FATCA: Final Regulations

Treasury Issues Long-Awaited Final Regulations on FATCA; U.S. Enters into Related Intergovernmental Agreement with Switzerland

SUMMARY

On January 17, 2013, the Treasury Department issued final regulations (the “Final Regulations”) under the foreign account tax compliance (“FATCA”) provisions of the Internal Revenue Code of 1986, as amended (the “Code”). The Final Regulations update and modify proposed regulations issued on February 8, 2012 (the “Proposed Regulations”), and provide significant detail regarding the implementation of FATCA, including coordinating FATCA withholding and information reporting with both the current withholding rules and the new system of IGAs designed to achieve FATCA’s goals.1

The Final Regulations finalized the “grandfathering” dates, clarified many points that caused confusion in the Proposed Regulations and made a number of other welcome changes, as follows:

- Extending the grandfathering date to exempt from FATCA withholding “obligations” outstanding on January 1, 2014;
- Specifying that, absent actual knowledge, a withholding agent may rely on a written statement from the issuer to determine if an obligation meets the requirements for grandfathered treatment, and further, that with respect to a determination of whether there has been a material modification of an “obligation,” such knowledge can come in the form of disclosure from the issuer that such a modification has occurred;
- Specifying that, for purposes of determining whether a debt obligation is grandfathered, debt issued in a qualified reopening will have the same issue date as the original debt;
- Allowing for a consolidated compliance program for affiliated entities;
- Allowing a financial institution to apply for a collective refund on behalf of account holders;
- Expanding the category of “excepted NFFE” to include certain financial institutions that only provide financial services within an affiliated group of entities and non-profit organizations recognized as such in their country of residence;
- Incorporating and making allowances for entities within jurisdictions that have signed IGAs; and
• Conforming the definition of “financial institution” to the provisions of the IGAs, which will change the reporting obligations of many investment entities and investment advisors.

To facilitate the ongoing interaction between the IRS and financial entities worldwide that FATCA and the IGAs will require, the IRS intends to launch the FATCA Registration Portal (the “Portal”) no later than July 15, 2013. Global intermediary identification numbers (“GIINs”) will be assigned for the purpose of identifying registering entities to withholding agents. The IRS will then publish a list (the “IRS FFI list”) of the names and GIINs of all participating FFIs, registered deemed-compliant FFIs, and reporting Model 1 FFIs, which will be used by withholding agents and participating FFIs in their respective due diligence processes.

This memorandum highlights areas of the law that have been of particular interest to stakeholders and that include important transitional rules, of which financial institutions should be aware as they develop their plans for FATCA compliance. Specifically, we discuss the finalized rules relating to grandfathered obligations, withholding, reporting of payments, and special transitional categories for entities in countries with laws that currently prevent full compliance with FATCA. This is followed by an explanation of the categorization of entities under FATCA and the basic obligations of the two major groups in this scheme, withholding agents and FFIs.

On February 14, 2013, the United States also entered into an intergovernmental agreement (“IGA”) with Switzerland to facilitate compliance with FATCA in that country. This memorandum briefly highlights some notable differences between the Switzerland IGA and the Model 2 IGA.

BACKGROUND

FATCA was enacted on March 18, 2010, as a section of the “Hiring Incentives to Restore Employment Act.” The Code provisions that comprise FATCA were colloquially so named because they were originally introduced as the “Foreign Account Tax Compliance Act.”

FATCA is intended to reduce the evasion of U.S. tax by U.S. citizens and residents who hold offshore assets. To accomplish this objective, FATCA encourages (i) foreign financial institutions (“FFIs”) to sign agreements to report information on their U.S. account holders to the IRS (such FFIs, “participating FFIs,” and such agreements, “FFI Agreements”) and (ii) other, non-financial foreign entities (“NFFEs”) to provide information regarding their beneficial owners to withholding agents. If entities do not comply, FATCA requires withholding agents to collect a 30 percent withholding tax on payments of U.S.-source “withholdable payments” made to these entities. FATCA also requires participating FFIs to withhold on “passthru payments” (which, as discussed below, include both “withholdable payments” and certain non-U.S.-source payments) made to “recalcitrant account holders” and to FFIs that do not sign an FFI Agreement with the IRS (such FFIs, “nonparticipating FFIs”).
Under Sections 1471 through 1474 of the Code, the FATCA regime is generally implemented through three main components.

- As part of the FFI agreement, every participating FFI is required to obtain such information regarding each holder of each account it maintains to determine whether such account is a U.S. account or an account held by a recalcitrant account holder or nonparticipating FFI. The information regarding U.S. accounts must be reported to the IRS, and the participating FFI must withhold 30 percent of withholdable payments made to recalcitrant account holders or account holders that are nonparticipating FFIs. The Final Regulations provide due diligence procedures for identifying and documenting account holders.

- Withholding agents are required to obtain information about payees because a withholding agent has an obligation to withhold 30 percent of any withholdable payment made to an FFI unless either (i) the withholding agent can reliably associate the payment with documentation upon which it is permitted to rely to treat the payment as exempt from withholding or (ii) the payment is made under a grandfathered obligation. This means that a withholding agent must determine who the payee is and determine the “Chapter 4” status of such payee. In order to do that, it must collect and retain the correct documentation for each type of payee. Furthermore, there are additional documentation requirements where a payment is made to an intermediary or flow-through entity that is not the payee. The Final Regulations provide rules for what type of documentation is acceptable to prove the Chapter 4 status of a payee or intermediary and how the documentation can be reliably associated with a payment.

- Withholding agents are also required to withhold 30 percent of any withholdable payment made to a payee that is an NFFE unless the beneficial owner of such payment is the NFFE (or any other NFFE) that either (i) the withholding agent can treat as having no substantial U.S. owners or as being an excepted NFFE or (ii) has provided documentation regarding its substantial U.S. owners, which the withholding agent must then pass on to the IRS, or its status as an excepted NFFE.

FATCA imposes a substantial administrative burden on foreign financial institutions and, to a lesser extent, withholding agents and many nonfinancial foreign entities, in order to identify U.S. individuals who are evading their U.S. tax liability. In addition to the high cost of compliance that such administrative burden requires, many FFIs are located in countries with laws preventing the type of disclosure to foreign governments that FATCA requires. The Proposed Regulations therefore contemplated an alternative regime based on a system of intergovernmental agreements that “facilitate the effective and efficient implementation of FATCA in a manner that removes domestic legal impediments to compliance, fulfills FATCA’s policy objectives, and further reduces burdens on FFIs located in partner jurisdictions.” To that end, on the same date as the release of the Proposed Regulations, the Treasury Department, along with the governments of France, Germany, Italy, Spain and the United Kingdom, issued a joint statement outlining these countries’ intention to “intensify their co-operation in combating international tax evasion” and to explore common approaches to implementing FATCA.

Following this general expression of intergovernmental cooperation, the Treasury Department released two model IGAs. Under the first model IGA (“Model 1 IGA”), published on July 26, 2012, a partner jurisdiction agrees to adopt rules to identify and report information about U.S. accounts to the IRS. FFIs covered by the Model 1 IGA will report information to the partner jurisdiction, which will then exchange the information with the IRS. Partner jurisdictions signing the second model IGA (“Model 2 IGA”), published...
November 14, 2012, agree to “direct and enable all FFIs that are located in the jurisdiction, and that are not otherwise excepted or exempt pursuant to the Model 2 IGA, to register with the IRS and report specified information about U.S. accounts directly to the IRS in a manner consistent with Chapter 4 and these final regulations, except as expressly modified by the Model 2 IGA.” In all situations where the two regimes overlap, the Final Regulations defer to and cross-reference the IGAs, as will be noted throughout this publication.

In September 2012, the United Kingdom became the first country to sign a Model 1 IGA with the United States. Model 1 IGAs with Ireland, Mexico and Denmark soon followed. On February 14, 2013, Switzerland became the first country to enter into a Model 2 IGA with the United States.

