With only four months to go, do you know the impact of the latest FATCA guidance?

February 28, 2014

In brief

The US Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released on February 20, 2014 two sets of final and temporary regulations. The first set (Link) contains changes to the provisions of Chapter 4 of the Internal Revenue Code (Code) commonly referred to as the Foreign Account Tax Compliance Act (FATCA Regulations). The second set of regulations (Link) coordinate the documentation standards, reporting and withholding rules relating to payments made to non-US and US persons (Chapters 3 and 61 and Section 3406 of the Code), with the FATCA regulations.

According to the Treasury press release (Link), the new guidance represents the last substantial package of regulations necessary to implement FATCA. As such, the regulations contain numerous changes with the impact varying depending on the products or services and whether your activities are on shore or offshore. This insight looks at the more significant items contained in over 550 pages of regulations and the preambles which provide background on the amendments and regulations. Broadly speaking, the guidance provided is a compilation of many smaller changes and clarifications.

In detail

The FATCA regulations contain over 50 discrete amendments and clarifications to the final regulations issued in January 2013. The amendments take into account certain stakeholder suggestions regarding ways to further reduce burdens consistent with FATCA's compliance objectives. Many of the modifications to the final regulations are intended to harmonize FATCA with the approach taken in the intergovernmental agreements (IGAs).

Further, the regulations coordinate FATCA requirements with pre-FATCA rules under Chapters 3 and 61 and Section 3406 of the Code. According to the Treasury fact sheet (Link), coordinating changes relate to four key areas: (1) rules for the identification of payees, (2) withholding requirements, (3) information reporting with respect to US persons, and (4) conforming changes to the regulations.

Entities in scope

With less than two months until financial institutions should finalize their registration to be on the June 2, 2014 IRS list of registered entities, the final and temporary FATCA regulations provide additional details about the types of entities qualifying as FFIs that need to register with the IRS.

Definition of financial institution

Understanding whether an entity is a 'financial

institution' is a key to determining the impact that FATCA will have on the entity's operations. The definition of 'financial institution' has been refined under the temporary regulations as follows:

Custodian as a financial institution - The determination of whether an entity is a financial institution by reason of holding financial assets for others is based on a quantitative analysis of the entity's income. The definition of income attributable to holding financial assets in the final regulations includes fees for providing financial advice. This definition could cause an entity providing advice to be classified as a custodial institution even if it does not hold any assets on behalf of others. The temporary regulations limit the fees taken into account for the analysis to fees earned for advice related to financial assets held or to be held in custody.

Holding companies - The scope of holding companies that will be classified as financial institutions was expanded to include partnerships or other non-corporate entities if substantially all of the activities of the partnership consist of holding stock in one or more expanded affiliated groups (EAGs). This provision was intended to allow such partnerships to qualify as nonfinancial group entities, if warranted. The definition now also clarifies that a holding company or treasury center will be an FFI only if it is in an EAG with a specified insurance company, as opposed to the prior guidance which imposed FFI status if the entity were in the same EAG with an insurance company.

Treasury centers - The definition of 'treasury center' was clarified to ensure that entities that manage the working capital of an EAG will not fail to qualify as excepted nonfinancial group entities solely because they have no investments and do not trade in financial assets. This clarification was necessary to also cover cash pooling entities that are in a deficit position and other entities that are not solely equity financed.

Nonfinancial group entities – An entity cannot be an excepted nonfinancial group entity if it was formed or availed of by an investment vehicle. Questions have been raised about how to interpret this provision in the context of an acquisition by a private equity vehicle of a group with an existing corporate structure. The temporary regulations provide relief for entities that existed six months prior to the acquisition and, prior to that time, regularly conducted activities in the ordinary course of business, as they will not be treated as 'formed or availed of' for these purposes. In addition, the test for a nonfinancial group was changed to apply for the shorter of a three year period or the period for which the group has been in existence. Finally, the passive asset test was clarified to exclude transactions between related members of the group.

Observation: *The changes to the definition of a financial institution should be particularly welcomed by entities outside of the financial services sector, as well as holding companies of insurance companies that solely issue casualty type insurance, many of whom have found they are unintentionally subject to the final FATCA regulations due to the broad definition of a financial institution.*

Excepted inter-affiliate FFI - Under the final regulations, non-US entities that meet the requirements to be treated as excepted inter-affiliate FFIs will not be classified as financial institutions. One of the requirements for such status is that the entity does not receive payments from, or hold an account with, a withholding agent other than a member of its EAG. The FATCA regulations were modified to allow such entities to hold depository accounts in the country where the entity is located and to pay for expenses in the country in which the entity is operating.

Observation: *Although this change is intended to remove a significant obstacle to qualifying as an excepted inter-affiliate FFI, the rule under the temporary regulations may still be prohibitive in cases where an entity needs to maintain depository accounts outside of its home country – e.g., for purposes of holding multiple currencies.*

Nonfinancial foreign entities (NFFEs)

The temporary regulations provide details about the additional types of NFFEs announced in Notice 2013-69 and also clarify certain existing definitions.

