Treasury Department and IRS Substantially Revise and Enhance the Proposed Regulations on the FATCA

On 1/17/13, the Treasury and IRS issued 544 pages of final Treasury Regulations under Code sections 1471-1474 pertaining to the implementation of FATCA. The Treasury and IRS have accepted numerous comments on the proposed regulations issued last year and, as a result, the final regulations are substantially longer and more detailed then the proposed regulations. The regulations will be published (and become effective) as of January 28, 2013.

This article sets forth the highlights of some of the provisions of the regulations.

I. Special Reporting for Calendar Year 2013

In contrast to what most people believe, FATCA is already in effect for this year (2013). The regulations clarify several key dates and deadlines with respect to FATCA. The regulations incorporate Announcement 2012-42, 2012-47 I.R.B. 561, with respect to calendar year 2013. If an FFI agreement (explained below) has an effective date that is on or before 12/31/14, the "Participating FFI" ("PFFI")[1] is required to report U.S. accounts that it maintained during 2013 that are outstanding on 12/31/13. PFFIs may report for both calendar years 2013 and 2014 on or before 3/31/15. All accounts maintained by an FFI prior to 1/1/14 are considered "pre-existing accounts" for due diligence purposes. The regulations exempt from withholding foreign passthru payments and gross proceeds from sales or dispositions of property occurring before 1/1/17.

II. Intergovernmental Agreements

On 7/26/12, Treasury published the intergovernmental model agreement for government-to-government information sharing ("IGA") to implement FATCA (the "Model 1 IGA"). The IGAs are based on a framework and negotiations Treasury announced in February with France, Germany, Italy, Spain, and the UK to set up intergovernmental information sharing arrangements. The IGAs establish a roadmap for reporting by financial institutions of certain financial account information to their respective tax authorities, followed by automatic exchange of such information under existing bilateral tax treaties or tax information exchange agreements.

Two versions of the model agreement were released: (i) a reciprocal version and (ii) a non-reciprocal version. The reciprocal version of the IGA provides for the U.S. to exchange information currently collected on accounts held in U.S. financial institutions by residents of partner countries. This version of the model agreement will be available only to jurisdictions with which the U.S. has in effect an income tax treaty or tax information exchange agreement and with respect to which the Treasury and IRS have determined that the recipient government has in place substantial protections and practices to ensure that the information remains confidential and that it is used solely for tax purposes. Subject to certain exceptions, the governments must exchange information within 9 months after the end of the year to which the information relates.

The IGA non-reciprocal version would allow countries to comply with FATCA under the same obligations; however, these countries would not receive an exchange of client banking information. The non-reciprocal version will be used for countries that do not have in effect with the U.S. an income tax treaty or tax information exchange agreement.

On 11/14//12, Treasury released its second IGA (the "Model 2 IGA"). The Model 2 IGA was outlined in joint statements with Japan and Switzerland released by Treasury in June 2012. Whereas the Model 1 IGA established government-to-government sharing of information to satisfy the reporting and withholding requirements of FATCA, the Model 2 IGA follows a business-to-government approach. Under the Model 2 IGA, FFIs report directly to the IRS, as opposed to through their tax authorities.

Article 2 of the Model 2 IGA sets forth the manner in which FFIs will report and exchange information with the U.S. The FATCA partner country must enable and direct all reporting FFIs to register with the IRS by 1/1/14 and, furthermore, to sign a reporting agreement, known as an FFI agreement. Article 2 of the Model 2 IGA also provides that U.S. Competent Authority may make group requests to the competent authority of the partner country for information for non-consenting account holders based on the aggregate information reported to the IRS.

See Appendix 1 for a list of countries that either signed or are considering signing an IGA with the US.

III. Interaction of IGAs with the Regulations

FFIs covered by a Model 1 IGA, and that are in compliance with the terms of the IGA, will be treated as satisfying the FATCA due diligence and reporting requirements and do not need to apply the regulations for purposes of complying with and avoiding withholding under FATCA. In certain cases prescribed in the Model 1 IGA, the laws of the partner jurisdiction may allow the resident FFI to elect to apply provisions of the regulations instead of the rules prescribed in the Model 1 IGA. FFIs covered by a Model 2 IGA will be required to implement FATCA in the manner prescribed by the regulations except to the extent expressly modified by the Model 2 IGA; the regulations accommodate such variations.