The Switzerland IGA is substantially similar to the Model 2 template, and it is the first IGA to incorporate a transitional rule, present in both the Model 1 and Model 2 IGA templates as well as the Final Regulations, allowing certain collective investment vehicles to qualify for registered deemed-compliant status even if it has issued physical shares in bearer form that would make reporting the owners of such shares an impossibility until such shares are presented for redemption. The Switzerland IGA does, however, have some differences from the Model 2 IGA template. First, the Switzerland IGA modifies the procedures for exchange of information between the U.S. and Swiss Competent Authorities. Under the Model 2 IGA template, the U.S. may make requests for all information regarding accounts of those account holders who do not voluntarily consent to having such information reported to the IRS and the partner jurisdiction Competent Authority is obligated to provide such information within six months of the request. The Switzerland IGA provides a process by which the account holders may appeal the decision of the Swiss taxation authority (“FTA”) to report the information and also extends the time for the Swiss government to comply with the request from six months to eight months. The IGA does not however, describe the consequences of a successful appeal. The Switzerland IGA also differs from the Model 2 template in the following ways:

- Provides an “enabling clause” under which Swiss financial institutions that enter into an FFI agreement or register with the IRS as deemed-compliant FFIs are not liable to any penalties under the Swiss Criminal Code; and
- Adds “Swiss Investment Advisers,” the client funds of which are held in an account with a participating FFI to the list of “Non-Reporting” Swiss Financial Institutions that will be treated as registered deemed-compliant FFIs under FATCA. This exception is new among the IGAs but mirrors an exception provided for sponsored investment entities under the Final Regulations.

Implementation of the Switzerland IGA, however, depends on the ratification of a protocol amending the 1996 Convention between the U.S. and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income (the “Protocol”). The Protocol, signed in 2009, was approved by the Senate Foreign Relations Committee in 2011 and continues to await a vote by the full Senate.
THE NEW REGULATIONS
I. TRANSITION RULES
GRANDFATHERING

The “grandfathering” provision exempts from the definition of “withholdable payment” any payments with respect to an obligation outstanding on January 1, 2014. Under the Final Regulations, an obligation is “outstanding” on January 1, 2014 if: (i) in the case of an obligation characterized as indebtedness for U.S. federal income tax purposes, it has an issue date that is before January 1, 2014 and (ii) in the case of any other obligation (including a credit agreement for a fixed term with material terms fixed), if a legally binding agreement establishing the obligation was executed between the parties to the agreement before January 1, 2014. In addition, the following obligations are grandfathered:

- Solely for the purposes of a foreign passthru payment, any obligation that is executed on or before the date that is six months after the date on which final regulations defining the term “foreign passthru payment” are filed with the Federal Register;¹¹ and
- Any obligation that gives rise to a withholdable payment solely because the obligation is treated as giving rise to a dividend equivalent pursuant to Section 871(m) of the Code and the regulations thereunder (which address the circumstances under which payments with respect to an equity derivative are treated as dividends subject to U.S. withholding tax), provided that the obligation is executed on or before the date that is six months after the date on which the regulations under 871(m) are finalized.¹²

Under the Final Regulations, the term “obligation” generally means any legally binding agreement or instrument but specifically excludes such agreements or instruments that:

- are treated as equity for U.S. tax purposes;
- lack a stated expiration or term (e.g., a savings deposit or demand deposit);
- are agreements to hold financial assets for the account of others and to make and receive payments of income and other amounts with respect to such assets (e.g., brokerage or custodial agreements, investment-linked insurance contracts, investment-linked annuity contracts); or
- are master agreements that merely set forth standard terms and conditions that are intended to apply to a series of transactions between parties but that do not set forth all of the specific terms necessary to conclude a particular transaction.

The Final Regulations set forth the following as examples of agreements that can constitute “obligations”:

- Debt instruments, as defined under the Code (for example, a bond, guaranteed investment certificate or term deposit);
- Binding agreements to extend credit for a fixed term (such as revolving credit facilities), if the material terms under which credit will be provided are fixed;
- Derivatives transactions, if entered into between counterparties under an ISDA Master Agreement, evidenced by a confirmation;
- Life insurance contracts under which the entire contract value is payable no later than upon the death of the individual(s) insured under the contract; and
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- Immediate annuity contracts payable for a period certain or for the life of the annuitant.\(^{13}\)

Additionally, the Final Regulations specifically list as a grandfathered obligation any agreement requiring a secured party to make a payment with respect to, or to repay, collateral posted to secure a grandfathered obligation.

In an attempt to clear up confusion regarding the grandfathering of debt obligations, the Final Regulations provide that the obligation is outstanding on the issue date of the debt. The Preamble to the Final Regulations explains that, with respect to debt issued in a qualified reopening, this means that such debt will be considered to have the same issue date as that of the original debt.\(^{14}\) Thus, debt obligations issued in qualified reopenings will be grandfathered if the original debt is issued before January 1, 2014. As in the Proposed Regulations, the Final Regulations provide that any material modification of an outstanding obligation will result in the obligation being treated as newly issued or executed as of the effective date of such modification.\(^{15}\)

In response to comments from withholding agents, the Final Regulations also specify that, absent actual knowledge, a withholding agent may rely on a written statement from the issuer to determine if an obligation meets the requirements for grandfathered treatment, and, further, that specifically with respect to a determination of whether there has been a material modification, such knowledge can come in the form of disclosure from the issuer that such an event has occurred.

In practice, these rules make it likely that paying agents and clearing organizations will seek written statements or representations from issuers declaring the grandfather status of their obligations, which issuers (particularly non-U.S. issuers) may be reluctant to provide as such statements and representations would require the issuers to make a legal determination under the Final Regulations. Furthermore, the Final Regulations do not specifically discuss the consequences of an incorrect determination by an issuer with respect to the grandfathered status of an obligation. In such case, it is possible that the general provision on withholding agent liability will apply to the issuer to the extent that it can be considered a withholding agent with respect to a payment made on such obligation, and, therefore, though the paying agent and/or clearing organization will not have any liability, the issuer would be liable for any underwithheld tax.

WITHHOLDING

Some withholding obligations are delayed in order to coordinate obligations under FATCA with obligations imposed by the IGAs. Under the Model 1 IGA, an FFI that does not have an agreement with the IRS to withhold under “Chapter 3” of the Code and is making a payment of U.S.-source FDAP to a nonparticipating FFI has an obligation to provide information required for withholding and reporting of that payment to the immediate payor, but is not itself required to withhold on the payment.\(^{16}\) As a temporary accommodation to the IGAs, the Final Regulations exclude from the definition of “withholdable payment,” any payment of U.S.-source FDAP made prior to January 2017 with respect to an offshore obligation if...
such payment is made by a person that is not acting as an intermediary with respect to the payment and is not a flow-through entity with a residual withholding requirement.\textsuperscript{17}

In addition, the Final Regulations contain several transitional rules intended to phase in withholding requirements.

- For withholdable payments made prior to January 1, 2016, with respect to a preexisting obligation,\textsuperscript{18} if the withholding agent does not have documentation indicating a payee’s status as a nonparticipating FFI, the withholding agent will not be required to withhold unless the payee is a prima facie FFI;\textsuperscript{19}
- A participating FFI is not required to withhold on a foreign passthru payment made to an account held by a recalcitrant account holder or to a nonparticipating FFI before the later of January 1, 2017, or the date on which final regulations defining the term “foreign passthru payment” are published; and
- For withholdable payments made prior to January 1, 2015 with respect to a preexisting obligation, a withholding agent is not required to withhold on payments to NFFEs if it does not have documentation indicating the payee’s status as a passive NFFE with one or more substantial U.S. owners. In addition to phasing in withholding obligations with respect to NFFEs, the Final Regulations also forego withholding agents’ obligation to report on NFFEs for any withholdable payments made prior to January 1, 2015.

REPORTING PAYMENTS

In addition to identifying payees and withholding when appropriate, withholding agents have an obligation to report to the IRS information with respect to those payments. While the obligation to withhold is on “withholdable payments,” the obligation to report is with respect to “Chapter 4 reportable amounts.” There are certain limitations on the reporting requirement applicable to withholding agents contained within the definition of Chapter 4 reportable amounts:

- With respect to grandfathered obligations, only payments of U.S.-source FDAP income that are reportable on Form 1042-S under Chapter 3 are required to be reported;
- Withholding agents are generally not required to report amounts paid to a U.S. person that it treats as the payee for purposes of determining whether withholding is required, \textit{e.g.}, a foreign branch of a U.S. person that is not a qualified intermediary (“QI”) acting as an intermediary with respect to the payment;
- In all other cases, withholding agents making payments to FFIs and NFFEs must begin reporting with respect to payments of U.S.-source FDAP income made on or after January 1, 2014 and with respect to payments of gross proceeds from the sale or other disposition of instruments producing U.S.-source FDAP income made on or after January 1, 2017.

