



FEBRUARY 17, 2012

IRS Issues Proposed Regulations with Respect to FATCA

On February 8, 2012, the Internal Revenue Service (IRS) issued proposed regulations regarding diligence, reporting, and withholding requirements under the provisions of the Internal Revenue Code (Code) added by the Foreign Account Tax Compliance Act (FATCA). While the proposed regulations largely incorporate provisions announced in prior IRS notices, the regulations deviate from the prior notices in a number of ways, including by providing new effective dates for certain reporting requirements and withholding requirements, and indicate that FATCA implementation continues to be an IRS priority.

The proposed regulations do not alter the date, which continues to be January 1, 2014, on which FATCA withholding will first apply with respect to “withholdable payments” to foreign financial institutions (FFIs) and to non-financial foreign entities (NFFEs).¹ Importantly, given how broadly the proposed regulations define “obligation” for purposes of the rule that excludes payments in respect of obligations outstanding as of January 1, 2013, U.S. persons generally do not need to seek to amend existing agreements to address the potential for FATCA withholding with respect to payments under those agreements after 2013.

SCOPE OF THE EXCEPTION FROM FATCA WITHHOLDING FOR OBLIGATIONS OUTSTANDING AS OF JANUARY 1, 2013

For purposes of the FATCA rules, a “withholdable payment” is generally a payment of interest, dividends, rents, and other fixed or determinable annual or periodic income, gains or profits from U.S. sources or a payment of gross proceeds of property of a type that can produce U.S. source interest or dividends. The proposed regulations provide that withholdable payments do not include payments under, or payments of gross proceeds in respect of a disposition of, any obligation outstanding as of January 1, 2013 (a “grandfathered obligation”). For this purpose, an obligation means any legal agreement that produces or could produce withholdable payments (as determined without regard to this exclusion), other than equity interests and agreements without a definitive expiration or term. It is not necessary for the obligation to

¹ Proposed regulations are not effective until the effective date specified in connection with their issuance in temporary or final form. While it is not possible to predict with certainty the content of any temporary or final regulations issued under the FATCA rules, it is evident that the IRS is issuing preliminary guidance under FATCA, such as the proposed regulations, in an effort to facilitate the orderly implementation of the FATCA rules, and, thus, it would be surprising if the substance of the final regulations, as opposed to their effective date, differed materially from that proposed in the proposed regulations.

make a payment under a grandfathered obligation to have actually accrued by January 1, 2013 in order for the payment to get the benefit of the exclusion from the definition of withholdable payments. The proposed regulations provide that after January 1, 2013 a material modification of a grandfathered obligation will result in that obligation losing its grandfathered status. For debt instruments, a material modification is any modification that is treated as a significant modification under Treasury Regulations § 1.1001-3, and for other obligations whether a modification is material is based on the relevant facts and circumstances.

Given the breadth of the exclusion for grandfathered obligations, it generally (other than for equity interests and deposit accounts, which generally do not include gross-ups for taxes) will not be necessary for U.S. persons to seek to amend existing agreements to address the potential for FATCA withholding with respect to payments under those agreements after 2013. While it also will generally not be necessary to address the potential for FATCA withholding for agreements entered into on or prior to January 1, 2013, parties may want to address the potential for FATCA withholding in such agreements to minimize risks arising from a subsequent material modification.

STATUTORY BACKGROUND

FATCA was enacted in 2010 and is in the process of being implemented. The act is intended to address attempts by U.S. taxpayers to avoid U.S. income tax through the use of offshore accounts or interests in non-U.S. entities. The goal of FATCA is for (1) FFIs to provide information to the IRS regarding accounts of U.S. persons or U.S.-owned foreign entities and (2) NFFEs to provide withholding agents with information regarding their substantial U.S. owners.

FATCA incentivizes FFIs and NFFEs to provide such information by requiring 30 percent withholding on “withholdable payments” to (1) an FFI that does not enter into an agreement with the IRS regarding FATCA compliance and is not otherwise “deemed compliant” (a “nonparticipating FFI”) and (2) an NFFE where the withholding agent has not received a certification regarding whether the NFFE that beneficially owns the payment has a substantial U.S. owner (generally, an owner of 10 percent or more of the foreign entity) and, if so, setting forth specified information regarding that U.S. owner.² In addition, participating FFIs are required to withhold 30 percent from “passthru” payments that they make to nonparticipating FFIs or account holders that fail to provide required information.

Withholding agents for purposes of FATCA include U.S. persons and, with respect to passthru payments, participating FFIs that enter into agreements with the IRS with respect to FATCA. For these purposes, a passthru payment is a payment that is attributable to a withholdable payment.

THE PROPOSED REGULATIONS

² The proposed regulations contain a series of provisions coordinating the FATCA withholding requirements with the preexisting rules requiring withholding on certain payments of U.S. source income to non-U.S. persons so as to avoid any obligation to withhold more than once with respect to a payment.

While generally the proposed regulations provide that any amount withheld under FATCA is allowed as a refundable credit against the income tax liability of the beneficial owner of the payment from which the withholding is made, special rules provide that (1) a nonparticipating FFI is not entitled to such a credit or refund unless a tax treaty provides for a reduced rate of withholding (and, if a tax treaty does apply, no interest is to be paid on the credit or refund), and (2) unless a tax treaty provides for a reduced rate of withholding, an NFFE can only claim the refund or credit if it attaches to its tax return specified information regarding its U.S. owners or documentation establishing that FATCA withholding was not required.

The key ways in which the proposed regulations deviate from or extend beyond earlier FATCA guidance are:

1. The set of grandfathered obligations payments on which, and payments of gross proceeds from any disposition of which, will not be treated as withholdable payments is proposed to be expanded to include all obligations outstanding as of January 1, 2013.
2. The rule preventing an FFI from becoming a participating FFI, unless every other FFI in its affiliated group is a participating FFI or a deemed compliant FFI, is proposed to be relaxed for two years with respect to affiliated groups that include an FFI in a jurisdiction with laws that prohibit the FFI from complying with FATCA reporting or withholding requirements.
3. The class of FFIs deemed compliant is proposed to be expanded to include certain FFIs with a local business focus.
4. Due diligence procedures to be followed by FFIs in identifying their U.S. accounts are proposed to be modified to ease compliance burdens.
5. Responsible FFI officers would be required to certify that the FFI has complied with the terms of its FFI agreement.
6. The definition of a financial account is proposed to be modified to exclude most debt instruments of, and stock interests in, banks and financial firms.
7. The information reporting requirements imposed on FFIs with respect to U.S. accounts are proposed to become effective on a phased-in basis with respect to the calendar years 2015 (reporting on income) and 2016 (reporting on gross proceeds).
8. The requirement that FFIs withhold with respect to passthru payments that are not withholdable payments is proposed to apply beginning January 1, 2017.

Comments on the proposed regulations are due by April 30, 2012.

Please call [Christine Bromberg](#), at (860) 275-8353, [Michael Walutes](#) at (212) 451-2933, or [Marianne Kane](#) at (617) 557-5962 if you have any questions regarding the FATCA rules, including questions on how to address the potential for FATCA withholding in drafting commercial agreements.

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