Significant Developments for the Implementation of FATCA: The IRS and Treasury Department Release Proposed Regulations

On February 8, 2012, the Internal Revenue Service (IRS) and Treasury Department released long-awaited proposed regulations on a set of statutory rules commonly referred to as the Foreign Account Tax Compliance Act rules (or, FATCA).[1] FATCA establishes a new information reporting regime to identify U.S. persons holding assets through offshore entities and overseas accounts. Non-compliance with FATCA generally leads to a 30% withholding tax on most U.S. source income and, potentially, on all or a portion of non-U.S. source income. The FATCA regime institutes significant changes not only for offshore entities (such as non-U.S. funds and banks) but also for U.S. entities (such as U.S. private investments funds, regulated investment companies and U.S. banks) that will be required to implement the new FATCA reporting and withholding procedures. FATCA's broad reach, its high implementation costs, and questions regarding compliance feasibility have raised significant concerns across industries, with many hoping that the proposed regulations would clarify and ease some of the compliance requirements.

In general, the proposed regulations do expand and clarify previous guidance and demonstrate responsiveness to comments by easing the burdens of compliance. Moreover, a Joint Statement by the Treasury Department and five European countries released simultaneously with the proposed regulations outlines an alternative intergovernmental approach intended to implement FATCA's objectives without creating local law conflicts. The proposed regulations provide guidance on a wide range of issues that allows entities to evaluate how they will be affected and to begin adopting appropriate policies and procedures in time to ensure compliance with FATCA.

The proposed regulations do not, however, delay the phase-in of FATCA withholding and reporting requirements scheduled to begin January 1, 2014. Similarly, the application deadline by which a foreign financial institution (an FFI, as discussed below) is required to enter into an agreement with the IRS (an FFI Agreement) to avoid the withholding tax remains June 30, 2013.

Below we provide (A) a brief overview of the FATCA regime, (B) a discussion of key issues relevant to various industry groups, and (C) a summary of potential implications of an intergovernmental approach to FATCA.

A. Brief Overview of the FATCA Regime

FATCA establishes a new reporting and withholding regime that will operate in tandem with the current reporting and withholding system. Under FATCA, U.S. withholding agents and FFIs will be required to withhold 30% on "withholdable payments" to entities and accounts that do not meet FATCA's requirements (and are not otherwise exempted from FATCA).

- "Withholdable payments" include payments of U.S.-source dividends, interest and other fixed or determinable annual or periodic income (FDAP income), and payments of gross proceeds from sales of property capable of producing U.S.-source dividends or interest.

[1] The FATCA rules were first introduced in 2009 and officially added to the Internal Revenue Code of 1986 by the Hiring Incentives to Restore Employment Act of 2010 on March 18, 2010.

The proposed regulations create new protocols for determining the recipient of payments for FATCA purposes and the documentation that is necessary to eliminate withholding on these payments. The proposed regulations are designed to meld FATCA with the current reporting system. As such, there will be new tax forms, including revised Forms W-8 and W-9, to take into account the additional certifications required by FATCA. In addition, the qualified intermediary and withholding foreign partnership regimes will be modified for FATCA.

Foreign Financial Institutions.

A foreign financial institution (an FFI) is a broadly defined term that includes not only non-U.S. banks and similar institutions but also non-U.S. funds and entities that merely hold financial assets.

To compel FFIs to comply with FATCA obligations, FATCA imposes a 30% withholding tax on withholdable payments to FFIs that do not meet FATCA's requirements (and are not otherwise exempt from FATCA). The withholding commences on January 1, 2014 with respect to FDAP income and on January 1, 2015 with respect to gross proceeds that are withholdable payments as described above.

In order to avoid the 30% FATCA withholding from the outset, an FFI must generally (a) either apply to enter into an FFI Agreement by June 2013 (to become a participating FFI) or qualify for an exception from entering into such FFI Agreement, and (b) provide appropriate certifications or other documentary evidence to the withholding agent certifying its exempt or participating FFI status (and in some cases the status of its beneficial owners).

Although the IRS has not yet provided a form of the FFI Agreement, the regulations contain sufficient guidance for FFIs to anticipate what the agreement may look like. The IRS expects to release a form FFI Agreement later this year.