The reporting obligations of participating FFIs are also subject to transitional rules. In addition to the reporting obligations mentioned above, participating FFIs are required to report payments of “foreign reportable amounts” made to nonparticipating FFIs during the years 2015 and 2016. A foreign reportable amount is a payment of FDAP income that would be a withholdable payment if paid by a U.S. person. The temporary requirement to report foreign reportable amounts is generally considered to be in lieu of withholding on foreign passthru payments which, as discussed above, is delayed until that term is defined.
ENTITIES IN JURISDICTIONS THAT PREVENT COMPLIANCE

As discussed below under “Definition of Foreign Financial Institutions—FFI Groups,” the presence of a nonparticipating FFI in a consolidated group may prevent other FFIs in the group from qualifying for FFI status. Under a transitional rule provided by the Final Regulations, until December 31, 2015 an FFI that is prevented from compliance with FATCA by the laws of its jurisdiction can generally become a “limited FFI” and avoid tainting the other FFI members of its expanded affiliated group if it agrees to register with the IRS, identify its accounts to the extent permitted, refrain from opening U.S. accounts or accounts held by nonparticipating FFIs, and identify itself to withholding agents as a nonparticipating FFI. Similarly, until December 31, 2015, an FFI that otherwise satisfies the requirements for participating FFI status will be allowed to become a participating FFI notwithstanding that one or more of its branches cannot satisfy all of the requirements of a participating FFI so long as the inability of all such branches to satisfy the FFI requirements is due, generally, to the laws of the jurisdiction that apply to its accounts (“limited branches”), the FFI maintains at least one branch that complies with all of the requirements of a participating FFI (even if the only such branch is a U.S. branch), and the FFI agrees to certain other requirements. Unless a branch of a participating FFI qualifies as a limited branch, it must generally meet the same requirements of an FFI Agreement as its parent in order to avoid affecting the Chapter 4 status of the parent.

It should be noted that, although the provisions for limited branches and FFIs are temporary under the Final Regulations, the Model IGAs provide a similar exception which is not transitional. Furthermore, with respect to limited branch status, the Final Regulations defer to the IGAs by providing that an FFI with one or more limited branches will lose its participating FFI status after December 31, 2015, unless otherwise provided pursuant to a Model 1 IGA or Model 2 IGA. In other words, starting January 1, 2016, FFIs in IGA jurisdictions will remain in compliance with FATCA despite being affiliated with certain nonparticipating FFIs while, in non-IGA jurisdictions, a participating FFI may be deemed to be out of compliance with its FFI Agreement if it is affiliated with an FFI whose “Limited FFI” status has just expired.

Other transition rules are discussed below. Some, like the “limited life debt investment vehicle” FFI category, give entities time to bring their structures in line with the requirements of FATCA, while others phase in documentation and reporting requirements. Additionally, as discussed below, the Final Regulations delay the effective date of early filed FFI agreements to align them with the requirements of the IGAs.

II. DEFINITION OF FOREIGN FINANCIAL INSTITUTIONS

Under the Final Regulations, an FFI is defined as any “financial institution” that is a foreign entity. However, any entity that is a resident in a country that has in effect a Model 1 IGA or Model 2 IGA will be an FFI only if it is treated as a financial institution pursuant to the IGA.20 The Final Regulations lists five general categories of financial institutions:
• Depository institutions;
• Custodial institutions;
• Investment entities;
• Specified insurance companies (which definition now includes a holding company of an insurance company that issues cash value insurance or annuity contracts); and
• Holding companies or treasury centers that are part of an expanded affiliated group that includes one of the companies described above or that are formed in connection with or availed of by a collective investment vehicle, mutual fund, exchange-traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.

While Section 1471 of the Code and the Proposed Regulations included a category of financial institution generally dealing with investment companies, in response to comments requesting “that the definition of ‘financial institution’ be clarified and more narrowly defined to exclude passive, non-commercial investment vehicles, including trusts,” Treasury heavily revamped that category. Under Section 1471 of the Code and the Proposed Regulations, “financial institution” included “an entity fifty percent or more of the gross income of which is generally attributable to investing, reinvesting, or trading in securities, partnership interests, commodities, notional principal contracts, insurance or annuity contracts, or any interest in such security, partnership interest, commodity, notional principal contract, insurance contract, or annuity contract.”

The Final Regulations substitute for that category the term “Investment Entity,” defined as any entity that meets any one of the following three descriptions:

• The entity 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 (checks, 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;
• The entity’s gross income is primarily attributable to investing, reinvesting or trading in financial assets and the entity is managed by a depository institution, custodial institution, specified insurance company or another investment entity; or
• The entity 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 fund or any similar investment vehicle established with an investment strategy of investing, reinvesting or trading in financial assets.

Thus, under the Final Regulations, an entity that is not one of the enumerated entities in the last bullet point above and is not itself a professional manager is not treated as a financial institution unless it is professionally managed by a financial institution. In a public statement following the release of the Final
Regulations, a Treasury official clarified Treasury’s position on what it means to be managed by an investment-entity financial institution by distinguishing between a family trust that is managed by an individual manager and a family trust that is managed by a firm that also manages other families' assets. In the former case, the family trust would be a passive NFFE only required to report U.S. owners to withholding agents. In the latter case, the family trust would be an entity whose gross income is primarily attributable to investing in financial assets that is managed by another investment entity and thus would be an investment-entity FFI itself. If, however, the management entity agrees to sponsor the family trust, the trust may qualify as a sponsored deemed-compliant FFI (discussed below). Alternatively, it could be an owner-documented FFI (discussed below) if withholding agents agree to report information to the IRS on its behalf. In either case, the family trust would be relieved of the burden of complying with an FFI Agreement.

In addition, the Final Regulations add to the definition of “financial institution” special rules affecting start-up entities. Start-up custodial institutions and investment entities that have no operating history will be considered to meet the requirements of those categories for purposes of FATCA if they expect to meet the requirements based on their anticipated functions, assets and employees and with due consideration given to any purpose or functions for which the entity is licensed or regulated (including those of any predecessor).

**FFI GROUPS**

Generally, an FFI is not eligible for participating or registered deemed-compliant FFI status if it is a member of an expanded affiliated group that includes nonparticipating FFIs. However, an FFI will be allowed to become either a participating FFI or registered deemed-compliant FFI notwithstanding that one or more of the FFIs in the expanded affiliated group of which the FFI is a member cannot comply with all of the requirements of a participating FFI if each such FFI is a limited FFI (discussed above).

The Final Regulations include a special rule for investment entities owned by a group member when the member’s ownership exists solely to provide seed capital investment in the entity. In those cases, the investment is made solely for the purpose of establishing a performance record and then the interests are sold to unrelated investors. The quick turnover in ownership would require constant monitoring to determine when to exclude the new entity as a member of the group. Accordingly, under the Final Regulations, an investment entity is excluded as a member of an expanded affiliated group if:

- a member of the group that is in the business of providing seed capital to form investment entities with the intention of selling its interests to unrelated investors provided the seed capital in the ordinary course of its business;
- the member providing the seed capital intends, within three years of making the investment, to retain no more than 50 percent of the value of the new investment entity; and
- three years after the seed capital is provided, the aggregate value of the equity interest held by members of the expanded affiliated group does not exceed 50 percent of the value of the investment entity.
EXCLUSIONS FROM FFI STATUS

The Final Regulations, in significant and welcome expansions on the Proposed Regulations, specifically exclude the following entities from the definition of “financial institution,” so long as they do not also come within the definition of “specified insurance company”:

- A foreign entity that generally serves as a holding company, treasury center or captive finance company for members of a nonfinancial group of entities and does not hold itself out as a private equity fund, hedge fund, venture capital fund or similar investment vehicle;

- A foreign entity that is investing capital in assets with the intent to operate a new business or line of business other than that of a financial institution or passive NFFE; provided that the entity previously qualified as an active NFFE. This exclusion applies only for two years from the date of organization of the new business or the date of approval for the new line of business;

- A foreign entity that was not a financial institution in the past five years and is in the process of either liquidating or reorganizing (with the intent to continue or recommence operations as a non-financial entity);

- A foreign entity that is a member of a participating FFI group if it: (1) does not maintain financial accounts (other than accounts maintained for members of its expanded affiliated group); (2) does not hold an account with or receive payments from any withholding agent other than a member of its expanded affiliated group; (3) does not make withholdable payments to any person other than to members of its expanded affiliated group that are not limited FFIs or limited branches; and (4) has not agreed to fulfill FATCA reporting requirements or otherwise act as an agent for Chapter 4 purposes on behalf of any financial institution, including a member of its expanded affiliated group; and

- Certain tax-exempt entities under Section 501(c) of the Code and other non-profit organizations.

DEEMED-COMPLIANT FFI CATEGORIES

As in the Proposed Regulations, the Final Regulations provide for three ways in which an FFI can be deemed compliant. An FFI can either be a registered deemed-compliant FFI or a certified deemed-compliant FFI, or, with respect to withholding agents that agree to such treatment, an owner-documented FFI.