Direct reporting NFFE - As expected, the temporary regulations provide that a direct reporting NFFE or a sponsored direct reporting NFFE will be classified as an excepted NFFE. A direct reporting NFFE is an NFFE that elects to report information about its direct or indirect substantial US owners to the IRS. These entities must register with the IRS to obtain a GIIN, but are not required to enter into an FFI agreement. A direct reporting NFFE is required to file Form 8966 with the IRS each calendar year reporting either that it has no substantial US owners or providing detailed information for each such owner. Direct reporting NFFEs must obtain a withholding certificate or written statement from each substantial US owner and make periodic certifications to the IRS regarding its FATCA compliance.

Sponsored direct reporting NFFE - A sponsored direct reporting NFFE is a direct reporting NFFE that has

engaged another entity to act as its sponsoring entity. The sponsoring entity must be authorized to act on behalf of the NFFE, register with the IRS as a sponsoring entity, register the NFFE with the IRS as a sponsored direct reporting NFFE, agree to perform all due diligence, reporting, and other requirements of a direct reporting NFFE, identify the NFFE in all reporting performed on behalf of the NFFE, comply with the certification requirements, not have had its sponsored status revoked, and agree to notify the NFFE and the IRS of a change in status and/or revocation. Similar to sponsored FFIs, the liability for Chapter 4 obligations for direct reporting NFFEs remains with the sponsored entity as opposed to the sponsoring entity.

Observation: *The Model IGAs have not been updated to reflect this classification or the requirements of a direct reporting NFFE. Given the reporting of substantial US owners by a direct reporting NFFE directly to the IRS, data privacy issues and the potential use of consents to disclose such information should be evaluated prior to registration with the IRS.*

Active NFFEs - The temporary regulations provide an NFFE with the option of using either calendar year or fiscal year financial statements to determine if it meets the active NFFE test. The regulations also clarify that the value of an NFFE's assets is based on the fair market value or book value reflected on the NFFE's balance sheet under either US or international financial accounting standards.

Deemed compliant FFIs

Certain FFIs will not be required to enter into an FFI agreement if they qualify as deemed compliant. The temporary regulations refine the categories of deemed compliant FFIs as follows:

Qualified credit card issuers - In response to comments that some groups separate the issuance of credit cards from their servicing, the definition of 'qualified credit card issuers' has been expanded to include entities that act as credit card servicers, even if they do not actually issue credit cards.

Sponsored entities - The definition of 'sponsored investment entity' has been amended to clarify that a nonparticipating FFI (NPFFI) cannot act as a sponsoring entity. In addition, the regulations clarify that a sponsored FFI remains liable for its withholding and reporting obligations despite having a sponsoring entity that performs these tasks on its behalf. The sponsoring entity is not liable for failure to withhold or report for one of its sponsored entities unless it is also acting as a withholding agent with respect to the payment.

Nonregistering local bank - The nonregistering local bank rules have been clarified to define an unrelated retail customer as a person owning 5% or less of the bank, credit union, or cooperative.

Investment advisors and investment managers – A new certified deemed compliant status with identification rules has been added for investment advisors and managers who do not maintain financial accounts.

Limited life debt investment entities - The definition of 'limited life debt investment entities' has been overhauled to allow more securitization vehicles to qualify as certified deemed compliant FFIs. The significant changes include:

- removing the requirement that the organizational documents cannot be amended without the consent of all of the investors
- allowing the vehicle to qualify until it liquidates according to its terms
- applying the status to entities that issued all of their interests on or before January 17, 2013 (the date of the final regulations)
- allowing de minimis interests not to be held in clearing organizations.

Pre-existing account due diligence

Under FATCA, pre-existing accounts (i.e., generally accounts that exist as of June 30, 2014) need to be reviewed and perhaps documented by certain prescribed dates based on the characteristics of balance, or value, location and type of ownership of each account. The following highlights some of the more significant modifications that relate to performing pre-existing account due diligence reviews:

Pre-existing obligations owned by US persons – 'eyeball test' - For pre-existing obligations, the final regulations allowed a withholding agent to treat a payee as a US person if the withholding agent had previously reviewed a Form W-9 or other documentation that established the payee's status as a US person that was an exempt recipient under Chapter 61. The temporary regulations relax this requirement and permit the withholding agent to treat the payee as a US person if the withholding agent had previously classified the person as a US person that is an exempt recipient under the provisions of Chapter 3 or Chapter 61. This includes a classification under the 'eyeball test' in the absence of a withholding certificate.

Pre-existing obligations owned by participating FFIs (PFFIs) and registered deemed-compliant FFIs (RDCFFIs) – Under the final regulations a withholding agent could treat a payee as a PFFI or RDCFFI if the payee provided the withholding agent with its global intermediary identification number (GIIN) and an

indication that the FFI was a PFFI or RDCFFI. The temporary regulations now require that a PFFI or RDCFFI, in addition to supplying a GIIN, must have provided the withholding agent with a valid pre-FATCA Form W-8.