Participating FFIs and FFI Agreement Requirements

- Participating FFIs are required to conduct diligence with respect to all pre-existing and new accounts (which can include non-publicly traded debt or equity). The proposed regulations, which simplify certain requirements, allow either one or, in some limited cases, two years from the date of signing an agreement with the IRS for the FFI to complete its diligence work on pre-existing accounts. Diligence requirements will generally require participating FFIs to obtain U.S. tax forms (e.g., Forms W-8 or W-9) and make additional inquiries if information regarding a non-U.S. investor contains indicia of U.S. ownership. Responsible compliance officers of participating FFIs will have to certify on a periodic basis that the required diligence with respect to accounts has been completed.
- Participating FFIs are required to identify their U.S. accounts, including equity in a private investment partnership, held by "specified United States persons." Similarly, a non-U.S. entity that is not an FFI (NFFEs) but has one or more "specified United States persons" that hold 10% by vote or value of such non-U.S. entity (each a substantial U.S. owner) must identify each substantial U.S. owner to the withholding agent. A specified U.S. person that has any ownership interest in certain investment vehicles and insurance arrangements may be considered a substantial U.S. owner. These accounts, generally, are referred to as U.S. accounts. A "specified United States person" does not include an organization exempt from tax pursuant to Section 501(a) of the Code, a U.S. wholly owned agency or instrumentality, an IRA, a REIT, a RIC or a publicly traded company.
- Participating FFIs must annually report the following information with respect to U.S. accounts:

- Identifying information of each U.S. account holder, including the name, address, taxpayer identification number, account number, and account balance of each (beginning in 2014 with respect to 2013).

- All income payments associated with each U.S. account holder (beginning in 2016 with respect to 2015).

- All payments, including payments of gross proceeds associated with each U.S. account holder (beginning in 2017 with respect to 2016).

The regulations clarify that account balances and payments may be reported in the currency in which the account is denominated.

- Participating FFIs are required to withhold on "passthru payments" to nonparticipating FFIs and holders that fail to provide the required information (recalcitrant account holders). Passthru payments consist of withholdable payments (discussed above) and "foreign passthru payments." The proposed regulations reserve on the definition of foreign passthru payment but generally a "foreign passthru payment" represents the portion of passthru payments that is "attributable to" FDAP income, and payments of gross proceeds from sales of property that can produce dividends or interest that are U.S.-source FDAP income. The proposed regulations defer withholding with respect to foreign passthru payments until January 1, 2017. This delay, combined with the potential for an alternative intergovernmental approach to FATCA (see below), reduces some of the immediate concern about foreign passthru payment withholding.

- Participating FFIs must close the account of a holder who is not permitted by law to provide information required by FATCA and who does not waive these restrictions. Although the proposed regulations do not prescribe account closing procedures, it is possible that the FFI Agreements will address this topic.

Exempt Beneficial Owners.

Under FATCA, certain non-U.S. entities, referred to as "exempt beneficial owners," are not subject to the 30% withholding tax on withholdable payments regardless of whether such non-U.S. entities are participating FFIs or are treated as deemed compliant FFIs. Such non-U.S. entities include foreign governments and wholly owned instrumentalities and agencies of foreign governments. Helpfully, the proposed regulations also extend the category of exempt beneficial owners to cover certain non-U.S. retirement funds provided that, among other requirements, the retirement fund is established in a country with which the U.S. has an income tax treaty and qualifies for treaty benefits. Although exempt, these entities still need to be mindful of the impact that FATCA may have on their investments in certain FFIs that may themselves become subject to withholding.

Deemed-Compliant FFIs.

"Registered deemed-compliant FFIs" and "certified deemed-compliant FFIs" are the other two categories of non-U.S. entities that do not have to enter into an FFI Agreement to avoid FATCA withholding.

- *Certified Deemed-Compliant FFI*

A "certified deemed-compliant FFI" needs only to provide an appropriate tax form certifying that it meets the requirements of such status. Two important categories of certified deemed-compliant FFIs include certain retirement funds and certain non-profit organizations. Consequently, even if a non-U.S. retirement fund cannot meet the requirements for exempt beneficial owner status, it still may be able to avoid entering into an FFI Agreement if: (a) it is organized in its home country to provide pension benefits, (b) its contributions are limited to employee income and are provided by the employee, employer, or government, (c) no beneficiary is entitled to more than 5% of its assets, and (d) either its contributions are tax deferred or excluded, or government and employers jointly provide more than 50% of contributions. An alternative test is available if it has fewer than 20 participants.