IV. The FATCA Registration Portal

The FATCA Registration Portal (the "Portal") is a new web-based system, which will be the primary means for financial institutions to interact with the IRS to complete and maintain their FATCA registrations, agreements, and certifications. Financial institutions will be able to register and agree to comply with their obligations as PFFIs or as "sponsoring entities," or to register and agree to act as limited FFIs or registered deemed-compliant FFIs (including reporting Model 1 IGAs and, in some cases, Model 2 IGAs) so long as the associated jurisdiction is identified on a list published by the IRS of countries treated as having in effect an IGA. A financial institution registering through the Portal will agree to comply with the FATCA requirements pertaining to its particular situation.

Once a financial institution has registered, the IRS will review and if everything is in order, approve its registration. The IRS will issue a Global Intermediary Identification Number ("GIIN") to each PFFI and registered deemed-compliant FFI beginning 10/15/13, which will be used as the institution's identifying number for satisfying its reporting requirements and identifying its status to withholding agents. The IRS will electronically post the first list of PFFIs and registered deemed-compliant FFIs (including those reporting under Model 1 IGAs) on 12/2/13.

The IRS intends to update the IRS FFI List on a monthly basis. Financial institutions that want to be on the Dec. 2013 FFI List must register by 10/25/13. Treasury and the IRS will publish a Revenue Procedure containing all of the terms and conditions applicable to FFIs for FATCA purposes, the terms of which will be fully consistent with the rules set forth in the regulations.

V. §1.1471-1 -- Scope of Chapter 4 and Definitions

In response to numerous comments, and to promote certainty, many definitions in the proposed regulations have been revised in the final regulations to be consistent with the IGAs and to address the comments received.

VI. §1.1471-2:- Withholding on "Withholdable Payments" to Certain FFIs

A. Grandfathered Obligations

The regulations changed several provisions pertaining to which obligations are "grandfathered." Grandfathered obligations now include: (1) any obligation outstanding on 1/1/14; (2) certain obligations that produce "dividend equivalent payments" pursuant to section 871(m);[2] and (3) any agreement requiring a secured party to make payments with respect to collateral securing grandfathered obligations (even if the collateral is not itself a grandfathered obligation). An obligation will not give rise to a foreign passthru payment if it is executed on or before the date that is 6 months after the date on which regulations defining the term "foreign passthru payment" are filed with the Federal Register (which are yet to be issued).

VII. §1.1471-3 -- Identification of Payee

A. Due Diligence and Documentary Evidence for Withholding Agents

The regulations significantly change due diligence and documentary evidence requirements imposed on withholding agents under FATCA. Most revisions were meant to simplify the process and converge it, to a significant extent, with the Chapter 3 withholding requirements. A withholding agent may rely on documentary evidence obtained from the payee in lieu of an IRS Form W-9, in order to establish the payee's status as a U.S. person and may rely on an "eyeball test" to determine the payee's status as other than a "specified U.S. person."[3] A modified standard of knowledge allows withholding agents to rely on a claim of status as a participating or registered-deemed compliant FFI based on checking the payee's GIIN against the published IRS FFI list. Withholding agents may rely on presumption rules similar to those under Chapter 3 in lieu of obtaining and reviewing documentation of payees. The regulations expand the types of documentary evidence upon which a withholding agent may rely with respect to offshore obligations, including government websites and reports from government agencies. A withholding agent may rely upon a pre-FATCA IRS Form W-8 in lieu of obtaining an updated version of the withholding certificate in certain circumstances.

VIII. §1.1471-4 -- FFI Agreement

A. General

The regulations delay the effective date of the FFI agreement until 12/31/13.[4] For all FFIs (otherwise not exempt from FATCA) that are not residents of a partner jurisdiction under an IGA, signing an FFI agreement with the IRS is the route to avoid FATCA withholding. The regulations made a few changes to the relevant provisions pertaining to FFI agreements. The regulations: (1) provide the requirements for verifying compliance with the FFI agreement; (2) allow PFFIs to file collective refund claims on behalf of certain account holders and payees for amounts overwithheld, and provide procedural requirements if a participating FFI is legally prohibited from reporting or withholding as required under the FFI agreement and (3) define an event of default of the FFI agreement and describe procedures for a PFFI to remediate it.

