Client Alert

December 2018

Global Wealth Management
Switzerland

Proposed Regulations Reduce FATCA and Chapter 3
US Withholding Tax Burdens

Withholding Agents and Financial Institutions to Benefit from Substantial Changes

The US Internal Revenue Service ("IRS") recently released proposed regulations (the "Proposed Regulations") designed to reduce the withholding and documentation burdens imposed on withholding agents and foreign financial institutions ("FFIs") under both the US Foreign Account Tax Compliance Act ("FATCA") and other US withholding tax ("Chapter 3") requirements. Treasury released the Proposed Regulations on December 13, 2018 (REG-132881-17), pursuant to numerous public comments received by the IRS and in line with the burden-reduction policies set forth in Executive Orders 13789 and 13777, issued by President Trump to enforce regulatory reform as well as identify and reduce tax regulatory burdens.

What Is New?

The Proposed Regulations reduce the burden on withholding agents and FFIs through a variety of measures:

- Elimination of the FATCA requirement to withhold on payments of gross proceeds, which was scheduled to begin January 1, 2019, and on non-cash value insurance premiums (both foreign-to-foreign and US-to-foreign payments)
- Further deferral of the requirement to withholding on so-called foreign passthru payments, until at least two years following publication of final regulations defining the scope of such payments
- Clarification of the definition of professionally managed investment entities in line with the definition applicable under the OECD Common Reporting Standard ("CRS")
- Further clarifications and relaxations of certain FATCA and Chapter 3 due diligence requirements
- Several changes to procedures regarding credits and refunds of overwithheld tax

Most of these measures are applicable immediately, until final regulations are issued to implement them. With respect to changes to due diligence requirements and certain withholding requirements, FFIs that are Qualified Intermediaries ("QIs") may rely upon such provisions until they are incorporated into the terms of the 2017 QI agreement. Taxpayers may not, however, rely on the changes relating to credits and refunds of withheld tax until IRS Forms 1042 and 1042-S are updated for the 2019 calendar year.
Elimination of FATCA Withholding on Gross Proceeds

Pursuant to existing FATCA final regulations, withholding agents would be required as of January 1, 2019, to begin withholding on certain payments of gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from US sources. The withholding requirement applied to such payments made to non-participating FFIs and, with respect to payments made by FFIs not relieved of the obligation by an applicable FATCA intergovernmental agreement (“IGA”), such payments made to recalcitrant account holders.

The Proposed Regulations eliminate the FATCA withholding requirement with respect to gross proceeds altogether. Withholding will continue to be limited to payments of qualifying US-source fixed, determinable, annual or periodic (“FDAP”) income that are withholdable payments for FATCA purposes.

In enacting this change, the Treasury Department and the IRS noted that the current withholding requirements already serve as a significant incentive for FFIs investing in US securities to avoid non-participating FFI status. Furthermore, the broad network of participating jurisdictions with IGAs in force or deemed in effect also allows for international cooperation to facilitate FATCA implementation. Many practitioners viewed this imposition of additional withholding on gross proceeds as a major burden and a potentially unnecessary measure, and certainly many financial institutions and other payors welcome this change.

Delay in Foreign Passthru Payment Withholding

Another welcome relief provided by the Proposed Regulations is the further suspension of the requirement of FFIs to withhold on so-called “foreign passthru payments” made to accounts of non-participating FFIs and recalcitrant account holders. These payments, as yet undefined for purposes of the FATCA regulations, are designed to include foreign payments that would not otherwise be considered withholdable payments, to the extent an NPFFI or recalcitrant account holder holds US assets. Determining these amounts would require FFIs to calculate a “passthru payment percentage” based on the proportion of the account holder’s US assets vs. total assets.

Not only would the actual foreign passthru payment withholding be burdensome for FFIs, but the implementation also presents significant technical challenges under existing FATCA regulations. Such withholding would require a framework for identifying foreign passthru payments and portions of foreign payments attributable to foreign passthru amounts, as well as the mechanisms for FFIs to track these amounts and to effectively look through any “blocker” arrangements or structures to determine whether and how much foreign passthru payment amounts may be involved. If foreign
passthrough payment regulations are ultimately enacted, then at least an additional two years’ time for FFIs to implement the required systems would make it more likely that they will be able to comply with the deadline to begin such withholding.

**Exception from Withholdable Payments for Non-Cash Value Insurance Premiums**

A more specific but significant reduction in the FATCA withholding requirements under the Proposed Regulations is the exception from withholding for premium payments for non-cash value insurance contracts. Previously, where such insurance contracts partially or wholly insured against US-based risk, the premium payments were withholdable payments for FATCA purposes. Such payments could include, for example, premiums for property and casualty insurance covering in part some US risk, even where the payments themselves were entirely between non-US parties (i.e., foreign-to-foreign payments). Treasury previously provided transition relief for foreign-to-foreign property and casualty premiums, but the transition relief expired on December 31, 2016.