Certain non-profit FFIs are also treated as "certified deemed-compliant FFIs" if such FFIs can meet certain requirements including having (a) a religious, charitable, scientific, artistic, cultural or educational purpose, (b) a tax exemption in its country of residence, and (c) income and assets that cannot be distributed to or benefit private individuals or noncharitable FFIs except in the service of the non-profit FFI's charitable purpose.

- *Registered Deemed-Compliant FFI*

A "registered deemed-compliant FFI" must conduct due diligence with respect to its investors and certify to the IRS that it meets the requirements of the proposed regulations to qualify for deemed-compliant status. Some of the categories of "registered deemed-compliant FFIs" include qualified collective investment vehicles and restricted funds. In general, to be deemed-compliant as a "qualified collective investment vehicle" or as a "restricted fund," a collective investment vehicle must be regulated as an investment fund in its country of organization. It is not entirely clear what type of regulatory regime satisfies this requirement. In addition, very generally, only deemed-compliant FFIs, participating FFIs, beneficial owners exempt from FATCA, and U.S. owners who are not treated as specified United States persons may own debt or equity interest in such vehicles. A restricted fund is subject to more onerous requirements, such as the prohibition of debt or equity sales (a) to a U.S. person, a nonparticipating FFI, or a passive NFFE with substantial U.S. owners, and (b) by persons other than "restricted distributors."

In anticipation of international cooperation with other countries, the proposed regulations allow an FFI that is deemed to comply with the requirements of FATCA pursuant to an agreement between the U.S. government and a foreign government to be treated as a "registered deemed-compliant FFI."

Non-Financial Foreign Entities.

A 30% withholding tax on withholdable payments is imposed on NFFEs unless an NFFE certifies to the withholding agent that it has no substantial U.S. owners or identifies its substantial U.S. owners by their names, addresses, and taxpayer identification numbers. Some NFFEs, such as publicly traded companies, entities engaged in active businesses, and entities that are treated as exempt beneficial owners, are considered to be low risk and are exempt from withholding. Many tax-exempt organizations and individual retirement plans would be excluded from the definition of substantial U.S. owners.

U.S. Withholding Agents.

As with the traditional U.S. withholding regime, a withholding agent will generally be required to reliably associate payments with valid withholding forms in order to determine that FATCA withholding is not applicable. New tax forms, including revised Forms W-8 and W-9, will be released to take into account the additional certifications required by FATCA and certain other arrangements with respect to withholding (such as the qualified intermediary regime and withholding partnership regime) will be modified to address FATCA. The proposed regulations introduce new rules for withholding agents to follow to identify the payee with respect to whom the withholding is applicable and the relevant documentation to be collected. As is the case under the current withholding regime, the withholding agent will be liable for tax, interest and penalties to the extent it does not follow the rules under FATCA in determining the appropriate amounts to withhold.

B. Key Industry Issues

The discussion below includes general observations about key issues FATCA raises for certain industry groups:

Grandfathered Obligations. One issue of common interest the proposed regulations address is the transition rules that establish which instruments will be subject to FATCA reporting. In this regard, the proposed regulations expand "grandfathered obligations" to include obligations outstanding on January 1, 2013. Income from grandfathered obligations and gross proceeds relating to the disposition of grandfathered obligations are not withholdable payments under FATCA. Grandfathered obligations do not include any agreements or instruments that are treated as equity for U.S. tax purposes or that lack a stated expiration date. Furthermore, the exemption does not cover grandfathered obligations that are significantly modified after January 1, 2013 or certain trades under an ISDA master contract. Accordingly, FATCA's application should be taken into account even in drafting terms of instruments that are currently being negotiated.

