Morgan Lewis

alert

tax lawflash

www.morganlewis.com

Recent IRS Notices Provide Supplemental FATCA Guidance and Phased-in Implementation

August 26, 2011

The Internal Revenue Service (IRS) recently issued its second and third notices concerning the implementation of the Foreign Account Tax Compliance Act (FATCA). Notice 2011-34 (the Second Notice) was issued on April 8, 2011 and Notice 2011-53 (the Third Notice) was issued on July 14, 2011. Both notices supplement and in some cases revise the first guidance on FATCA implementation released by the IRS in Notice 2010-60 on August 27, 2010. Notably, the Third Notice provides for a phased-in approach to the implementation of FATCA so that full compliance with FATCA as of January 1, 2013 is no longer required.

FATCA added a set of antitax evasion provisions to the Internal Revenue Code that generally require "foreign financial institutions" (FFIs) such as non-U.S. banks and offshore investment funds, as well as certain other non-U.S. entities, to provide information to the IRS with respect to their account holders and investors who are U.S. persons. An FFI that enters into a formal agreement with the Treasury and IRS (an FFI Agreement) to provide such client/investor information is known as a "participating FFI" and will thereby be exempt from a new 30% withholding tax on certain payments in respect of U.S. securities, such as dividends, interest, and gross disposition proceeds (known as "withholdable payments"). On the other hand, an FFI not entering into such an agreement will be treated as a "non-participating FFI" subject to the 30% withholding tax on such withholdable payments. While the 30% withholding tax will not be imposed on withholdable payments received by the participating FFI, the participating FFI will be obligated under its agreement with the IRS to withhold the 30% tax on payments attributable to such withholdable payments that it makes to its account holders/investors that are either non-participating FFIs or U.S. persons that do not cooperate with certain documentation requests by the participating FFI (a "recalcitrant account holder"). To date, the Treasury has released more than 100 pages of guidance on FATCA and further guidance, including regulations, is expected.

PHASED-IN IMPLEMENTATION

As noted above, the Third Notice provides details concerning the phase-in of FATCA. Instead of requiring full compliance with FATCA on January 1, 2013, the IRS envisions a phase-in process that delays withholding and reporting obligations at least until 2014, with certain withholding obligations delayed until 2015. The Third Notice provides for the following phase-in schedule:

- June 30, 2013 – By June 30, participating FFIs should execute an FFI Agreement to ensure their exemption from withholding on payments they receive during 2014. FFIs executing agreements after this date are still participating FFIs for 2014, but may not be identified as such in time to

prevent withholding in 2014. FFI Agreements executed by June 30 will be effective as of July 1, 2013, and agreements executed after June 30, 2013 will be effective as of the execution date; the effective date of the FFI Agreement is relevant for purposes of various diligence and compliance requirements imposed on participating FFIs.

- January 1, 2014 – Withholding begins, but only with respect to payments of U.S. source "fixed, determinable, annual or periodical income" (U.S. FDAP) such as interest and dividends. "Passthru payments" of U.S. FDAP are also subject to withholding beginning on this date.
- June 30, 2014 – Participating FFIs must begin filing reports detailing information about their U.S. accounts identified by June 30, 2014. In the first year of reporting, the Third Notice provides that a participating FFI may furnish a summary report indicating each U.S. account holder's name, address, U.S. taxpayer identification number, account balance as of December 31, 2013, and account number.
- January 1, 2015 – Withholding is expanded to all "withholdable payments" (and "passthru payments") including gross proceeds from the disposition of assets that generate U.S. source dividends and interest, in addition to payments of U.S. source FDAP.

The Third Notice also indicates that regulations will be proposed by the end of 2011, with final regulations expected during summer 2012. Draft and final versions of the FFI Agreement and reporting forms are expected to be issued in conjunction with such regulations.

SUBSTANTIVE GUIDANCE PROVIDED IN THE SECOND NOTICE

Among other things, the Second Notice provides guidance on the following topics, which may be of interest to offshore investment funds:

- Identification of U.S. ownership among preexisting individual accounts
- Determination of so-called "passthru payments" made by FFIs to account holders and investors
- The definition of "deemed-compliant FFI" status
- Rules regarding reporting by compliant FFIs
- Compliance with FATCA by affiliated groups of FFIs
- FFI Officer Certification

While the guidance contained in the Second Notice is applicable to FFIs generally, the discussion below summarizes key points that are of interest to offshore investment funds.