Observation: *PFFIs and RDCFFIs would have been required to provide a valid Form W-8 to qualify for a reduced rate of withholding under Chapter 3, if the payee received US source payments of fixed, determinable, annual, or periodical (FDAP) income.*

Review of account files narrowed – Under the temporary regulations, a withholding agent will have reason to know that a Chapter 3 claim is unreliable or incorrect if any account information, including documentation collected for purposes of anti-money laundering (AML) due diligence, conflicts with the account holder's claim of Chapter 3 status. In addition, a withholding agent that has previously documented a pre-existing obligation for purposes of Chapter 3 or Chapter 61 prior to July 1, 2014 will not be required to review the documentation or account information associated with the obligation for US indicia. However, if the withholding agent reviews documentation for an individual account holder claiming foreign status that contains a US place of birth or if the withholding agent is notified of a change in circumstances, the account will be treated as having experienced a change in circumstances as of the date that the withholding agent reviews the documentation or receives the notification.

Account documentation and classification

Documentation, such as Form W-8 (e.g., Forms W-8BEN, W-8IMY, etc.), generally provides the basis for classifying account holders and payees. The temporary regulations make numerous changes to provisions impacting the validity of Form W-8 as follows:

Indefinite validity of Forms W-8 - Although the final FATCA regulations issued in January 2013 provided that under certain circumstances withholding certificates can remain valid indefinitely or until there is a change in circumstances, the coordination regulations specify that indefinite validity does not apply to the portion of the withholding certificate that pertains to a claim for treaty benefits.

Observation: *Provisions for indefinite validity of Forms W-8 are not as generous as previously anticipated. Since the treaty claim portion is not eligible for indefinite validity, withholding agents will still have to solicit new forms when the treaty claim portion of the form expires.*

Due to changes in the final FATCA regulations related to validity periods, the coordination regulations eliminate the provision that permitted a withholding agent to treat a Form W-8 as valid indefinitely, if the form contained the beneficial owner's tax identification number (TIN) and the withholding agent reported a payment each year on a Form 1042-S.

The coordination regulations eliminate the requirement for Section 501(c) entities to furnish documentary evidence of foreign status to make their withholding certificates qualify for indefinite validity.

To provide transitional relief during the period that withholding agents are obtaining documentation for pre-existing accounts, the temporary regulations extend the period of validity for withholding certificates and documentary evidence that would have expired on December 31, 2013 until December 31, 2014, unless a change in circumstance occurs before that date. The validity period of these withholding certificates had previously been extended through June 30, 2014. Thus, the temporary regulations effectively extend the expiration date by another six months.

Observation: *The additional six months of validity will come as welcome relief to withholding agents who were faced with a compressed time-frame in which to obtain new forms from their account holders and other types of payees. Further, this time frame is more in line with annual solicitation periods and eliminates the possibility of systematically or manually applying presumption rules and withholding for pre-existing obligations on July 1, 2014.*

Faxed and e-mailed forms – The temporary regulations provide that a withholding agent may rely on a signed form or a document received either by facsimile or scanned and sent by e-mail, unless the withholding agent knows that the person transmitting the form or document is not authorized to do so. The final regulations required a withholding agent to authenticate the identity of the person sending the document.

Observation: *By allowing withholding agents to receive forms via fax and email, the IRS is removing a significant compliance challenge. Prior to this rule, withholding agents encountered significant challenges obtaining original signed forms in a timely manner. Withholding agents should confirm that procedures are in place to comply with these rules.*

Qualified Intermediaries (QIs) must provide their GIIN and employer identification number (EIN) - Temporary regulations clarify that a QI, withholding foreign partnership (WP), or withholding foreign trust (WT) must provide its QI/WP/WT EIN on an intermediary withholding

certificate (i.e., Form W-8IMY), in addition to a GIIN. The final regulations only required a GIIN and did not specify that the QI/WP/WT EIN was also required.

Observation: *It is important to note that a GIIN is different from a TIN and should be recorded separately or distinctly within the systems or records of withholding agents.*

Chapter 4 status required on a Form W-8 from an entity - A beneficial owner withholding certificate (i.e., Form W-8BEN-E) must include the Chapter 4 status in order to be valid.

US branches of foreign banks and insurance companies - A withholding certificate furnished by a US branch of a regulated foreign bank or insurance company must contain the branch's EIN and its parent's GIIN in order for the branch to be treated as a US person.

Qualified securities lenders - Withholding certificates from qualified securities lenders will be required to contain an EIN.

Branches and disregarded entities - The temporary regulations also clarify that a Form W-8IMY provided by a branch or disregarded entity owned by a PFFI or RDCFFI must include a GIIN. If the branch is a non-US branch, it must include its own GIIN.

FFI withholding statements and Chapter 4 withholding rate pools - The temporary regulations make several clarifications to the final regulations addressing FFI withholding statements, including: (i) a requirement that payments held in escrow for dormant recalcitrant accounts be identified as such; (ii) for FFIs that have elected to backup withhold, a requirement to report the portion of a reportable payment that is a withholdable payment allocated to each recalcitrant account holder that is subject to backup withholding; and (iii) a clarification that an FFI can include certain recalcitrant account holders (e.g., presumed US non-exempt recipients) in a Chapter 4 withholding rate pool of US payees when the payments are not subject to withholding under Chapter 3 or Chapter 4 or Section 3406, provided certain criteria are satisfied.

