

# Client Alert

Latham & Watkins Tax Department

## IRS Releases Proposed FATCA Regulations

### Summary

On February 8, 2012, the Internal Revenue Service (the IRS) released new proposed regulations (the Proposed Regulations) providing guidance for the implementation of the Foreign Account Tax Compliance Act (FATCA). Simultaneously with the issuance of the Proposed Regulations, the US Treasury Department (Treasury) issued a joint statement with France, Germany, Italy, Spain and the United Kingdom (the Joint Statement), announcing their intent to create an intergovernmental framework for the automatic exchange of information on accounts held in US financial institutions by residents of these countries, as well as future participating non-US jurisdictions.

### Background

FATCA was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act on March 18, 2010, and is generally effective as to payments made after December 31, 2012. Since March 2010, the IRS has released several Notices outlining the anticipated regulatory guidance and delaying the full implementation of the FATCA rules while guidance is being finalized.

The FATCA provisions establish a new regime of withholding and reporting on certain types of payments to foreign recipients. The rules generally require foreign financial institutions (FFIs) and nonfinancial foreign entities (NFFEs) to either report certain information about their financial accounts held by specified US account holders or US-owned foreign entities to the IRS or face a 30 percent withholding tax on "withholdable payments." Withholdable payments are US-source dividends, interest and other fixed or determinable annual or periodic income (FDAP income) and gross proceeds from the sale of any property of a type that can produce US-source dividends or interest. Payments that are effectively connected with the recipient's US trade or business are not considered withholdable payments.

FFIs may avoid FATCA withholding taxes by entering into an agreement with the IRS (an FFI Agreement) to (i) conduct due diligence to determine whether the FFI has any US account holders, (ii) report various information about any US account holders to the IRS, and (iii) withhold on "passthru payments" (withholdable payments or payments attributable to withholdable payments) made to non-compliant FFIs or certain other account holders.

"Proposed Regulations released by the IRS on February 8, 2012, replace the guidance issued in prior IRS notices."

An FFI is generally any non-US entity that is a bank, holds financial assets for the account of others, or is engaged in the business of investing or trading financial instruments. Examples of FFIs include many offshore hedge funds and private equity funds and issuers of collateralized debt obligations. The statute provides exemptions for certain FFIs, such as FFIs affiliated with foreign governments.

An NFFE, which is generally any non-US entity that is not a financial institution, would also be withheld upon unless the NFFE either provides information about its substantial US owners or certifies that it does not have any such owners. The FATCA provisions provide exemptions for certain NFFEs, such as corporations the stock of which are regularly traded on an established securities market and foreign governments and certain of their affiliates.

The Proposed Regulations (REG-121647-10), which were released by the IRS on February 8, 2012, replace the guidance issued in prior IRS Notices.

Attached at the end of this *Client Alert* is a timeline chart showing various dates that are relevant for FATCA.

## Proposed Regulations

Highlights of the Proposed Regulations and the Joint Statement include:

- *Expanded Scope of Grandfathered Obligations.* The HIRE Act provided that no withholding is required on payments under (or gross proceeds from the disposition of) obligations outstanding on March 18, 2012. The Proposed Regulations extend this date to January 1, 2013. A grandfathered obligation is any legal agreement (including debt obligations, letters of credit, revolving credit facilities and certain derivative contracts) outstanding on January 1, 2013 (and not materially modified after such date), that produces or could produce a withholdable or passthru payment, other than an instrument that is treated as equity for US tax purposes or lacks a stated term.
- *Additional Categories of Deemed-Compliant FFIs.* The Proposed Regulations expand the list of deemed-compliant FFIs (FFIs not required to enter into FFI Agreements in order to avoid FATCA withholding), and provide two categories of deemed-compliant FFIs: registered deemed-compliant FFIs and certified deemed-compliant FFIs. Registered deemed-compliant FFIs are certain categories of FFIs that register with the IRS to declare their status as a deemed-compliant FFI and meet various other procedural requirements. Entities eligible to register in this category include "local" FFIs (entities that operate almost exclusively in the entity's country of organization and meet other requirements), qualified collective investment vehicles, regulated investment funds, and FFIs that qualify under an agreement between the United States and the foreign jurisdiction in which the FFI is established. Certified deemed-compliant FFIs, which would not need to register with the IRS but must certify their qualifications as deemed-compliant FFIs, include small local banks, non-profit organizations, retirement plans, and FFIs that only have low-value accounts.
- *Effective Dates for Withholding and Information Reporting.*
  - The Proposed Regulations provide that beginning on January 1, 2014, all withholding agents must generally withhold on payments of US-source FDAP income to non-exempt FFIs that do not enter into FFI Agreements (nonparticipating FFIs) and non-exempt NFFEs that fail to provide required information or certifications regarding substantial US owners. Beginning on January 1, 2015, withholding agents must withhold on gross

proceeds from the disposition of property that can produce US-source dividends and interest paid to such recipients. The term "withholding agents" is defined to include US and foreign payors having custody of withholdable payments and participating FFIs having custody of passthru payments.

