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Treasury and IRS Release FATCA Regulations

New Regulations Address Some Concerns and Coordinate FATCA Rules with Other Reporting and Withholding Rules

On February 20, 2014, the Department of the Treasury and the IRS issued a comprehensive set of final and temporary regulations implementing Sections 1471-1474, or Chapter 4, of the Internal Revenue Code, commonly known as the Foreign Account Tax Compliance Act or FATCA.

Background

Enacted in 2010, FATCA aims to combat tax avoidance by U.S. taxpayers holding assets in offshore accounts. FATCA imposes sweeping new reporting and withholding obligations on foreign financial institutions (FFIs), defined to include not only banks and custodians but also investment funds and certain insurance companies. FATCA also requires certain nonfinancial foreign entities (NFFEs) to report information about their substantial U.S. holders. In order to compel FFIs and NFFEs to comply with FATCA's reporting regime, FATCA requires payors to withhold 30 percent of, and report to the IRS, payments of certain U.S.-source (and potentially other) income (withholdable payments) to FFIs and NFFEs that fail to comply.

FATCA's scope is broad, and its requirements are extensive. Since FATCA's enactment, the Treasury Department and the IRS have issued detailed regulations and guidance. Despite this guidance, key aspects of FATCA have remained in need of clarification and coordination, even as its start date of July 1, 2014, approaches. In addition to the complicated requirements that financial institutions face, many nonfinancial corporate groups continue to struggle with uncertainty in analyzing the status of their international subsidiaries, which may be caught unexpectedly by FATCA's broad definitions, as well as preparing their accounts payable departments to comply with the new rules.

Also worth noting, the Treasury Department has concluded a number of intergovernmental agreements (IGAs) with other countries to implement FATCA for institutions in those countries and is currently negotiating many more. The IGAs contemplate that authorities in the relevant countries will issue laws implementing FATCA for institutions in their respective countries. This means that FFIs in an IGA jurisdiction ultimately will be governed by their own country's IGA and implementing laws. Thus, many companies and institutions must prepare for FATCA based on the existing Treasury Regulations and published IGAs, while facing the difficult prospect that the specific requirements ultimately may differ for institutions based in different countries once the Treasury Department concludes the relevant IGAs and authorities in those countries issue implementing laws.

Finally, since well before FATCA, the U.S. has imposed information reporting and back-up withholding requirements on certain payors of income to U.S. taxpayers (under Chapter 61 and section 3406 of the Code), as well as information reporting and withholding requirements on those who pay certain U.S.-source income to non-U.S. persons (under Chapter 3 of the Code). For some time, the Treasury and IRS have acknowledged the need to coordinate FATCA's new rules with these existing regimes.

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

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

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

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

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

Jennifer L. Sabin
New York
212.735.2927
jennifer.sabin@skadden.com

* * *

1440 New York Avenue, NW,
Washington, D.C. 20005
Telephone: 202.371.7000

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

WWW.SKADDEN.COM

The newly released regulations (the new FATCA regulations) supplement and clarify the previously issued FATCA regulations (the prior FATCA regulations). Additionally, the Treasury Department and the IRS released a separate package of final and temporary regulations (the coordinating regulations) intended to coordinate FATCA's diligence, reporting and withholding requirements with existing information reporting and withholding regulations. Although the new FATCA regulations do not significantly change FATCA's breadth, complexity or general timeline, they do contain a number of helpful clarifications and changes in response to concerns raised by stakeholders. In addition, the coordinating regulations provide important consistency between FATCA and the existing reporting and withholding rules.

Revisions to the FATCA Rules

The following highlights some, but not all, of the more notable changes to the FATCA rules.

More Flexibility for NFFEs.

- The prior FATCA regulations required passive NFFEs[1] to report information about their substantial U.S. owners to withholding agents (*i.e.*, anyone making a withholdable payment). The new FATCA regulations now enable a passive NFFE instead to report such information directly to the IRS. Furthermore, such an NFFE may contract with another entity (a sponsor) to perform the required FATCA diligence, reporting and withholding on its behalf. These changes may lessen the administrative burden for passive NFFEs and will allow them to preserve confidentiality about their owners or investors.