B. Due Diligence Required by FFIs

One of the key elements of FATCA is imposing due diligence requirements on FFIs with respect to their "foreign accounts." The regulations made several changes to the proposed regulations to make them consistent with IGAs and in response to comments by financial institutions. The regulations modify the general requirements for identifying and documenting account holders in a number of ways. Recognizing the substantial burden for the FFI to separately document an existing customer, the regulations revise the definition of a "preexisting obligation" to permit, subject to certain conditions, a new account of a customer that has a preexisting account to be treated as a preexisting account. The regulations modify the identification and documentation procedures of PFFIs with respect to new individual accounts to permit certain alternative forms of documentation. The regulations provide a more detailed explanation of the application of these rules to preexisting accounts.

C. U.S. Branches of PFFIs

The regulations provide rules for the treatment of U.S. branches and U.S. agencies (collectively, "U.S. branches") of PFFIs. The issue whether U.S. branches are the functional equivalent of U.S. domestic banks for FATCA purposes had not been specifically addressed by Treasury and IRS in prior published guidance. The regulations now confirm that a U.S. branch of a PFFI will be treated as a U.S. person (under §1.1441-1(b)(2)(iv)) and be subject to the same withholding, due diligence, and reporting requirements that a US financial Institution must comply with under FATCA. As a result, similar to a U.S. domestic bank, a U.S. branch is required to file a separate Form 1042 to report amounts subject to reporting under FATCA and any taxes withheld. A U.S. branch of a PFFI that is not treated as a U.S. person is required to fulfill the general and more onerous requirements set forth in §1.1471-4 for withholding, due diligence, and reporting.

D. Certifications of Responsible Officer

An important aspect of FFI compliance with FATCA involves the certification/verification process by the officer who is charged with FATCA compliance at the FFI. The regulations provide more guidance on the obligations and responsibilities of such a "responsible officer" than did the proposed regulations. The regulations include the verification and certification requirements for PFFIs, which rely on a responsible officer to establish a compliance program that includes policies, procedures, and processes sufficient for the PFFI to satisfy the requirements of the FFI agreement. A responsible officer must certify, to the best of his/her knowledge, after conducting a reasonable inquiry, that the PFFI does not have any formal or informal practices or procedures in place to assist account holders in avoiding FATCA, such as advising account holders to split up their accounts to avoid reporting as high-value accounts.

E. IRS Review of Compliance

The regulations include guidance as to the IRS's level of review of the information reporting forms filed by the PFFI and the procedures that follow if the PFFI is deemed to be in default with the requirements of the FFI agreement. If the IRS determines in its discretion, after a review of the information reporting forms filed by the PFFI, that the PFFI may not have complied with its FFI agreement, then the IRS may request additional information from the responsible officer.

The additional information requested by the IRS to verify compliance may include: (1) documentation regarding the PFFI's policies and procedures to comply with the FFI agreement, (2) copies of its reports regarding its reviews of accounts, (3) account statements, and (4) the performance of specified review procedures by a competent person or an external auditor or third-party consultant.

If the IRS determines that the PFFI has failed to perform material obligations required with respect to the due diligence, withholding or reporting requirements of the FFI agreement, or the FFI has failed to substantially comply with the requirements of the FFI agreement, then the IRS will deliver to the FFI a Notice of Default. The Notice of Default will specify the event of default and will request the FFI to cure the default within a specified time period. If the PFFI does not respond to the Notice of Default or cure the default within the requested time period then the IRS will issue a Notice of Termination that terminates the FFI's participating status.

IX. §1.1471-5 - Definitions Applicable to Section 1471

Many definitions have been revised in the regulations, mainly as a result of comments requesting that they be conformed to the definitions in the two Model IGAs.

A. Account Holder

The regulations clarify that an account held by a disregarded entity shall be treated as held by the person owning such entity.

B. Financial Accounts

Many revisions have been made in the regulations to address comments pertaining to the definitions of the various "financial accounts" that are subject to due diligence. Mostly, the regulations provided more relief to FFIs by reducing the scope of "financial accounts" that are subject to due diligence by the FFI.

1. <u>Depository Accounts</u>

The regulations limit the scope of "depository accounts" in a number of ways (e.g., they exclude certain escrow accounts established for commercial transactions and negotiable debt instruments that are traded on a regulated market or over-the-counter market and distributed through financial institutions).