Determining U.S. Ownership of Preexisting Individual Accounts

The Second Notice modifies the process to be used by a participating FFI to identify U.S. ownership of preexisting individual accounts. As in the earlier guidance, the Second Notice first requires that a classification of a "U.S. Account" be applied to individual accounts associated with documentation indicating that the account may be owned by a U.S. person (i.e., a Form W-9 has been received with respect to the account). The FFI may exercise its option to treat accounts having a balance of $50,000 or less as a non-U.S. account; however, for purposes of determining balances, the Second Notice provides for aggregation of multiple accounts having partial or complete common ownership.

"Private Banking Relationships." The Second Notice provides special rules concerning "private banking accounts" managed by the FFI through its "private banking department" or a "private banking relationship." A "private banking relationship" includes not only a relationship involving the provision

of personal services to individual clients not provided to account owners generally, but also the gathering of information regarding a client above and beyond that generally obtained with respect to account holders. Thus, for FATCA purposes, a "private banking account" appears to be broad and may cover accounts not maintained in the traditional private bank, such as in an offshore investment fund. A private banking relationship manager must identify clients that are known to be U.S. persons, and review account records for other clients for indicia of U.S. ownership. For those accounts identified by the manager as having indicia of U.S. ownership (either from such review or from personal knowledge), the manager must obtain documentation from the clients owning such accounts affirmatively establishing such clients' U.S. or non-U.S. status, as the case may be. An FFI cannot rely on documents relating to such private bank accounts that the relationship manager knows or has reason to know (because of such relationship) are incorrect. The due diligence requirements for such private banking accounts must be completed by the end of the first year that the participating FFI's agreement with the IRS is in effect. Thereafter, accounts for which documentation of U.S. or non-U.S. status is not received by the end of such first year are to be treated as "recalcitrant accounts" until the FFI is furnished with the proper information.

Other Identification Procedures. The Second Notice contains further diligence procedures intended to uncover U.S.-owned accounts not identified above. First, the Second Notice requires the FFI to investigate its electronically searchable files for accounts with balances exceeding $50,000 for indicia of U.S. ownership (scanned documents and PDF-formatted documents are not considered "electronically searchable" for this purpose). Second, the participating FFI must perform diligence review of "high value" accounts not flagged as "U.S. accounts" under the above steps for indicia of U.S. ownership ("high value" accounts are those with balances of $500,000 or more as of the end of the year preceding the effective date of the FFI's agreement with the IRS). Where such further diligence review uncovers suspected U.S.-owned accounts, the FFI is required to obtain documentation of U.S. or non-U.S. status (i.e., a Form W-9 from a U.S. person or Form W-8 from a non-U.S person) from the account owner by the end of the second year after which the agreement is effective. If the FFI fails to obtain this documentation within such time period, the FFI must treat the owner of such suspected U.S. accounts as a "recalcitrant account holder" and withhold and pay over to the IRS tax of 30% with respect to "passthru payments" paid by the FFI to the accounts of such holder.

Determination of "Passthru Payment"

As noted above, participating FFIs are required to withhold the 30% tax on payments made to a recalcitrant account holder or non-participating FFI that are "attributable to" U.S. source payments in respect of U.S. securities received by the participating FFI (i.e., withholdable payments). Such payments made by the participating FFI to its account holders attributable to withholdable payments are known as "passthru payments." Unfortunately, the method for computing "passthru payments" adopted in the Second Notice is not a simple tracing mechanism. Instead, the Second Notice requires that an FFI take into account the ratio of its "U.S. assets" over all its assets when computing the amount of a "passthru payment." For this purpose "U.S. assets" means any asset that could give rise to a withholdable payment. Thus, *any* payment made by an FFI to non-participating FFIs or recalcitrant account holders may be subject to the 30% withholding tax, depending on the overall percentage of U.S. assets held by the FFI. As illustrated below, this formula may result in a scenario where a non-participating FFI may be subject to 30% withholding tax on payments it receives in respect of its interest in the participating FFI, even if such non-participating FFI has little or no connection to the United States.

Specifically, the Second Notice provides that a passthru payment made by the participating FFI to an account holder/investor is equal to the sum of (i) the amount of the withholdable payment paid to the

account holder, plus (ii) the "passthru payment percentage" of the remaining amount of such payment. Where payments are made other than in the FFI's capacity as a custodian, the "passthru payment percentage" component of the formula set forth above is equal to the sum of the FFI's U.S. assets (held on each of the last four quarterly testing dates) *divided by* the sum of the FFI's total assets (held on those same dates).[1] Thus, if the FFI's U.S. assets are 25% of the FFI's total worldwide assets, then the FFI's passthru payment percentage is 25%, and therefore 25% of the FFI's foreign source payments made to account holders will constitute passthru payments. In fact, so long as the FFI holds U.S. assets that could generate withholdable payments, some portion of payments made by the FFI to non-participating FFIs or recalcitrant account holders will be subject to a 30% withholding tax. An upper-tier FFI holding an interest in a lower-tier FFI (e.g., the typical offshore master/feeder structure) will treat its interest in the lower-tier FFI as a U.S. asset to the extent of the passthru payment percentage of the lower-tier FFI. The Second Notice requires that a participating FFI calculate and publish its passthru payment percentage on a quarterly basis, or else be deemed to have a passthru payment percentage of 100%.

