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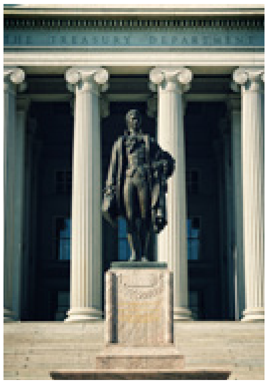
New FATCA Compliance Obligations Facing Business Entities

By Marianna G. Dyson and Michael M. Lloyd

True or False? The original drafters of the Federal legislation now known as "FATCA" intended for the law to be known as "FATCAT." True. Unfortunately, the drafters could not identify a term starting with "T" to complete the acronym. Thus, the body of law that has effectively been imposed on the entire world to hinder the efforts of U.S. citizens to conceal money in overseas accounts is known as FATCA.

FATCA and its implementing regulations are, perhaps, the most complex, far-reaching, and peculiar set of rules in the more than 100 year history of the Internal Revenue Code. Rather than being passed to raise revenue, the sole legislative basis for enacting this unusual legislation was simply to ensure that U.S. citizens could no longer hide financial assets from the Federal government in non-U.S. banks and other foreign financial repositories. Although significant doubt existed as to whether the law could be implemented successfully with the cooperation of U.S. trading partners, the international buy-in to FATCA's principles proved to be widespread and predictions of the law's forthcoming demise and financial catastrophe for the United States proved inaccurate.

The following excerpt from Critical Issues Series: U.S. Information Reporting and Withholding at the Source—FATCA pertains to the complex web of new tax compliance obligations now facing business entities.



Conceptual Overview of FATCA

FATCA (Chapter 4 of the Internal Revenue Code) is conceptually straightforward. Congress did not intend for FATCA to be a direct revenue raiser for the U.S. Treasury. The purpose of FATCA is to encourage U.S. investors to report their foreign investment income and disclose the financial assets they own outside of the United States. FATCA encourages this process by imposing information reporting on those foreign financial institutions (FFIs) and passive non-financial foreign entities (NFFEs) that serve as vehicles for foreign investment. In the event that an FFI or passive NFFE refuses to comply with the reporting requirements, it in turn becomes subject to a penalty in the form of a withholding tax imposed by all payers of U.S. source income to that entity.

The potential application of FATCA withholding has the effect of imposing significant economic harm to noncompliant payees and alienating those payees that choose not to comply. This alienation process arises when entities refuse to register or comply with the account holder identification or substantial owner disclosure process, as required, or they refuse to provide required certifications or documentary evidence to other withholding agents. In practice, financial institutions often refuse to do business with nonparticipating FFIs or recalcitrant account holders, so noncompliance appears to be a very lonely road.

At its core, FATCA is a reporting regime that enforces its reporting requirements through the penalty of a 30 percent withholding tax on noncompliant FFIs and NFFEs. An FFI becomes compliant by registering with the IRS, if required, by reporting required information, and in certain cases, by closing the accounts of certain account holders, unless it is a type of FFI that is within an appropriate deemed compliant category. An NFFE becomes compliant by determining if it is a passive NFFE, and if it is, by reporting its substantial U.S. owners to withholding agents or the IRS. To determine which obligations FATCA imposes on it, an entity must determine whether it is an FFI, NFFE, or exempt beneficial owner (EBO), perhaps the most difficult part of the FATCA rules, and once it has narrowed down its general classification, it must identify the specific type of FFI or NFFE that applies, assuming that it is not an EBO. Often the most challenging determination under FATCA is determining whether or not an entity is an FFI.

Although this determination is often clear, it can be an extremely difficult determination at the margins. For example, a licensed bank that accepts deposits from customers, maintains traditional banking type accounts, and makes loans to customers is clearly an FFI because it is a depository institution engaged in a banking business. However, the question of whether an entity primarily engaged in the manufacture and sale of goods that receives and manages cash from affiliated entities to achieve certain efficiencies or economies of scale is also a depository institution is extremely nuanced, and the determination of its status as an FFI or NFFE may vary depending upon whether the entity is in an intergovenmental agreement (IGA) jurisdiction, and indeed, even which IGA jurisdiction it is in. Once an entity knows its status though, applying the rules under FATCA or the IGAs is generally straightforward.

