PROPOSED AMENDMENTS TO F.A.T.C.A. SUGGEST REDUCING OR DEFERRING WITHHOLDING

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On December 13, 2018, the I.R.S. issued proposed regulations under Code §§1471 through 1474 (F.A.T.C.A provisions) as well as under Code §§1441 and 1461 (withholding on non-U.S. persons and withholding agent liability for under-withholding, respectively). The proposed regulations are the result of an I.R.S. review of existing regulations and public comments received in response to President Trump's executive order requiring Federal government agencies to review existing regulations with the goal of modifying or eliminating regulations to reduce unnecessary burdens.

This F.A.T.C.A. update will focus on the proposed regulations under F.A.T.C.A. The proposed regulations would eliminate F.A.T.C.A. withholding on gross proceeds, defer F.A.T.C.A. withholding on Passthru Payments, eliminate withholding on certain insurance premiums, and clarify the definition of an investment entity, a subcategory of a foreign financial institution ("F.F.I."). The Preamble to proposed regulations explains that the significant relief from potential withholding and compliance burdens is possible thanks to the wide network of intergovernmental agreements ("I.G.A.'s") that the U.S. engaged in, and which facilitates international F.A.T.C.A. compliance.

WITHHOLDING ELIMINATED ON PAYMENTS OF GROSS PROCEEDS

F.A.T.C.A. imposes withholding on "withholdable payments" made to certain F.F.I.'s and certain non-financial foreign financial entities ("N.F.F.E.'s"). Withholdable payments were defined in the Code:

- Any of the following U.S.-source payments: interest, including original issue discount ("O.I.D."); dividends; rents; salaries; wages; premiums; annuities; compensations; remunerations; emoluments; and other fixed or determinable, annual or periodical ("F.D.A.P.") gains, profits, and income
- Any gross proceeds from the sale or other disposition of any property of a type that can produce U.S.-source interest or dividends

Withholding on gross proceeds would have imposed a great burden on withholding agents. Therefore, the I.R.S. issued guidance deferring the date when withholding would begin, with the latest guidance deferring withholding until January 1, 2019. The preamble to the proposed regulations explains that with 87 jurisdictions having an I.G.A. (intergovernmental agreement) in force and another 26 jurisdictions having I.G.A.'s signed or agreed in substance, international cooperation to facilitate F.A.T.C.A. implementation is sufficient. Current withholding serves as a significant deterrent for noncompliance, and as a result, it is not necessary to impose the burdens of gross proceeds withholding, which can be eliminated. This change will result in only U.S.-source F.D.A.P. that is withholdable under the definition, and not

otherwise exempt, being subject to F.A.T.C.A. withholding.

WITHHOLDING DEFERRED ON FOREIGN PASSTHRU PAYMENTS

F.A.T.C.A requires an F.F.I. to withhold on any “Passthru Payment” made to (i) any account holder that does not comply with the self-certification requirements (a “Recalcitrant Account”) and (ii) any account holder that is a nonparticipating F.F.I. The Code defines a Passthru Payment as any withholdable payment or a payment attributable to a withholdable payment (referring to it as a Foreign Passthru Payment).

The I.R.S. proposed a framework for F.F.I.’s to determine whether payments are attributable to withholdable payments; however, it was viewed to be complex and to impose significant burdens and thus was not incorporated in the final F.A.T.C.A. regulations published in 2013. The regulations provided that withholding on Passthru Payments will not begin before the later of January 1, 2019, or the date the final regulations defining Foreign Passthru Payment are published. In recognition of the time necessary to implement a system for withholding on Foreign Passthru Payments and successful engagement in a significant number of I.G.A.’s, the I.R.S. proposed to further delay the implementation of withholding on Foreign Passthru Payments.

The I.R.S. is reluctant to eliminate this withholding, as it provides a way for a participating F.F.I. to continue to remain in compliance even when some account holders are noncompliant and, more importantly, it prevents nonparticipating F.F.I.’s from avoiding F.A.T.C.A. by investing in the U.S. through a participating F.F.I. “blocker.” Therefore, the proposed regulations defer the obligation to withhold on Passthru Payments until two years after the date of publication of final regulations defining Foreign Passthru Payment.

INVESTMENT ENTITY CLARIFICATION

The definition of an F.F.I. includes Investment Entities. Under the regulations, an Investment Entity is one of the following:

- Any entity that primarily conducts as a business one or more of the following activities or operations for or on behalf of a customer:
  - trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures;
  - individual or collective portfolio management; or
  - otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons
- Any entity whose gross income is primarily attributable to investing, reinvesting, or trading in financial assets that is “managed by” another entity that is a depository institution, custodial institution, insurance company, or an Investment Entity described above.

- Any entity that functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.

The regulations provided examples to illustrate the "managed by" category of Investment Entities and those referred to entities that are managed by an F.F.I. by virtue of an F.F.I. having discretionary authority to manage the entity's assets. As a result, it was unclear whether an entity that meets the gross income requirement and that invests in a mutual fund could be viewed as an Investment Entity itself due to the mutual fund's discretionary authority over the entity's assets. However, the preamble to the proposed regulations confirms that the examples in the regulations were intended to cover entities that receive professional management advice that is tailored to the investment needs of the entity. They were not intended to cover entities that invest in a widely-held fund that employs a predetermined investment strategy. Thus, the proposed regulations clarify that an entity is not "managed by" an F.F.I. solely because the entity invests all or a portion of its assets in a mutual fund, an exchange traded fund, or a collective investment entity that is widely held and is subject to investor-protection regulation.

In contrast, an investor in a "discretionary mandate" is managed by the F.F.I. providing this investment product. A discretionary mandate is an investment product where the F.F.I. manages and invests the client's funds directly in accordance with the client's investment goals (rather than the client investing in a mutual fund, for example).

PERMANENT RESIDENCE SUBJECT TO HOLD MAIL INSTRUCTIONS

Current regulations allow an address to be treated as a permanent residence address despite being subject to a hold mail instruction when a person provides documentary evidence establishing residence in the country in which the person claims to be a resident for tax purposes. In response to comments that noted that establishing residence in a particular country is unnecessary when the person is not claiming treaty benefits, the proposed regulations clarify that the documentary evidence required is that which will support the person's claim of foreign status. When a person claiming treaty benefits provides an address subject to a hold mail instruction, the person must provide evidence to support the person's residency in that country. Additionally, the proposed regulations clarify that a hold mail instruction does not include a request to receive all correspondence electronically.

FINAL NOTES

Despite the latest report by the Treasury Inspector General for Tax Administration ("T.I.G.T.A."), which concluded that after spending nearly $380 million the I.R.S. is still not prepared to enforce F.A.T.C.A. compliance, F.A.T.C.A. is here to stay. This is evident in the recent LB&I campaign that attacks entities that have F.A.T.C.A. reporting obligations but do not meet all their compliance responsibilities, as well as by these proposed regulations, which offer some relief for taxpayers and aim to enhance F.A.T.C.A. compliance.

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