

Treasury and IRS Finalize Highly Anticipated FATCA Regulations

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Pamela Lawrence Endreny
New York
212.735.2976
pamela.endreny@skadden.com

Edward E. Gonzalez
New York
212.735.3160
edward.gonzalez@skadden.com

Roseann M. Cutrone
Washington, D.C.
202.371.7366
roseann.cutrone@skadden.com

Jared H. Binstock
Washington, D.C.
202.371.7166
jared.binstock@skadden.com

Yvonne L. Lee
New York
212.735.3523
yvonne.lee@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

1440 New York Avenue, NW
Washington, DC 20005
Telephone: 202.371.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

On January 17, 2013, the Treasury Department and the IRS issued comprehensive final regulations implementing Sections 1471 through 1474 of the Internal Revenue Code (commonly known as the Foreign Account Tax Compliance Act, or FATCA). FATCA aims to combat tax avoidance by U.S. taxpayers by imposing sweeping reporting and withholding obligations on a broad range of foreign financial institutions (FFIs) and requiring certain non-financial foreign entities (NFFEs) to report information about their substantial U.S. holders.¹ Although some uncertainties remain, the final regulations include welcome modifications and clarifications to the proposed regulations issued in February 2012.

The Treasury and the IRS attempted to minimize the burdens of FATCA compliance by adopting a targeted, risk-based approach to achieving FATCA's policy goals, such as extended grandfathering and compliance dates, expanded exemptions and less onerous documentation and due diligence requirements. As expected, the final regulations harmonize key aspects of FATCA with the intergovernmental agreements (IGAs) that the United States is putting into place with partner countries in order to overcome legal impediments to FATCA compliance by institutions in those countries.² Finally, the regulations provide specifics on the administrative process for FFIs registering and entering into an agreement with the IRS.

Certain key points include the following:

Targeted Risk Changes

- **Extension of Grandfather Rule:** The final regulations exclude from FATCA withholding payments made under an obligation outstanding on January 1, 2014, and any associated collateral (the prior grandfathering date was January 1, 2013). Consistent with the IRS's 2012 notice, the regulations grandfather obligations (and associated collateral) that may give rise to "foreign passthru" payments provided the obligations are outstanding on or prior to the date that is six months after regulations addressing those payments are published. The regulations provide the same grandfather rule for obligations that may give rise to dividend equivalent payments. This is important given that the final

¹ Very generally, FATCA imposes a 30 percent withholding tax on certain U.S.-source payments (and payments of gross proceeds from the disposition of property that can produce such payments) made to an FFI unless the FFI enters into an agreement with the IRS to report the identities and other information about its U.S. account holders. FATCA also requires FFIs that enter into such agreements (participating FFIs) to withhold 30 percent of "passthru payments" made to other FFIs that do not comply with the FATCA rules. FATCA requires NFFEs to report information about their substantial U.S. holders to paying agents in order to avoid a 30 percent withholding tax.

² One significant impediment to FATCA's implementation has been local bank secrecy laws, which may prevent FFIs from disclosing account holder information directly to the IRS. To address this concern, the United States has entered into several IGAs with other countries that either allow financial institutions to report information to their local jurisdiction (which is then shared with the IRS) or enable financial institutions in the foreign jurisdiction to register with and report directly to the IRS. To date, the United States has signed or initialed IGAs with the United Kingdom, Denmark, Mexico, Ireland, Norway, Spain and Switzerland and expects to enter into many more in the coming months.

regulations, like the proposed regulations, do not define foreign passthru payments³ and the Treasury has not yet finalized separate regulations on dividend equivalent payments. The preamble to the final regulations confirms that a debt instrument issued in a qualified reopening is treated as having the same issue date as the original debt instrument.⁴

- **Scope of Covered Financial Institutions:** In response to comments, the final regulations treat passive entities that are not professionally managed as NFFEs rather than as FFIs. For example, a foreign family trust managed by an individual trustee is not an FFI but would be an FFI if managed by a trust company. The final regulations also provide exceptions for financial institutions and certain passive NFFEs that are part of a nonfinancial group of companies and that support the operations of the group, such as holding companies, treasury centers and captive finance subsidiaries where the group is not engaged in a financial business. The holding company/finance company exception does not apply, however, if the entity is a depository or custodial institution, an insurance company, a professionally managed investment entity or an entity that “functions or holds itself out as” or “is formed in connection with or availed of by” a private equity fund, venture capital fund, hedge fund or similar investment vehicle with an investment strategy of investing, reinvesting or trading in financial assets. The regulations do not provide guidance as to the meaning of these essential terms.

— The final regulations broaden the definition of an FFI in one respect. The definition now includes a foreign entity that, on behalf of customers, primarily engages in trading, portfolio management or investing, administering or managing funds, money or financial assets. This change conforms with the definition used in the IGAs, although it is not clear why investment advisers should be covered from a policy perspective.

- **Expansion of Deemed-Compliant and Other Exempt Categories:** The final regulations expand the categories of FFIs that are deemed to comply with FATCA without the need to enter into an agreement with the IRS in order to focus the application of FATCA on higher-risk financial institutions. The Treasury and the IRS declined, however, to adopt comments to add jurisdiction-specific deemed-compliant categories, opting instead to address such comments in IGAs with the particular partner jurisdictions. New categories of deemed-compliant FFIs include certain credit card issuers, sponsored FFIs, limited-life debt investment entities and sponsored, closely held investment vehicles. In addition, the final regulations expand the scope of retirement funds that are considered exempt beneficial owners, the income of which is not subject to FATCA withholding. The final regulations also expand the categories of excepted NFFEs.

