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FATCA: Transitional Relief

Soft Opening for FATCA: 2014 and 2015 Deemed a "Transition Period" and Other Limited Transitional Relief Under FATCA Announced

SUMMARY

On May 2, 2014, the IRS and the Treasury Department issued Notice 2014-33 announcing that calendar years 2014 and 2015 will be regarded as a transition period for purposes of IRS enforcement and administration of FATCA. Notice 2014-33 also provides additional transitional relief under FATCA and the other U.S. withholding regimes. In direct response to comments from stakeholders, the IRS and Treasury have—to a limited degree—broadened the application of certain transitional rules:

- The cut-off date for treating an account or other obligation held by an entity as a "preexisting obligation" for FATCA purposes has been moved from July 1, 2014 to January 1, 2015;
- A withholding agent may continue to treat a direct account holder as having been "documented" for nonresident alien and backup withholding purposes prior to July 1, 2014, even if the account documentation is required to be renewed on or after that date; and
- The requirements for treatment as a "limited FFI" or "limited Branch" have been relaxed.

In addition to changes to these transitional rules, Notice 2014-33 announces a modest expansion of the range of reasonable explanations of foreign status that may be accepted under the FATCA due diligence process.

BACKGROUND

Chapter 3 of the Internal Revenue Code (the "Code") provides rules on reporting and withholding on payments of certain U.S.-source income to non-U.S. persons ("nonresident alien withholding"). Chapter 61 and Section 3406 of the Code provide rules for reporting and withholding on payments made to certain U.S. persons ("backup withholding"). The Foreign Account Tax Compliance Act ("FATCA"), enacted in

March 2010, and the regulations thereunder provide additional withholding and reporting rules intended to promote tax compliance by U.S. citizens and residents by encouraging non-U.S. financial institutions to report information to the IRS regarding their U.S. customers.

FATCA generally establishes a complex set of withholding, information reporting and due diligence requirements for U.S. withholding agents and Foreign Financial Institutions ("FFIs"), and imposes a 30% penalty withholding tax on FFIs that do not comply with these rules.[1] FFIs that sign an agreement ("FFI Agreement") with the U.S. to comply with these rules are referred to as "participating FFIs". FATCA also requires participating FFIs to withhold on certain payments made to "recalcitrant account holders" and nonparticipating FFIs. Under the statute, FATCA's withholding provisions would have been effective for payments made on or after January 1, 2013, but this effective date was administratively postponed to July 1, 2014.[2]

The FATCA regulations provide certain FFIs with the option of becoming "deemed-compliant". Provided that the requirements for deemed-compliance are met, such FFIs will not have to enter into an FFI Agreement to avoid FATCA withholding. Certain deemed-compliant FFIs are still required to register with the IRS ("registered deemed-compliant FFIs"). Other deemed-compliant FFIs are not required to register but must certify to withholding agents that they meet the requirements to be treated as deemed-compliant ("certified deemed-compliant FFIs").

Since 2012, the Treasury Department has entered into intergovernmental agreements ("IGAs") to facilitate the implementation of FATCA. IGAs are intended to remove domestic legal impediments to compliance and reduce burdens on FFIs located in jurisdictions ("partner jurisdictions") that enter into IGAs. There are two models of IGAs: under "Model 1 IGAs", covered FFIs report FATCA information to the partner jurisdiction, which then transmits the information to the IRS, and under "Model 2 IGAs", a partner jurisdiction agrees to facilitate FATCA compliance by its resident FFIs, but those FFIs generally must still report information about U.S. accounts directly to the IRS. Under Notice 2013-43 and Announcement 2014-17, the Treasury Department announced that it will treat a jurisdiction that has signed an IGA or has agreed in substance to an IGA as having an IGA in effect, even if that IGA has not yet come into force or has not yet been signed, as the case may be.[3]

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1 A detailed discussion of the regulations under FATCA, including many of its defined terms, can be found in the Sullivan & Cromwell LLP publication entitled "FATCA: Final Regulations" (February 26, 2013).

2 Additional background on changes to the FATCA regulations and FATCA guidance issued by the Treasury Department subsequent to the publication of the "final" FATCA regulations can be found in the Sullivan & Cromwell LLP publications entitled "FATCA: Delayed Start Dates" (July 15, 2013) and "FATCA: Updates and Draft FFI Agreement" (November 4, 2013).

3 The Treasury Department maintains a list of jurisdictions treated as having an IGA in effect at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx.