1. Registered Deemed-Compliant FFIs

An FFI of one of the following types will be deemed compliant with FATCA provided that it registers with the IRS, certifies to the IRS that it meets the requirements for the deemed-compliant category it claims to have satisfied, and agrees to notify the IRS if there is a change in circumstances that would make it ineligible for the deemed-compliant status for which it has registered:

- Local FFIs;
- Nonreporting members of participating FFI groups;
- Qualified collective investment vehicles;
- Restricted funds;
- Qualified credit card issuers;
- Sponsored investment entities and controlled foreign corporations (“CFCs”);
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- FFIs treated as registered deemed-compliant FFIs under a Model 2 IGA.

The Final Regulations make several changes to the registered deemed-compliant FFI category, including the following:

- Coordinating the IGA regime with the Final Regulations, by including in the definition of a “registered deemed-compliant FFI” those FFIs that are deemed compliant under a Model 2 IGA and those FFIs (or branches of FFIs) that are “reporting Model 1 FFIs” in compliance with the requirements of a Model 1 IGA;
- Expanding the local FFI category and bringing it in line with the IGAs by allowing any type of financial institution to be a local FFI, not just banks, brokers, dealers and investment advisors; and
- Expanding the definition of qualified collective investment vehicles beyond the definition provided in the Proposed Regulations and Model IGAs to include such entities that may not be regulated by its country of incorporation but are regulated in all of the countries in which it is registered and in all of the countries in which it operates.

Additionally, the Final Regulations add two new categories to the list of registered deemed-compliant FFIs: qualified credit card issuers, and sponsored investment entities and “controlled foreign corporations” (“CFCs”). A credit card issuer will qualify as a registered deemed-compliant FFI if it only accepts deposits when a customer makes a payment in excess of a balance due (and the overpayment is not immediately returned to the customer) and it implements policies and procedures to either prevent a customer deposit in excess of $50,000 or to ensure that any customer deposit in excess of $50,000 is refunded to the customer within 60 days. A customer deposit in this case excludes disputed charges but includes amounts refunded as a result of returns of merchandise.

An investment entity or CFC may generally qualify as “sponsored” for these purposes if it is not a QI, Withholding Partnership (“WP”), or Withholding Trust (“WT”) under Chapter 3 and if a sponsoring entity that is authorized to manage the FFI and enter into contracts on behalf of the FFI (e.g., as a fund manager, trustee, corporate director, or managing partner) has agreed to perform, on behalf of the FFI, all due diligence, withholding and other requirements that the FFI would have been required to perform if it were a participating FFI. The sponsoring entity must also register with the IRS as such, register the FFI with the IRS, and identify the FFI in all reporting completed on the FFI’s behalf to the extent required under the Final Regulations. In the case of CFCs, the sponsor must be a U.S. financial institution that, directly or indirectly, wholly owns the FFI and must share a common electronic account system with the FFI. The preamble explains that commenters noted that “a number of U.S. financial institutions have systems in place to perform all due diligence, withholding, and reporting obligations of its controlled foreign corporation subsidiaries for U.S. tax purposes.”

2. CERTIFIED DEEMED-COMPATIBLE FFIs

An FFI of one of the following types will be deemed compliant with FATCA; provided that it has certified its status as a deemed-compliant FFI by providing a withholding agent with certain identifying documentation:
Nonregistering local banks;
FFIs with only low-value accounts;
Sponsored, closely held investment vehicles; and
Until January 1, 2017, limited life debt investment entities.

Additionally, any FFI that is identified as a nonreporting financial institution pursuant to a Model 1 IGA or Model 2 IGA (that is not a registered deemed-compliant) FFI will be considered a certified deemed-compliant FFI.

The Final Regulations added to the list of FFIs that may qualify as a certified deemed-compliant FFI: (i) sponsored, closely held investment vehicles, and (ii) as a transitional rule, limited life debt investment entities. An investment entity will be eligible for certified deemed-compliant status as a sponsored, closely held investment vehicle if it is an FFI solely because it is an investment entity, it does not hold itself out as an investment vehicle for unrelated parties, and 20 or fewer individuals own all of its debt and equity interest (disregarding debt interests owned by participating FFIs, registered deemed-compliant FFIs, and certified deemed-compliant FFIs and equity interests owned by an entity if that entity owns 100 percent of the equity interests and is itself a sponsored, closely held investment vehicle). The sponsoring entity must be a participating FFI, reporting Model 1 FFI or a U.S. financial institution that, in each case, is authorized to manage the investment-entity FFI and enter into contracts on its behalf and meets the requirements for registered deemed-compliant sponsoring entities discussed above.

In response to comments, Treasury added a transitional category of registered deemed-compliant FFIs: limited life debt investment entities. This category addresses trustees of investment vehicles that are often granted only limited authority to act in a manner not specifically provided for under the trust agreement. These situations typically arise with trusts that have a fixed lifespan and were created for the purpose of investing in a limited type of debt obligation with the intent to hold such obligations until maturity or until the liquidation of the vehicle (“limited life debt vehicles”). The application of this transitional rule is extremely limited. In order to automatically qualify as a certified deemed-compliant FFI until December 31, 2016, an investment entity must:

- be formed pursuant to a trust indenture or similar fiduciary arrangement;
- be an FFI solely because it is an investment entity that offers interests primarily to unrelated investors;
- have been in existence before January 1, 2012;
- be required by the organizational documents to liquidate on or prior to a set date;
- prohibit amendments to the organizational documents, including the trust indenture, without the agreement of all of the FFI's investors;
- have been formed for the purpose of purchasing (and in fact, purchases) specific types of indebtedness and holding these assets until the termination of the asset or vehicle;
use a clearing organization or trustee that is a participating FFI, reporting Model 1 FFI or U.S. financial institution to make all payments to its investors; and

have a trust indenture or similar fiduciary arrangement that only authorizes the trustee or fiduciary to engage in activities specifically designated in the trust indenture and does not authorize the trustee, or any other person, to fulfill the obligations to which a participating FFI is subject.

This automatic deemed-compliant status expires on December 31, 2016, after which the entity will be required to comply with the terms of any applicable IGA or otherwise register as a participating FFI.

3. Owner-Documented FFIs

An FFI that is not owned by, or in an expanded affiliated group with, any other FFI that is a depository institution, custodial institution or specified insurance company may qualify for deemed-compliant status with respect to a particular withholding agent if:

- it only falls within the investment-entity category of FFIs;
- it does not maintain a financial account for any non-participating FFI; and
- it provides a withholding agent with an FFI owner reporting statement.

The withholding agent must agree to report all requisite information to the IRS on behalf of the owner-documented FFI. Unlike the other certified deemed-compliant FFIs discussed above, owner-documented FFIs may only be treated as certified deemed-compliant with respect to payments received from and accounts held with a designated withholding agent (or with respect to payments received from and accounts held with another FFI that is also treated as an owner-documented FFI by such designated withholding agent), and such withholding agent must be a U.S. financial institution, participating FFI or reporting Model 1 FFI.

Under the Proposed Regulations, owner-documented FFIs were prohibited from maintaining financial accounts for any nonparticipating FFIs or issuing debt which constitutes a financial account to any person in excess of $50,000. Under the Final Regulations, owner-documented deemed-compliant FFIs are still prohibited from maintaining financial accounts for nonparticipating FFIs but are no longer prohibited from issuing debt interests that constitute financial accounts in excess of $50,000 to persons other than nonparticipating FFIs; provided that the owner-documented FFI reports all individuals and specified U.S. persons that directly or indirectly hold such interests (other than persons that hold such interests through a participating FFI, registered deemed-compliant FFI, certified deemed-compliant FFI, U.S. person, exempt beneficial owner or excepted NFFE) to the designated withholding agent.27

EXEMPT BENEFICIAL OWNER

While certain entities are removed from the definition of FFI because the purposes of FATCA are adequately served by treating such entities as NFFEs, other entities are treated as exempt beneficial owners instead of FFIs because they have neither customers nor assets relevant to the application of FATCA.
The following entities are exempt beneficial owners and are therefore not subject to FATCA withholding with respect to payments of which they are, or are deemed to be, the beneficial owner:

- Foreign governments, political subdivisions of a foreign government, and wholly owned instrumentalities and agencies of a foreign government;
- International organizations and wholly owned agencies or instrumentalities of an international organization;
- Foreign central banks of issue;
- Governments of U.S. territories; and
- Certain foreign retirement funds.