Example. Consider Offshore Fund, Ltd., a Cayman limited company that counts among its investors a number of other non-U.S. investment funds. Offshore Fund invests in U.S. and non-U.S. equities, debt and derivatives, and has entered into an agreement to become a participating FFI. Certain of its non-U.S. fund investors, however, have not so agreed and will be treated as non-participating FFIs. Offshore Fund has total assets of $1,000 (based on the sum of quarterly assets), $400 of which are U.S. assets that generate "withholdable payments" such as dividends and interest. Therefore, Offshore Fund's "passthru payment percentage" is $400 U.S. assets/$1000 total assets, or 40%. As a result of its investments, in year 1, Offshore Fund receives a total of $100 of dividend and interest payments generated from its U.S. investments, $50 of which is allocable to its non-participating FFI investors. At the end of year 1, Offshore Fund distributes $100 to its non-participating FFI investors in respect of their interests in the fund. Applying the formulas above, the first $50 of the $100 payments is subject to 30% withholding by Offshore Fund, as that amount is "traceable" to the U.S. source payments received by the fund that are allocable to the non-participating FFI investors. The remaining $50 of payments is then multiplied by Offshore Fund's passthru payment percentage of 40%, and that portion is likewise subject to a 30% withholding tax. Thus, the total passthru payment is $70 ($50 withholdable payment + $20 amount attributable to ratio of U.S. assets to total assets held by Offshore Fund), and pursuant to its agreement with the IRS, Offshore Fund will be required to withhold 30% from this amount, or $21.

Deemed-Compliant FFIs

Certain FFIs will be deemed to be compliant with the requirements of FATCA if certain obligations that are set forth in the Second Notice are satisfied. In general, to secure "deemed-compliant status," FFIs must submit an application to the IRS for such status, obtain an "FFI identification number," and certify to the IRS every three years that it qualifies for deemed-compliant status. An FFI that is granted

1. On the other hand, where a participating FFI makes a payment to an account in its capacity as custodian (e.g., an account with respect to which the FFI acts as a custodian, broker or other agent for the benefit of an account holder), the "passthru payment percentage" for such payment is the passsthru payment percentage of the issuer of the security in respect of which the withholdable payment was made. Where the FFI making the "custodial" passthru payment is a non-participating FFI, the passthru payment percentage of such entity is deemed to be 0% because the non-participating FFI will already have been subject to the 30% tax on such payment. Assets held in a custodial account are not considered assets of the FFI for purposes of determining the FFI's passthru payment percentage. Finally, the Second Notice provides that transactions before and after quarterly measuring dates that are designed to reduce the amount of the FFI's passthru payment percentage will be disregarded, as provided in future guidance.

"deemed-compliant" status is relieved from the due diligence and other obligations of a participating FFI.

Funds that are "Deemed Compliant" with FATCA. The Second Notice provides that the Treasury and IRS intend to issue guidance under which certain "collective investment vehicles and other investment funds" will be deemed compliant with FATCA. Three requirements will need to be met if such funds are to be treated as "deemed compliant." First, all holders of record of direct interests in the fund must be participating FFIs or deemed-compliant FFIs holding on behalf of other investors. Second, the fund must prohibit the acquisition of interests in the fund by a non-participating FFI or an FFI that is not deemed compliant. Third, the fund must certify that any passthru payment percentages it calculates and publishes must be done so in accordance with the Second Notice.

The Treasury and IRS are currently evaluating whether certain offshore exchange-traded funds (ETFs) and similar vehicles the interests in which are publicly traded might be considered a "deemed-compliant" FFI. The Second Notice states that while such vehicles do not maintain U.S. accounts, they may still be subject to the FATCA requirements to the extent they receive passthru payments. The Second Notice also states that a "deemed-compliant" FFI may use paying agents and transfer agents to perform certain actions, such as diligence, associated with the maintenance of the FFI's deemed-compliant status. More detailed guidance is required concerning the application of FATCA to offshore investment funds, particularly with respect to their ability to obtain "deemed-compliant" status.

Reporting

Under FATCA, a participating FFI must report to the IRS the account balance or value and the gross receipts and withdrawals/payments with respect to each U.S. account maintained by the FFI. The Second Notice contains less burdensome procedures that FFIs may follow in complying with their reporting requirements.