In addition, Section 6038D imposed an annual income tax return reporting requirement on specified individuals who have specified foreign financial assets. The reporting requirement can be burdensome, and the failure to comply by timely filing Form 8938 (Statement of Specified Foreign Financial Assets) or omitting required assets may result in stiff penalties and in the tolling of the statute of limitations for an individual's Federal income tax return until the required filings are properly made. Section 6038D works in tandem with the rules under FATCA by requiring disclosures by specified individuals, whereas the rules under FATCA focus exclusively on compliance by entities.

Overview of the FATCA Part of U.S. Information Reporting and Withholding at the Source

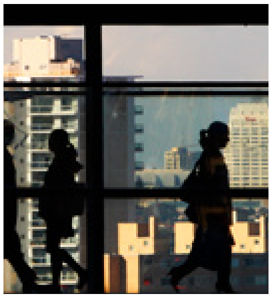
The FATCA part is written to provide background and detail regarding all elements of FATCA under the Treasury Regulations and the IGAs as well as practical observations regarding the application of the rules in various instances. FATCA is a new and unique body of law, and a new language has evolved to apply its principles. The iterative process that resulted in the FATCA regulations spawned numerous defined terms. To illustrate the growth in the number of defined terms over the period during which the rules were developed, Proposed Regulation § 1.1471-1(b), issued in February 2012, included ninety-two defined terms (primary terms and subsidiary term definitions), whereas the number of defined terms under Treasury Regulation § 1.1471-1(b) ultimately grew to 151 defined terms.[†]

Most, but not all, of the definitions under the FATCA regulations are found primarily in three regulations: Treasury Regulation §§ 1.1471-1(b), 1.1471-5, and 1.1473-1. In many instances, terms defined under Treasury Regulation § 1.1471-1(b) cross-reference definitions set forth in the other two regulations. A significant portion of the rulemaking in this area relates to classifying entities, which is a prerequisite to determining whether the entity must register with the IRS and obtain a global intermediary identification number (GIIN), the type of withholding certificate or documentary evidence that it must provide to withholding agents, and ultimately whether a withholding agent must impose withholding. The IGAs also include a number of defined terms, the meaning of which may be the same as the meaning in the regulations or may be different depending upon the language of the IGA or the meaning ascribed under foreign law. Nevertheless, understanding the meaning of key terms is integral to successfully applying the rules under FATCA.

FATCA Compliance In General

FATCA sets forth a dense and daunting compilation of complex rules with which business entities must comply or potentially face significant tax and business consequences. Although FATCA is intended to prevent tax evasion by wealthy individuals by forcing foreign financial institutions (FFIs) to report their U.S. account holders to the IRS, nonfinancial entities—particularly multinational corporations—are also affected by the FATCA. In order to comply, an entity must determine its responsibilities and obligations under FATCA from various perspectives, including that of a withholding agent making potentially withholdable payments, a nonfinancial entity, and a foreign financial institution. This discussion provides guidance to business entities regarding how to comply with the law.

† Notwithstanding the fact that there are 151 defined terms identified under Treasury Regulation § 1.1471-1(b), various additional terms are defined throughout the FATCA regulations.



Withholding Agents

With respect to making potentially withholdable payments under FATCA, withholding agents should consider taking the following actions:

Document domestic payees that are exempt recipients that may receive potentially withholdable payments of U.S. source interest, dividends, or payments for financial services. Historically, a Form W-9 was not required to avoid reporting when making payments to a payee that was a bank or financial institution or that included terms such as "corporation," "incorporated," or "insurance company" in its name. New rules under FATCA make the collection of such forms (or other documentary evidence) necessary; otherwise, if the payee is receiving a FATCA withholdable payment, the payee will be presumed to be foreign and noncompliant. Withholdable payments generally include payments of fixed or determinable annual or periodic (FDAP) income such as interest, dividends, insurance premiums on U.S. risks, and bank and brokerage fees.

Obtain forms W-8 from recurring foreign payees to establish their FATCA status. Withholding agents should collect Forms W-8 from foreign payees to which they make FATCA withholdable payments. The new Form W-8 series (Form W-8BEN-E, Form W-8IMY, etc.) includes the payee's FATCA status. Businesses will need this information to determine whether withholding on the payment is required and to report the payment on Forms 1042 and 1042-S.