In addition, certain entities that are wholly owned by one or more of the classes of persons listed above and any person treated as an exempt beneficial owner pursuant to a Model 1 IGA or Model 2 IGA (generally in Annex II of the agreement) are also exempt beneficial owners under the Final Regulations.

The general rule is that an entity must be the beneficial owner of a payment in order to be an exempt beneficial owner with respect to such payment. A retirement fund is generally treated as the beneficial owner of payments with respect to which it is treated as the payee. Additionally, a foreign central bank of issue is treated as the beneficial owner with respect to income earned on securities, including securities held as collateral or in connection with a securities-lending transaction that it holds in the normal course of its business.

Under the Proposed Regulations, a controlled entity of a foreign government, a political subdivision of a foreign government, or a wholly owned instrumentality or agency of any one of the foregoing was not considered an exempt beneficial owner to the extent the controlled entity conducted commercial activity and was a depository or custodial institution.

The Final Regulations liberalized these rules by providing that an exempt beneficial owner will not lose its exempt status as a result of engaging in commercial activity. However, the Final Regulations now deny exempt treatment to payments derived by any exempt beneficial owner (other than retirement funds) from an obligation held in connection with a commercial financial activity of a type engaged in by an insurance company, custodial institution or depository institution. Although this exception threatens to prevent the exemption of international organizations, foreign central banks and governments of U.S. territories along with foreign governments, the exemption will only apply with respect to specific payments and will generally not apply at all if the commercial financial activity is only undertaken on behalf of other exempt beneficial owners.
III. OBLIGATIONS OF WITHHOLDING AGENTS AND PARTICIPATING FFIS

OBLIGATIONS OF WITHHOLDING AGENTS

1. Identify the Payee

As with the Proposed Regulations, withholding agents are only required to withhold under FATCA with respect to *withholdable* payments made to FFIs. A withholdable payment is any payment of U.S. source FDAP income and, for any sales or other dispositions occurring after December 31, 2016, any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends that are U.S.-source FDAP income. The Final Regulations direct that if a withholding agent has knowledge of the facts giving rise to a payment but is unable to determine at the time of payment the character of the payment sufficiently to determine whether it is a withholdable payment, the payment must be treated as a withholdable payment. Additionally, if a withholding agent has knowledge of the facts giving rise to a payment but is unable to determine at the time of payment the source of the payment, the payment must be treated as U.S.-source income.

Under the basic requirements of Sections 1471 and 1472 of the Code, a withholding agent is generally not required to withhold on a withholdable payment made to a payee that is a participating FFI or deemed-compliant FFI, excepted NFFE, or exempt beneficial owner. The Final Regulations, however, provide for certain other instances in which withholding is not required. For example, if a withholding agent has no control over or custody of money or property owned by a payee or beneficial owner of a payment, or lacks knowledge of the facts giving rise to such payments (subject to the assumptions described above), there is generally an exception from withholding. What it means, however, to have knowledge of the facts giving rise to a payment remains somewhat unclear.

Under FATCA, all withholding agents are required to identify the payee of every payment it makes, and to obtain sufficient documentation in order to determine the payee’s status under FATCA. Generally, the payee is the person to whom a payment is made, or the holder of a financial account to which payments are credited, regardless of whether such a person is the beneficial owner of the payment or the account. The Final Regulations provide several exceptions to this general rule. In these cases, the withholding agent will be required to determine the Chapter 4 status of each intermediary or flow-through entity in the payment chain until the withholding agent is able to identify the payee.

In particular, similar to the Proposed Regulations, the payee whose status determines whether withholding is required will not be the direct recipient of the payment if the payment is made to:

- certain foreign agents or intermediaries (that are not QIs with primary withholding responsibility and that are non-participating FFIs);
- certain foreign flow-through entities (e.g., partnerships and trusts that have not accepted withholding responsibility and that are nonparticipating FFIs);

FATCA: Final Regulations
February 26, 2013
Withholding Rules for Foreign Intermediaries and Flow-Through Entities

There are special rules under FATCA to accommodate intermediaries or flow-through entities depending on their status under Chapter 3 of the Code.

- Payment of U.S.-source FDAP income to participating FFIs (or reporting Model 1 FFIs) that are nonqualified intermediaries (“NQIs”), nonwithholding partnerships (“NWPs”), or nonwithholding trusts (“NWTs”) must generally be withheld upon by the payor unless the FFI provides certain documentation showing the payment is allocable to payees for whom no withholding is required.\(^\text{28}\)

- An intermediary or flow-through entity generally has a residual withholding responsibility with respect to withholdable payments it receives unless it is an NQI, NWP or NWT that has provided the proper withholding certificate.

- The obligation of a QI, WP or WT to withhold and report will be determined in accordance with its agreement with the IRS under Chapter 3 of the Code.\(^\text{29}\)

In specified cases, a participating FFI or registered deemed-compliant FFI that is acting as a QI with respect to a payment of U.S.-source FDAP can elect instead to be withheld upon by the person from whom it receives payment.

2. Determine the Chapter 4 Status of the Payee

All reporting and withholding requirements under FATCA center around the Chapter 4 status of the parties involved. The term Chapter 4 status means a person’s status as a U.S. person, a specified U.S. person, an individual that is a foreign person, a participating FFI, a deemed-compliant FFI, a restricted distributor, an exempt beneficial owner, a nonparticipating FFI, a territory financial institution, an excepted NFFE, or a passive NFFE. Additionally, some entities are intermediaries or flow-through entities that may have a status under Chapter 3 that affects their treatment under FATCA.

The Proposed Regulations listed “QI branch of U.S. financial institution” as a possible Chapter 4 status. The Final Regulations remove this status because, as is explained under Treas. Reg. § 1.1471-2(a)(v), a QI branch of a U.S. financial institution is actually both a withholding agent and either a participating FFI or registered deemed-compliant FFI. Additionally, in coordination with the addition of “restricted distributors” to the list of foreign persons acting as an agent or intermediary that a participating FFI is not required to treat as a payee (in the case of a payment of U.S.-source FDAP), the Final Regulations now list “restricted distributor” as a Chapter 4 status.
3. Collect Documentation Confirming Chapter 4 Status

A withholding agent must base its determination of the Chapter 4 status of a payee on documentation on which it is permitted to rely under the Final Regulations and which it can reliably associate with the payment. If it cannot do this, either because the payee has not provided acceptable documentation or the documentation is faulty in some way, the Final Regulations provide presumption rules under which a withholding agent can presume the Chapter 4 status of a payee. In response to comments requesting greater flexibility with respect to the due diligence requirements, the Final Regulations make a number of changes, including:

- expanding the types of documentary evidence upon which a withholding agent may rely in certain cases;
- as a transitional rule to accommodate FFIs that would have difficulty obtaining new documentation on all preexisting account holders in a compressed time frame, allowing a withholding agent to rely upon a pre-FATCA Form W-8 in lieu of obtaining an updated version of the withholding certificate in certain circumstances with respect to payments made prior to January 1, 2017;
- IN the case of certain categories of types of persons determined to be low-risk, allowing documentation to remain valid indefinitely rather than expiring in three years, subject to a change in circumstances; and
- allowing a withholding agent to treat a withholding certificate as valid, notwithstanding an inconsequential error, if it otherwise has documentation to cure the error that does not contradict the information on the withholding certificate.

Additionally, the Final Regulations add new rules to the due diligence requirements regarding treatment of payees in IGA jurisdictions. For example, the Final Regulations provide guidance on when to treat an FFI as a nonreporting IGA FFI and also direct withholding agents to treat a payee as an exempt beneficial owner if it receives a withholding certificate that identifies the payee as an entity treated as an exempt beneficial owner under the relevant Model 1 IGA or Model 2 IGA (in recognition of the fact that the IGAs may allow for categories of exempt beneficial owners that are not provided for under the Final Regulations).

4. Withhold on Withholdable Payments

Under Section 1471(a) of the Code and Treasury Regulation §1.1471-2, withholding agents are required to withhold on withholdable payments to nonparticipating FFIs. As discussed above under “Transition Rules—Grandfathering” and “Transition Rules—Withholding,” there are several transitional rules that serve to phase in the withholding requirements. Additionally, as discussed in this section under “Identify the Payee,” a withholding agent’s obligation to withhold is largely dependent on the Chapter 4 status of the payee or the beneficial owner of the payment.
1. In General

In order to avoid being withheld upon under Section 1471(a) of the Code, a participating FFI is required to have an agreement with the IRS in effect under which it will generally be required to:

- deduct and withhold tax with respect to passthru payments (initially, domestic, withholdable payments and, after defining regulations are promulgated, foreign passthru payments) made to recalcitrant account holders and nonparticipating FFIs. If it is prohibited from doing so by foreign law, it is generally required to close the relevant account within a reasonable time or block or transfer the account;
- obtain information regarding each holder of each account it maintains to determine whether withholding is required;
- report the information it obtains with respect to its U.S. accounts. If it is required by foreign law to obtain a waiver in order to report such information and it fails to obtain such waiver, it must close or transfer such account within a reasonable period of time;
- adopt a compliance program under the authority of a responsible officer who will be required to certify periodically to the IRS on behalf of the FFI regarding the FFI’s compliance with requirements of the FFI agreement; and
- cure an event of default with respect to the FFI agreement.

