Model IGAs. Negotiation of additional Model IGAs is actively ongoing with numerous other countries. However, not all countries will enter into Model IGAs.

Conclusion

The Final Regulations will significantly impact non-US banks, funds and other non-US persons. Although the IRS has attempted to be sensitive to the burdens involved in implementing and complying with FATCA, the rules are necessarily complex. **Non-US persons subject to FATCA are advised to register with the IRS by October 25, 2013 to ensure that they will not be subject to withholding when FATCA withholding begins to go into effect in 2014.**

FATCA Implementation Timeline Summary

October 25, 2013	FFIs that register with the IRS through the Portal by this date are guaranteed that they will not be subject to withholding on payments made to them when FATCA withholding goes into effect on January 1, 2014.
January 1, 2014	<p>Participating FFIs and other withholding agents must have FATCA due diligence procedures in place for opening new accounts.</p> <p>Withholding begins on payments of US-source interest, dividends and other similar FDAP payments made by (i) participating FFIs to nonparticipating FFIs and recalcitrant account holders and (ii) other withholding agents to nonparticipating FFIs.</p> <p>Certain obligations outstanding on this date generally will not be subject to the FATCA withholding regime (so-called “grandfathered obligations”). The category of grandfathered obligations has been expanded under the Final Regulations.</p>
June 30, 2014	Participating FFIs and other withholding agents must complete certain due diligence requirements with respect to their <u>preexisting entity</u> obligations (generally including contracts, accounts, instruments, debt, or equity interests issued or maintained by them that are outstanding on December 31, 2013 and certain other obligations regardless of when entered into) held by “prima facie FFIs” (e.g., persons with certain indications of being FFIs). The category of preexisting obligations has been expanded under the Final Regulations.
December 31, 2014	Participating FFIs must complete certain due diligence requirements with respect to their <u>preexisting individual</u> accounts that exceed \$1,000,000.
March 31, 2015	Limited FATCA reporting begins (with respect to the 2013 and 2014 calendar years), limited to the name, address, taxpayer identification number, account number, and account balance or value.
December 31, 2015	<p>Participating FFIs must complete certain due diligence requirements with respect to all of their <u>preexisting individual</u> accounts.</p> <p>Participating FFIs and other withholding agents must complete certain due diligence requirements with respect to all of their <u>preexisting entity</u> obligations.</p>
March 31, 2016	Additional FATCA reporting on income earned on accounts (other than certain gross proceeds from the sale of property) begins (with respect to the 2015 calendar year).
January 1, 2017	Withholding begins on all types of withholdable payments (i.e., including gross proceeds from the sale of property that can produce US-source interest or dividends) made by (i) participating FFIs to

nonparticipating FFIs and recalcitrant account holders and (ii) other withholding agents to nonparticipating FFIs.

Withholding begins on “foreign passthru payments” (yet to be defined) made by participating FFIs to nonparticipating FFIs and recalcitrant account holders.

March 31, 2017

Additional FATCA reporting on certain gross proceeds from the sale of property begins (with respect to the 2016 calendar year).

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