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Alert | Tax

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FATCA Proposed Regulations

Introduction

On Dec. 13, 2018, the Internal Revenue Service and the Treasury Department issued proposed regulations (the Proposed Regulations) that provide certain guidance and relief from the regulatory burden associated with Sections 1471 through 1474 of the Internal Revenue Code (IRC), commonly referred to as Foreign Account Tax Compliance Act (FATCA), as well as with respect to withholding under Chapter 3 of the IRC (Withholding of Tax on Nonresident Aliens and Foreign Corporations). The Proposed Regulations also provide guidance on the definition of an "investment entity," modify certain due diligence requirements of withholding agents, and revise certain provisions relating to refunds and credits of amounts overwithheld. This GT Alert summarizes the provisions of the Proposed Regulations.

Elimination of FATCA Withholding on Certain Gross Proceeds

Generally, under the FATCA provisions, "withholdable payments" made to certain non-U.S. persons, including certain foreign financial institutions (FFIs), investment funds, and non-financial foreign entities (NFFEs), could be subject to a U.S. 30 percent withholding tax. The term withholdable payment includes two categories of payments: (i) payments of U.S.-source interest, dividends, and other specified types of fixed or determinable annual or periodic (FDAP) income (unless excepted) and (ii) beginning Jan. 1, 2019, gross proceeds from the sale or other disposition of property that can give rise to U.S.-source interest and dividends. The Proposed Regulations would remove gross proceeds from the definition of the term "withholdable payment" and make other relevant changes in the FATCA regulations that relate to withholding on gross proceeds such that only payments of U.S.-source FDAP would be subject to FATCA withholding. This change reflects comments received from withholding agents on the burden of implementing a requirement to withhold on gross proceeds.

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Deferral of Withholding on Foreign Passthrough Payments

FATCA subjects to withholding certain payments made by FFIs to nonparticipating FFIs and recalcitrant account holders (Foreign Passthrough Payments), after the later of Dec. 31, 2018, or the date of the publication of the final Treasury Regulations defining the term Foreign Passthrough Payment. The Proposed Regulations would defer the withholding requirement on a Foreign Passthrough Payment made to nonparticipating FFIs or recalcitrant account holders to a date that is two years after the date the final regulations are published in the Federal Register. The preamble to the Proposed Regulations notes that the IRS and the Treasury Department continue to be concerned about the long-term omission of withholding on Foreign Passthrough Payments and will continue to consider the feasibility of a system for implementing this withholding requirement. Thus, the IRS and the Treasury Department request additional comments from stakeholders on alternative approaches.

Elimination of FATCA Withholding on Non-Cash Value Insurance Premiums

As noted above, the term "withholdable payment" includes U.S.-source FDAP income, except for certain "excluded nonfinancial payments." Under the current regulations, excluded nonfinancial payments do not include premiums for insurance contracts. Withholding on insurance contracts that do not have a cash value (non-cash value insurance premiums) creates a substantial administrative burden on insurance brokers to document insurance carriers, intermediaries, and syndicates of insurers for Chapter 4 purposes. In addition, the Tax Cuts and Jobs Act of 2017 amended the provisions applicable to passive foreign investment companies (PFICs), which provide that income derived in the active conduct of an insurance business will constitute passive income for PFIC purposes unless a company's insurance liabilities equal a certain minimum percentage of its assets. As a result of that rule, it is expected that there will be increased reporting of U.S. owners of certain foreign entities that conduct a relatively small amount of insurance business. Considering the change in the PFIC rules and to alleviate administrative burden for insurance brokers, the Proposed Regulations provide that the term "excluded nonfinancial payments" includes premiums for insurance contracts that do not have a cash value. Cash value means any amount (determined without reduction for any charge or policy loan) that any person can borrow under or with regard to (e.g., by pledging collateral) an insurance contract, or is payable under an insurance contract to any person upon surrender, termination, cancellation, or withdrawal.

Clarification of Definition of Investment Entity

Determining whether a foreign entity is an FFI or NFFE is a threshold determination under FATCA. A foreign entity is an FFI if, *inter alia*, it is an "investment entity" as defined in the Treasury Regulations. There are various circumstances in which a foreign entity may be treated as an investment entity, including if the following two conditions are satisfied: (i) the entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets; and (ii) the entity is managed by another entity that is a depository institution, custodial institution, insurance company, or a certain investment entity.

The examples in the current Treasury Regulations indicate that the "managed by" condition may be satisfied where an entity has discretionary authority to manage another entity's assets. However, the term "discretionary authority" is not defined in the current Treasury Regulations, and the examples do not describe the nature or scope of the authority granted to the managing entity. It has also been unclear whether management of less than all of an entity's assets meets the "managed by" test. Thus, practitioners have been uncertain about how this rule applies in various circumstances — including in situations where an entity invests all or a portion of its assets with an investment fund and grants the fund manager the authority to invest those assets in accordance with the fund's general investment strategy.