Slightly Narrower Definition of FFI. The new FATCA regulations provide relief for certain entities that may have been inadvertently covered by the definition of an FFI under the prior FATCA regulations.

- **Custodial Institution Must Hold Financial Assets.** Under the prior FATCA regulations, the definition of a custodial institution (one category of FFI) included entities with a certain percentage of gross income attributable to financial assets and related financial services. Stakeholders noted that this definition could include entities that do not themselves hold financial assets, have no financial accounts and whose only business is to provide financial advice to clients. The new FATCA regulations revise the definition to clarify that a custodial institution must hold financial assets in custody.

- **Deemed-Compliant Status for CLOs and Investment Managers.** The new FATCA regulations revise the definition of a certified deemed-compliant FFI to, among other things, (i) broaden the definition of a limited life debt investment entity, such as a CLO, to accommodate certain industry practices, and (ii) include investment advisers and investment managers that do not maintain financial accounts. Status as a certified deemed-compliant FFI means that these entities generally are relieved of FATCA's reporting and withholding requirements and do not have to register with the IRS.

- **Safe Harbor for Nonfinancial Group Entities Owned by Investment Vehicles.** The new FATCA regulations include helpful changes relevant to when an entity that might otherwise fall within the definition of FFI qualifies for an exemption because it is part of a corporate group engaged in a nonfinancial business (a nonfinancial group). This exemption is important because the definition of FFI is otherwise so broad that it may capture treasury centers or holding companies that have nothing to do with the policy underpinnings of FATCA. The prior FATCA regulations excluded entities from this nonfinancial group

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1 Passive NFFE means, generally, any nonfinancial foreign entity unless it has sufficient active income and assets or meets another exception, such as an exception for certain publicly traded corporations and their affiliates as well as for certain companies that are part of a nonfinancial group (as defined herein).

exemption if they were formed or availed of by an investment vehicle, raising concerns about whether entities owned, in whole or in part, by private equity funds or other investment vehicles could ever qualify for the exemption. The new FATCA regulations provide that entities that have existed for at least six months prior to acquisition by an investment vehicle and have regularly conducted ordinary course business generally are not considered to have been formed or availed of by the investment vehicle.

More Favorable Rules for Groups.

- In response to comments, the new FATCA regulations provide that a pre-existing limited life debt investment entity (*i.e.*, one that issued all of its interests, and was in existence, on or before January 17, 2013) will not be considered a member of a majority investor's expanded affiliated group (EAG). Therefore, these entities are not required to monitor their ownership structure in order to avoid inadvertently becoming part of a group.
- The new FATCA regulations provide that exempt beneficial owners within an EAG will not taint the participating FFI status of the other group members. This amendment addresses a technical glitch that could have jeopardized the FATCA status of many investment funds with exempt beneficial owners, such as sovereign wealth funds, as majority investors.
- The new FATCA regulations allow a non-corporate entity, such as a trust or a partnership, that owns more than 50 percent of the vote and value of the stock of the common parent corporation of an EAG to be treated as the common parent entity. As a result, such entities may qualify for the exception to FFI status generally afforded to holding companies that are part of a nonfinancial group. Being able to avoid FFI status could not only eliminate certain registration and other administrative requirements but also could mitigate the risk of unintentionally tainting the group with a nonparticipating FFI.
- In response to comments, the new FATCA regulations clarify the ownership rules for members of the group and provide that constructive ownership rules do not apply, simplifying the determinations required under the rules.

Separate Treatment of FFI Branches. Consistent with the draft FFI agreement published in IRS Notice 2013-69, the new FATCA regulations provide that the term "branch" includes a branch of an FFI even if it is disregarded for U.S. federal income tax purposes. As a result, a branch of an FFI that is a disregarded entity must nonetheless obtain a global intermediary identification number in order to be considered FATCA-compliant. Likewise, if such disregarded entity is unable to comply with the terms of an applicable FFI agreement due to local law restrictions, it may be treated as a "limited branch."