Train accounts payable, treasury, and other groups that make payments to identify potentially withholdable and reportable payments. Employees making payments will need to be trained on the new reporting and withholding regime so that they can determine whether FATCA applies to a payment. In addition, employees responsible for establishing vendor and bank relationships will need to be trained to review the new Form W-8BEN-E to determine whether it has been properly completed and to verify a payee's global intermediary identification number (GIIN) and status on the list of FFIs published by the IRS, if applicable.

Implement procedures to obtain and review appropriate withholding certificates or documentation prior to making potentially withholdable payments. Withholding agents should consider what changes are necessary to their current payment procedures to avoid FATCA withholding and reporting failures. Historically, accounts payable (AP) and treasury departments have been focused on making payments and not necessarily on tax compliance, particularly for payments to foreign payees. Withholding agents should consider empowering the staff responsible for making such payments to stop the process before such payments are made if the payee's status has not been properly documented.

Determine whether systems for tracking payments to foreign payees for purposes of Chapter 3 and FATCA reporting are updated and compliant. Withholding agents will need to update their current systems to capture information needed for FATCA reporting, including the new FATCA statuses of payees and GIINs provided by FFI payees.

Foreign entities should know their withholding agent obligations. Foreign entities that make payments of U.S. source income to affiliates and third parties alike should be aware of the documentation requirements of FATCA. Although it is less common for foreign entities to make U.S. source payments, when they do so, they are withholding agents subject to the same requirements as U.S. entities. Accordingly, those making such payments must identify the FATCA status of each payee, withhold, and report, if required. For example, a foreign entity making a payment of insurance premiums directly to a foreign insurer for property located in the United States is a withholding agent with respect to such payment.

Nonfinancial Entities

Nonfinancial entities (domestic or foreign) must make various determinations regarding their entity structure to ensure compliance with FATCA in addition to the steps identified above for withholding agents. The following steps are applicable for nonfinancial entities:

Determine which affiliated entities are included in the expanded affiliated group. The expanded affiliated group (EAG) is a key concept under FATCA, as noncompliant FFIs within the EAG may have negative repercussions on FFIs within the same group.

Identify any potential FFIs in the EAG and determine if they are excepted FFIs under the rules applicable to nonfinancial groups. FATCA defines the term "financial institution" broadly to include depository institutions, custodial institutions, investment entities, certain insurance companies, and certain treasury centers and holding companies. Companies should identify the FATCA status of each entity within the EAG to determine whether any such entities might be an FFI. Entities that may be FFIs include customer financing operations, treasury centers, captive offshore insurers, and certain foreign pension plans, among others.

Determine whether the EAG satisfies the quantitative tests for nonfinancial group status. The definition of financial institution exempts many entities that might otherwise qualify as FFIs from its requirements if they are part of an EAG that is a nonfinancial group. To qualify as a nonfinancial group, the group must satisfy certain quantitative tests relating to passive income, proportion of group income from FFIs, and passive assets. In addition, any FFIs within the group must be compliant with FATCA. Importantly, a group may fail to qualify as a nonfinancial group even if it has no FFIs or passive nonfinancial foreign entities (NFFEs) within the group. FFIs that are holding companies, treasury centers, or captive finance companies, and that are part of a nonfinancial group may be treated as excepted nonfinancial group entities avoiding the compliance obligation that would otherwise apply. If an EAG is not a nonfinancial group, these exceptions are unavailable.

Identify all foreign retirement arrangements sponsored or maintained by members of the EAG. Because FATCA defines financial institution broadly, foreign retirement arrangements may be treated as FFIs unless they meet certain requirements and qualify as exempt beneficial owners. To determine whether any retirement arrangements are FFIs, businesses should contact members of their EAG to identify all of the arrangements that are sponsored or maintained by members within the group. Retirement arrangements that qualify as exempt beneficial owners are not subject to FATCA withholding, due diligence, and reporting requirements. The various exemptions include treaty-qualified retirement funds, broad participation retirement funds, narrow participation retirement funds, and others. In addition to the exemptions in the U.S. Treasury Regulations, an applicable IGA may provide additional exclusions.

If a retirement arrangement cannot satisfy the requirements for any of the available exempt beneficial owner categories, the arrangement will likely have to be registered with the IRS as an FFI. Arrangements that are required to register will generally be subject to the same annual reporting requirements, due diligence requirements for identifying U.S. account holders, and additional compliance obligations as with other FFIs.

