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Final FATCA Regulations Amplify Broad Sweep of Legislation for Securities and Banking Industry

Highlights

- FATCA creates a new reporting and taxing regime for foreign financial institutions with U.S. account holders
- Hedge funds and private equity funds fall within the definition of foreign financial institution
- New Chapter 4 provides for withholding taxes as a means to enforce new reporting requirements
- The legislation's principal goal is to collect tax from U.S. taxpayers who have evaded their responsibilities by investing through foreign institutions
- New Section 1472 deals with withholdable payments to non-financial foreign entities
- The legislation provides a carve-out for corporations whose stock is regularly traded on an established securities market
- Final regulations provide relief from withholding with respect to certain grandfathered obligations
- Intergovernmental agreements designed to reduce administrative burdens

Inside

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The Treasury and IRS have adopted final regulations implementing the Foreign Account Tax Compliance Act (FATCA). The regulations provide additional certainty for financial institutions and government counterparts by finalizing the step-by-step process for U.S. account identification, information reporting, and withholding requirements for foreign financial institutions, other foreign entities, and U.S. withholding agents.

The final regulations also build on intergovernmental agreements the U.S.Treasury has entered into with foreign governments to facilitate the effective and efficient implementation of FATCA by eliminating legal barriers to participation, reducing administrative burdens, and ensuring the participation of all non-exempt financial institutions in a partner jurisdiction. In order to reduce administrative burdens for financial institutions with operations in multiple jurisdictions, the final regulations coordinate the obligations for financial institutions under the regulations and the intergovernmental agreements.

Passed in 2010 as part of the Hiring Incentives to Restore Employment Act (HIRE)), FATCA creates a new reporting and taxing regime for foreign financial institutions with U.S. account holders. FATCA adds a new Chapter 4 to the Internal Revenue Code, essentially requiring foreign financial institutions to identify their customers who are U.S. persons or U.S.-owned foreign entities and then report to the IRS on all payments to, or activity in the accounts of, those persons.

The Act broadly defines foreign financial institution to comprise not only foreign banks but also any foreign entity engaged primarily in the business of investing or trading in securities, partnership interests, or commodities or any derivative interests therein. According to the Joint Committee on Taxation, investment vehicles such as hedge funds and private equity funds fall within this definition. Firms meeting the definition must enter into agreements with the IRS and report information annually in order to avoid a new U.S. withholding tax.

The final regulations broadly define financial institution and investment entities to allow the Act to effectively and efficiently combat offshore tax evasion. The regulations include investment entities within the definition of a financial institution; they define an "investment entity" as an entity that primarily conducts as a business one or more of the following activities or operations for or on behalf of a customer: (1) trading in money market instruments (checks, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, or index instruments; transferable securities; or commodity futures; (2) individual or collective portfolio management; or (3) otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons. Moreover, the entity functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets. (Reg. § 1.1471-5(d).)

The legislation's principal focus is tax compliance by U.S. persons that have accounts with foreign financial institutions. The Act imposes substantial new reporting and tax-withholding obligations on a broad range of foreign financial institutions that could potentially hold accounts of U.S. persons. The reporting and withholding obligations imposed on the foreign financial institutions will serve as a backstop to the existing obligations of the U.S. persons themselves, who have a duty to report and pay U.S. tax on the income they earn through any financial account, foreign or domestic. These new reporting obligations for financial institutions will be enforced through the imposition of a 30-percent U.S. withholding tax on a wide range of U.S. payments to foreign financial institutions that do not satisfy the reporting obligations. The legislation provides substantial flexibility to Treasury and the IRS to issue regulations detailing how the new reporting and withholding tax regime will work. It also gives Treasury broad authority to establish verification and due-diligence procedures with respect to a foreign financial institution's identification of any U.S. accounts.

Chapter 4 also provides for withholding taxes as a means to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons or by U.S.-owned foreign entities. The provision establishes rules for withholdable payments to foreign financial institutions and for withholdable payments to other foreign entities. The Act essentially presents foreign financial institutions, foreign trusts and foreign corporations with the choice of entering into agreements with the IRS to provide information about their U.S. accountholders, grantors and owners or becoming subject to 30-percent withholding.