FFIs that are covered by a Model 1 IGA will be treated as satisfying the due diligence and reporting requirements of Chapter 4 if they are in compliance with the local laws implemented in accordance with the terms of the Model 1 IGA and thus do not need to apply the Final Regulations to avoid withholding under FATCA.

The Model 1 IGA specifies that account-review procedures for preexisting accounts, and account-opening procedures for new accounts, must be in place by January 1, 2014. In order to (i) allow FFIs sufficient time to modify systems and to implement account-opening procedures as required under the Code and (ii) align the effective date of, and due diligence periods under, the FFI agreement with the timelines provided under the IGAs, the Final Regulations delay the effective date of the FFI agreement until December 31, 2013 for all participating FFIs that register with the IRS prior to January 1, 2014. The Final Regulations also specifically state that, regulations notwithstanding, each particular FFI Agreement will take into account any modifications set forth in an applicable Model 2 IGA, and any provisions applicable to a reporting Model 1 FFI.

The obligations of an FFI under the FFI Agreement to withhold and report are with respect to its “accounts.” For the purposes of FATCA, the following are accounts of an FFI:

- Depository accounts maintained by the FFI;
- Custodial accounts maintained by the FFI;
- Equity or debt interests in certain FFIs and certain holding companies and treasury centers, other than interests regularly traded on an established securities market; and
FATCA: Final Regulations
February 26, 2013

SULLIVAN & CROMWELL LLP

- Contracts issued or maintained by an insurance company, a holding company of an insurance company or other type of FFI, if the contract is a cash value insurance contract or an annuity contract.

The Final Regulations also explicitly exclude the following from the definition of “account” of an FFI:

- Accounts or financial products excluded from the definition of “account” under a Model 1 IGA or Model 2 IGA;
- Accounts held by an estate;
- Certain savings and escrow accounts; and
- Certain term life insurance and annuity contracts.

**Equity or Debt Interests as Accounts**

The Final Regulations make several changes to the definitions of accounts that are equity or debt interests issued by FFIs. First, equity or debt interests issued by an FFI are only considered accounts of the FFI if they are not regularly traded on an established securities market, and the Final Regulations significantly modify the definition of “regularly traded” for the purposes of determining what constitutes an account. Under the Proposed Regulations, such debt or equity interests were considered “regularly traded” if (i) trades in such interests are effected other than in de minimis quantities, on an established securities market on at least 60 days during the prior calendar year and (ii) the aggregate number of such interests that were traded was at least ten percent of the average number of such interests outstanding during the prior calendar year. Under the Final Regulations, “regularly traded” is defined by reference to the definition of “regularly traded” provided by the regulations under Section 1472 regarding exceptions to the NFFE category, which has itself been revised since the Proposed Regulations.

Thus, under the Final Regulations, equity or debt interests in an FFI are considered regularly traded if:

- one or more classes of stock of the corporation that, in the aggregate, represent more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on an established securities market during the prior calendar year, and
- with respect to each class relied on to meet the more-than-50-percent listing requirement, trades in each such class are effected, other than in de minimis quantities, on an established securities market on at least 60 days during the prior calendar year, and the aggregate number of shares in each such class that are traded on an established securities market in the prior year are at least ten percent of the average number of shares outstanding in that class during the prior calendar year.

A special rule related to the definition of “regularly traded” provides that a class of stock will meet the trading requirements for a calendar year if the stock is traded during such year on an established securities market located in the United States and is regularly quoted by dealers making a market in the stock. Another special rule modifies the requirements to account for part-year trading in the case of a corporation in the year of its initial public offering. The revision of the “regularly traded” definition with
respect to debt interests is problematic because the prior definition referred to trades in “such interests” whereas the new cross-referenced definition refers only to trading of “stock.” This raises questions as to how publicly traded interests in an entity can qualify for the exemption if the issuing entity itself is not publicly traded (e.g., debt, nonvoting preferred stock, low-vote stock).

The Final Regulations also amend the definition of an account that is a non-regularly traded equity or debt interest in an investment entity. The new definition now corresponds to the new definition of an “investment entity FFI” as discussed above. This amendment excludes from the treatment as an account of an FFI any equity or debt interest in an investment entity that qualifies as an investment entity solely because it primarily conducts trading and investment activities for or on behalf of a customer. In other words, the debt and equity interests of investment advisory companies will generally not be considered “accounts.” Non-regularly traded equity and debt of funds that are investment entities, however, will continue to be treated as accounts.

The treatment of non-regularly traded equity or debt interests in a holding company or treasury center was also changed. Debt and equity interests in holding companies and treasury centers of expanded affiliated groups whose aggregate income is derived primarily from active NFFEs, depository institutions, custodial institutions and insurance companies are no longer covered by the definition (e.g., non-publicly traded debt of a bank holding company is no longer treated as an account); however, this exception does not apply in cases in which the debt or equity interest tracks the performance of certain investment entities.

Finally, the new definition of accounts provides that debt and equity interests in holding companies, treasury centers, depository institutions, custodial institutions and investment entities (other than those that are solely investment advisory companies, discussed above) will be considered an account if the value of the interest is determined, directly or indirectly, primarily by reference to assets that give rise (or could give rise) to withholdable payments. The Final Regulations clarify that the value of an interest is determined, directly or indirectly, primarily by reference to assets that give rise (or could give rise) to withholdable payments if the amount payable upon redemption of the interest is either secured or determined primarily by reference to assets that give rise to withholdable payments. The Final Regulations also provide that the value of a debt interest is determined, directly or indirectly, primarily by reference to assets that give rise (or could give rise) to withholdable payments if (i) the debt is convertible into stock of a U.S. person, (ii) amounts payable as interest or upon redemption of the debt are determined primarily by reference to profits or assets of a U.S. person, or (iii) the debt is secured by assets of a U.S. person.

2. Identify Account Holders

The requirements imposed on participating FFIs under Section 1471(b) of the Code to report on each U.S. account and withhold upon recalcitrant account holders and nonparticipating FFIs make thorough
SULLIVAN & CROMWELL LLP

information-gathering and due diligence a practical necessity (in addition to being a requirement for not losing participating FFI status). The obligations of a participating FFI with respect to a specific account will largely depend upon its determination of (i) whether the account is held by an individual or an entity, (ii) the Chapter 4 status of the individual or entity, and (iii) whether the account was in existence before or after the effective date of such FFI’s FFI Agreement.

While the Final Regulations preserve the overall framework and concepts of the Proposed Regulations and the IGAs for purposes of FFI due diligence (including the relaxed requirements for preexisting entity accounts and offshore accounts), a number of changes were made. Among the more significant changes are:

- A special rule covers participating FFIs that acquire accounts in mergers or bulk acquisitions from another participating FFI, a deemed-compliant FFI or a U.S. financial institution. The rule allows the acquiring FFI to rely on the Chapter 4 determinations made by the transferor entity in specified circumstances; and
- The definition of “preexisting account” has been modified. Under the new rule, a new account of a preexisting account holder may also be treated as a preexisting account if the participating FFI maintaining the accounts treats them as one account (generally referred to as “consolidated obligations” under the Final Regulations) for the purposes of applying AML due diligence and certain other procedures.  

After making a determination that the account is held by an entity, the Final Regulations direct participating FFIs to apply “the principles of §1.1471-3(b), (c), and (d) to establish the Chapter 4 status of each account holder and each payee regardless of whether the participating FFI makes a payment to the account.” Thus, as under the Proposed Regulations, the general payee identification rules applicable to all withholding agents apply for purposes of determining the documentation requirements and presumption rules applicable to an account held by an entity. The Final Regulations make several modifications to the due diligence rules for entity accounts, including:

- clarifying that if an entity account holder receiving a payment is not considered the payee under the applicable rules, the participating FFI is also required to establish the Chapter 4 status of the person treated as the payee in order to determine whether withholding applies (e.g., if an account is held by an NFFE that is a flow-through entity (other than a WP, WT, or excepted NFFE), the participating FFI is also required to identify and document the partners, owners or beneficiaries);
- specifying that, for entity accounts that are not preexisting accounts, a participating FFI must perform the requisite identification and documentation procedures by the earlier of the date a withholdable payment or foreign passthru payment is made with respect to the account or within 90 days of the date the participating FFI opens the account; and
- shortening the timeframe for applying identification and documentation procedures for any entity account holder of a preexisting account that is a prima facie FFI from one year to six months of the effective date of the FFI agreement.