- All withholding agents are required to annually file Forms 1042 and 1042-S to report amounts of US-source FDAP income, as well as gross proceeds and passthru payments subject to FATCA withholding, that are paid during the preceding calendar year. This requirement applies whether or not such payments are actually taxed.
- Participating FFIs that enter into FFI Agreements are required to report specified information about the participating FFI's US accounts. Participating FFIs must annually report the following information about each US account: (1) identifying information about the account holder (or, for an account held by a US-owned foreign entity, the identities of the entity's US owners); (2) the account number; (3) the account balance or value; and (4) the gross receipts and gross withdrawals or payments from the account. The Proposed Regulations only require limited reporting of identifying information for US accounts in 2014 and 2015 (for calendar years 2013 and 2014 respectively). Beginning in 2016, the required reporting is expanded to include income from US accounts. Beginning in 2017, full FATCA reporting with respect to US accounts will be required
- *Foreign Passthru Payments.* The Proposed Regulations delay withholding on "foreign passthru payments" until January 1, 2017. Under the Proposed Regulations, participating FFIs will report, but not withhold on, these payments in 2015 and 2016, and both report and withhold beginning on January 1, 2017. The Proposed Regulations do not define foreign passthru payments. When defined, such payments are expected to encompass payments that are treated as "attributable" to withholdable payments.
- *Two-Year Transitional Period for Affiliated Groups.* Under the FATCA provisions, all entities that are in the same "expanded affiliate group" are generally required to comply with (or be deemed-complaint with) the FATCA reporting requirements in order for any entity in the group to be treated as a participating FFI (the EAG Rule). In recognition that some non-US jurisdictions (restrictive jurisdictions) have laws that would prohibit FFIs established in such jurisdictions from complying with the FATCA requirements, the Proposed Regulations provide that the EAG Rule will not be fully implemented until January 1, 2016. During the two-year transitional period prior to January 1, 2016, the existence of FFIs in restrictive jurisdictions that meet specified requirements will not automatically prevent other FFIs in the expanded affiliate group from becoming participating FFIs.
- *Expanded List of Exempted NFFEs.* The Proposed Regulations exempt payments from FATCA withholding that are made to "active NFFEs," which are NFFEs with either (i) less than 50 percent gross income that is passive income in the previous calendar year, or (ii) less than 50 percent of assets that produce passive income at any time in the previous calendar year.
- *Reduced Due Diligence Procedures for FFIs.* In general, the Proposed Regulations permit FFIs to satisfy much of their due diligence obligations by relying on electronic reviews of many accounts. The Proposed Regulations limit the categories of accounts that would require manual reviews of paper records or requests for additional information from account holders.

- *Revised Definition of Financial Account.* The definition of "financial account" is narrowed in the Proposed Regulations to include debt and equity interests issued by FFIs only if the debt or equity interest is not regularly traded on an established securities market and either (1) the FFI is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities or various other financial interests or (2) for all other FFIs, the value of the equity or debt interest is determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments.
- *Intergovernmental Framework.* In connection with the release of the Proposed Regulations, Treasury released the Joint Statement describing an intergovernmental approach to improving international tax compliance and implementation of FATCA. The Joint Statement lays out the framework for an alternative information reporting regime with participating foreign jurisdictions (FATCA Partners). Essentially, the US would waive the reporting and withholding requirements on FFIs established in a FATCA Partner if the FATCA Partner enacts legislation requiring these FFIs to report information regarding their US accounts to the tax authorities of the FATCA Partner (rather than directly to Treasury) and the FATCA Partner provides information about any US accounts held by such FFIs to Treasury pursuant to a bilateral treaty. This country-to-country information exchange would eliminate the need for each FFI in the FATCA Partners to enter into agreements with Treasury and is designed to address foreign privacy law issues.

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