The legislation's principal goal is to collect tax from U.S. taxpayers who have evaded their responsibilities by investing through foreign financial institutions and foreign entities not subject to IRS reporting obligations. To achieve this goal, the legislation imposes the risk of a withholding tax on a broad class of U.S.-related payments (including gross proceeds) to a broad class of foreign investors, unless the foreign financial institutions and foreign entities agree to provide information to the IRS regarding their U.S. account holders and owners. Essentially, the withholding tax will function as a hammer to induce reporting.

Many of the foreign financial institutions that hold accounts on behalf of U.S. persons fall outside the reach of U.S. law. As a result, the current ability of the United States to require foreign financial institutions to disclose and report on U.S. accountholders is significantly limited, even though many of these foreign financial institutions have substantial investments in U.S. financial assets either on their own behalf or for the account of others.

The federal government imposes a tax on the beneficial owner of income, not its formal recipient. For example, if a U.S. citizen owns securities that are held in street name at a brokerage firm, that U.S. citizen (and not the brokerage-firm nominee) is treated as the beneficial owner of the securities. A corporation (and not its shareholders) ordinarily is treated as the beneficial owner of the corporation's income. Similarly, a foreign complex trust ordinarily is treated as the beneficial owner of income that it receives, and a U.S. beneficiary or grantor is not subject to tax on that income unless and until he or she receives a distribution.

Under FATCA, the financial world is essentially divided into foreign financial institutions and U.S. financial institutions. U.S. financial institutions have the first compliance obligations under FATCA as the primary withholding agents for withholdable payments made to foreign financial institutions. IRS Notices 2010-60 and 2011-34 detail how participating foreign financial institutions must identify, report, and withhold on their accounts, and how U.S. financial institutions must identify and withhold on some payments to foreign financial institutions; many details regarding U.S. financial institutions have not yet been provided.

The Act imposes a 30-percent withholding tax on certain income from U.S. financial assets held by a foreign financial institution unless the foreign financial institution agrees to: (1) disclose the identity of any U.S. individual that has an account with the institution or its affiliates; and (2) annually report on the account balance, gross receipts and gross withdrawals and payments from the account. Foreign financial institutions also must agree to disclose and report on foreign entities that have substantial U.S. owners. These disclosure and reporting requirements are in addition to any requirements imposed under the Qualified Intermediary program. It is expected that foreign financial institutions will comply with these disclosure and reporting requirements in order to avoid paying this withholding tax.

In addition to requiring 30-percent withholding on the expanded category of withholdable payments for financial institutions that do not enter into an agreement with the IRS, new Internal Revenue Code Section 1474(b)(2) will deny a credit or refund to a foreign financial institution that is the beneficial owner of a payment except to the extent that the firm is eligible for a reduced treaty rate of withholding. The section will also deny interest on refunds.

The agreement between the IRS and the foreign financial institution must contain several provisions. Specifically, the foreign financial institution must obtain information regarding each holder of each account maintained by the firm as is necessary to determine which accounts are U.S. accounts, to comply with verification and due-diligence procedures with respect to the identification of U.S. accounts, and to report annually information with respect to any U.S. account maintained by the firm. The foreign financial institution must also deduct and withhold 30- percent from any pass-through payment that is made to a recalcitrant account holder or another financial institution that does not enter into an agreement. A "pass-through" payment is any withholdable payment or payment that is attributable to a withholdable payment.

A "recalcitrant account holder" is defined as any account holder that fails to comply with reasonable requests for information necessary to determine if the account is a U.S. account; fails to provide the name, address, and tax identification number (TIN) of each specified U.S. person and each substantial U.S. owner of a U.S.-owned foreign entity; or fails to provide a waiver of any foreign law that would prevent the foreign financial institution from reporting any information required under this provision.

The Act adds a new Section 1472 to the Internal Revenue Code to deal with withholdable payments to non-financial foreign entities, which it defines as any foreign entities that are not financial institutions. Specifically, the legislation requires a withholding agent to deduct and withhold a tax equal to 30- percent of any withholdable payment made to a non-financial foreign entity if the beneficial owner of the payment is a non-financial foreign entity that does not meet specified requirements. A non-financial foreign entity meets the requirements of the provision, and payments made to it will not be subject to the imposition of 30-percent withholding tax, if the payee or the beneficial owner of the payment provides the withholding agent with either: (1) a certification that the foreign entity does not have a substantial U.S. owner; or (2) the name, address and TIN of each substantial U.S. owner.