Modest but Helpful Changes to FATCA Withholding and Reporting Rules.

- **Security Arrangements Eliminated from Financial Account Definition.** The definition of financial account includes certain equity and debts interests whose value is determined primarily by reference to assets that could give rise to withholdable payments (generally, certain U.S.-source payments) or whose return is determined primarily by reference to one or more investment entities or passive NFFEs. The prior FATCA regulations included (i) debt interests secured by the assets of a U.S. person or one or more investment entities and passive NFFEs, and (ii) equity interests if the amount payable upon redemption of such interests was secured primarily by assets that could give rise to withholdable payments. The new FATCA regulations eliminate these security provisions such that if, for example, a debt interest is secured by the assets of a U.S. person, such security alone no longer results in a foregone conclusion that the interest is a financial account under FATCA.

- **Foreign Grantor Trust Treated as Separate Entity.** To make the treatment of a grantor trust under FATCA consistent with its treatment under Chapters 3 and 61, which treat the trust itself, rather than the grantor, as the payee, the new FATCA regulations revise the prior FATCA regulations to provide that the grantor trust is an account holder that must provide documentation of its Chapter 4 status as an FFI or an NFFE.

- **Withholding Agent Must Have Actual Knowledge of Material Modification Before Withholding on Grandfathered Obligation.** The new FATCA regulations provide that a withholding agent (other than an issuer or an agent of the issuer) is required to withhold on a grandfathered obligation only if the withholding agent has actual knowledge of such material modification, such as if it receives disclosure to such effect.

- **Transition Relief for Certain Secured Transactions.** In response to comments, the new FATCA regulations create a transitional rule for certain payments made by a secured party with respect to collateral securing transactions (for example, under a credit support annex (CSA) to an International Swaps and Derivatives Association Agreement for hedging and other financial transactions or a lending or financing transaction). As a result of industry-standard commingling of collateral from all counterparties, the new FATCA regulations add a transitional rule such that withholding on these payments is not subject to withholding until January 1, 2017, provided that only a commercially reasonable amount of collateral is held by the secured party as part of the collateral arrangement.

- **Easing of Requirement for Compliant FFIs to Report on Foreign-Source Payments to Non-Compliant FFIs.** The new FATCA regulations, consistent with Notice 2013-69, significantly narrow the reporting requirements for a participating FFI or a registered deemed-compliant FFI making a payment of a foreign reportable amount to a nonparticipating FFI, mitigating administrative burdens and potential traps for the unwary. The new FATCA regulations provide that a participating FFI or registered deemed-compliant FFI must report foreign reportable amounts paid to a nonparticipating FFI only if the nonparticipating FFI maintains an account with the payor. Moreover, the scope of the term "foreign reportable amount" is narrowed and, in some cases, certain aggregate reporting with respect to these payments is permitted.

- **Use of Eyeball Test for Pre-Existing Obligations.** The new FATCA regulations provide that a withholding agent (other than a participating FFI or a registered deemed-compliant FFI) that makes a payment with respect to a preexisting obligation can treat the payee as a U.S. person if the withholding agent previously had classified the payee as a U.S. person for purposes of Chapters 3 and 61 and established that the payee is an exempt recipient for Chapter 61 purposes. The withholding agent could have established the payee's exempt recipient status either through documentation or through the "eyeball test," which enables the withholding agent to conclude that a payee is exempt based solely on certain indicators in the payee's name.

- **Event of Default Not Triggered by Recalcitrant Holders.** The New FATCA Regulations clarify that if a participating FFI complies with the required due diligence procedures, the failure to significantly reduce, over a period of time, the number of recalcitrant account holders and payees that are nonparticipating FFIs will not trigger an event of default. In other words, this event of default is triggered only if the failure is due to a lack of compliance with the required procedures.

Rules Coordinating the Existing Information Reporting and Withholding Regimes With the FATCA Rules

To the extent the different objectives of the regimes under FATCA (Chapter 4), Chapter 3 and Chapter 61 (and section 3406) allow, the coordinating regulations integrate the rules of these three regimes so as to reduce the burdens placed on withholding agents. Thus, the coordinating regulations generally reduce duplicative information reporting and withholding and coordinate the required due diligence procedures.