Withholding statement of a nonqualified intermediary (NQI) - The temporary regulations modify the requirements for an NQI's withholding statement (i.e., the statement that must be provided to a withholding agent with respect to reportable amounts such as amounts subject to Chapter 3 withholding), and describe the circumstances under which an NQI's withholding statement is required to contain Chapter 4 information about beneficial owners either in a withholding rate pool or on a payee-specific basis. The regulations also describe the circumstances under which an NQI may provide a withholding agent a withholding statement that includes allocations to a Chapter 4 withholding rate pool of US payees in lieu of providing Forms W-9 for each US non-exempt recipient.

Requirement to furnish documentation on account by account basis - The final regulations permitted a withholding agent to rely on documentation held at a branch of a withholding agent or other EAG member if the accounts are treated as consolidated obligations under the final regulations. This requirement has been relaxed and now provides that a withholding agent can rely on documentation furnished by a payee for a pre-existing account held at another branch of the withholding agent or EAG member to determine the account holder's Chapter 3 and/or Chapter 4 status, provided the withholding agent obtains and reviews copies of such documentation and has no reason to know that the documentation is unreliable or incorrect.

Foreign TINs to claim treaty benefits – Certain payments of US source FDAP income are eligible for a reduced rate of withholding under Chapter 3 if the beneficial owner of the income makes a valid claim on Form W-8BEN or BEN-E pursuant to an income tax treaty. Generally, to make a valid claim for a reduced rate of withholding tax under an income tax treaty, a Form W-8BEN or BEN-E must contain the beneficial owner's US TIN. Under the coordination regulations, the requirement to obtain a US TIN has been replaced with a requirement to obtain either a US TIN or a non-US TIN issued by the beneficial owner's country of residence. The IRS and Treasury believe a non-US TIN is "an effective alternative to a US TIN" in supporting a claim for treaty benefits.

Observation: *This is a significant change to the Chapter 3 regulations and may make it easier for beneficial owners to claim treaty benefits. However, withholding agents will need to obtain and store non-US TINs which may require systems modifications to be completed in a very short time-frame in addition to enhancing reporting systems or confirming that vendor reporting packages are able to include the data field for non-US TINs on Form 1042-S.*

Presumption rules

Prior to making a payment, if a withholding agent cannot reliably associate the payment with valid documentation, a set of presumption rules must be used to 'presume' a payee's status in the absence of documentation. The coordination regulations under Chapter 3 modify the presumption rules in several respects.

Undocumented exempt recipients – An undocumented exempt recipient is generally presumed to be a non-US person if the withholding agent has one or more specified types of indicia of foreign status with respect to the exempt recipient. The temporary regulations modify these indicia to better align with the FATCA regulations and add a fifth indicator - telephone number outside the US. In addition, the coordination regulations provide that names containing 'corporation' or 'company' are not indications that the payee is an entity included on the list of per se foreign corporations for purposes of treating the entity as a non-US person.

Special presumption rule for withholdable payments made to exempt recipients – Certain undocumented payees that are presumed to be exempt recipients will be further presumed to be foreign persons. The special presumption rule for exempt recipients is limited to the following circumstances:

- Applies only to withholdable payments under FATCA. However, a withholding agent may elect to apply the special presumption rule to payments other than withholdable payments.
- It does not apply to payments made to a payee of a pre-existing obligation for which the withholding agent determined prior to July 1, 2014 that the payee was a US exempt recipient.

Observation: *The special presumption rule for withholdable payments made to exempt recipients is a significant departure from the presumption rule contained in the final FATCA regulations. Those regulations would have forced undocumented exempt recipients into foreign status without regard to whether a payment was a withholdable payment or whether it was made with respect to a pre-existing obligation. By limiting this presumption rule to only withholdable payments and new obligations, the adverse impacts (e.g., excessive withholding) of classifying an exempt recipient as an undocumented foreign person may be somewhat mitigated.*

Joint accounts - Under the temporary regulations, if the joint payees appear to be individuals, then the payment is presumed made to an unidentified US person. If any joint account holder does not appear to be an individual (by name and other information) and the withholding agent cannot associate valid documentation from each payee, the entire payment will be treated as being made to a NPFFI. However, if one of the joint payees provides a valid Form W-9, the payment shall be treated as made to that payee.

US settlor of a foreign trust - A withholding agent that has both a US TIN and a US address for a settlor of an undocumented foreign trust must presume such trust to be a grantor trust when the settlor is a US person. In this case, the withholding agent would issue Forms 1099 to the US settlor instead of applying nonresident alien withholding and reporting to payments made to the trust in accordance with its obligations under Chapter 3.

US branches - A withholding agent may presume that payments made to a US branch of a regulated foreign bank or insurance company are income effectively connected with a US trade or business without having to obtain a Form W-8 from the US branch. The revised Chapter 3 regulations add a requirement that the withholding agent obtain an EIN from the US branch in order to presume that its income is effectively connected. If an EIN is not provided, a withholding agent will be required to treat the payment as US source FDAP income paid to an undocumented foreign person.

Presumed US individuals limited - The temporary regulations also add a new presumption rule for payments that are not subject to withholding under Chapter 3 made to a payee that is an individual with respect to an offshore obligation. Under the new rule, only individuals with US indicia present will be presumed to be US non-exempt recipients.

