NEW GUIDANCE ON FOREIGN ACCOUNT TAX COMPLIANCE ACT

Federal/International Tax Alert
October 8, 2010

The Internal Revenue Service (IRS) recently issued Notice 2010-60, which provides preliminary guidance on the Foreign Account Tax Compliance Act (FATCA). FATCA was implemented as part of the Hiring Incentives to Restore Employment (HIRE) Act, which was signed into law by President Obama on March 18, 2010. The purpose of the new law is to prevent U.S. individuals from evading U.S. tax by holding income- producing assets through accounts at foreign financial institutions (FFIs) or through other non-financial foreign entities (NFFEs). It adds significant new reporting and compliance obligations on certain foreign entities.

The new law which is contained in new Sections 1471 through 1474 of the Internal Revenue Code (Code) is divided into two broad categories: payments to FFIs and payments to NFFEs. In either case, the new law imposes a 30 percent withholding tax requirement on withholdable payments to FFIs and NFFEs unless the foreign entity complies with certain reporting and disclosure requirements. A "withholdable payment" generally includes U.S.-source fixed or determinable, annual or periodical (FDAP) income and gross proceeds from the sale of property that produces interest and dividend income. Subject to certain exceptions, the new provisions generally take effect on January 1, 2013.

The following is a summary of some of the key provisions of Notice 2010-60.

Grandfathered Obligations

In general, any payment made under an "obligation" outstanding on March 18, 2012 (or any gross proceeds from the disposition of such obligation) will not be subject to FATCA withholding. The Notice indicates that Treasury and the IRS intend to issue regulations defining the term obligation to mean "any legal agreement that produces or could produce withholdable payments," except that it does not include any instrument treated as equity for U.S. tax purposes or any legal agreement that lacks a definitive expiration or term. Thus, an instrument with a definitive expiration or term will be grandfathered if it is outstanding on March 12, 2012 (e.g., lease agreement or debt obligation). However, savings deposits, demand deposits, and similar accounts that do not have a definitive term will not be grandfathered. The Notice also states that brokerage, custodial, and similar agreements to hold financial assets for the account of others will not be grandfathered.

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The Notice further provides that an obligation entered into on or before March 18, 2012 will be treated as outstanding on March 18, 2012. However, any material modification of an obligation will result in the obligation being treated as newly issued on such date, and thus the obligation will lose its grandfathered status. Accordingly, the grandfathered obligation rules are quite limited in application.

Foreign Financial Institution Defined

An FFI is defined as any financial institution that is a non-U.S. entity. Code Section 1471(d)(5) defines a financial institution to include any entity that (1) accepts deposits in the ordinary course of banking or similar business, (2) holds financial assets for the account of others as a substantial portion of its business, or (3) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interest, or commodities. The IRS intends to issue regulations on each of these three defined categories. For the first category, the Notice indicates that financial institutions would include (but not be limited to) an entity that would qualify as a bank under certain Code provisions, including savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies, and other cooperative banking institutions.

The Notice also clarifies that the second category of financial institutions includes entities such as broker-dealers, clearing organizations, trust companies, custodial banks, and entities acting as custodians with respect to the assets of employee benefits plans.

The third category of financial institutions is perhaps the broadest and generally includes (but is not limited to) mutual funds (or their foreign equivalent), funds of funds (and other similar investments), exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools, and other investment vehicles. The Notice also states that the definition of engaged in the business of investing is much broader than it is for other federal tax purposes. Activities that may not otherwise give rise to a trade or business for other purposes of the Code may nevertheless cause an entity to be engaged primarily in the business of investing for FATCA withholding purposes.

Exempt Entities

The IRS intends to issue regulations providing that a foreign entity that otherwise satisfies the definition of an FFI because it is primarily engaged in investing, reinvesting, or trading in securities (i.e., the third category of FFIs) will not be treated as an FFI if it falls within one of the following categories of foreign entities: (1) certain holding companies, (2) certain start-up entities, (3) companies in liquidation, and (4) hedging and financial centers of a non-financial group.

Other Exclusions

Certain investment funds and other entities that have only a small number of direct or indirect account holders, all of whom are individuals or NFFEs that would not be subject to withholding or reporting under Code Section 1471 or 1472 will be excluded from FATCA. For example, a family trust formed and funded by a single person for the sole benefit of his

children would be exempt from FATCA. The IRS also intends to provide guidance regarding certain foreign retirement plans that pose a low risk of tax evasion for FATCA purposes.

The Notice also states that FFIs receiving withholdable payments solely through their U.S. branches will not be exempt from the requirement to enter into an FFI agreement in order to avoid the FATCA withholding. However, it should be noted that payments received by a U.S. branch for its own account may be excluded from the definition of withholdable payment because the payment is treated as effectively connected to a U.S. trade or business. The IRS intends to issue regulations regarding the effectively connected income exclusion. The Notice also confirms that controlled foreign corporations (CFCs) will not be excluded from FATCA withholding.

FFI Agreements

FFIs must generally enter into agreements with the IRS to avoid the FATCA withholding. Pursuant to the agreement, an FFI agrees to (1) obtain information regarding each holder of each account maintained by the FFI as is necessary to determine which accounts are U.S. accounts (if any), (2) comply with due diligence procedures that the IRS may require for the identification of U.S. accounts, and (3) report certain information with respect to U.S. accounts maintained by the FFI. The Notice provides detailed guidance as to what is required to comply with an FFI agreement. In particular, the Notice states that FFIs that enter into agreements with the IRS will be allowed to rely on IRS Forms W-9 that they have already obtained for other U.S. tax purposes. FFIs will also be required to identify the status of other FFIs as participating FFIs, deemed-compliant FFIs, non-participating FFIs, or entities described in Section 1471(f) (e.g., foreign governmental entities). It is expected that the IRS will issue special employer identification numbers to participating FFIs to assist withholding agents in determining the FFI's status. Until such numbers are issued, withholding agents and participating FFIs may rely on certifications provided by the FFIs as to their status.

Reporting of U.S. Accounts

The IRS is developing a new form for reporting the information required by the FATCA rules. This form will be filed electronically. The IRS also intends to issue guidance coordinating the FATCA reporting provisions with other U.S. tax reporting obligations in an effort to avoid duplication.

Conclusion

The detailed guidance in Notice 2010-60 certainly provides some clarification on the complicated withholding rules that are to come. However, the IRS has requested comments on many open issues and many unanswered questions still remain. The next step will likely be proposed regulations, in addition to the release of sample FFI agreements and new IRS forms. There is no question that these rules will impact several withholding agents and foreign entities with U.S. investments. It is imperative for the foreign entities to determine whether the costs and burdens of these new rules outweigh the benefits of investing in the United States or having U.S. account holders. Although the rules generally do not take effect until January 1, 2013, entities should become aware of these rules and begin reviewing their internal procedures to gear up for compliance.

For more information about FATCA matters, we invite you to contact the following Hodgson Russ attorneys:

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