The IRS has opened an online registration system that can be used by financial institutions to register with the IRS under FATCA. The online FATCA registration system can be used by both (i) financial institutions entering into a FATCA Agreement with the IRS and (ii) financial institutions and branches that otherwise need to register with the IRS under FATCA (including, generally, FFIs covered by a Model 1 IGA, other registered deemed-compliant entities, and sponsoring entities). Entities registering with the IRS will be issued a Global Intermediary Identification Number ("GIIN") that will be used by withholding agents to ensure that such entities are in compliance with FATCA (*i.e.*, are not subject to FATCA withholding) by verifying the GIIN against a list containing the GIINs of all FATCA-compliant foreign entities. This list will be published and regularly updated by the IRS beginning June 2, 2014.

On February 20, 2014, the IRS and the Treasury Department issued the last substantial package of regulations necessary to implement FATCA. In addition to providing new or amended regulations under FATCA, these regulations modified the nonresident alien and backup withholding rules to coordinate with the FATCA regulations. The regulations were released in final and temporary form, meaning that although they are subject to further comments and revision, they are generally effective as drafted as of March 6, 2014, the date they were published in the Federal Register.[4]

CHANGES ANNOUNCED UNDER NOTICE 2014-33

A. TWO-YEAR TRANSITION PERIOD

Notice 2014-33 announces that calendar years 2014 and 2015 will be treated as a transition period for purposes of IRS enforcement and administration of the due diligence, reporting and withholding provisions under FATCA. In addition, 2014 and 2015 will also be treated as a transition period with respect to the nonresident alien and backup withholding rules to the extent that such provisions were modified by the coordinating regulations issued on February 20, 2014. In general, this means that the IRS will take into account the extent to which a withholding agent or other entity subject to such provisions of the Code has made good faith efforts to comply with the requirements of FATCA and the coordinating regulations. No relief will be granted with respect to nonresident alien and backup withholding rules that were not modified by the coordinating regulations and of course, no relief will be granted to an entity that has not made a good faith effort to comply with the new regulations.

B. EXTENSION OF CERTAIN TRANSITIONAL RULES

1. Preexisting Obligations Under FATCA

In general, the term "preexisting obligation" refers to accounts, debt obligations, and other obligations opened, issued or otherwise executed before July 1, 2014. Preexisting obligations are generally subject to modified or relaxed due diligence procedures, whereas obligations created on or after July 1, 2014 are

[4] Additional background on the amendments to the FATCA regulations can be found in the Sullivan & Cromwell LLP publication entitled "FATCA: Updates and Coordinating Regulations" (March 21, 2014).

generally subject to more stringent "new account" opening procedures. Notice 2014-33 announces that, with respect to obligations held by entities, the cut-off date for treatment as a preexisting obligation is extended to January 1, 2015 (this change does not apply to obligations held by individuals). This means, for example, that a withholding agent issuing an obligation to an entity on September 1, 2014 will be able to treat such obligation as a "preexisting obligation" and will generally have two years to document such entity for FATCA purposes, rather than being required to complete such diligence and documentation procedures before the earlier of ninety days or the date a payment withholdable for FATCA purposes is made to the entity. This change in the cutoff date for treatment as a preexisting obligation will generally be applicable under an IGA as well.

2. Chapter 3 Documentation Expiration Dates

As part of the coordinating regulations issued on February 20, 2014, a change was made to the rules under Chapter 3 under which a withholding agent is deemed to have reason to know that documentation establishing the foreign status of a direct account holder is unreliable or incorrect if, *inter alia*, (i) the only current telephone number the withholding agent has for such account holder is a U.S. telephone number or (ii) the withholding agent has documentation showing a U.S. place of birth for the account holder. The coordinating regulations also provided a transitional rule, however, that would (in the absence of either notification of a change of circumstances or the review of documentation indicating that the account holder was born in the U.S.) generally allow a withholding agent to continue to rely on documentation of the foreign status of a direct account holder collected prior to July 1, 2014 for nonresident alien or backup withholding purposes (without regard to whether such previously collected information contains a U.S. telephone number or U.S. place of birth for the account holder).

Treasury and the IRS received comments indicating that this transitional rule will be of limited benefit in cases where an account holder had been properly documented prior to July 1, 2014 but the period of validity for the withholding certificate or documentary evidence that a withholding agent has on file for such account holder is set to expire on or after that date. In response to such comments, Notice 2014-33 provides that, for purposes of the transitional rule described above, in cases where a direct account holder's foreign status has been previously documented but will expire on or after July 1, 2014, such direct account holder will generally continue to be considered documented prior to July 1, 2014 so long as the withholding agent has not been notified of a change in circumstances with respect to such account holder's foreign status and the withholding agent has not since reviewed documentation indicating that the account holder was born in the U.S.

