

## The Treasury Department and IRS Release Updates to Final FATCA Regulations as well as Coordination Regulations

### Closing the distance

Global Financial Services Industry



#### Deloitte's initial analysis in response to the Treasury Department and IRS release of updates to final FATCA Regulations as well as Coordination Regulations

On Thursday, February 20, 2014, the U.S. Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS") released temporary regulations that revise and clarify **the final FATCA regulations ("Temporary Regulations")**. The government also released temporary regulations coordinating the final regulations under Chapters 3 and 61 of the Internal Revenue Code ("Code") with the final FATCA (Chapter 4) regulations ("**Coordination Regulations**"). The new rules do not provide any further extensions to the effective date of FATCA, or to the required timeframes in which an FFI that has entered into an FFI Agreement (a "participating FFI" or "PFFI") must comply with the due diligence, withholding or reporting obligations under the that agreement.

In this initial analysis, we highlight some of the most significant updates made to the final FATCA regulations and also some of the noteworthy coordinating changes to Chapters 3 and 61, and other related provisions.

## MODIFICATIONS TO DEFINITIONS AFFECTING CLASSIFICATION OF ENTITIES

The Temporary Regulations modify and add certain definitions to the final regulations that impact the classification of entities:

- An entity is considered a **custodial institution**, and thus a financial institution, if at least 20% of its income is attributable to holding financial assets for others and related financial services. The Temporary Regulations provide that financial advisory fees are considered income attributable to holding financial assets only if those fees are earned with respect to financial assets held in (or to be held in) custody by the entity.
- The term **U.S. person** now includes a foreign insurance company that has made an election under Code section 953(d), provided that either the foreign insurance company is not a specified insurance company or the foreign insurance company is a specified insurance company and is licensed to do business in any State. A specified insurance company that is not licensed to do business in any State will continue to be treated as a foreign person under the final regulations.
- An **investment advisor** and an **investment manager** will now be considered a certified-deemed compliant FFI if the entity is an FFI solely because it is an investment entity under Treas. Reg. § 1.1471-5(e)(4)(i)(A) and the entity does not maintain financial accounts.
- The requirements for an entity to be a **limited life debt investment entity** (“LLDIE”) have been liberalized to expand the types of securitization vehicles that will qualify as a LLFIE. The changes include the removal of the requirement that the LLDIE’s organizational documents cannot be amended without the consent of all investors.
- Passive NFFEs can now choose to be “**direct reporting NFFEs**” and “**sponsored direct reporting NFFEs**”, and the definition of “**excepted NFFE**” has been updated to include these two types of NFFEs, as well as NFFEs that are qualified intermediaries, withholding foreign partnerships or withholding foreign trusts.

## EXPANDED AFFILIATED GROUP ALSO REDEFINED

The Temporary Regulations modify the definition of an **expanded affiliated group** (“EAG”) to allow a partnership or other non-corporate entity to elect to be treated as the common parent entity of an EAG. The temporary regulations also set forth new rules for establishing the ownership requirements for determining if an entity is a member of an EAG. For example, a corporation owned by a partnership or other non-corporate entities can now be included in a chain of entities that are part of the same EAG. Further, in determining whether an entity is an EAG member, only direct – not indirect or constructive – ownership is considered.

## OTHER DEFINITIONAL AND INTERPRETIVE CHANGES

- The final regulations included a **grantor trust** rule in the definition of account holder that would have treated the grantor of the trust as an account holder. The Temporary Regulations remove this rule so that the grantor trust is now treated as the account holder of any account. A grantor trust must provide documentation of its Chapter 4 status as an FFI or NFFE.
- The term “**branch**” with respect to an FFI is modified to include an entity that is a **disregarded entity** separate from the FFI. The Global Intermediary Identification Number (“GIIN”) verification procedures that apply with respect to a branch of an FFI also apply to a disregarded entity that is owned by an FFI.
- A **sponsored FFI** remains liable for its withholding and reporting obligations even if a sponsoring entity performs these obligations on its behalf. The Temporary Regulations

clarify a **sponsoring entity** will not be jointly and severally liable for the sponsored entity's obligations unless the sponsoring entity is also a withholding agent that is separately liable for such obligations.

- The term “**offshore obligation**” is now used instead of “offshore account”, and the definition used under the Code section 6049 regulations is adopted.