A depository account includes an amount that an insurance company holds under a guaranteed investment contract or under a similar agreement to pay or credit interest thereon. A depository account does not include an advance premium or premium deposit received by an insurance company, provided the prepayment or deposit relates to an insurance contract for which the premium is payable annually and the amount of the prepayment or deposit does not exceed the annual premium for the contract; such amounts are also excluded from cash value for purposes of determining whether a contract is a cash value insurance contract.

2. Equity and Debt Interests

With regard to equity or debt interests in investment entities, the regulations revise the financial account definition to correspond to the changes to the definition of FFI for "investment entities."

3. Insurance Definitions and Contracts

The regulations replace the references to U.S. tax law rules when defining "annuity contract," "life insurance contract," and "insurance company" with plain language definitions and incorporate, where appropriate, references to local law definitions and practices. The regulations also clarify that: (1) an insurance company that is not a specified insurance company must independently determine whether it is a depository institution, custodial institution, or investment entity; (2) an insurance company's reserve activities with respect to its insurance contracts and annuity contracts are not taken into consideration in determining whether the company is a depository institution, custodial institution, or investment entity; and (3) an insurance company that is not a financial institution is a NFFE.

The regulations expand the exclusion from financial account status for certain term life insurance contracts. The regulations also made a number of revisions to the rules associated with cash value insurance contracts.

4. Exception for Certain Savings Accounts

Substantial revisions were made to the exceptions for savings accounts. For retirement and pension accounts, the excepted category is revised to eliminate the requirements that all contributions to the account are government, employer, or employee contributions and that the contributions be limited to earned income. The limitation on contributions is liberalized to allow plans that either have an annual contribution limit of $50,000 or less or a maximum lifetime contribution limit of $1M or less.

The relevant tax authority must require information reporting with respect to the account. For non-retirement savings accounts, the regulations eliminate the requirement that contributions be limited by reference to earned income and instead require that the account be tax favored. The regulations expand the definition of "tax favored" provided in the proposed regulations for purposes of these rules.

C. Financial Institutions

1. Depository Institution

The regulations clarify that accepting deposits is necessary but not sufficient to create depository entity status. Therefore, an entity that accepts deposits must also engage in one or more of the enumerated banking or financing activities (adapted from section 864's and section 954(f)'s active banking, financing, and similar business rules). To be treated as a depository institution, an entity needs to engage on a regular basis in one or more such activities. An entity that completes money transfers by instructing agents to transmit funds is not in a banking or similar business because it does not accept deposits or other similar temporary investments of funds. An entity that solely accepts deposits from persons as collateral or security pursuant to a lease, loan, or similar financing arrangement is not a depository institution. This exception is intended to exclude from FFI status entities such as finance companies that do not fund their operations through deposits and entities acting as networks for credit card banks that hold cash collateral from such banks.

2. Investment Entities

The regulations generally incorporate the definition of investment entity contained in the IGAs by providing that an investment entity includes any entity that primarily conducts as a business on behalf of customers: (1) trading in an enumerated list of financial instruments; (2) individual or collective portfolio management; or (3) otherwise investing, administering, or managing funds, money, or certain financial assets on behalf of other persons. The regulations treat an entity as an investment if its gross income is primarily attributable to investing, reinvesting, or trading and the entity is managed by a depository institution, a custodial institution, another investment entity, or an insurance company that qualifies as a financial institution.

Entities that function or hold themselves out as mutual funds, hedge funds, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets are investment entities. An entity primarily conducts an activity as a business if gross income attributable to such activity equals or exceeds 50% of the entity's gross income. Passive entities that are not professionally managed are generally treated as passive NFFEs rather than as FFIs.

3. Insurance Companies and Holding Companies

A holding company that is a member of an expanded affiliated group that includes an insurance company will be treated as an FFI if it issues or is obligated to make payments with respect to a cash value insurance contract or annuity contract, regardless of whether it would otherwise be treated as an FFI.

4. Certain Holding Companies and Treasury Centers

The regulations limit the circumstances under which a holding company or treasury center is treated as a financial institution. Such entities are FFIs in two situations. First, subject to limited exceptions for nonfinancial groups, such entities are FFIs if they are part of an expanded affiliated group that includes a depository institution, custodial institution, insurance company, or investment entity. Second, they are FFIs regardless of whether they are a member of a nonfinancial group if they are formed in connection with or availed of by a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.