C. LIMITED FFIS AND BRANCHES

Under FATCA, an FFI will generally not be granted participating FFI or registered deemed-compliant status unless each of its branches and each affiliated FFI in its "expanded affiliated group" is either

compliant with, or exempt from, FATCA.[5] In cases where the laws of the relevant jurisdiction prevent a branch or an affiliated FFI from complying with FATCA however, the FATCA regulations provide a temporary exception to this rule. Under the exception, an FFI will not be prevented from becoming a participating FFI so long as any branch or affiliated FFI that is prevented by local law from complying with FATCA meets the requirements to be treated as a "limited branch" or "limited FFI". The conditions for limited branch or limited FFI status include, among other things, that the branch or FFI not open accounts that it is required to treat as U.S. accounts or accounts held by nonparticipating FFIs. In addition, a limited FFI is required to be registered with the IRS as part of its expanded affiliated group.

Treasury and the IRS received comments that the requirements for treatment as a limited branch or limited FFI were overly restrictive because some jurisdictions require banks to provide residents that are individuals with access to banking services (in other words, it may be illegal in such jurisdictions to turn away a U.S. individual looking to open an account). Commenters also noted that an FFI will sometimes need a loan from an FFI in the same jurisdiction but, if the local laws prevent compliance with FATCA, that other FFI will likely be a nonparticipating FFI and thus, the borrowing FFI may find itself maintaining an "account" (under the broad definition of "account" provided by the FATCA regulations) for a nonparticipating FFI. In addition, commenters explained, some local laws would prevent an FFI from even registering with the IRS as a limited FFI. In response to these concerns, Notice 2014-33 provides that a limited FFI or limited branch will be permitted to open U.S. accounts for persons resident in the jurisdiction where the limited branch or limited FFI is located, and accounts for nonparticipating FFIs that are resident in that jurisdiction, provided that (i) the limited FFI or limited branch does not solicit U.S. accounts from persons not resident in, or accounts held by nonparticipating FFIs that are not established in, the jurisdiction where the FFI or branch is located and (ii) the FFI or branch is not used by another FFI in its expanded affiliated group to circumvent the obligations of such other FFI under FATCA. Furthermore, under Notice 2014-33, a limited FFI is not required to register itself with the IRS if such registration is prohibited by local law. In addition, where a limited FFI is barred by local law from registering with the IRS, certain members of its expanded affiliated group may register the limited FFI and may even omit identifying information (*e.g.,* the legal name of the limited FFI) if providing such information would be prohibited under the laws of the limited FFI's jurisdiction.[6]

It should be noted that provisions in the FATCA regulations allowing limited FFI or branch status are transitional rules and the expiration dates for these provisions have not been amended by Notice 2014-33. Therefore, a limited FFI will lose this status after December 31, 2015, or if earlier, the beginning of the third calendar quarter following the date on which the FFI is no longer prohibited from complying with

[5] An expanded affiliated group is generally defined as one or more chains of entities connected with a common parent through at least 50 percent ownership.

[6] This exception is not needed for branches because limited branches are not required to register themselves with the IRS and a registering FFI with a limited branch is only required to indicate that it has a limited branch and provide the jurisdiction in which the branch is located.

the requirements of a participating FFI. Similarly, a participating FFI with one or more limited branches will generally cease to be a participating FFI after December 31, 2015. It should be further noted however, that these time limits are generally without effect in IGA jurisdictions. Thus, an FFI in an IGA jurisdiction will continue to be in compliance with the IGA and will continue to be treated as a participating FFI, deemed-compliant FFI or exempt beneficial owner, as appropriate, even if it has a related entity or branch that is treated as a nonparticipating FFI due to the expiration of the transitional rule for limited FFIs and limited branches provided under the FATCA regulations.

D. REASONABLE EXPLANATION OF FOREIGN STATUS

Both the FATCA regulations and the regulations under Chapter 3 of the code provide that in certain cases, a withholding agent may rely on an individual account holder's claim of foreign status even if the due diligence process has revealed certain indicia of U.S. citizenship or residence ("U.S. indicia"), provided that the account holder provides a "reasonable explanation" supporting such claim. However, there is a small discrepancy between the FATCA regulations and the regulations under Chapter 3 in the requirements for what constitutes a "reasonable explanation". Under both the FATCA regulations and the Chapter 3 regulations, a withholding agent may accept as a reasonable explanation of foreign status either a written statement prepared by the individual or a checklist (provided by the withholding agent and completed by the individual) on which the individual certifies that he or she meets certain enumerated requirements. It appears however, that under the FATCA regulations, the written statement is only valid if it contains the same certifications that would be made in the checklist. Notice 2014-33 makes clear that Treasury and the IRS did not intend for the contents of an acceptable written statement to be so limited under either Chapter 3 or FATCA and that the FATCA regulations will be amended to clarify that an individual making a claim of foreign status may provide a written statement with a reasonable explanation of his or her foreign status that is not limited to an explanation meeting the requirements of the checklist.

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