In general, for new individual accounts, a participating FFI must follow the due diligence rules applicable to withholding agents in order to establish the account holder’s Chapter 4 status. Similar to the Proposed Regulations, for preexisting individual accounts, a participating FFI may generally identify the Chapter 4
status of the account by reviewing the account for any U.S. indicia with enhanced review being required for accounts in excess of $1,000,000. The Final Regulations make a few notable modifications to the due diligence rules with respect to individual accounts, including:

- expanding the documentation on which a participating FFI may rely to establish the U.S. Taxpayer Identification Number ("TIN") of an individual account holder such that the participating FFI is no longer required to exclusively rely on a Form W-9;
- foregoing the requirement of an insurance company to document each employee that is covered by a group insurance contract held by an employer until the date on which an amount is payable to an employee or beneficiary, if the contract meets certain requirements and the employer certifies that none of the employees are U.S. persons; and
- clarifying that, in cases where the participating FFI has not received enough documentation to establish the Chapter 4 status of an individual account holder, the presumption rules (discussed above) do not apply and the account must generally be treated as held by a recalcitrant account holder.

3. Report U.S. Accounts and Recalcitrant Account Holders to the IRS

Once the Chapter 4 status of an account holder has been determined, a participating FFI generally has an obligation to report U.S. accounts and accounts held by recalcitrant account holders. There are certain special rules that apply with respect to account holders of territory financial institutions, sponsored FFIs, owner-documented FFIs, and accounts held by branches of an FFI. The Final Regulations provide no significant changes with respect to the reporting obligations of participating FFIs; however, it should be noted that a participating FFI is not required to file its reports of U.S. accounts and accounts held by owner-documented FFIs for the 2013 and 2014 calendar years until March 31, 2015.

4. Withhold on Payments to Nonparticipating FFIs and Recalcitrant Account Holders

A participating FFI is required to withhold on any passthru payment it makes to a recalcitrant account holder or nonparticipating FFI. A passthru payment is defined to include withholdable payments and foreign passthru payments. Special transitional rules with respect to the obligation of participating FFIs to withhold and report on payments are discussed above under “Transition Rules – Grandfathering,” “Transition Rules – Withholding” and “Transition Rules – Reporting Payments.” In the event that there is overwithholding, the Final Regulations provide, in addition to the set-off and reimbursement procedures provided for under the Proposed Regulations, that participating FFIs and Reporting Model 1 FFIs that have overwithheld on certain account holders now have the ability to request from the IRS a collective credit refund on behalf of all such account holders.

Pursuant to the Model 1 IGA, a Reporting Model 1 FFI is not required to withhold with respect to an account held by a recalcitrant account holder, or to close such account, so long as it reports identifying information regarding the holder of the account. The Final Regulations nonetheless still generally require participating FFIs to close, block or transfer an account that is recalcitrant or otherwise preventing the FFI
from complying with FATCA “within a reasonable time.” The Final Regulations, however, still do not specify what constitutes a “reasonable time.”

Special Rules for U.S. Branches of Foreign Entities

A U.S. branch of a participating FFI is generally subject to the withholding, due diligence and reporting requirements of FATCA. However, under Chapter 3 regulations, a U.S. branch and a withholding agent may agree to treat the branch as a U.S. person. Because such U.S. branches are required to fulfill the withholding, due diligence and reporting requirements applicable to U.S. financial institutions to the extent provided under chapters 3 and 61 and Section 3406(a) of the Code, the Final Regulations provide special rules for such U.S. branches that are branches of participating FFIs in order to avoid duplicating the requirements placed upon them.32

A payment to a U.S. branch of a foreign person is generally a payment to a foreign person and withholding will apply to the extent required under FATCA. However, a withholding agent is not required to withhold on payments to a U.S. branch of a participating FFI or registered deemed-compliant FFI if the U.S. branch and the withholding agent have agreed to treat the U.S. branch as a U.S. person for purposes of Chapter 3 withholding. Additionally, the Final Regulations state that a U.S. branch of a participating FFI that is treated as a U.S. person must:

- apply the FATCA due diligence requirements applicable to withholding agents in order to determine the Chapter 4 status of account holders and payees that are entities and apply the documentation requirements of Chapter 3 or 61 (as applicable) with respect to individual account holders;
- follow the reporting requirements applicable to U.S. persons when reporting with respect to account holders that are U.S. nonexempt recipients and persons subject to backup withholding on payments of interest and dividends under Section 3406 of the Code;
- follow the reporting requirements of FATCA when reporting with respect to (i) substantial U.S. owners of NFFEs that are not excepted NFFEs and (ii) specified U.S. persons that are owners of owner documented FFIs.

Such a U.S. branch may not elect to be withheld upon for purposes of FATCA and must otherwise report for FATCA purposes as a U.S. person.

5. Establish and Implement a Compliance Program

A participating FFI is required to establish a compliance program under which it will appoint a responsible officer to oversee the FFI’s compliance with the requirements of the FFI agreement and certify such compliance to the IRS. Through this process, the responsible officer will have to report material failures and events of default, whether or not they have been cured. A material failure occurs as a result of a deliberate action on the part of one or more employees of the participating FFI to avoid the requirements of the FFI agreement. A material failure can also occur as a result of an unintentional failure of the participating FFI to implement internal controls sufficient for the participating FFI to meet its requirements under the FFI agreement. A material failure does not rise to the level of an event of default unless it

FATCA: Final Regulations
February 26, 2013

-24-
happens in more than limited circumstances and the participating FFI has not substantially complied with
the requirements of an FFI agreement. An event of default is a broader concept than material failure and
includes repeated material failures but also includes situations where a participating FFI fails to fulfill
requirements of the FFI Agreement, such as:

- failure to significantly reduce, over a period of time, the number of account holders or payees that the
  participating FFI is required to treat as recalcitrant account holders or nonparticipating FFIs;
- failure to establish or maintain a compliance program for fulfilling the requirements of the FFI
  agreement or to perform a periodic review of the participating FFI's compliance; and
- failure to cooperate with an IRS request for additional information or making any fraudulent statement
  or misrepresentation of material fact to the IRS.

The IRS can terminate the participating FFI status of an entity that does not timely respond to a notice of
event of default and remediate such event of default.

The Final Regulations provide participating FFIs within an expanded affiliated group the ability to
establish a compliance program on a consolidated basis. Under the consolidated compliance program
option, a participating FFI that is a member of an expanded affiliated group that includes one or more
FFIs may elect to be part of a consolidated compliance program under the authority of a participating FFI,
reporting Model 1 FFI or U.S. financial institution (“compliance FI”) within its expanded affiliated group.
An FFI can elect to be part of a consolidated compliance program even if other members of the group do
not, but each branch that it maintains will be subject to periodic review as part of the program. In the
case of a sponsored FFI group, the sponsoring entity is required to act as the compliance FI.

* * *
ENDNOTES

1 The Proposed Regulations are further discussed in the Sullivan & Cromwell LLP publication titled, “FATCA: Proposed Regulations, IRS and Treasury Department Release Proposed FATCA Regulations” (February 28, 2012), which can be obtained by following the instructions at the end of this publication.

2 Under Treas. Reg. § 1.1471-5(g), a recalcitrant account holder is generally an individual or NFFE that holds an account with an FFI and that fails to provide the FFI with documentation necessary to determine whether the account is a U.S. account (including whether the NFFE has any substantial U.S. owners) and/or provide a waiver permitting the FFI to provide account information to the IRS.

3 A withholdable payment is any payment of U.S.-source FDAP income and (for sales and other dispositions occurring after December 31, 2016) any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends that are U.S.-source FDAP income. Subject to certain exceptions, the term “FDAP income” refers to fixed or determinable annual or periodic income including interest, dividends, annuities, compensation and remuneration.

4 A withholding agent is any person, U.S. or foreign, in whatever capacity acting, that has the control, receipt, custody, disposal or payment of a withholdable payment or foreign passthru payment. This includes participating FFIs and registered deemed-compliant FFIs to the extent that such FFI is required to withhold on a passthru payment as part of the conditions for maintaining its status as a deemed-compliant FFI.