Observation: *Historically, payments to undocumented individuals were treated as a payment to a US person potentially subject to backup withholding. Requiring that a payee have an indicator of US status with respect to individual accounts that are offshore obligations may reduce the incidence of inappropriate backup withholding.*

Foreign intermediaries and flow through entities – Under Chapter 61, payments of certain US source short-term interest or original issue discount and bank deposit interest paid to a non-US intermediary or flow-through entity are currently treated as made to a US non-exempt recipient. The temporary regulations under Section 6049 remove bank deposit interest from this rule to make it consistent with the Chapter 4 presumption rule applicable to withholdable payments (which includes such interest) made to a non-US intermediary or flow-through entity. Payments of bank deposit interest that cannot be associated with valid documentation will now be treated as made to a NPFFI.

Standards of knowledge – 'Reason to know'

Although most practitioners focus on the collection of withholding certificates and documentary evidence as a key component of compliance, one of the lesser understood areas is

what constitutes reason to know that such documentation is unreliable or incorrect, which would prevent a withholding agent from relying on the documentation to reduce or avoid withholding on a payment. The FATCA regulations were amended to provide clarity that a withholding agent will have reason to know a payment is being made to a limited branch of a PFFI or RDCFFI when it is directed to make a payment to an address of the FFI in a jurisdiction other than the address of the PFFI or RDCFFI (or branch of such FFI) that is identified as the FFI (or branch of such FFI) that is supposed to receive the payment.

The use of AML due diligence

The final regulations require that withholding agents review information used to satisfy AML due diligence requirements in determining whether a claim of Chapter 4 status is unreliable or incorrect. The temporary regulations modify the final regulations such that when a withholding agent has classified a person by business type for AML due diligence or another regulatory purpose (other than for a tax purpose) that requires the withholding agent to periodically monitor or update the classification, the withholding agent will have reason to know that information contained in its account files conflicts with the person's claim of Chapter 4 status only if the classification recorded by the withholding agent is inconsistent with the claimed Chapter 4 status. The temporary regulations provide that this review of AML due diligence information must occur within 30 days for new accounts.

Observation: *Withholding agents could find this 30 day timeframe difficult to operationalize, as it may not be coordinated with the current AML/know your customer procedures.*

The coordination regulations modify the 'reason to know' standards for Chapters 3 and 61 and Section 3406 to conform to standards issued under the Chapter 4 regulations, provide transition rules for pre-existing obligations, and allow additional grace periods for reviewing documentation. The main highlights of the changes introduced by the coordination regulations are:

- *30-day grace period for reviewing AML documentation* - A withholding agent will not be considered to have reason to know that a person's Chapter 3 claims (e.g., Form W-8BEN) are unreliable or incorrect based on documentation collected for AML due diligence until the date that is 30 days after the obligation is executed or the account is opened.
- *Indicia of US status* – telephone number and place of birth - The coordination regulations adopt the additional indicia of US status that are contained in the FATCA regulations. As such, a withholding agent will have reason to know that a claim of Chapter 3 status is unreliable or incorrect if the withholding agent has a current telephone number for the account holder in the US and has no telephone number for the account holder outside of the US. Similarly, a withholding agent has reason to know that a withholding certificate claiming foreign status provided by a direct account holder that is an individual is unreliable or incorrect if the withholding agent has, either on accompanying documentation or as part of its account information, an unambiguous indication of a place of birth for the individual in the United States. Documentation needed to cure a US telephone number or US place of birth are similar to the cures contained in the Chapter 4 regulations.
- *Multiple obligations* - The temporary regulations provide limitations on a withholding agent's reason to know when multiple accounts are held by the same person. A withholding agent that maintains multiple accounts for a single person will have reason to know that a claim of foreign status for the person is inaccurate based on account information for another obligation held by the person only to the extent that:
  - the withholding agent's computerized systems link the obligations by reference to a data element such as client number, EIN, or foreign TIN and consolidate the account information and payment information for the accounts, or
  - the withholding agent has treated the obligations as consolidated obligations for purposes of sharing documentation or for purposes of treating one or more accounts as pre-existing obligations.
- *Expanded circumstances for relying on documentary evidence* – The temporary regulations expand the circumstances in which documentary evidence may be relied upon allowing payors to rely on documentary evidence for payments made outside the US for an offshore obligation. The temporary regulations also allow a payor that is a PFFI or a RDCFFI to establish a payee's status based on identification by a third-party credit agency. Thirdly, consistent

with the provision in the Chapter 4 regulations that permits reliance on documentary evidence without a definitive renewal period for payments made with respect to offshore obligations, the temporary regulations provide the same treatment for documentation permitted to be relied upon by a payor. Finally, the temporary regulations allow payors to maintain a record of documentary evidence rather than keeping the actual documentation.

Withholding requirements

The FATCA regulations and coordination regulations eliminate the instances when a withholding agent could be required to withhold more than 30% under a combination of FATCA, Chapter 3, and Section 3406 by refining when the obligation to withhold will apply. The transition rules related to offshore payments of US source FDAP have been modified. Other significant changes have been made and are highlighted in this section.