3 FATCA withholding generally applies to certain U.S.-source payments such as dividends and interest and gross proceeds from the sale of instruments that could produce U.S.-source dividends and interest. FATCA withholding also can apply, however, to certain non-U.S. source “foreign passthru payments” made by foreign financial institutions. While IRS notices initially had defined the scope of foreign passthru payments broadly, the proposed regulations reserved on the concept. The proposed regulations delayed commencement of withholding on such payments, but they did not grandfather instruments that could give rise to such payments beyond the end of 2012. Thus, parties were faced with having to allocate risk for potential withholding in many common types of transactions (for example, financings and derivative transactions), even where the transactions could not give rise to any U.S.-source payments and the transactions involved solely non-U.S. parties.

4 Note, however, that if reopened debt issued after the grandfather date was not treated as part of a qualified reopening under Treas. Reg. Section 1.1275-2(k), the new debt may not be fungible with the original debt issued before the grandfather date because the new debt will be subject to FATCA, even though both may be issued without original issue discount and thus otherwise be fungible for U.S. tax purposes.

- **Limited Relief for Groups.** An FFI that is a member of an “expanded affiliated group” (generally determined by treating affiliates connected through 50 percent ownership as part of the group) is not permitted to become a participating FFI unless every other FFI in its group complies, subject to a transition period ending January 1, 2016. Commentators had asked that an expanded affiliated group be permitted to hold indefinitely, instead of only through the end of 2015, a historically owned FFI that is prohibited under local law from complying with the participating FFI requirements. The Treasury and IRS did not accommodate these requests, stating that these concerns are more appropriately addressed in the IGAs. The regulations did, however, modify the definition to exclude an investment entity owned by an FFI group member when the member’s ownership exists solely to provide a seed capital to an entity.
- **Extension of Timelines:** Consistent with the IRS’s prior announcement, the final regulations provide FFIs more time to complete due diligence procedures and generally conform with the implementation timeline in the IGAs. In particular, all accounts maintained by an FFI prior to January 1, 2014, may be treated as pre-existing accounts. In addition, participating FFIs and withholding agents have until December 31, 2015, to document account holders and payees that are not *prima facie* FFIs. The final regulations also extend the due date for the first information report by participating FFIs with respect to the 2013 and 2014 calendar years to March 31, 2015.
- **Simplification of Due Diligence Requirements:** The final regulations calibrate FATCA’s due diligence requirements based on the value and risk profile of the account and by permitting FFIs in many cases to rely on information they already collect.

Model Intergovernmental Agreements

As noted above, IGAs with partner countries represent a main focus of the effort to implement FATCA. Partner jurisdictions that enter into a “Model 1 IGA” agree to adopt rules requiring FFIs to identify and report information about U.S. accounts to the partner jurisdiction, which then exchanges this information with the IRS on an automatic basis. The Model 2 IGA, on the other hand, is an agreement whereby a partner jurisdiction agrees to “direct and enable” all FFIs that are located in the jurisdiction to register with and directly report information to the IRS about U.S. accounts in a manner consistent with FATCA. Certain information about recalcitrant account holders is supplemented by government-to-government exchange of information. The final regulations confirm that FFIs covered by a Model 1 IGA do not need to apply the final regulations for purposes of complying with and avoiding withholding under FATCA. FFIs covered by a Model 2 IGA, however, will be required to follow the final regulations except to the extent expressly modified by the agreement. While the final regulations harmonize FATCA’s requirements with the provisions of the existing IGAs in many respects, the extent to which they will be coordinated fully remains to be seen.

Administrative Approaches

- **FFI Agreements:** In response to comments, the final regulations describe the substantive requirements for an FFI under an FFI agreement. It will still be important for FFIs to see a draft agreement as soon as possible. The Treasury and the IRS have said they expect to publish a revenue procedure setting out the terms of an FFI agreement, consistent with these final regulations, coordinating an FFI’s obligations under the FFI agreement with other withholding obligations and with the provisions of any applicable IGA, and including administrative provisions such as those relating to termination, renewal and modification of the agreement.

- **IRS Review:** The final regulations provide for general inquiries under which the IRS contacts the participating FFI to request additional information regarding the information reported on returns, and for inquiries when the IRS determines that there may have been substantial noncompliance with an FFI agreement. The IRS expects that these inquiries will not be made on a routine basis. In the case of suspected substantial noncompliance, the IRS may inquire as to the FFI's compliance with certain requirements of the FFI agreement. Events of default, however, will not result in automatic termination of the FFI agreement. Rather, the IRS will allow a participating FFI to develop a plan to remediate before it terminates its participating FFI status.
- **Electronic Registration:** A FATCA Registration Portal, which will be open by July 15, 2013, will be the primary means for FFIs to interact with the IRS regarding FATCA registrations, agreements and certifications. The IRS intends to assign global numbers (GIINs) and to post a list of participating FFIs and registered deemed-compliant FFIs (including reporting Model 1 FFIs) by December. The last date by which a financial institution may register with the IRS to ensure its inclusion on the December 2013 list is October 25, 2013.
- **New IRS Forms:** New and revised IRS forms must be issued so that taxpayers may comply with the FATCA certification, reporting and withholding requirements. In particular, the IRS already has issued draft versions of revised Forms W-8s. The IRS intends to release shortly a new Form W-8BEN for individuals and one for entities. The IRS also will release a new Form 8966, "FATCA Report," that will be used for reporting purposes, along with a revised Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," and Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding."

In sum, while further developments are needed, the final regulations represent a significant step forward in terms of providing clarity and easing certain of the burdens of FATCA's far-reaching rules.