D. Deemed Compliant Foreign Financial Institutions

The regulations treat an FFI as compliant with FATCA without the need to enter into an FFI agreement (as discussed above) if such FFI is a member of a class of institutions listed in the regulations. There are three different categories of deemed-compliant entities.

(A) Registered Deemed Compliant FFIs which include (i) local FFIs, (ii) non-reporting members of PFFI groups, (iii) qualified investment vehicles, (iv) restricted funds and (v) FFIs that comply with deemed compliant status under an IGA. Registered Deemed Compliant FFIs must register with IRS, agree to certain conditions and certify that they satisfy the requirements associated with deemed compliant status every 3 years.

(B) Certified Deemed Compliant FFIs, which include (i) non-registered local banks, (ii) certain retirement plans, (iii) non-profit organizations, and (iv) FFIs with only low-value accounts. Certified Deemed Compliant FFIs must certify to the withholding agent that they meet the FATCA requirements.

(C) Owner-Documented FFIs. An FFI that meets the requirements to be treated as an Owner Documented FFI will only be treated as a deemed compliant FFI with respect to a payment or account for which it does not act as an intermediary.

The regulations generally retain the same deemed-compliant categories that were included in the proposed regulations but have made several modifications and clarifications in response to comments received. The regulations also introduce new categories of deemed-compliant FFIs for (i) certain credit card issuers, (§1.1471-5(f)(1)(i)(E)), (ii) sponsored FFIs (1471-5(f)(2)(iii)), and (iii) limited-life debt investment entities (§1.1471-5(f)(2)(iv)) (discussed below) .

E. Registered Deemed Compliant FFIs

1. Local FFIs

This category should be available only to FFIs whose activities are limited to a single country. The regulations expand the types of entities that qualify to include insurance companies, credit unions, and investment entities. The regulations also eased some of the requirements to be eligible for this exception in certain ways. For example, if the local FFI operates a website or advertises through print, radio, or television that is distributed in multiple countries in addition to the FFI's country, it is not considered to have solicited customers or account holder outside the FFI's country, provided the FFI's website or advertising is distributed or aired primarily within the FFI's country and the FFI does not advertise services or accounts for nonresidents and does not otherwise target or solicit U.S. customers or account holders through the website or advertising. The regulations kept the 98% resident account holder threshold provided in §1.1471-5(f)(1)(i)(A)(5).[5] Finally, the regulations add a requirement that the local FFI not have policies or practices that discriminate against opening or maintaining accounts for U.S. individuals that are resident in the local FFI's country.

2. Nonreporting Members of PFFI Groups

The regulations generally retain the same requirements for a nonreporting member of a PFFI group that were provided in the proposed regulations

3. Qualified Collective Investment Vehicles

The primary purpose of this category is to provide relief for investment entities that are owned solely through PFFIs or directly by large institutional investors, payments to which would not be subject to withholding or reporting under FATCA. The regulations expand the availability of this category in certain ways, and permit investors that are retirement plans and nonprofit organizations. The regulations expand the cases in which an investment entity will be considered to be "regulated" to include cases in which the investment entity is regulated in all of the countries in which it is registered and all countries in which it operates, or the investment entity's manager is regulated with respect to the investment entity in all countries in which the investment entity is registered and all countries in which the investment entity operates.

4. Restricted Funds

This category was created to provide relief for foreign funds that only target foreign investors. As with the previous category, the regulations expand the methods under which a fund will be considered to be regulated to include cases in which the fund is regulated in all of the countries in which it is registered and all countries in which it operates, or the fund's manager is regulated with respect to the investment entity in all countries in which the fund is registered and all countries in which it operates. All interests in the fund must be sold through identified distributors or redeemed directly by the fund. Interests in the fund may be issued by the fund directly if the investor can only dispose of those interests by having them redeemed or transferred by the fund, and not by selling them on a secondary market. Further, interests in the fund can only be issued directly by the fund or by designated distributors described in §1.1471-5(f)(1)(i)(D)(3).

5. Qualified Credit Card Issuers

The regulations add a new category of registered deemed-compliant FFIs to the final regulations for credit card issuers that agree to prevent a customer from having a deposit with the credit card issuer in excess of $50,000.

6. Registered Deemed-Compliant Procedural Requirements

The regulations provide a registered deemed-compliant FFI with 6 months from the time it becomes ineligible for the registered deemed compliant status to cure the default or notify the IRS of its change in status.

