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Proposed FATCA Regulations: Some Significant Relief for Foreign Institutions, But Challenges Ahead

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The authors of this article discuss the proposed Foreign Account Tax Compliance Act regulations.

The Internal Revenue Service ("IRS") and the Treasury Department recently released the highly anticipated proposed regulations ("Proposed Regulations") that, when published in final form, will implement the withholding and information reporting provisions of the Foreign Account Tax Compliance Act ("FATCA"), and will have far-reaching implications for companies and individuals conducting international financial transactions.[1] FATCA is generally effective January 1, 2013.

FATCA, which was included in the Hiring Incentives to Restore Employment Act of 2010, is part of an ongoing effort to combat offshore tax evasion by U.S. persons. FATCA establishes a withholding and reporting system that requires foreign financial institutions ("FFIs") (typically foreign banks and foreign hedge and private equity funds) to report certain information regarding U.S. ownership of foreign accounts and foreign entities or be subject to a 30-percent withholding tax on all payments the FFI receives of certain U.S. source income (including interest, dividends, and capital

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gains). To avoid this withholding tax, FFIs must enter into an agreement with the IRS (an "FFI Agreement") that requires the FFI to: (1) identify U.S. accounts; (2) report certain information regarding the U.S. accounts to the IRS; and (3) withhold a 30-percent tax on "passthru payments" (payments attributable to withholdable payments) made to other, nonparticipating FFIs or accountholders unwilling to provide requested information (recalcitrant accounts). FATCA also requires certain nonfinancial foreign entities ("NFFEs"), including most nonfinancial foreign institutions, to report certain information to the IRS regarding payees; if the NFFE does not report such information, withholdable payments to the NFFE on behalf of the beneficial owner will be subject to 30 percent withholding

In response to substantial international comment regarding the burdens and, in some cases, legal impossibility of complying with FATCA, the Proposed Regulations provide significant relief to affected foreign institutions. They reduce compliance burdens and limit the types of entities and accounts subject to the regime, and they postpone the implementation of FATCA's reporting and withholding obligations. Nevertheless, U.S. withholding agents and foreign institutions will need to take significant steps in the near future to comply with the FATCA regime.

JOINT STATEMENT WITH CERTAIN EUROPEAN COUNTRIES

Many foreign financial institutions have objected to FATCA on the basis that their national laws, including privacy laws, prevent compliance with FATCA's reporting, withholding, and account closure requirements. Simultaneously with the release of the Proposed Regulations, the Treasury Department released a joint statement ("Joint Statement") with France, Germany, Italy, Spain, and the United Kingdom, under which these countries will negotiate alternative frameworks with the U.S. designed to fulfill the purposes of FATCA.[2] These alternative frameworks would allow foreign institutions in those countries to report the necessary information regarding U.S. accounts to their respective governments rather than to the IRS directly, without being subject to withholding on certain U.S. source payments they receive. The governments would, in turn, supply the information to the IRS. However, these modifications come at a cost to U.S. financial institutions: U.S. institutions will be required to share information regarding their account holders with those account holders' home country governments. The Joint Statement also indicates that it will serve "as a model for the United States' work with other countries," and Treasury Department officials have publicly indicated that negotiations are currently ongoing with other, unidentified countries to permit such countries to enter into similar alternative frameworks.

THE PROPOSED REGULATIONS

The IRS previously issued three notices concerning FATCA prior to the issuance of the Proposed Regulations. In Notice 2010-60 (August 27, 2010), Notice 2011-34 (April 8, 2011), and Notice 2011-53 (August 8, 2011), the IRS set forth initial guidance regarding the operation of the new reporting and withholding regime, including progressive relaxation of various requirements.

The Proposed Regulations expand on and further liberalize the guidance provided in the prior notices by providing significant relief from the compliance burdens and obligations imposed by FATCA. Some key aspects of the Proposed Regulations that minimize the compliance burden on foreign institutions include the following topics.

More Entities Excluded from FATCA

The Proposed Regulations broaden the categories of entities that are excluded from the definition of an FFI and are therefore not subject to FATCA. Excluded entities include certain start-up companies, nonfinancial entities that are liquidating or emerging from reorganization or bankruptcy, certain NFFEs with limited passive income, companies that engage in hedging and financing transactions with their non-financing affiliated group, certain not-for-profit organizations, and certain "nonfinancial holding companies."