Foreign entities should be prepared to provide withholding certificates or other required documentation to payors of U.S. source FDAP income and financial institutions with which they have accounts. A foreign entity may find itself facing erroneous withholding if it fails to certify its FATCA status to payors of U.S. source interest and dividends. FFIs and U.S. banks with which foreign entities have accounts may request documentation, including Forms W-8, to satisfy their due diligence requirements under FATCA.

Qualified intermediaries, withholding foreign partnerships, and withholding foreign trusts must enter into new agreements with the IRS. QIs, WPs, and WTs may be nonfinancial entities or FFIs. In 2014, the IRS modified the qualified intermediaries (QI), withholding foreign partnership (WP), and withholding foreign trust (WT) agreements in Revenue Procedures 2014-39 (QIs) and 2014-47 (WPs and WTs) to address new requirements under FATCA and Chapter 3 of the Internal Revenue Code. In connection with the publication of the new agreements, existing QIs, WPs, and WTs must renew their agreements.

Foreign Financial Institutions

FFIs must be prepared to register with the IRS, document the status (U.S. or foreign) of account holders, certify compliance to the IRS, and withhold and report as required, in addition to the requirements described above for withholding agents and nonfinancial entities.

Many FFIs must register with the IRS. Participating FFIs and registered deemed-compliant FFIs (including reporting Model 1 FFIs and reporting Model 2 FFIs) must register with the IRS through the online registration portal. The Form 8957 (FATCA Registration) reflects the steps used to register FFIs using the portal. If a Form 8957 is submitted, the IRS will establish an online FATCA account for the financial institution and provide information regarding how to access the online FATCA account to view, manage, and edit its FATCA information.

FFIs must document the status of account holders. FFIs generally must obtain information and documentation from account holders to determine whether the account is held by a U.S. person, recalcitrant account holder, or nonparticipating FFI. The regulations set forth detailed requirements for identifying and determining the status of account holders largely by reference to the rules for identifying payees. Similar rules that provide for the use of self-certifications and anti-money laundering / know your customer (AML/KYC) documentation for these purposes are set forth in the IGAs.

Many FFIs must certify compliance to the IRS. Participating FFIs and registered deemed-compliant FFIs must periodically certify to the IRS that the FFI maintains effective internal controls or make a qualified certification identifying any event of default or material failure that the FFI has not corrected as of the date of the certification. These requirements are greatly relaxed for many FFIs in IGA jurisdictions.

FFIs must report information related to U.S. account holders, recalcitrant account holders, and nonparticipating FFIs. Participating FFIs and reporting Model 2 FFIs generally must report information regarding U.S. accounts, recalcitrant account holders (non-consenting U.S. accounts for reporting Model 2 FFIs), and nonparticipating FFIs to the IRS annually on Form 8966 (FATCA Report). Reporting on payments to nonparticipating FFIs is transitional and generally only applies to foreign reportable amounts paid in 2015 and 2016. Reporting Model 1 FFIs generally must report similar information regarding U.S. accounts to the local tax authorities in their jurisdictions. For U.S. accounts, these FFIs generally must report the account holder's identifying information and information regarding the value of the account and payments made to the account during the year.

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*FATCA Essentials includes the content provided in Critical Issues Series: U.S. Information Reporting and Withholding at the Source - FATCA

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Marianna G. Dyson is a member of the Tax Group and Chair of the Employee Benefits group of the law firm Miller & Chevalier Chartered. She is also a member of the firm's Executive Committee and is the immediate past Executive Committee Chair. She practices in the areas of payroll tax, fringe benefits, and information reporting, with a specific focus on perquisites provided to employees and independent contractors (including directors), worker classification, tip reporting, cross-border compensation, backup withholding, information reporting, and penalty abatement. Ms. Dyson's government experience includes time spent as a Senior Attorney, Office of IRS Associate Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service (1990 - 1994).

Michael M. Lloyd is a member of the Tax Group of the law firm Miller & Chevalier Chartered with a focus on Foreign Account Tax Compliance Act (FATCA), information reporting and withholding on cross-border payments, backup withholding, employment taxation, the treatment of fringe benefits, cross-border compensation, domestic information reporting, penalty abatement, and general tax planning and controversy matters. Mr. Lloyd recently completed a three-year term on the IRS Information Reporting Program Advisory Committee (IRPAC), during which time he worked with the IRS on FATCA. In 2005, the ABA Tax Section recognized Mr. Lloyd as a John S. Nolan Fellow. Mr. Lloyd advises large U.S. and foreign multinationals regarding compliance with information reporting and withholding issues.

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