The following highlights some, but not all, of the more significant coordinating changes.

Determining Payee Status

- **Presumption Rules Revised to Conform With FATCA.**

  — **Change to "Eyeball" Test for Exempt Recipients.** For certain types of recipients (including "eyeball" exempt corporations and financial institutions), to which reportable payments are exempt from Chapter 61 information reporting (and backup withholding), the current Chapter 3 rules presume these payees to be foreign only if there is foreign indicia. For payments that are also Chapter 4 withholdable payments (made to certain exempt recipients and with respect to obligations that are not preexisting obligations), the coordinating regulations flip that presumption to be consistent with the Chapter 4 presumption, so the recipient will be treated as foreign for both Chapter 3 and Chapter 4 purposes unless there is documentation establishing the entity to be a U.S. person. While simply implementing the same presumption rule already in place for FATCA and not applicable to preexisting obligations, this presumption will require a significant change in documentation collected by accounts payable (AP) departments since there does not appear to be any specified "documentation" that can establish U.S. status other than a Form W-9, which typically is not collected today by AP departments doing business with obviously domestic corporations and/or financial institutions.

  — **U.S. Indicia Revised.** The coordinating regulations revise the Chapter 3 rules to provide for the same categories of U.S. indicia (and cures) as are applicable under FATCA. (For example, U.S. indicia previously did not include a U.S. place of birth.) In addition, the coordinating regulations provide a transition rule for preexisting obligations (*i.e.*, existing on July 1, 2014) that if documentation had been obtained prior to 2014, the withholding agent does not need to review that documentation again for U.S. indicia. However, if that documentation *is* reviewed and is found to include newly added U.S. indicia that was added to conform with FATCA (*e.g.*, U.S. place of birth) or if there is a change in circumstances, there generally will be "reason to know" that the payee is a U.S. person as of that date of review/changed circumstances.

  — **U.S. Branch ECI Presumption.** The current Chapter 3 rule treats payments to an undocumented U.S. branch of a regulated foreign bank or insurance company as income effectively connected to a U.S. trade or business (ECI). The coordinating regulations condition this ECI presumption on obtaining the payee's employer identification number (EIN). Unless the EIN is obtained (which can be included on a Form W-8ECI), the income paid will be subject to Chapter 3 withholding.

  — **Payment Made Outside the U.S. to an Offshore Account.** In certain instances, the existing regulations limit (i) certain presumptions and (ii) alternative documentation rules to payments that are "made outside the U.S. to an offshore account."

The coordinating regulations revise this term (now "payments with respect to an offshore obligation") to expand the types of payments (beyond payments to foreign bank accounts) that can qualify for these rules. Under the coordinating regulations, payments with respect to offshore obligations for both the presumption rules and the alternative documentation rules include payments with respect to bonds, debentures, notes and other evidences of indebtedness, as well as payments by broker-dealers with respect to contracts and other instruments.

— **All Payments to Individuals With Respect to Offshore Obligations.** Under the current rules affecting Form 1099 reporting, in the absence of documentation, recipients of payments made by a U.S. payor (including a controlled foreign corporation (CFC)) outside the U.S. to an offshore account were presumed to be foreign for Chapter 3 purposes, but U.S. for Form 1099 reporting purposes. Thus, for example, if the payment made was U.S.-source income, Chapter 3 withholding would apply; if the payment made was foreign-source income, Form 1099 reporting would apply. The coordinating regulations modify these rules so that individual recipients without documentation are presumed to be U.S. persons for this purpose only when there is U.S. indicia (*e.g.*, U.S. address, standing instructions to send payments to a U.S. account, etc.). This rule relieves U.S. payors of foreign source income with respect to offshore obligations of the significant burden of having to collect documentation or perform Form 1099 reporting and will prevent the application of reporting penalties for those payors who failed to obtain the previously required documentation.