Grandfathered obligations - If a grandfathered obligation loses its grandfathered status due to a material modification, a withholding agent is only required to withhold under FATCA if it has actual knowledge that the material modification occurred (rather than mere 'reason to know' as provided by the prior regulations). A disclosure indicating that there has been or will be a material modification to the obligation is sufficient to establish actual knowledge.

Offshore payments – transitional relief (2017) – The final FATCA regulations provide that a withholdable payment does not include certain non-intermediated offshore payments of US source FDAP income paid prior to 2017. The temporary regulations add an anti-abuse rule. Under the temporary regulations, the exclusion does not apply to debt or equity issued by a US person. This provision is intended to prevent US persons form exploiting the exclusion by issuing debt or equity interests through a foreign branch.

Reportable payments made outside the US by foreign persons - The temporary regulations modify the current exceptions for backup withholding on certain reportable payments. This includes an exception for backup withholding on certain reportable payments made outside of the US to payees other than known US persons and for payments made outside of the US in which documentary evidence (instead of a withholding certificate) can be relied upon to identify the payee (i.e., the documentary evidence rule). The modification redefines reportable payments outside of the US as reportable payments that are paid and received outside of the US with respect to an offshore obligation, including a sale effected outside the US.

Optional escrow procedure - Under Chapter 3, a withholding agent must generally withhold 30% federal tax from payments made to foreign persons where the source and character of the payment is unknown at the time of payment. Under a new escrow procedure introduced in the temporary regulations, a withholding agent may escrow 30% of the undetermined amount until the earlier of one year or the date that the amount subject to Chapter 3 withholding can be determined. This new escrow procedure is consistent with a similar procedure in Chapter 4.

Observation: *The new escrow rule should allow withholding agents and payees to avoid complicated refund procedures for over withholding on payments ultimately determined to not be subject to Chapter 3 withholding.*

Escrow for dormant accounts - With respect to dormant accounts owned by recalcitrant account holders, the final regulations permit a PFFI to escrow amounts withheld under Chapter 4 rather than deposit such amounts with the IRS. The temporary regulations limit the availability of this particular escrow procedure to withholdable payments that are not subject to Chapter 3 withholding.

Reporting requirements

Although the first FATCA reporting is not due until March 2015, many of the systems enhancements required to be compliant must be prepared to gather data starting on July 1, 2014. The FATCA regulations provide both transitional rules and permanent provisions which are intended to accommodate the technology preparation necessary to accomplish reporting under Chapters 3, 4, and 61.

Form 1042-S – The temporary regulations amend the final regulations to remove the allowance for withholding agents to include more than one type of income or other payment on the Form 1042-S sent to the recipient. As a transition, for calendar year 2014, a withholding agent will be permitted to include more than one type of income on the recipient copy of the Form 1042-S. Beginning in 2015, a separate Form 1042-S must be prepared for each type of income. In addition, the temporary regulations clarify that an excepted or passive NFFE that is a flow-through entity is not treated as a recipient.

The temporary regulations provide that for payments made by US withholding agents to PFFIs, deemed-compliant FFIs, and certain QIs, and for which the withholding agent receives a withholding statement, the US withholding agent must report each pool identified on the withholding statement on a separate Form 1042-S.

PFFI FATCA reporting - The final regulations permit a PFFI to comply with its reporting obligations with respect to US accounts and recalcitrant account holders on a branch-by-branch basis. The temporary regulations provide that a PFFI is now permitted to report with respect to all of its accounts, or separately with respect to any clearly identified group of accounts (which could be on a branch-by-branch basis or, alternatively, by line of business or the location of where the account is maintained). A PFFI must include the GIIN assigned to the PFFI or its branch to identify the jurisdiction of the FFI or branch that maintains the accounts subject to reporting.

Transitional reporting to NPFFIs – As previously announced in Notice 2013-69, the temporary regulations make several modifications to the transitional reporting required of PFFIs related to foreign reportable amounts paid to NPFFIs. The temporary regulations:

- clarify that transitional reporting will be limited to NPFFIs that are account holders
- simplify the definition of 'foreign reportable amount' to generally mean payments of foreign source income
- provide an option to report all payments made to the account rather than only foreign reportable amounts
- permit aggregate reporting where the PFFI is prohibited under local law from reporting on a specific payee basis without consent from the NPFFI and the PFFI is unable to obtain consent
- provide that transitional reporting will be on Form 8966 rather than Form 1042-S
- require PFFIs to retain account statements for their NPFFI account holders.

FATCA reporting for US branches not treated as US persons – The temporary regulations correct an oversight in the final regulations by including a rule for reporting by a US branch of a RDCFFI or limited FFI that is not treated as a US person. Under the rule, such a US branch is treated as having satisfied its FATCA reporting requirements if it reports the information required under Chapter 61 with respect to its account holders that are US accounts or accounts held by owner-documented FFIs.

Special reporting rule for PFFIs that are US payors other than US branches - The temporary regulations allow a PFFI that is a US payor to satisfy its FATCA reporting obligations with respect to its US accounts or accounts held by owner-documented FFIs either by reporting the information described in Chapter 61 and supplementing that reporting with the information required to be reported on the US persons behind owner-documented FFIs and passive NFFEs; or reporting as generally provided on Form 8966. However, reporting on Form 8966 does not alleviate any obligation a US payor may have to report under Chapter 61.