More Entities "Deemed Compliant" with FATCA

The Proposed Regulations expand the categories of FFIs that would be "deemed compliant" with FATCA and would not be required to enter into an FFI Agreement with the IRS to avoid being subject to withholding under FATCA. These "deemed compliant" entities include local banks, FFIs that are members of an affiliated group of which one member is a participating FFI, certain regulated investment funds, retirement plans, and certain not-for-profit organizations. In each case, these entities would be required to either (1) register with the IRS, or (2) certify to withholding agents that they meet certain procedural requirements in order to be deemed compliant with FATCA.

Narrower Definition of "Financial Accounts"

The Proposed Regulations significantly narrow the definition of the "financial account" that an FFI must identify under FATCA. Although FATCA broadly defines a financial account to include any depository account, custodial account, or debt or equity interest in an FFI, other than those that are regularly traded, the Proposed Regulations focus on traditional bank, brokerage, and money market accounts. Excluded from the revised definition of a "financial account" are most debt and equity security interests issued by FFIs, as well as retirement accounts and certain nonretirement savings accounts.

Simplified Due Diligence Requirements

Commentators and the international community criticized the IRS for the burden associated with previously proposed due diligence measures that FFIs were required to implement to identify U.S. accounts among both preexisting and new accounts. In response, the Proposed Regulations relax due diligence procedures for both individual and entity accountholders and raise the *de minimis* threshold, below for which no review is required. For most preexisting individual accountholders, an electronic search of existing records will be deemed sufficient. Increased due diligence, including a potential review of paper records, will only be required when an account balance or value exceeds U.S. $1,000,000. For preexisting entity accounts, the Proposed Regulations rely heavily on existing anti-money laundering/"know your customer" ("AML/KYC") rules to simplify due diligence. The Proposed Regulations raise the *de minimis* threshold for due diligence of both individual cash value insurance contracts and entity accounts to U.S. $250,000 (the threshold for the balance or value of individual accounts remains U.S. $50,000). For new individual accounts, FFIs will be required to review the intake information, including any documentation collected under AML/KYC rules. If U.S. indicia are identified, the FFI must obtain additional documentation or treat the account as held by a recalcitrant account holder. For new entity accounts, FFIs must determine whether the entity has any substantial U.S. owners, generally by obtaining a certification from the account holder.

Transitional Rule for Affiliated Groups

Under the general FATCA rules, every FFI in an expanded affiliated group must be a participating FFI or deemed compliant FFI in order for one of its members to enter into an FFI Agreement. The IRS recognized that some jurisdictions have laws in place that may prohibit an FFI's compliance with FATCA reporting and withholding requirements. The Proposed Regulations thus create a two-year transitional period, through December 31, 2015, during which the existence of an FFI affiliate in such a restrictive jurisdiction will not prevent the other FFIs in the same group from entering into an FFI Agreement, provided that the FFI in the restrictive jurisdiction agrees to perform due diligence to identify its U.S. accounts and meet certain other requirements. Withholdable payments made to such restricted FFIs would nevertheless be subject to withholding.

Phase-In of Information Reporting

The IRS acknowledges that certain types of information, like gross proceeds, are more difficult to gather and report, and thus the Proposed Regulations gradually phase-in the amount of information required to be reported. With respect to the 2013 and 2014 reporting years, participating FFIs are only required to report U.S. persons' identifying information and U.S. account balance information. Participating FFIs must begin reporting income with respect to the 2015 reporting year and begin reporting gross proceeds with respect to the 2016 reporting year.

Expanded Grandfathering Provision

The Proposed Regulations provide that no withholding is required from any payment relating to an "obligation" (for example, a debt instrument) that is outstanding as of January 1, 2013 (under prior guidance, the grandfather date was March 18, 2012). Additionally, the Proposed Regulations provide that participating FFIs will not be required to withhold on foreign pass thru payments until January 1, 2017, two years later than in prior guidance.

NOTES

[1] The Proposed Regulations are *available at*: http://www.irs.gov/pub/newsroom/reg-121647-10.pdf.

[2] The Joint Statement is *available at*: http://www.treasury.gov/press-center/press-releases/Documents/020712% 20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf.