

# CLIENT UPDATE

## IRS ISSUES FINAL FATCA REGULATIONS

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On January 17, 2013, the IRS issued final regulations (the “Final Regulations”) under FATCA (Foreign Account Tax Compliance Act). This update summarizes key provisions and significant developments in the Final Regulations.

### BACKGROUND

In order to prevent U.S. taxpayers from evading U.S. tax through offshore accounts, FATCA generally imposes a 30% withholding tax on payments to foreign financial institutions (“FFIs”) and non-financial foreign entities of “withholdable payments,” unless the recipient complies with certain reporting and other requirements or an exception applies. Withholdable payments consist of (i) U.S. source dividends, interest, rents and other fixed and determinable income and (ii) gross proceeds from the disposition of U.S. stocks and securities.

In order to avoid the 30% withholding tax, an FFI will be required to enter into an agreement with the IRS (an “FFI Agreement”), unless an exception applies. Under an FFI Agreement, an FFI must (i) comply with diligence, reporting and verification procedures with respect to its financial accounts that are held by U.S. persons or by certain foreign entities with U.S. owners and (ii) withhold on withholdable payments and “foreign passthru payments” that the FFI makes to

account holders that fail to comply with reasonable information requests or to waive foreign laws preventing FATCA reporting or to FFIs that do not themselves enter into FFI Agreements or otherwise comply with the requirements of FATCA.

The Treasury Department is implementing an alternative approach for FFIs resident in a country that has entered into an intergovernmental agreement (“IGA”) with the United States. Payments to an FFI that is subject to an IGA generally will not be subject to FATCA withholding if the FFI satisfies identification and reporting rules regarding U.S. accounts adopted by the FFI’s country of residence. The United States has announced that it is engaged with more than 50 jurisdictions regarding an IGA, including the Cayman Islands and other offshore jurisdictions, and has already signed or initialed IGAs with the United Kingdom and six other countries.

## HIGHLIGHTS OF THE FINAL REGULATIONS

### *Effective Dates for FATCA Withholding*

- The effective dates for FATCA withholding are consistent with previous IRS guidance:
  - January 1, 2014, for withholding on payments of U.S. source income;
  - January 1, 2017, for withholding on gross proceeds from sales or dispositions of U.S. stock or debt instruments; and
  - In the case of “foreign passthru payments,” the definition of which is reserved for future regulations, withholding will not be required before the later of January 1, 2017 and the date that is six months after the publication of such regulations.

### *Grandfathered Obligations*

- FATCA withholding will not apply to payments under obligations that are outstanding on January 1, 2014, or to any proceeds from the disposition of such obligations. This represents a one-year extension from prior guidance. Subsequent modifications, however, may result in loss of grandfather status.
- For purposes of the grandfather rules, an obligation is a legally binding agreement or instrument. Obligations include debt instruments; lines of credit or revolving credit facilities (provided the material terms, including maturity date, have been fixed); and life insurance and annuity contracts (other than investment-linked insurance and annuity contracts). However, stock and instruments with an indefinite term are not obligations.

- The preamble to the Final Regulations confirms that a “qualified reopening” of a debt obligation will not be treated as a new issuance of debt for purposes of the grandfather rules, which addresses concerns that new debt instruments issued after the grandfather date may not be fungible for tax purposes with the original grandfathered debt instruments.
- The Final Regulations grandfather obligations that give rise to withholdable payments under the dividend equivalent rules in section 871(m) of the Internal Revenue Code and obligations that give rise to “foreign passthru payments,” in each case if the obligation is outstanding on or prior to six months after final regulations addressing these payments are adopted.
- The grandfather rules also apply to any agreement requiring a secured party to make a payment with respect to, or to repay, collateral posted to secure a grandfathered obligation (*e.g.*, in connection with derivative transactions). Collateral posted to secure both grandfathered and non-grandfathered obligations must be allocated *pro rata* by value.

#### *FFI Compliance and FFI Agreement*

- Beginning no later than July 15, 2013, FFIs will be able to register with the IRS through a secure online web portal from anywhere in the world. The portal is designed to allow FFIs to register their FATCA status and to facilitate electronic communications between the IRS and registrants.
- The first date on which FFI Agreements will come into effect is December 31, 2013, for all participating FFIs that register prior to January 1, 2014.
- Information reporting requirements for participating FFIs will be phased in beginning in 2015, when participating FFIs must file limited information reports with respect to calendar years 2013 and 2014.
- To ease the diligence requirements of FFIs, the Final Regulations treat all accounts maintained by an FFI prior to January 1, 2014 as “preexisting accounts” subject to lower levels of diligence. This brings the Final Regulations into alignment with the IGAs.
- Although the IRS has not yet published the actual terms of an FFI Agreement, the Final Regulations set forth the substantive requirements applicable to an FFI under an FFI Agreement. The FFI Agreement will require periodic self-certifications by a responsible officer, and define an “event of default” and procedures for remediating an event of

default. If an FFI fails to comply with a remediation plan, the IRS may terminate the FFI's status as a participating FFI within a reasonable period of time.

- The failure of a participating FFI to reduce significantly over a period of time the number of account holders that are recalcitrant account holders or non-participating FFIs will be considered an event of default that, if not remediated, may result in termination of the FFI Agreement.

### *Entities Treated as FFIs*

- The main categories of FFIs are: foreign banks and other depository institutions; foreign custodial institutions; foreign investment entities; and foreign insurance companies that issue or make payments on cash value insurance or annuity contracts.
- The Final Regulations expand the definition of "investment entity" so that it now includes investment advisors and asset managers, including private equity and hedge fund managers, as well as hedge funds, private equity funds, and other entities engaged in investing and trading financial assets.
- A foreign holding company is treated as an FFI if it is part of a group that includes a financial institution, unless the group benefits from an exception for "nonfinancial groups."
- A foreign holding company formed or availed of by an investment fund is treated as an FFI, even if the company is formed to acquire a nonfinancial portfolio company.

### *Consolidated Compliance Procedures and Sponsoring Entities*

- A participating FFI may elect to be part of a consolidated compliance program and perform a consolidated periodic review under the authority of an FFI or U.S. financial institution in the same expanded affiliated group.
- In response to industry comments, a manager of investment funds is permitted to act as a "sponsoring entity" that registers its managed funds as FFIs and performs participating FFI due diligence, withholding and reporting obligations on behalf of the funds.

### *Insurance Companies*

- Certain insurance contracts, including contracts that do not have a cash value in excess of \$50,000 at any time during the calendar year, are excepted from the definition of "financial account."

- Indemnity reinsurance contracts are not themselves treated as cash value insurance contracts even if the underlying ceded risks arise under cash value insurance or annuity contracts. In addition, an insurance company is not treated as an FFI by reason of its reserving activities.
- Certain insurance companies operating only in their home jurisdictions may be able to qualify as “deemed-compliant” FFIs pursuant to a limited exception that was available only to banks under previous IRS guidance.
- Foreign insurance companies that have elected under section 953(d) of the Code to be treated as domestic corporations under the Code are nonetheless treated as foreign for purposes of FATCA. The Final Regulations provide only a limited exemption for foreign insurance companies that have made a section 953(d) election and are licensed to do business in the United States.

*Limited Branches and Limited FFIs*

- The Final Regulations do not extend the sunset date for “limited branches” and “limited FFIs” (*i.e.*, FFIs and branches of FFIs that cannot comply with all of the FATCA reporting and diligence obligations because of restrictions imposed under local law). If a limited branch or limited FFI cannot comply with the applicable requirements by December 31, 2015, the expanded affiliated group that includes such branch or FFI will lose its FATCA compliant status, except to the extent an IGA applies.

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Please do not hesitate to contact us with any questions.

February 4, 2013

*The foregoing was not intended to be used, and it cannot be used, by any taxpayer for the purposes of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax law.*