5 “Chapter 4” of the Code and, alternatively, “FATCA” are used herein to refer to sections 1471 through 1474 of the Code and the regulations thereunder.

6 When the withholding agent is a participating FFI in compliance with its obligations under the FFI Agreement, it will be deemed to satisfy its obligations with respect to withholdable payments made to NFFEs that are account holders. However, there are cases in which a participating FFI may make a payment to a payee that is not an account holder, such as when it makes a payment with respect to a contract that does not constitute a financial account for FATCA purposes. In those instances, the participating FFI will have to follow all of the documentation and reporting rules that apply to any withholding agent making payments to an NFFE. Treas. Reg. § 1.1472-1(a).

7 Preamble to the Final Regulations.

8 The IGAs are further discussed in the Sullivan & Cromwell LLP publications entitled, “FATCA International Agreements: US and UK Release Joint FATCA Intergovernmental Agreement” (September 20, 2012).

9 A revised Model 1 IGA was posted on Treasury’s website on November 14, 2012. Also, it should be noted that the Model 1 IGA was published in two forms, one unilateral, the other bilateral. The bilateral agreements require reciprocal reporting of foreign account holders by U.S. financial institutions whereas the unilateral Model 1 IGA would not require the United States to provide any information to the partner jurisdiction. To date, no unilateral Model 1 IGAs have been adopted. For further discussion of the Model 1 IGAs, please see the Sullivan & Cromwell LLP publication entitled, “FATCA Model Joint Agreements Released: U.S. Treasury Department Publishes Model Intergovernmental Agreements Permitting Foreign Financial Institutions to Report Information About U.S. Account Holders to Their Home Jurisdictions Instead of the Internal Revenue Service” (August 1, 2012).

10 Preamble to the Final Regulations. For further discussion of the Model 2 IGA, please see the Sullivan & Cromwell LLP publication entitled, “FATCA International Agreements: US Treasury Department Releases ‘Model 2’ FATCA Intergovernmental Agreement; Signs FATCA Agreements with Denmark, Mexico and Spain” (November 28, 2012).
11 Aside from stating that a foreign passthru payment does not include any payment made under a grandfathered obligation, the Final Regulations reserve on the definition of the term “foreign passthru payment.”

12 Regulations under Section 871(m) of the Code providing guidance on the treatment of dividend equivalent amounts were proposed on January 23, 2012 but have not yet been finalized.

13 A premium paid with regard to an insurance contract or annuity contract that is a grandfathered obligation is treated as a payment made under a grandfathered obligation.

14 A reopening generally is an issuance of new debt with terms identical to the remaining terms of an outstanding issue of debt. Under Treas. Reg. § 1.1275-2(k) of the Code, such issuance meeting certain requirements will be deemed a “qualified reopening” and thus will be deemed to have the same issue date as the original debt instruments for United States federal income tax purposes.

15 With respect to debt obligations, a “material modification” is a significant modification as defined in Treas. Reg. § 1.1001-3(e). In all other cases, the determination will be made based on the facts and circumstances.

16 “Chapter 3” is used herein to refer to Sections 1441 through 1464 of the Code and the regulations thereunder which generally deal with withholding on nonresident aliens and foreign corporations.

17 For purposes of this exception, the Final Regulations expressly treat a qualified securities lender as an intermediary and therefore not eligible for the exception from withholding.

18 Under Treas. Reg. § 1.1471-1(98), a preexisting obligation is any account, instrument, contract, debt, or equity interest maintained, executed, or issued by the withholding agent that is outstanding on December 31, 2013. With respect to participating and deemed-compliant FFIs, preexisting obligation means any account, instrument, contract (including any debt or equity interest) maintained, executed, or issued by the FFI that is outstanding on the effective date of the FFI agreement or when the FFI is generally recognized as deemed-compliant by the IRS, as the case may be. The term preexisting obligation also includes any obligation (referring to an account, instrument, contract, debt, or equity interest) of an account holder or payee, regardless of the date such obligation was entered into, if (i) the account holder or payee also holds with the withholding agent (or a member of the withholding agent's expanded affiliated group or sponsored FFI group) an account, instrument, contract, or equity interest that is a preexisting obligation; (ii) the withholding agent (and, as applicable, the member of the withholding agent's expanded affiliated group or sponsored FFI group) treats both of the aforementioned obligations, and any other obligations of the payee or account holder that are treated as preexisting obligations, as consolidated obligations; and (iii) with respect to an obligation that is subject to AML due diligence, the withholding agent is permitted to satisfy such AML due diligence for the obligation by relying upon the AML due diligence performed for the preexisting obligation already outstanding.

19 A prima facie FFI is a payee for whom the withholding agent has information in its system showing that it is a QI or NQI or is otherwise presumed to be a foreign financial institution based on available information. If the payee is a prima facie FFI, the withholding agent must treat the payee as a nonparticipating FFI starting on July 1, 2014, until it receives sufficient documentation.

20 For example, neither the Model 1 IGA nor the Model 2 IGA includes the holding companies and treasury centers category in its definition of “financial institution.” Accordingly, it appears that any such entity that is a resident of an IGA jurisdiction will be treated along with all other holding companies and treasury centers as an excepted NFFE that is a member of a non-financial group (discussed below). The Final Regulations note that, “with respect to any entity that is resident in a country that has in effect a Model 1 IGA or Model 2 IGA, an FFI is any entity that is treated as a Financial Institution pursuant to such Model 1 IGA or Model 2 IGA.”
21 Preamble to the Final Regulations.

22 Jesse Eggert, Treasury associate international tax counsel speaking at the Practising Law Institute’s annual tax seminar on January 31, 2013.

23 An expanded affiliated group is generally defined as one or more chains of certain corporations connected through stock ownership with a common parent corporation if the common parent owns directly at least 50 percent of the total vote and value of each corporation in the group and 50 percent of the total vote and value of each corporation in the group is owned directly by at least one other corporation in the group. Partnerships and entities other than corporations are generally also part of an expanded affiliated group if they are controlled by members of the group.

24 A non-financial group is generally made up of entities producing active income rather than passive income. Non-financial groups are permitted to include FFI members when all such members are participating FFIs or deemed-compliant FFIs.

25 Qualified intermediaries (“QIs”) are foreign entities that have entered into an agreement described under Treas. Reg. § 1.1441-1(e)(5)(iii) with the IRS to verify the beneficial ownership of payments for purposes of determining withholding under Chapter 3. Withholding foreign partnerships (“WP”) are foreign partnerships that have executed the agreement described in Treas. Reg. § 1.1441-5(c)(2)(ii). Withholding foreign trusts (“WT”) are foreign grantor trusts or foreign simple trusts that have executed the agreement described in Treas. Reg. § 1.1441-5(e)(5)(v). Under these agreements, WPs and WTs are generally obligated to withhold, for Chapter 3 purposes, on payments made to their partners and beneficiaries.

26 Preamble to the Final Regulations.

27 A specified U.S. person generally means any U.S. person other than a publicly traded corporation, tax-exempt organization or retirement plan, bank, REIT, RIC, common trust fund, registered dealer in securities, commodities or derivative instruments, broker or certain tax exempt trust. Under the Proposed Regulations, trusts exempt from tax under Sections 664(c) or 4947(a)(1) of the Code were excluded from the definition of specified U.S. person. The Final Regulations expand the exclusion, making any tax-exempt trust that is a Section 403(b) or Section 457(g) plan exempt from treatment as a specified U.S. person.

28 Foreign intermediaries, partnerships and trusts that do not have agreements with the IRS (discussed in Endnote 25) are labeled nonqualified intermediaries (“NQIs”), and nonwithholding partnerships and trusts (“NWPs,” “NWTs”).

29 All such agreements entered into by an FFI (other than an FFI that is a registered deemed-compliant FFI, including a reporting Model 1 FFI) with an effective or renewal date on or after December 31, 2013 will double as an FFI Agreement.

30 A U.S. account is any financial account maintained by an FFI that is held by one or more specified U.S. persons or U.S.-owned foreign entities. Among other exceptions, U.S. accounts do not include any depository account maintained by a participating FFI during a calendar year if the account is held solely by one or more individuals and, with respect to each holder of such account, the aggregate balance or value of all depository accounts held by each individual, determined under rules provided in the Final Regulations, does not exceed $50,000 (“low-value depository account”).

31 See, Note 8, supra.

32 Section 3406(a) of the Code generally requires backup withholding on taxpayers who fail to provide a TIN or have previously underreported their tax owed.
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