Observation: *Given the transitional nature of reporting on NPFFIs, it is expected to be one of the more intensive efforts for non US financial institutions, especially given the limited life of the requirement. As such, any refinement that minimizes the extent of such reporting will be welcomed by industry.*

Requirements to treat a US branch of a foreign bank or insurance company as a US person

A US branch of a regulated foreign bank or insurance company may be treated as a US person for purposes of Chapters 3 and 4. The temporary regulations under Chapter 3 add the following requirements for US branches to be treated as US persons:

- The US branch must be a branch of a PFFI or a registered deemed-compliant FFI, including a reporting Model 1 or 2 FFI.
- If a branch is treated as a US person for purposes of Chapter 3, it must also be treated as a US person for Chapter 4.
- If a US branch agrees to be treated as a US person, it must be treated as a US person with respect to all withholding agents from which it receives payments.
- The US branch must provide a GIIN and a TIN.

FFI Agreement

Although many of the provisions from the final FATCA regulations and the final FFI Agreement were previously released in Rev. Proc. 2014-13, the FATCA regulations provide additional clarity on a number of issues related to EAGs, events of default, and upcoming guidance.

EAGs - The EAG definition has been overhauled and a number of changes have been made including the following:

- Membership of an EAG includes an entity, whether corporate or otherwise, meeting the ownership requirements (over 50% of vote and value for corporations and over 50% of capital or profits for partnerships). The qualifying interest can be owned by any

member entity, whether corporate or otherwise. As a result under the FATCA regulations, the insertion of a partnership into a larger group will not break the group into sub-groups. In addition, an entity other than a corporation can elect to be treated as the common parent of the EAG.

- The coordination of the EAG rules with the consolidated return rules has been made more explicit with a list of excluded corporations and specific reference to when option attribution rules apply. The final regulations require that, in general, each FFI within an EAG must be either a PFFI or a RDCFFI. The temporary regulations modify the final regulations to exclude FFIs that are exempt beneficial owners from this requirement.
- Any vehicle that qualifies as a limited life debt investment entity will not be included in the EAG of any party. As the status of interests in such vehicles as debt or equity is sometimes difficult to determine, this provision is extremely welcome.

Event of default - The temporary regulations clarify that a failure to significantly reduce, over a period of time, the number of account holders or payees that the PFFI is required to treat as recalcitrant account holders or NPFFIs will not be treated as an event of default unless the failure is the result of the PFFI failing to comply with required due diligence procedures for the identification and documentation of account holders and payees.

Future IRS guidance - The temporary regulations provide that future guidance will describe the verification requirements of sponsoring entities. In addition, the FFI agreement will be revised through a revenue procedure to accommodate the changes in these temporary regulations. The FFI agreement is expected to be revised to reflect:

- The tax withheld by a PFFI in an optional escrow becomes due 90 days after the date that the account ceases to be a dormant account.
- A change to the reporting requirements for PFFIs that elect to backup withhold under Section 3406 rather than to withhold under Chapter 4 on a withholdable and reportable payment made to a recalcitrant account holder that is a US non-exempt recipient subject to backup withholding.
- The election for a PFFI to apply backup withholding under Section 3406 with respect to an account holder is only available if the PFFI complies with the information reporting rules under Chapter 61.

Verification - IRS review of compliance – During a review of Form 8966, the temporary regulations allow the IRS to request additional information to determine an FFI's compliance with the applicable FFI agreement and to supplement its review of account holder compliance with tax reporting requirements.

Insurance companies

Of all the financial services sectors, it appears that the insurance sector received the most beneficial provisions. The changes were primarily in response to recent comment letters submitted by the stakeholders in the insurance industry, and they are particularly welcome given that the focus to date has been on the banking and asset management industries.

US insurance brokers treated as payees – Under the FATCA regulations, a withholding agent can treat a US insurance broker, rather than the underlying foreign insurer, as a payee when it is receiving insurance premiums on behalf of a foreign insurance company as long as the withholding agent does not have reason to know that the US insurance broker will not satisfy its withholding obligations under FATCA.

Transitional relief for offshore payments – This transitional relief for offshore payments also applies to insurance brokers who are treated as intermediaries, clarifying for this limited purpose, an insurance broker is not considered an intermediary. US source insurance and reinsurance premiums paid to non-US insurance companies by non-US insurance brokers are provided transitional relief until January 1, 2017.

Certain foreign insurance companies treated as US persons - The temporary regulations modify the definition of the term 'US person' to include a foreign insurance company that has made an election under Section 953(d) and that either is not a specified insurance company or is a specified insurance company that is licensed to do business in any State of the United States. As such, insurance company FFIs can document themselves for Chapter 4 purposes by furnishing a Form W-9. Further, a foreign insurance company will be required to continue to report on its owners in accordance with its election under Section 953(d). In addition, the foreign insurance company would document its status on Form W-9. A foreign insurance company that has made an election under Section 953(d) and that is a specified insurance company that is not licensed to do business in any of the United States will continue to be treated as a foreign person for FATCA purposes.

Grandfathered obligations - Certain outstanding life insurance contracts

(but not annuity contracts) that permit the substitution of an insured, such that they could not have been eligible for grandfathered status under the final regulations, are now eligible for grandfathered status until this provision is invoked or a substitution occurs.