The Act defines a "substantial U.S. owner" as a person who owns more than 10- percent of the company's stock or is entitled to more than 10- percent of the profits in a partnership. In the case of an investment firm, however, that limit is reduced from 10- percent to zero. Additionally, the withholding agent cannot know or have reason to know that the certification or information provided regarding substantial U.S. owners is incorrect, and the withholding agent must report the name, address and TIN of each substantial U.S. owner to the Secretary of the Treasury.

The legislation provides a carve-out for corporations whose stock is regularly traded on an established securities market. The carve-out is presumably based on a congressional belief that the risk of tax evasion in connection with a publicly traded corporation is low. Similarly, the legislation provides a carve-out for charitable and other organizations that are exempt from tax under IRC Section 501(a), again presumably because these entities pose a low risk of being used to facilitate U.S. tax evasion. A further carve-out is provided for SEC-regulated investment companies.

The final regulations phase in over an extended transition period to provide sufficient time for financial institutions to develop necessary systems. In addition, to avoid confusion and unnecessarily duplicative procedures, the final regulations align the regulatory timelines with the timelines prescribed in the intergovernmental agreements. The final regulations allow reasonable timeframes to review existing accounts and implement FATCA's obligations in stages to minimize burdens and costs consistent with achieving the statute's compliance objectives.

To limit market disruption, reduce administrative burdens, and establish certainty, the final regulations provide relief from withholding with respect to certain grandfathered obligations and certain payments made by non-financial entities.

To better align the obligations under FATCA with the risks posed by certain entities, the final regulations expand and clarify the treatment of certain categories of low-risk institutions, such as governmental entities and retirement funds. They also provide that certain investment entities may be reported on by the foreign financial institutions with which they hold accounts rather than being required to register as foreign financial institutions and report to the IRS. The regulations also clarify the types of passive investment entities that must be identified and reported on by financial institutions.

The final regulations provide more streamlined registration and compliance procedures for groups of financial institutions, including commonly managed investment funds, and provide additional detail regarding the obligations of foreign financial institutions to verify their compliance under FATCA.

Moreover, the final regulations treat passive entities that are not professionally managed as non-financial foreign entities rather than as foreign financial institutions. The final regulations also provide appropriate exemptions for financial institutions and certain passive non-financial foreign entities that are part of a non-financial group of companies and that support the operations of the group.

The final regulations also expand the categories of foreign financial institutions that are deemed to comply with FATCA without the need to enter into an agreement with the IRS in order to focus the application of FATCA on higher-risk financial institutions that provide services to the global investment community. In addition, the final regulations expand the scope of retirement funds that are considered exempt beneficial owners the income of which is not subject to Chapter 4 withholding.

Intergovernmental Agreements

There has been widespread concern among foreign financial institutions that complying with FATCA would violate privacy laws and other restrictions in their respective jurisdictions. This placed the foreign financial situations between a rock and a hard place. In an effort to defuse the situation, the Treasury Department worked with foreign governments to develop and sign intergovernmental agreements that facilitate the effective and efficient implementation of FATCA by eliminating legal barriers to participation, reducing administrative burdens, and ensuring the participation of all non-exempt financial institutions in a partner jurisdiction. In order to reduce administrative burdens for financial institutions with operations in multiple jurisdictions, the final regulations coordinate the obligations for financial institutions under the regulations and the intergovernmental agreements.

The United States, France, Germany, Italy, and the United Kingdom, among others, have agreed to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchange of information based on existing bilateral tax treaties. It is envisioned that the United States and a FATCA partner country would agree that the FATCA partner would pursue implementing legislation to require foreign financial institutions in its jurisdiction to collect and report to the authorities of the FATCA partner the required information; enable foreign financial institutions established in the FATCA partner country to diligently identify U.S. accounts; and automatically transfer to the United States the information reported by the foreign financial institutions.