U.S. Withholding Agents. U.S. withholding agents should begin evaluating their current systems and determining the policies and procedures they will need to put in place to become FATCA-compliant. All U.S. withholding agents (including U.S. funds) will need to engage in the potentially time-consuming exercise of determining into which FATCA categories their clients and investors fall, who counts as a "payee" for FATCA withholding purposes, and whether the withholding agent has received adequate documentation with respect to such "payee" to meet the FATCA requirements. To the extent withholding may be necessary, U.S. withholding agents will need to figure out how to implement appropriate withholding systems, which will require understanding how FATCA's withholding mechanics coordinate with the current withholding system.

Private Equity and Hedge Funds. The specific application of the FATCA rules to private equity funds and hedge funds will depend on the structure of a given fund group. Most hedge fund groups and many private equity fund groups include both U.S. and non-U.S. entities. Consequently, a fund group may be impacted both by the requirements imposed on U.S. withholding agents and on FFIs. In particular:

- *U.S. funds*. Affected U.S. funds will typically include U.S. stand-alone or feeder funds (e.g., formed in Delaware) and master funds, mini-masters and certain other fund entities that are organized in the United States. U.S. funds will not be required to enter into an FFI Agreement but will be withholding agents with respect to payments to (a) nonparticipating FFIs, (b) certain intermediaries and pass-through entities through which nonparticipating FFIs invest, and (c) NFFEs that do not identify their substantial U.S. owners or are not otherwise exempted NFFEs.

- *Non-U.S. funds*. Affected non-U.S. funds will typically include non-U.S. stand-alone or feeder funds (e.g., Cayman limited partnerships or limited companies) and master funds, mini-masters and certain other fund entities that are organized outside the United States. Non-U.S. funds will typically be considered FFIs and will be required to enter into an FFI Agreement to avoid being subject to FATCA withholding unless they qualify for an exception. A participating FFI will be required to report its U.S. accounts (including a "general partner" interest in a participating FFI treated as a partnership that is held by a U.S. person), withhold on recalcitrant account holders and nonparticipating FFIs, and otherwise meet its obligations under the FFI Agreement as described above. Non-U.S. funds that previously have not collected tax documentation from investors will need to begin doing so in order to comply with FATCA account diligence and identification requirements.

- *Additional Considerations*.

    - The proposed regulations continue to require that a participating FFI's "responsible officer" periodically certify that the participating FFI is in compliance with the FFI Agreement.

    - Very generally, in order for any FFI to qualify as a participating FFI (or to be a deemed compliant FFI as a qualified collective investment vehicle or a restricted fund) every member of its affiliated group must so qualify. These rules may expose non-U.S. funds without any U.S. source income to FATCA requirements, if affiliated non-U.S. funds within the sponsor group have U.S. source income. Although the proposed regulations have provided limited relief for affiliated groups with FFIs that are not permitted by the jurisdictions in which they are organized to comply with the FATCA requirements, this relief is not helpful to affiliated groups that are organized in jurisdictions that do not impose legal restrictions on FATCA compliance. Consequently, investment managers are advised to review their fund structures to determine which entities may be viewed as being part of the same affiliated group. Although some fund structures may alleviate the burden of FATCA compliance, the structures will need to be carefully scrutinized within the context of the affiliated group rules.

    - Very generally, participating FFIs that are partnerships for U.S. federal income tax purposes that have not assumed withholding responsibility pursuant to certain agreements with the IRS will be obligated to provide information with respect to their beneficial owners, including a withholding statement that identifies to a withholding agent the appropriate allocation of income among various categories of beneficial owners. Non-U.S. funds that are not willing to provide such information may want to consider entering into additional agreements with the IRS to assume withholding responsibility.

    - It is unclear whether most non-U.S. funds (and, in particular, a typical offshore hedge fund or private equity feeder fund blocker) would qualify as "deemed compliant" either as a qualified collective investment vehicle or as a restricted fund (and thereby avoid having to become a participating FFI). In particular, it is not clear whether these funds would qualify as regulated in their country of organization as "investments funds" or whether they could limit their ownership to permitted owners. Moreover, it is not clear whether a foreign *individual* owner would prevent a fund from qualifying as a qualified collective investment vehicle. Even if such qualification were possible, a fund would nonetheless be subject to the diligence, registration and certification requirements described above.