## DUE DILIGENCE

**Identification of U.S. Persons – Presumption Rules for Pre-existing Obligations** - The final regulations required a U.S. withholding agent that made a payment with respect to a pre-existing obligation to treat the payee as a U.S. person only if it previously reviewed a Form W-9 or other documentation that established the payee as a U.S. person that was an exempt recipient under chapter 61. The Temporary Regulations modify this rule to allow U.S. withholding agents to treat a payee as a U.S. person if the withholding agent has previously established, either through documentation or the application of the “eyeball test” and other rules set forth in Treas. Reg. § 1.6049-4(c)(1)(ii), that the payee is an exempt recipient for purposes of Chapter 61. This rule is only applicable for pre-existing obligations. U.S. withholding agents will be required to collect Forms W-9 or other documentation to establish the exempt recipient status of new account holders.

**Substitute Form Requirements** - A withholding agent can substitute its own form for an official Form W-8 as long as certain substitute form requirements are met. The Temporary Regulations clarify that a withholding agent may choose to provide a substitute form that does not include all of the Chapter 4 statuses provided on the official Form W-8 but must include any Chapter 4 status for which withholding may apply, such as the categories for a nonparticipating FFI or passive NFFE.

- The Temporary Regulations also provide that a substitute form for individuals (**non-IRS form for individuals**) no longer must contain the city of a person's birth but the new rules now require that the substitute form contain the individual's date of birth, without regard to whether a foreign tax identification number is provided.

**Documentation from Participating FFIs and Registered-Deemed Compliant FFIs** – The final regulations provide a transitional rule that allows a withholding agent may treat a payee as a PFFI or registered-deemed compliant FFI (“RDC-FFI”) with respect to a payment made prior to January 1, 2017 on a pre-existing obligation. Under that rule, the PFFI or RDC-FFI does not need to provide the withholding agent with a withholding certificate but only its GIIN (to be verified by the withholding agent) and an indication of whether the FFI is a PFFI or RDC-FFI. The Temporary Regulations modify this transitional rule to coordinate with the rules under Chapters 3 and 61, now requiring the payee to also provide the withholding agent with a pre-FATCA Form W-8, since payees that receive U.S. source FDAP income would have already been required to provide a withholding certificate.

**Documentation Collected by U.S. Payor Agent of PFFI** - The final regulations do not require a PFFI to perform an electronic search or enhanced review if the PFFI previously established an account holder's status as foreign in order to fulfill its reporting obligation as a U.S. payor under Chapter 61. The Temporary Regulations update this rule to expand this exception to circumstances where a paying agent of the PFFI is a U.S. payor that has previously obtained documentation to establish the account holder's status as a foreign individual under its Chapter 61 obligations.

## REPORTING

**Reporting Options for PFFIs** - The Temporary Regulations allow a PFFI to report on all of its U.S. and recalcitrant accounts, or separately with respect to any clearly identified group of accounts, such as by business line or location. However, the PFFI must include the GIIN assigned to the PFFI or its branch (including a disregarded entity of the FFI), if applicable to identify the jurisdiction of the FFI (or its branch or disregarded entity) that maintains the accounts subject to reporting.

**Transitional Reporting to Nonparticipating FFIs** – The Temporary Regulations incorporate the changes announced in Notice 2013-69 and the final FFI Agreement regarding the transitional reporting of foreign reportable amounts paid to nonparticipating FFIs. The transitional reporting

applies only with respect to payments made to a nonparticipating FFI that maintains an account with the PFFI, and allows the PFFI to report all payments made with respect to an account, not just payments of foreign reportable amounts. The Temporary Regulations also modify the definition of a foreign reportable amount to mean foreign source payments as described in Treas. Reg. § 1.1471-(d)(4)(iv) paid to or with respect to an account.

**Reporting for U.S. Payors Other than U.S. Branches** – The Temporary Regulations allow a PFFI that is a U.S. payor to satisfy its Chapter 4 reporting obligations with respect to U.S. accounts or accounts held by owner-documented FFIs either by reporting the information that would be made on Form 1099 for U.S. accounts that are not U.S.-owned NFFEs or by reporting the information that would be made on Form 8966 with respect to accounts held by specified U.S. persons, U.S. owned foreign entities, and by owner-documented FFIs. If a PFFI chooses to report on Form 8966, but is also required to report on such accounts under Chapter 61, the PFFI will not be relieved of that obligation.

