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IRS Issues Proposed Regulations on the Foreign Account Tax Compliance Act

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On February 8, 2012, the IRS released proposed regulations (Proposed Regulations) interpreting the new Chapter 4 of Subtitle A of the Internal Revenue Code of 1986, as amended, commonly referred to as the Foreign Account Tax Compliance Act (FATCA).

Background

FATCA was enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act to assist the IRS in detecting and discouraging tax evasion by US taxpayers holding investments in foreign institutions, primarily in foreign financial institutions (FFIs). FATCA achieves this by imposing a punitive withholding tax on certain US source payments made to FFIs and non-financial foreign entities (NFFEs) and certain non-US source payments made by FFIs unless the recipients of such payments comply with FATCA or qualify for an exemption.

If an FFI becomes a "participating FFI," it agrees with the IRS to perform due diligence on financial account holders to ascertain US status and to report information about US account holders to the IRS. A draft FFI agreement is expected by summer 2012. If an account holder does not provide information or is found to be a non-participating FFI, the participating FFI must withhold on certain US source and non-US source payments (passthru payments) made to the account holder. The participating FFI may also be required to close the account or redeem the interest of any non-compliant account holder.

NFFEs, which are also subject to withholding if they do not comply with FATCA, are generally subject to less onerous diligence and reporting requirements.

Payments subject to withholding under FATCA include US source interest, dividends, and other fixed or determinable annual or periodical (US source FDAP) income, gross proceeds from the disposition of property that can produce US source interest or dividends, and certain foreign source payments that are attributable to such payments.

Intergovernmental Framework

On February 8, 2012, the US issued a joint statement with France, Germany, Italy, Spain, and the United Kingdom (FATCA Partner Countries) outlining a possible intergovernmental framework for implementing FATCA. Under the framework, FFIs would report information to the FATCA Partner in the country in which the FFI is located. The FATCA Partner would submit the information to the IRS pursuant to an information exchange agreement. FFIs located in FATCA Partner Countries would not need to enter into an agreement with the IRS, would not be subject to US withholding under FATCA, and would not need to terminate the accounts of non-FATCA compliant holders.

Treasury sources indicate that the intergovernmental framework may serve as a model for future agreements.

Explanation of the Proposed Regulations

The Proposed Regulations are largely consistent with initial guidance published by the IRS over the past two years in Notices 2010-60, 2011-34, and 2011-53 (Notices) but also supplement and modify the Notices.

Due Diligence Procedures

The Proposed Regulations outline in detail the procedures that participating FFIs must follow to identify their account holders. The Proposed Regulations not only clarify and streamline these procedures but in many instances significantly reduce them.

- In contrast to the Notices, the Proposed Regulations do not describe the order in which participating FFIs must complete the due diligence procedures. Treasury sources indicate that deadlines and practical considerations are intended to drive the order of due diligence.
- The Proposed Regulations, as in the Notices, require different due diligence procedures depending on whether such diligence is performed on preexisting individual accounts, new individual accounts, preexisting entity accounts, or new entity accounts.
- For preexisting individual accounts, the Proposed Regulations, as in the Notices, provide that accounts with a value of $50,000 or less will be excluded from due diligence. The Proposed Regulations also add that certain preexisting cash value insurance or annuity contracts held by individuals with a value of $250,000 or less will be excluded from due diligence.
- Electronic searches will still be required for preexisting individual accounts with a value greater than $50,000. Manual review will need to be performed for accounts with a balance or value in excess of $1,000,000 (from $500,000 under the Notices) and will be limited to the current customer master file and certain other documents except to the extent that information is already captured by an electronic search (as opposed to manually reviewing "all available documents" under the Notices).
- Due diligence will not require special identification of private banking accounts.
- The Proposed Regulations create a new exemption from due diligence for preexisting entity accounts with a value of $250,000 or less. For all other preexisting entity accounts, FFIs will be permitted to rely on anti-money laundering and know-your-customer (AML/KYC) records and other documentation to identify their account holders except if an account holder has US indicia, is an FFI, or is a passive investment entity (a change from performing electronic searches and requesting documentation under the Notices).
- For new individual and entity accounts, FFIs will be permitted to rely on current customer intake procedures and AML/KYC records to identify account holders except if an account holder has US indicia, is an FFI, or is a passive investment entity as applicable (a change from developing new customer intake procedures and requesting particular documentation under the Notices).

Extended Grandfathering

The grandfathering date is extended to obligations outstanding on or after January 1, 2013 (from March 18, 2012). Grandfathered obligations will include revolving credit facilities if the credit agreement fixes the material terms pursuant to which the credit will be extended, and derivatives governed by an ISDA Master Agreement that are evidenced by a confirmation.

Extended Transition Period for Reporting

The Proposed Regulations extend the transition period for the reporting obligations of participating FFIs. Participating FFIs need only report the name, address, TIN of each US account holder, as well as the account number, and balance of each US account maintained in 2013 and 2014 (limited reporting would have applied only to 2013 and early 2014 under the Notices). For 2015, reporting is expanded to include gross income paid and credited to US accounts and is expanded again in 2016 to include gross sale proceeds (full reporting would have applied to 2014).

Extended Transition Period for Withholding

The Proposed Regulations also extend the transition period for the withholding obligations by US withholding agents and participating FFIs.

- Withholding on US source FDAP will not apply on payments made before January 1, 2015 (from January 1, 2014) unless such payments are made to "prima facie FFIs" or documented non-participating FFIs, in which case withholding will begin on January 1, 2014.
- On January 1, 2015 (consistent with the Notices), withholding will be expanded to include gross proceeds from the sale or disposition of property that can produce US source interest or dividends.
- On January 1, 2017 (from January 1, 2015), participating FFIs will be required to withhold on "foreign passthru payments," subject to further guidance.