Qualified intermediaries

Consistent with the FFI agreement, the QI agreement will require a QI to establish procedures to ensure compliance with its QI agreement, arrange for periodic review and provide certain factual information to the IRS. The IRS may require that an approved auditor perform review procedures and may conduct a review of the auditor's findings. Although additional changes were made in the regulations, it is expected that these changes will also be contained in the soon to be released revised QI agreement.

Observation: *This appears to be a departure from the current QI audit cycle as it is conforming QI rules with the rules for PFFIs their FFI agreement.*

Some other notable highlights regarding QIs that were covered in the temporary regulations are:

- A QI that is an FFI must be FATCA-compliant, either by becoming a PFFI (including a reporting Model 2 FFI), a RDCFFI (including a reporting Model 1 FFI), or an FFI treated as certified deemed compliant pursuant to an applicable IGA.
- QIs will be required to report their US accounts regardless of whether the QI designates a particular account as covered by its QI agreement.
- The QI agreement will specify the requirements of a QI acting as a qualified securities lender with respect to payments of U.S. source substitute dividends.
- A QI that assumes primary responsibility for reporting and withholding under Chapter 3 (i.e., a withholding QI) will be required to assume such responsibility for Chapter 4.

Repeal of portfolio interest treatment for foreign-targeted obligations

The temporary regulations provide an additional extension until January 1, 2016 for portfolio interest treatment of foreign targeted registered obligations issued before July 1, 2014. The purpose is to provide time for foreign institutions to become QIs under the QI agreement, not yet released. The temporary regulations include updated citations for the sunset dates of the obligations and include provisions to coordinate the exception from withholding for portfolio interest with the withholding requirements of Chapter 4.

Legal entity analyses

A pressing issue is whether the new guidance alters any legal entity analyses for purposes of registering FFIs with the IRS. Most notably, the changes with respect to what qualifies as a financial institution could cause an entity's classification to change. For example, the allowance of partnerships to qualify as nonfinancial group entities and the expansion of how treasury centers are defined could cause a change in how a legal entity is classified.

Moreover, the creation of direct reporting and sponsored direct reporting NFFEs could lead additional stakeholders to register in the IRS on-line registration website. And changes to the make-up of EAGs may also affect how entities register.

It is important to note that if companies have not yet engaged in a legal entity analysis for FATCA purposes, now is a critical time to complete one. April 25 is the cut-off date in which entities must register to be on the first list of GIINs published by the IRS. With the new guidance, companies should feel more comfortable that the final parameters to determine a legal entity's classification are more firmly in place.

Procedures to document and classify payees

Documentation and classification procedures are also an area where stakeholders should more closely consider the impact of the new regulations. Some changes are definitely expected to provide some welcomed relief such as the additional six months of validity with respect to certain Form W-8s already on file. However, other changes may prove burdensome.

For example, the new clarification that the rules regarding the indefinite validity of Forms W-8 do not apply to treaty claims will likely mandate process changes that stakeholders will need to implement quickly. While the ability to utilize foreign TINs on the Form W-8BEN is a welcome change, a withholding agent's timeline to implement proper systems to accommodate this information may be challenging. Moreover, the new requirement for PFFIs and RDCFFIs to also provide a pre-FATCA Form W-8 to avoid withholding may also cause a shift in procedures for businesses.

Broader compliance timelines

Companies should expect that this new guidance will likely have some impact on their broader FATCA compliance plans for the coming year. A specific concern is that previously performed analysis will need to be re-evaluated to determine if the regulations change any conclusions. In addition, software and technology, as well as policies and procedures, will also need to be altered. For most

businesses, this newly released guidance will likely mean a push-back of timelines so as to build in additional time for these actions.

IGAs are being signed and released at a more robust pace. However, the local details needed to implement changes to various processes such as account opening, customer onboarding, customer due diligence, documentation, and tax reporting and withholding are still needed so the US regulations continues to be an important cornerstone.

Next steps

Despite all of the changes and points of clarification contained in the coordination and temporary regulations, FATCA withholding is still effective for certain payments starting as early as July 1, 2014 and entities classified as FFI's still have less than two months until April 25, 2014 to finalize their registration to be on the first IRS list of FFIs with GIINs.

The takeaway

While the core foundational concepts of FATCA appear to be unchanged, this new guidance 'fills in the cracks' in response to stakeholder comments provided to the IRS. Broadly speaking, the guidance provided is a compilation of many smaller changes and clarifications. However, depending on the products or services you offer certain changes could have a large impact, for example, the insurance industry.

As a result, an important action for stakeholders is a thorough review of the changes to identify the impact to their specific situation – a task that may be more time-consuming than expected due to the shear length of the released guidance and the large number of provisions impacted. Notwithstanding, due to imminent FATCA dates such as those relating to registrations, due diligence, and withholding, time is of the essence to review the new guidance and act accordingly.

Let's talk

For more information on how the regulations might impact you, please contact a member of the Global Information Reporting Network. To view contacts for over 70 countries worldwide, click ***here***.

For more information

For thought leadership regarding FATCA guidance and implementation please see PwC's FATCA Publications archive.