**Automatic 90-day Extension of Time to File Form 8966** - The IRS will grant an automatic 90-day extension to file Form 8966 but a request for extension must be filed no later than the due date of Form 8966. The IRS may grant an additional 90-day extension under certain hardship conditions.

**Transitional Reporting Recipient Copy of Form 1042-S** – For calendar year 2014 reporting, a withholding agent will be permitted to include more than one type of income or other payment on the recipient copy of Form 1042-S. However, beginning in calendar year 2015, the Form 1042-S and accompanying instructions will require a separate Form 1042-S for each type of income or other payment.

## WITHHOLDING

**Grandfathered Obligations – Material Modifications** - An outstanding obligation that constitutes indebtedness can lose its grandfathered status under the FATCA regulations if the obligation is materially modified after June 30, 2014. The temporary regulations provide that a withholding agent, other than the issuer of the obligation (or its agent) is required to treat a modification of the obligation as material only if the withholding agent has actual knowledge of such modification, such as in the case where the withholding agent receives a disclosure indicating there has or will be a material modification to the obligation.

**Modifications to FFI Withholding Statements** – The Temporary Regulations clarify the FFI withholding statement requirements, including with respect to rules on when a Chapter 4 withholding rate pool may be used by an FFI to allocate withholdable payments to a class of persons within a particular withholding rate pool. In some cases, a PFFI will not need to provide payee specific information to the withholding agent with respect to the account holder even if such information would be typically required under Chapter 61, because the information will be reported to the IRS under Chapter 4.

**Transitional Rule for Withholding on Offshore Payments of U.S. Source FDAP Income and on Collateral** – The Temporary Regulations provide that the transitional withholding exclusion for U.S. source FDAP income paid with respect to offshore obligations prior to January 1, 2017 does not apply in the case of payments made with respect to debt or equity issued by a foreign branch of a U.S. person. The exclusion continues to apply to interest payments made by a foreign branch of a U.S. financial institution with respect to depository accounts it maintains for retail customers.

- The Temporary Regulations also provide that a withholdable payment does not include a payment made prior to January 1, 2017, by a secured party with respect to collateral securing one or more transactions under a collateral arrangement, provided that only a commercially reasonable amount of collateral is held by the secured party as part of the collateral arrangement.

**Optional Escrow Procedure for Dormant Accounts** – A PFFI that withholds on a withholdable payment not otherwise subject to Chapter 3 withholding or backup withholding made to a recalcitrant account holder of a dormant account may set aside the amount in escrow until the date the account

ceases to be a dormant account, at which time the tax withheld becomes due 90 days following such date if the account holder does not provide the documentation required to establish that withholding does not apply.

## FFI AGREEMENT

**Verification Procedures** - The Temporary Regulations provide that, as part of its general inquiries, in addition to requesting information in its review of Form 8966, the IRS may request additional information to determine an FFI's compliance with its FFI agreement and to assist the IRS with its review of account holder compliance with tax reporting requirements. Further, the IRS can request information from a sponsoring entity regarding the substantial non-compliance of any sponsored FFI.

**Events of Default** - The Temporary Regulations also clarify that an **event of default** for failing to significantly reduce, over a period of time, the number of account holders or payees of a PFFI that must be treated as recalcitrant account holders or nonparticipating FFIs occurs only if the PFFI failed to actually comply with the due diligence procedures for the identification and documentation of account holders and payees as set forth in the FFI Agreement.

## COORDINATION REGULATIONS

Treasury and the IRS released temporary regulations, under Chapters 3 and 61, and Code section 3406, which are intended to coordinate and conform elements of those regulations to the FATCA regulations. In most cases, but with some notable exceptions discussed below, these Coordination Regulations adopt concepts implemented in the FATCA regulations that impact requirements for identifying payees and also coordinate the current rules with the FATCA regulations with the intent of reducing duplicative requirements. The Coordination Regulations also seek to implement uniform definitions, examples and cross references amongst the various sets of requirements. Some notable changes to the current rules under Chapters 3 and 61, and section 3406 are highlighted below:

**Coordinated and Conformed Rules for Identifying the Payee** - Chapters 3 and 61 contain a set of presumptions that withholding agents apply to determine the status of a payee for withholding and reporting purposes in the absence of specified documentation. The Coordination Regulations generally adopt the changes to the presumption rules implemented in the FATCA regulations, including:

- Limiting the so called "eyeball" test for identifying exempt U.S. payees
- Adopting specific conditions articulated under the FATCA regulations as to when a withholding agent will have "reason to know" that a withholding certificate is invalid or has U.S. indicia
- Changing the current presumption rule with respect to payments to a U.S. branch of a foreign person that treats the payment as effectively connected income ("ECI") if there is no withholding certificate to require that a withholding agent either obtain an employer identification number ("EIN") from a U.S. branch before it may treat the income as ECI, or if no EIN is obtained, then treat the payment as made to a foreign person and not as ECI

The Coordination Regulations also adopt several concepts from the FATCA regulations regarding the validity of withholding certificates and clarify certain issues with respect to documentation, including:

- Extending the validity period for all existing withholding certificates that would have expired on December 31, 2013 to January 1, 2015, unless a change in circumstances occurs before the latter
- Requiring certain withholding certificates from FFIs to present a valid GIIN to be valid for Chapter 3 purposes

- Allowing electronic transmission and storage of withholding certificates, withholding statements, and documentary evidence under certain conditions and removing the requirement to withhold on payments during the grace period when a form is received by fax
- Permitting indefinite validity for withholding certificates from individuals and certain entities provided a treaty claim is not being made
- Requiring a withholding agent to obtain certain documentation to cure a withholding certificate obtained after the payment date
- Providing some allowance for a withholding agent to rely on a substitute withholding certificate, for Chapter 3 purposes, that omits FATCA related information that is irrelevant to the transaction and not necessary for the withholding agent to perform its Chapter 3 obligations
- Setting forth a list of persons authorized to sign a withholding certificate
- Adopting some of the shared/consolidated withholding certificate and account management concepts in the FATCA regulations pertaining to shared information systems among an EAG, information obtained from acquired companies, and information collected under principal-agency rules, but not allowing reliance on information from third-party data providers as allowed in some circumstances under Chapter 4

However, the Coordination Regulations did not adopt all concepts from the FATCA regulations. For example, in order to avoid potential deficits in Chapter 3 withholding, they did not extend to Chapter 3 the rule under the FATCA regulations that permits a withholding agent to apply a 90-day grace period during which they can rely on the payee's claimed FATCA status while waiting on new documentation following a change in circumstances.

***Coordinated and Conformed Rules for Withholding*** - The Coordination Regulations also clarify and generally eliminate situations where duplicative withholding could be required under Chapters 3, 4 and 61, and under section 3406. Additionally, the Coordination Regulations implement other notable changes, such as:

- Coordinating rules for withholding under Chapters 3 and 4, and section 3406 on payments to nonqualified intermediaries and qualified intermediaries involving withholding rate pools and underlying beneficial owner information
- Expanding the existing rules under Chapter 3 that allow for a reduced rate of withholding under a tax treaty if the payee provides a U.S. tax identification number ("TIN") to also allow the payee to provide its foreign TIN as an alternative
- Modifying and clarifying definitions of certain payees, including U.S. agents of foreign persons, U.S. branch of foreign banks and authorized foreign agents
- Conforming the definition of financial institution to the FATCA definition

***Coordinated and Conformed Rules for Information Reporting*** - The Coordination Regulations clarify and eliminate situations where duplicative reporting may be required under Chapters 4 and 61.

- FFIs and passive foreign investment companies required to report both under Chapter 4 on Forms 8966 and under Chapter 61 on Forms 1099 can generally meet their Chapter 4 requirements with Form 1099 reporting. However, Model 1 FFIs may still be required to comply with separate reporting requirements in their own jurisdictions under an applicable intergovernmental agreement

- In some cases, an FFI may be able to satisfy its Chapter 61 reporting obligations, if any, by reporting on a Form 8966
- U.S. financial institutions that have reporting requirements under Chapters 4 and 61, however, will not be able to use Forms 8966 under Chapter 4 to meet their Chapter 61 requirements, but will instead have to continue to report on Forms 1099

## **FUTURE GUIDANCE**

***Verification Requirements of Sponsoring Entities*** – The IRS will separately issue proposed regulations describing the verification requirements of sponsoring entities. Under these proposed regulations, a sponsoring entity will be required to make two separate compliance certifications. The first will be on behalf of its sponsored FFI or sponsored direct reporting NFFE with respect to the compliance of those entities. The second certification will be on the sponsoring entity's own behalf with respect to its compliance as a sponsoring entity.

***FFI Agreement*** – The Treasury Department and IRS also intend to publish a revenue procedure revising the FFI Agreement to conform to the Temporary Regulations.

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