    - Many funds, especially funds that were formed prior to release of FATCA, do not have sufficient contractual protection in the governing fund documents to ensure compliance with FATCA requirements. Although investors are incentivized to cooperate regardless of legal provisions and obligations, fund groups affected by FATCA should start reviewing fund documentation to determine (a) what rights the sponsors currently have vis-à-vis investors to request additional documentation and to redeem recalcitrant investors, (b) how flexible the withholding provisions are, and (c) whether a sponsor is permitted to use alternative investment structures (more relevant in the non-U.S. fund context).

U.S. Regulated Investment Companies. As domestic entities, RICs are not FFIs and do not need to enter FFI Agreements with the IRS. RICs, however, as U.S. financial institutions and withholding agents are subject to additional withholding and reporting obligations under FATCA, including withholding on any payments to (a) nonparticipating FFIs, (b) certain intermediaries and pass-through entities through which nonparticipating FFIs invest, and (c) NFFEs that do not identify their substantial U.S. owners or are not otherwise exempted NFFEs. The proposed regulations provide sufficient information to enable RICs to begin readying for compliance, but leave a number of RIC-specific concerns outstanding.

- *Competitive concerns.* Some industry concerns have been raised that RICs would suffer a competitive disadvantage if RIC distributions were to be treated as 100 percent U.S. source payments for withholdable payment and passthru payment purposes regardless of RICs' underlying portfolio investments. The proposed regulations address these concerns, in part, by providing that a distribution designated by a RIC as a "capital gain dividend" or as a "short-term capital gain dividend" (if this treatment is extended) would be treated as a withholdable payment and in turn a passthru payment only if it is attributable to property of the RIC that can produce U.S. source dividends or interest (e.g., stock or bonds of a U.S. corporation held by the RIC). The proposed regulations do not expressly address other types of RIC distributions, including other types of dividend distributions and distributions made in redemption of RIC shares. Under the proposed definitions of withholdable payment and related terms, it generally appears that 100 percent of any such other distributions could be treated as a withholdable payment and a passthru payment.

- *Reciprocity concerns.* A longer-term concern for RICs is potential reciprocal reporting to the extent U.S. withholding agents become subject to other governments' reporting systems. In this regard, to the extent foreign regulated investment companies (such as UCITs, etc.) were exempted from FATCA, RICs might reasonably anticipate similar reciprocal carveouts. Under the proposed regulations, some foreign regulated investment companies may qualify as a deemed-compliant collective investment vehicle. As described above, however, there are numerous restrictive qualifications (including, significantly, limitations on ownership and distribution by any specified U.S. persons) to satisfy and thus this is far from a wholesale exemption (which in turn, could limit hopes for reciprocal carveouts).

C. Implications of Intergovernmental Approach Announced by the Treasury

As a significant initial step, the Treasury Department released, along with the proposed regulations, a Joint Statement with France, Germany, Italy, Spain and the U.K., announcing that these countries intend to partner with the United States in an intergovernmental approach to implementing FATCA and improving international tax compliance. In exchange for the cooperation of these foreign countries in its reporting regime, the Joint Statement indicates that the United States is willing to commit to collecting and reporting information on an automatic basis to these partnering foreign countries. The preamble to the proposed regulations indicates that the Treasury Department and the IRS, in consultation with foreign governments, are considering an alternative approach to FATCA implementation, whereby an FFI could satisfy its obligations if (a) the FFI collects the required information and reports it to its residence country government, and (b) the residence country government agrees to report this information annually to the IRS, pursuant to an income tax treaty, tax information exchange agreement, or other agreement with the IRS.

The Joint Statement and the efforts being directed toward an intergovernmental approach are noteworthy in several regards. Such an approach would permit certain non-U.S. entities located in a participating jurisdiction to comply with the otherwise applicable requirements of FATCA without violating local laws.

Moreover, to the extent the intergovernmental approach is successfully implemented, it may enable the U.S. government to avoid imposing a burdensome foreign passthru payments system. The United States' commitment to reciprocity under intergovernmental agreements, however, means that U.S. withholding agents may be subject to additional reporting obligations on payments to non-U.S. persons. The scope and impact of the intergovernmental approach and agreements is expected to become clearer in the future as the U.S. government provides additional information.

Taxpayers who wish to comment on the proposed regulations have until April 30, 2012 to do so.

For more information regarding the proposed regulations, please contact a member of Ropes & Gray's tax practice group or your regular Ropes & Gray attorney.

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