Extended Transition Period for Affiliated FFI Groups

The Notices required all members of an expanded affiliated group to qualify as participating FFIs or deemed compliant FFIs. In recognition of legal difficulties faced by some groups in complying, until January 1, 2016, FFI members can be participating or deemed-compliant FFIs notwithstanding the status of another FFI (limited FFI) as long as the limited FFI (1) is located in a jurisdiction that prohibits reporting and withholding under FATCA, and (2) agrees to perform certain due diligence and record-keeping requirements with respect to US accounts. Because such limited FFI cannot comply with the FATCA requirements, the limited FFI may be subject to FATCA withholding despite the fact that its FFI affiliates may not be subject to FATCA withholding.

Expanded Categories of Deemed-Compliant FFIs

The Proposed Regulations expand the scope of deemed-compliant FFIs and provide three new categories.

- The first category of deemed-compliant FFIs consists of "registered deemed-compliant FFIs," which must register with the IRS to establish their deemed-compliant status. This category includes local FFIs, non-reporting members of a participating FFI group, qualified investment vehicles, and restricted funds.

- The second category of deemed-compliant FFIs, “certified deemed-compliant FFIs,” are not required to register with the IRS but must provide each withholding agent with a W-8 that identifies their deemed-compliant status. This category includes local banks, retirement funds, non-profit organizations, and FFIs with only low value accounts.

- The third category consists of “owner-documented deemed-compliant FFIs.” These FFIs must provide each withholding agent with certain documentation regarding their owners, and each withholding agent must agree to report any US owners to the IRS. Because withholding agents must agree to report on behalf of owner-documented FFIs, such FFIs may have deemed-compliant status only with respect to specific withholding agents.

The IRS has reserved the right to expand the categories of deemed-compliant FFIs.

Narrowed Definition of Financial Account

Under the Code and the Notices, “financial accounts” include debt and equity interests in an FFI not regularly traded in an established security market. The Proposed Regulations narrow this definition by excluding debt and equity issued by banks, brokerage firms, and insurance companies but only if the value of those interests are not determined primarily by reference to assets that could give rise to withholdable payments. Further excluded from the definition of a financial account are certain retirement and pension accounts, nonretirement savings accounts, insurance contracts providing pure insurance protection, and accounts held by certain beneficial owners. The Proposed Regulations clarify that cash value insurance or annuity contracts constitute financial accounts.

Expanded Definition of Excepted NFFEs

An NFFE can be subject to FATCA withholding if it does not provide information about its US owners or certify that it does not have any US owners. The Notices listed “excepted NFFEs” that would not be subject to these requirements. The Proposed Regulations expand this list to include “Active NFFEs,” which are defined as any NFFE if less than 50% of its gross income is passive income or less than 50% of its assets produce passive income.

Definition of Withholdable Payment

The Code and Notices define a “withholdable payment” as US source FDAP income and gross proceeds from the sale or disposition of property that can produce US source interest and dividends. The Proposed Regulations exclude from this definition (1) payments of interest or original issue discount on debt obligations with a term of 183 days or less and (2) payments made in the ordinary course of a withholding agent’s business such as wages, office and equipment leases, and interest arising from the acquisition of nonfinancial services, goods, or other tangible property. In addition, the Proposed Regulations provide that gross sale proceeds include redeeming stock or indebtedness, entering into a short sale and a closing transaction in a forward or option, or terminating a specified notional principal contract. However, gross sale proceeds do not include granting or exercising certain options or a mark to fair market value

Dormant Accounts

The Proposed Regulations provide that a participating FFI making a passthru payment to a recalcitrant “dormant account” may, in lieu of remitting withholding tax, set aside the amounts withheld until such time that the account is “reactivated.” In such case, the account holder must provide the information that had been requested by the FFI within 90 days, or the FFI will be required to remit the withheld amounts to the IRS.

Verification

The Proposed Regulations provide more specific guidance about the nature and timing of procedures that participating FFIs must follow to certify to the IRS that they comply with FATCA. FFIs will be required to adopt written policies and procedures governing the FFI's compliance with FATCA, conduct periodic internal reviews, and certify that they comply with FATCA in accordance with deadlines specified in the Proposed Regulations. FFIs will not be subject to external mandatory audits except in the case of repetitive or systematic failures in the FFI's compliance processes.

Reserved Provisions

The Proposed Regulations include a number of provisions that will be drafted at a later date. These "reserved" provisions include:

- The definition of a "foreign passthru payment."
- The reporting requirements of Qualified Intermediaries, Withholding Partnerships, and Withholding Trusts with respect to US accounts.
- The rules for determining when gross proceeds from the sale or disposition of property can be treated as paid to a partner, owner, or beneficiary of a flow through entity. The Proposed Regulations provide that amounts of US source FDAP treated as paid to partners, owners, or beneficiaries of flow through entities are governed by rules similar to those described in Chapter 3 of the Code.

Conclusion

The issuance of the Proposed Regulations represents a significant milestone in the development of FATCA. The Proposed Regulations provide clarity to many previously unanswered questions regarding the potential impact, cost, and global reach of FATCA. Further, the Proposed Regulations and intergovernmental framework indicate an intention by the Treasury and IRS to lessen the compliance burdens associated with FATCA in response to industry concerns. Despite the greater clarity offered by the Proposed Regulations, some issues remain unclear. We await, for example, the highly anticipated guidance regarding "foreign passthru payments." The IRS intends to release final regulations by summer 2012.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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