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The Proposed Regulations clarify that the "managed by" category of investment entities is intended to cover entities that receive specific professional management advice from an advisor that is tailored to the needs of the entity. Accordingly, an entity is not "managed by" another entity under the Proposed Regulations solely because the first-mentioned entity invests all or a portion of its assets in the other entity, provided that the other entity is a mutual fund, an exchange traded fund, or a collective investment entity that is widely held and is subject to investor-protection regulation. The implication of this rule is that, if the first-mentioned entity invests all or a portion of its assets in an entity that is not a mutual fund, an exchange traded fund, or such a collective investment entity, the first-mentioned entity will be considered to be "managed by" the entity in which it invests. Furthermore, the preamble to the Proposed Regulations makes clear that an entity is "managed by" another entity where the first-mentioned entity invests in products or solutions offered to clients of the other entity, and the other entity manages and invests the client's funds directly (rather than the client investing in a separate entity) in accordance with the client's investment goals. The clarification in the Proposed Regulations is consistent with guidance interpreting the definition of a "managed by" investment entity under the Common Reporting Standard.

Modifications to Due Diligence Requirements for Withholding Agents

The Proposed Regulations also modify the due diligence requirements applicable to withholding agents under Chapter 3 (Withholding of Tax on Nonresident Aliens and Foreign Corporations) and Chapter 4 (FATCA) of the IRC.

Under Chapter 3, a withholding agent generally is required to obtain either a withholding certificate (generally, an applicable IRS Form W-8) or other documentary evidence and a treaty statement before it can apply an exemption or reduced rate of withholding based on a recipient's claim for benefits under an income tax treaty. Final and temporary Treasury Regulations issued in 2017 (the 2017 Coordination Regulations): (i) added a requirement that when a treaty statement is provided by a beneficial owner that is an entity, the statement must identify the specific limitation on benefits (LOB) provision relied upon in the treaty; (ii) imposed a three-year validity period applicable to treaty statements provided with documentary evidence; and (iii) adopted a transition period, expiring Jan. 1, 2019, for withholding agents to obtain new treaty statements that comply with the new LOB requirement for accounts that were documented before Jan. 6, 2017. These changes were also relevant for Chapter 4 purposes because the qualified intermediary agreement procedures cross-reference the 2017 Coordination Regulations.

Following the issuance of the 2017 Coordination Regulations, financial institutions noted the burden of complying with the new treaty statement requirements. Given the large number of account holders impacted by the new requirement, financial institutions were concerned with the administrative burden of obtaining new treaty statements for preexisting accounts within the short transitional period, as well as the burden associated with the three-year validity period.

The Proposed Regulations address these concerns in two ways. First, they extend the transition period described above by one year, to Jan. 1, 2020. Second, they provide exceptions to the three-year validity period for certain categories of entities whose treaty status is unlikely to change — i.e., exempt organizations (other than tax-exempt pension trusts or pension funds), governments, and publicly traded corporations.

The Proposed Regulations also provide guidance for withholding agents in the context of a "permanent residence address" subject to hold mail instructions. In addition, they correct an inadvertent omission of the actual knowledge standard for a withholding agent's reliance on a beneficial owner's identification of an LOB provision on a treaty statement provided with documentary evidence.

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Revisions Related to Refunds and Credits of Overwithheld Tax

A U.S. partnership is required to withhold under Chapter 3 on certain amounts includible in the gross income of a partner that is a foreign person. Typically, a U.S. partnership satisfies this requirement by withholding on distributions to the foreign partner that include an amount subject to Chapter 3 withholding. However, to the extent a foreign partner's distributive share of income subject to Chapter 3 withholding is not actually distributed to the partner, the U.S. partnership is required to withhold on the undistributed share of the income by the earlier of: (i) the date that the Schedule K-1 is furnished to the partner; or (ii) the due date for furnishing the Schedule K-1. Similar rules apply for purposes of Chapter 4 withholdable payments allocated to a foreign partner in a partnership.

In addition to withholding in accordance with the Chapter 3 and 4 withholding requirements, a U.S. partnership is required to report withholdable payments and amounts withheld to the IRS on Forms 1042 and 1042-S. In various circumstances, withholding and reporting may not occur in the same year, and these mismatches present obstacles to foreign partners attempting to claim credits or refunds for overwithholding.

The Proposed Regulations contain various revisions designed to mitigate mismatches between withholding and reporting under Chapters 3 and 4. Additionally, the Proposed Regulations modify the reimbursement and set-off procedures that may be used by a withholding agent in the case of overwithholding.

Separately, the Proposed Regulations modify the rules for Chapter 3 and 4 reporting by nonqualified intermediaries to address certain cases where a nonqualified intermediary receives a payment that was subject to Chapter 4 withholding.

Conclusion

The preamble to the Proposed Regulations refers to the burden-reducing policies of recent executive orders, as well as to public input on various issues under Chapters 3 and 4 of the IRC. In this regard, it appears that the IRS and the Treasury Department are working to reduce the compliance burden under FATCA, and we expect the Proposed Regulations to be well-received by financial institutions and their advisers. The Proposed Regulations also provide welcome guidance on the definition of an "investment entity" for FATCA purposes.

Taxpayers are invited to submit comments on all aspects of the Proposed Regulations before they are adopted as final regulations.

Effective Date

The Treasury Department and the IRS provide that taxpayers can generally rely on the modifications in the Proposed Regulations until final regulations are issued. However, taxpayers may not rely on the provisions of the Proposed Regulations that relate to credits and refunds of withheld tax until Form 1042 and Form 1042-S are updated for the 2019 calendar year.

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