7. Sponsored FFIs

The regulations create a registered deemed compliant FFI category for sponsored FFIs for which a sponsoring entity agrees to perform all due diligence, withholding, reporting, and other requirements the sponsored FFI would have been required to perform if it were a PFFI, and complies with certain other requirements.

F. Registered Deemed Compliant FFIs

1. Nonregistering Local Banks

This category was intended to apply only to very small FFIs. In response to comments requesting a simplification of the definition of a “bank” for this purpose, the regulations do not include a cross reference to section 581 and (the definition of a “bank”) have clarified that, in addition to banks, certain credit unions or similar organizations may also qualify as nonregistering local banks.

2. Sponsored, Closely Held Investment Vehicles

The regulations create a new category for closely held investment vehicles that are sponsored by a sponsoring FFI in the same manner as the registered deemed-compliant category.

3. Limited Life Debt Investment Entities

Certain investment vehicles that have a fixed lifespan and that were created for the purpose in investing in a limited type of debt obligation with the intent to hold such obligations until maturity or until the liquidation of the vehicle will often provide the trustee of the vehicle with limited authority to act in a manner not specifically provided for under the agreement. In most cases, the trustee would not be permitted to register the vehicle as a PFFI or comply with the due diligence requirements of a PFFI unless the trust indenture requires the trustee to do so, the trustee is required to do so under a provision of law, or all of the investors in the vehicle agree to amend the trust agreement to provide the trustee with the power to act in such a manner. The regulations permit such entities to qualify as deemed-compliant FFIs until 12/31/16, at which point the deemed-compliant status of these entities terminates, and each such entity will be required to comply with the terms of any applicable IGA or otherwise register as a participating FFI.

G. Owner-Documented FFIs

The proposed regulations set a $50,000 debt limit on owner-documented FFIs. The final regulations no longer prohibit owner-documented FFIs from issuing debt interests that constitute financial accounts in excess of $50,000 to persons other than nonparticipating FFIs, provided that the owner-documented FFI reports all individuals and specified U.S. persons that directly or indirectly hold such interests (other than persons that hold such interests through a PFFI, registered deemed compliant FFI, certified deemed-compliant FFI, U.S. person, exempt beneficial owner, or excepted NFFE) to the designated withholding agent.

H. Recalcitrant Account Holders

The regulations expand the definition of recalcitrant account holder to include an account holder that is documented as an NFFE (other than a Withholding Partnership or Withholding Trust) but that fails to provide the information required under §1.1471-3(d) regarding its owners. The regulations revise the start of recalcitrant account holder status to coordinate with a PFFI's withholding requirements. The regulations require a PFFI or deemed-compliant FFI to treat an account other than preexisting account or an account (including preexisting account) that undergoes a change in circumstances as held by a recalcitrant account holder beginning on the earlier of the date a withholdable payment or foreign passthru payment is made to the account or the date that is 90 days after account opening or the change in circumstances.

The regulations coordinate recalcitrant account holder status under FATCA with the chapter 61 backup withholding procedures for cases in which a PFFI receives a notice from the IRS regarding a name and TIN mismatch for an account holder. An account for which the PFFI or deemed-compliant FFI receives such a notice from the IRS will be treated as a recalcitrant account holder following the date of such notice if the account holder does not provide a correct name and TIN combination within the time prescribed in §31.3406(d)-5(a). A PFFI or deemed-compliant FFI is required to treat an account holder for which it receives a notice indicating a name/TIN mismatch as a recalcitrant account holder (and withhold and report to the extent required) on or before the 30th business day after the FFI receives such notice.

X. §1.1472-1 -- Withholding on NFFEs

A. Withholding Agents

The regulations provide rules applicable to withholding agents for withholding on certain NFFEs and reporting with respect to the "substantial U.S. owners" of certain NFFEs. Withholding agents are required to withhold under section 1472 only with respect to "withholdable payments" made after 12/31/13. Regulation §1.1472-1(b)(2) provides that withholding agents are not required to withhold under section 1472 on payments made before 1/1/15, with respect to a "preexisting obligation" to a payee that is not a "prima facie FFI" and for which the withholding agent does not have documentation indicating the payee's status as a "passive NFFE" with one or more substantial U.S. owners.