In return, the United States would agree to eliminate the obligation of each foreign financial institution established in the FATCA partner country to enter into a separate comprehensive agreement directly with the IRS, provided that each foreign financial institution is registered with the IRS or is exempted from registration pursuant to the agreement or IRS guidance. The U.S. would also allow foreign financial institutions established in the FATCA partner country to comply with their reporting obligations under FATCA by reporting information to the FATCA partner rather than reporting it directly to the IRS and eliminating U.S. withholding under FATCA on payments to foreign financial institutions established in the FATCA partner country by identifying all foreign financial institutions in the FATCA partner country as either participating or deemed-compliant institutions, as appropriate.

The U.S. would also identify in the agreement specific categories of foreign financial institutions established in the FATCA partner country that would be treated, consistent with IRS guidelines, as compliant or presenting a low risk of tax evasion. The U.S. would also commit to reciprocity with respect to collecting and reporting on an automatic basis to the authorities of the FATCA partner information on the U.S. accounts of residents of the FATCA partner.

In addition, as a result of the agreement with the FATCA partner, foreign financial institutions established in the FATCA partner country would not be required to terminate the account of a recalcitrant account holder; impose pass-through payment withholding on payments to recalcitrant account holders; or impose pass-through payment withholding on payments to other foreign financial institutions organized in the FATCA partner country or in another jurisdiction with which the United States has a FATCA implementation agreement.

More broadly, the U.S. and the FATCA partner would commit to developing an effective alternative approach to achieve the policy objectives of pass-through payment withholding that minimizes burden and commit to working with other FATCA partners, the OECD, and the EU, on adapting FATCA in the medium term as a common model for automatic exchange of information, including the development of reporting and due diligence standards.

Due Diligence

The Act does not mandate any particular method or procedure to identify U.S. accounts. But the legislation does give Treasury broad authority to establish verification and due diligence procedures with respect to a foreign financial institution's identification of any U.S. accounts.

Generally, a customer-identification program requires the financial institution, at a minimum, to collect the name, date of birth (for individuals), address and identification number for new customers. In fulfilling their customer due-diligence requirements, institutions must verify enough customer information to enable the firm to form a reasonable belief that it knows each customer's true identity.

The final regulations reduce the administrative burdens associated with identifying U.S. accounts by calibrating due diligence requirements based on the value and risk profile of the account and by permitting foreign financial institutions in many cases to rely on information they already collect.

The final regulations exempt from review entirely all preexisting accounts held by individuals with a balance or value of $50,000 or less. This threshold is raised to $250,000 for preexisting accounts held by entities and for preexisting accounts that are cash value insurance and annuity contracts. In addition, the final regulations exempt insurance contracts with a balance or value of $50,000 or less from treatment as financial accounts.

In the case of preexisting accounts with a balance or value of $1,000,000 or less, the final regulations permit a participating foreign financial institution to determine whether any of its accounts held by individuals are U.S. accounts based solely on a search of electronically searchable account information for certain U.S. indicia. In addition, for such accounts held by passive non-financial foreign entities, the regulations allow a withholding agent to rely on its review conducted for anti–money laundering due diligence purposes to identify any substantial U.S. owners of the payee in lieu of obtaining a certification. In the case of accounts held by entities, the final regulations expand the ability of foreign financial institutions to rely on a self-certification from an account holder as to its Chapter 4 status.

U.S. Branches of Participating Foreign Financial Institutions

Commenters requested further clarification on the application of the Chapter 4 rules to U.S. branches of participating foreign financial institutions. In response to these comments, the final regulations provide that a U.S. branch of a participating foreign financial institution that is treated as a U.S. person, as provided in Section 1.1441-1(b)(2)(iv), is subject to special requirements to fulfill the withholding, due diligence, and reporting requirements of a U.S. financial institution to the extent provided under Chapters 4 and 61 and Section 3406(a). Additionally, such a U.S. branch is required to file a separate Form 1042 to report amounts subject to reporting under chapter 4 and any taxes withheld. A U.S. branch of a participating foreign financial institution that is not treated as a U.S. person is required to fulfill the general requirements set forth in Section 1.1471-4 for withholding, due diligence, and reporting. ■

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