Reporting Account Balance/Value. With respect to the reporting of account balances, the Treasury and IRS intend to issue regulations that limit the account balance reporting obligation to year-end account balances or values. With respect to traditional offshore bank accounts, these balances are as determined for purposes of reporting to the account holder. With respect to interests in an offshore investment fund, the reportable balances or values are those as determined for the purpose that requires the most frequent determination of value. This revised reporting of balances and values is an improvement over the proposed reporting method in earlier guidance, which required reporting of the highest month-end balances during the year (as well as more up-to-date balance information that would have had to be furnished to the IRS on request).

Reporting Account Activity. The Second Notice contains guidance with respect to the reporting of gross receipts and withdrawals associated with each U.S. account, reflecting comments received by the IRS and Treasury regarding the burdensome nature of reporting such information. Under forthcoming regulations, an FFI must annually report the following information on gross receipts and withdrawals:

- The gross amount of dividends and interest paid or credited to the account
- Other income paid or credited to the account
- Gross proceeds from the sale or redemption of property paid or credited to the account with respect to which the FFI acted as a custodian, broker, or nominee or otherwise as an agent for the account holder/investor

Affiliated Groups of FFIs

Under FATCA, the reporting and withholding requirements applicable to an FFI will also apply to any other FFI that is a member of the same "expanded affiliated group."[2] The Second Notice contains guidance on how such FFI affiliates can comply with their obligations under FATCA, and how such affiliates will be able to apply for participating FFI status. While each FFI in the group will have to satisfy its own diligence, reporting, and withholding obligations and will have its own FFI identification number, the Second Notice outlines certain streamlining measures that the Treasury and IRS hope will reduce inefficiencies. For instance, the Second Notice envisions a centralized application process under which a "lead FFI" will be appointed to act as a point of contact for the IRS with respect to applications by group members for participating FFI status (or deemed-compliant FFI). Also envisioned is a centralized compliance procedure whereby a single FFI in the group may establish policies and procedures for FATCA compliance by group members, oversee compliance by group members with such policies, and account to the IRS regarding compliance by group members.

The process may be streamlined even further for groups of offshore funds. The Treasury and IRS are evaluating whether to streamline the process even further to permit a common asset manager (i.e., the General Partner) to execute a single FFI Agreement on behalf of each member of the group and to perform the obligations under the agreement with respect to each member. This option would be available so long as the common asset manager is able to monitor each group member's compliance with the common agreement.

FFI Officer Certification

Notably, the Second Notice adds a requirement for a senior officer of an FFI to certify procedural compliance to the IRS. An FFI's chief compliance officer or another equivalent-level officer (the "responsible officer") must certify to the IRS when the FFI has completed the procedures described above for its preexisting individual accounts. As part of these certifications, the responsible officer will be required to certify that, between the publication date of the Second Notice and the effective date of the FFI's FFI Agreement, FFI management personnel did not engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging, or assisting account holders with respect to strategies for avoiding identification of their accounts as U.S. accounts under the procedure referred to above. The responsible officer will further be required to certify that the FFI had written policies and procedures in place as of the effective date of the FFI's FFI Agreement prohibiting its employees from advising U.S. account holders on how to avoid having their U.S. accounts identified.

CONCLUSION

The notices represent important steps taken by the Treasury and IRS to help FFIs understand their obligations under FATCA. In particular, the Third Notice provides FFIs with much needed time to deal with the highly complex task of preparing for FATCA compliance. However, the notices leave many open issues, particularly as to how FATCA will affect offshore investment funds. If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following members of the Morgan Lewis Tax Practice:

2. The "expanded affiliated group" concept as applied in this context is the same as the consolidated group concept generally applicable to "C" corporations, whereby a group of entities are under common control (over 50% ownership).

London
Charles G. Lubar +44 (0)20 3201 5531 clubar@morganlewis.com

New York
Richard S. Zarin 212.309.6879 rzarin@morganlewis.com

Palo Alto
Barton W. S. Bassett 650.843.7567 bbassett@morganlewis.com

Philadelphia
William P. Zimmerman 215.963.5023 wzimmerman@morganlewis.com
Gabriel A. Quihuis 215.963.4796 gquihuis@morganlewis.com

San Francisco
Gary A. Herrmann 415.442.1380 gherrmann@morganlewis.com

Washington, D.C.
Mark E. Matthews 202.739.5655 mark.matthews@morganlewis.com

About Morgan, Lewis & Bockius LLP
With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see http://www.morganlewis.com/circular230.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states.
Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2011 Morgan, Lewis & Bockius LLP. All Rights Reserved.