The regulations clarify the interaction of section 1472 withholding with a PFFI's withholding obligations under section 1471(b) and the associated regulations. A PFFI that complies with its withholding obligations under §1.1471-4(b) will be deemed to satisfy its obligations under section 1472 with respect to withholdable payments made to NFFEs that are account holders.
Section 1472 will continue to apply to a PFFI that acts as a withholding agent on a withholdable payment made to an NFFE that is not an account holder (e.g., a payment with respect to a contract that does not constitute a financial account).

Withholding obligations will be limited by §1.1473-1(a)(4)(vi), which provides a temporary exception from the definition of withholdable payment for certain payments of U.S. source FDAP income made prior to 1/1/17 with respect to offshore obligations. Regulation §1.1472-1(c)(1)(i)(B) clarifies the application of the publicly traded rules for excepted NFFE status in the year of an initial public offering.

B. Passive Income

The regulations clarify the scope of passive income, including the rules regarding commodities.
The regulations expand the exceptions to passive income in a number of respects. First, §1.1472- 1(c)(1)(iv)(B) provides that passive income will not include dividends, interest, rents, and royalties received or accrued from a related person to the extent that they are properly allocable to income of the payor that is not passive income. Second, the regulations provide an exception from passive income for certain income earned by dealers acting in the ordinary course of their trade or business.

C. Active NFFE

With regard to the exception from withholding for payments to "active NFFEs," the Treasury and the IRS intend to provide a specific list of items constituting passive income that will provide more certainty for withholding agents and NFFEs. The regulations provide expanded categories of "Excepted NFFEs" to address the treatment of holding companies and similar entities that are part of and that support a group conducting an active trade or business. An entity will not be an active NFFE unless less than 50% of its gross income is from passive income and less than 50% of its assets are passive assets (assets that produce or are held for the production of passive income), on a weighted average basis.

XI. §1.1473-1 -- Section 1473 Definitions

A. Withholdable Payment

1. Withholding on Gross Proceeds

The regulations allow clearing organizations to determine gross proceeds based on the net amount paid or credited to a member's account under the settlement procedures of such organization. The definition of gross proceeds excludes proceeds from transactions not subject to recognition under section 1058.

2. Section 871(m)

Any contract that results in the payment of a dividend equivalent (as defined in section 871(m) and regulations thereunder) is treated as property of a type that can produce U.S. source FDAP income, including if such dividend equivalent is part of a termination payment.

B. Exceptions to Withholdable Payment

1. Offshore Payments of U.S. Source FDAP Income

To coordinate the regulations' withholding requirements with those of the Model 1 IGAs, the regulations temporarily exclude from the definition of withholdable payment a payment of U.S. source FDAP income made with regard to an offshore obligation prior to 1/1/17, by a person that is not acting as an intermediary with regard to the payment. For this purpose, a "qualified securities lender" is considered an intermediary. The regulations limit the application of this rule for certain flow-through entities.

2. Excluded Nonfinancial Payments

The proposed regulations contain an ordinary course of business exception to withholdable payments. The final regulations replace the ordinary course of business exception with a more comprehensive exception for "excluded nonfinancial payments." The revised exception explicitly describes payments that are excluded from withholdable payments and provide a list of payments that are withholdable payments.

The proposed regulations also excluded payments for the sale of goods. The final regulations remove the reference to "goods" in the nonfinancial payments exclusion and define a payment of U.S. source FDAP income to expressly incorporate the exclusion under §1.1441-2(b)(2)(i) (stating that certain gains from the sale of property do not constitute FDAP income).

C. Substantial U.S. Owner

The rules for determining whether a specified U.S. person is a "substantial U.S. owner" remain substantially unchanged from the proposed regulations, subject to a few modifications. The determination of whether a person is a substantial U.S. owner must be made by calculating such person's direct and indirect interest in the entity. The proposed regulations required that a specified U.S person's indirect interest in an entity be determined by looking through interests held by entities that are U.S. persons. The final regulations do not require an entity to look through interests held by a U.S. person that is not a specified U.S. person when determining whether the entity has a substantial U.S. owner.

The regulations add a provision that requires an entity making a determination as to whether a specified U.S. person is a substantial U.S. owner to aggregate the interests owned by persons related to the specified U.S. person, applying certain provisions under section 267 to determine whether such persons are related. The regulations provide a safe harbor that permits an entity, or a withholding agent with respect to the entity, to treat a specified U.S. person as a substantial U.S. owner in lieu of making the calculations necessary to determine whether such person holds a sufficient interest to be a substantial U.S. owner.