Withholding Certificates and Documentation

- **Elimination of Need for U.S. Tax Identification Number (TIN) on Treaty Claim.** Under the current rules, a beneficial owner who seeks to claim treaty benefits must provide a U.S. TIN on its W-8BEN. Under the coordinating regulations, these beneficial owners can instead provide their foreign TINs. This welcome change will provide significant relief for beneficial owners in treaty countries who often are resistant to applying for U.S. TINs.

- **Validity Period.** The coordinating regulations under Chapter 3 provide expanded rules for indefinite validity for certain withholding certificates and documentation to be consistent with Chapter 4. The coordinating regulations, however, do not apply the indefinite validity rules to the portion of the withholding certificate that includes the treaty benefit claim. Thus, the coordinating regulations remove the current requirement that annual payments be made to a payee in order for a withholding certificate with a TIN to remain valid indefinitely. In addition, for payees whose *documentation* is not indefinitely valid, the coordinating regulations extend the validity period (beyond the current three-year period) to the end of the year in which the documentation itself expires. Finally, to allow for documentation gathering for preexisting accounts under Chapter 4, the coordinating regulations extend the expiration date for withholding certificates and documentation that would otherwise expire on December 31, 2013, so that they will not be treated as invalid until January 1, 2015.

- **Electronic Submission.** In response to many requests received by the Treasury Department, the coordinating regulations allow withholding certificates and withholding statements to be accepted by facsimile, scan, etc. unless the withholding agent knows that the sender is not authorized to provide those forms. The withholding agent is not required to authenticate that the person sending the electronic submission is the person who is permitted to sign the forms.

- **M&A Documentation.** In the case of mergers and acquisitions by financial institutions, a new rule allows a withholding agent to rely on its predecessor's documentation. Such acquirors also may rely on the determinations made by their predecessors with respect to that documentation for six months absent actual knowledge to the contrary or a change in circumstances as long as the predecessor was a U.S. withholding agent or a qualified intermediary (QI). Acquirors that discover at the end of this transition period that the Chapter 3 status was incorrect, however, are required under this new rule to withhold the tax that should have been collected (had the classification not been erroneous) on future payments (if any).

Reporting

- **All FFI Payors.** The coordinating regulations allow FFIs to avoid duplicative reporting by electing to satisfy their Chapter 4 obligations by reporting on Forms 1099 as modified to include certain Chapter 4 information.

- **FFI Payors that are not US Payors (including Model 1 and Model 2 FFIs).** Under the coordinating regulations, FFI payors that are not U.S. payors (like CFCs) will be excepted from the requirement to report on U.S. non-exempt recipients under Chapter 61 to the extent the payor reports on the account under Chapter 4.

Withholding

- **Avoiding Duplicative Withholding.** The coordinating regulations provide that when withholding is required under both Chapter 4 and either Chapter 3 or section 3406, the withholding agent should withhold only under Chapter 4 (subject to an ability to elect to backup withhold under section 3406 in certain circumstances).

- **Conforming Rules.** The coordinating regulations conform the Chapter 3 rules with the Chapter 4 rules in a number of areas including the rules for: curing late/incomplete documentation; retaining withholding certificates/documentation; intermediary notifications associated with changes in circumstances; inter-branch/intra-company document sharing; ensuring compliance under a QI agreement; withholding rate pools on withholding statements provided by QIs and non-QIs, reporting on Forms 1042 and 1042-S; and obtaining refunds/credits under section 6402 (so as to make the Chapter 3 rules applicable to Chapter 4 claims).

- **Lack of Conformity Where Policies Differ.** Notably, the coordinating regulations did not conform the Chapter 3 rules with the Chapter 4 rules where the purposes of the provisions were not consistent. For example: the coordinating regulations do not permit the 90-day, non-withholding grace period following a change in circumstances (as allowed under FATCA) to apply to Chapter 3 withholding.

Portfolio Interest Exemption Repeal for Foreign-Targeted Obligations

The coordinating regulations push back the sunset date to December 31, 2015 for the repeal of the portfolio interest rules for certain foreign targeted obligations to afford the time for foreign institutions to become QIs in accordance with the forthcoming amendments to the QI agreement.