D. Specified U.S. Person

The final regulations add section 457(g) plans and exempt trusts under section 403(b) to the classes of U.S. persons that are not specified U.S. persons.

XII. §1.1474-1 -- Liability for Withheld Tax and Withholding Agent Reporting

A. Use of Agents

The proposed regulations described the circumstances under which a withholding agent could appoint agents to fulfill its obligations under FATCA. Commentators requested removal of the restrictions on the use of sub-agents. The regulations remove these restrictions but clarify that the withholding agent remains liable for the acts of both its agents and its sub-agents. Any agent or sub-agent that acts as a reporting agent for filing Form 1042 or making deposits and payments reportable on the form on behalf of a withholding agent must file a Form 8655, "Reporting Agent Authorization," with the IRS.

B. Information Reporting

The proposed regulations set forth the information reporting requirements of a withholding agent and of a PFFI or registered deemed-compliant FFI making a payment of a foreign reportable amount to a nonparticipating FFI. The proposed regulations required financial institutions to file such returns electronically on magnetic media without regard to the general annual 250 return threshold applicable to withholding agents other than financial institutions. The final regulations modify and clarify certain provisions with respect to these reporting requirements. The regulations modify which persons are recipients for purposes of reporting FATCA reportable amounts and describe categories of recipients with respect to payments of U.S. source FDAP income.

Information reporting is required with respect to a payment of gross proceeds only if the payment is "an amount subject to withholding." §1.1471-1(b)(118) define an "amount subject to withholding" as an amount withheld upon or required to be withheld upon under FATCA.

A chapter 4 "reportable amount" excludes an amount paid to a payee that the withholding agent treats as a U.S. person.

In the case of payments that are not subject to FATCA withholding, the regulations require reporting to the extent that reporting is required under §1.1461-1.

XIII. §§1.1474-2 through -5 – Refunds, Credits, and Reimbursement

§§1.1471-2 through -5 provide rules relating to the refund or credit of taxes withheld under chapter 4 and reimbursement procedures for withholding agents in cases of overwithholding. The regulations provide for PFFIs and reporting Model 1 FFIs to obtain refunds on behalf of their account holders under the collective refund procedures of §1.1471-4(h). To facilitate the refunds in other appropriate cases, §1.1474-1(d) provides for a withholding agents to issue a specific Form 1042-S to an account holder subjected to withholding under FATCA (in lieu of the pooled reporting otherwise permitted) for purposes of substantiating withholding of amounts under chapter 4.

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[1] A "Participating FFI" is an FFI that has entered into an FFI agreement with the IRS to perform specific compliance functions in connection with its U.S. accounts.

[2] In a nutshell, section 871(m) and regulations thereunder provides that with respect to certain equity-linked derivatives, payments under the contract that are considered to be "substitute dividends" will be subject to withholding as if such payments were actual dividends. Final regulations under section 871(m) have yet to be finalized.

[3] A specified U.S. person is any U.S. person other than certain types of US entities listed in the regulations.

[4] This change aligns the effective date of, and due diligence periods under, the FFI agreement with the timelines provided under the IGAs.

[5] The resident threshold will be applied based on account value instead of the number of accounts. In addition, a local FFI may apply the test based on residents or citizens rather than solely based on residents.

APPENDIX 1: STATUS OF IGAs AS OF DECEMBER 2012

COMPLETED

- Denmark
- Mexico
- Spain
- Switzerland
- United Kingdom
- Norway

ACTIVE NEGOTIATIONS

- Canada
- Finland
- France
- Germany
- Guernsey
- Ireland
- Isle of Man
- Italy
- Japan
- Jersey
- Netherlands
- Argentina
- Australia
- Belgium
- Cayman Islands
- Cyprus
- Estonia
- Hungary
- Israel
- Korea
- Liechtenstein
- Malaysia
- Malta
- New Zealand
- Singapore
- Slovak Republic
- Sweden

ACTIVE DISCUSSIONS

- Gibraltar
- India
- Lebanon
- Luxembourg
- Romania
- Russia
- Seychelles
- Saint Maarten
- Slovenia
- South Africa

EXPLORING

- Bermuda
- Brazil
- British Virgin Islands
- Chile
- Czech Republic

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