The Proposed Regulations cited comments that this requirement placed a significant burden on insurance brokers of documenting insurance carriers, intermediaries, and syndicates of insurers. These parties would be required to obtain documentation from upstream parties and determine what portion of foreign-to-foreign payments could be considered withholdable. In many cases, determining this allocation may not be practicable. Further, the Proposed Regulations noted that changes to the passive foreign investment company (“PFIC”) rules under the TCJA should also help ensure that certain other companies not predominantly engaged in an insurance business would be subject to increased PFIC reporting requirements, thus mitigating the need for reporting of their US owners under FATCA. Moreover, it was unclear why property and casualty insurance was initially included as a FATCA withholdable payment, as such insurance does not provide a vehicle for tax avoidance.

The Proposed Regulations specifically carve out premiums for insurance contracts that do not have cash value, as excluded nonfinancial payments that are therefore not withholdable payments, irrespective of whether there is insurance of any US-based risk. Premium payments on cash value insurance products remain subject to potential withholding, to the extent treated as withholdable payments. Withholding agents can immediately rely on this exception, significantly reducing the burden on property and casualty insurers.
PMIE Scope Clarification

In addition to providing limited relief from withholding requirements, the Proposed Regulations clarify the scope of a professionally managed investment entity ("PMIE") for FATCA purposes, aligning this concept more closely with the corresponding definition under the OECD Common Reporting Standard ("CRS"). PMIE status results in classification as a financial institution and therefore the potential application of FATCA compliance requirements.

The Proposed Regulations clarify that an entity should not be considered “managed by” another entity for this purpose solely because it invests all or a portion of its assets in such other entity, and such other entity is a mutual fund, an exchange traded fund, or a collective investment entity that is widely held and is subject to investor-protection regulation. However, an investor in a discretionary mandate is for this purpose “managed by” the other financial institution.

The explanations to the Proposed Regulations specifically mention that this clarification is similar to guidance published by the OECD interpreting the definition of a PMIE under the Common Reporting Standard. In general, many practitioners and tax authorities in other jurisdictions took this approach, aligning the concept of a PMIE for both FATCA and CRS purposes. This clarification does not impact the definition of a PMIE under the FATCA IGAs, which is read more broadly. However, in most FATCA partner jurisdictions, the definition in the FATCA regulations may be applied and thus the definition of a PMIE is more clearly aligned for FATCA and CRS purposes.

This is an interesting development, as the United States has not officially adopted CRS. Perhaps this indicates a willingness to adopt additional definitions and policies from CRS.

Chapters 3 and 4 Due Diligence Requirements (also for QIs)

The Proposed Regulations contain a number of changes to due diligence requirements of withholding agents, which apply for both FATCA and Chapter 3 purposes, with respect to tax treaty statements. In general, a withholding agent must obtain either (a) a withholding certificate, generally on an applicable IRS Form W-8, or (b) both documentary evidence and a treaty statement, in order to apply a reduced rate of US withholding tax, where a payee claims the benefits of a US income tax treaty. The following revisions also specifically impact Qualified Intermediary ("QI") procedures, and QIs may rely upon these updated procedures until they are incorporated into the terms of the 2017 QI Agreement:

1. **Extension of Time to Obtain Treaty Statements.** The Proposed Regulations extend the time for withholding agents to obtain treaty
statements with the specific limitation on benefits ("LOB") provision identified for preexisting accounts until January 1, 2020 (rather than January 1, 2019). To make a valid claim of reduced withholding tax rates under a US income tax treaty, an entity must meet at least one of the categories specified in the LOB clause of the applicable treaty, and this basis for eligibility under the LOB provision must be provided.

2. **Indefinite Validity for Certain Treaty Statements.** The Proposed Regulations add exceptions to the three-year validity period for treaty statements provided by tax exempt organizations (other than tax-exempt pension trusts or pension funds), governments, and publicly traded corporations. The qualification of these entities under an applicable income tax treaty is unlikely to change and thus their treaty statements shall remain valid indefinitely, absent a change in circumstances.

3. **Actual Knowledge Standard Applies to Treaty Statements.** The Proposed Regulations correct an inadvertent omission of the actual knowledge standard for a withholding agent’s reliance on a beneficial owner’s identification of an LOB provision on a treaty statement. Where the treaty statement is provided with documentary evidence, the same actual knowledge standard will apply that applies to a withholding certificate (i.e., an IRS Form W-8) used to make a treaty claim.

4. **Documentary Evidence for Hold Mail Addresses.** The Proposed Regulations also update due diligence requirements regarding a residence address subject to a hold mail instruction. While such hold mail addresses have commonly been used by banks for a number of reasons, both hold mail and in care of addresses are considered US indicia for FATCA purposes where they are the only addresses associated with an account, and they require further documentation for Chapter 3 purposes in case of a claim of tax treaty benefits.

The documentary evidence required in order to treat a hold-mail address as a permanent residence address now includes documentary evidence that supports the person’s claim of foreign status or, for a person claiming treaty benefits, documentary evidence that supports the person’s residence in the country where the person claims treaty benefits.

5. **Electronic Account Statements not Hold Mail.** Also in response to comments, the Proposed Regulations clarify that the definition of a hold mail instruction does not include a request to receive all correspondence (including account statements) electronically.
**Changes to Credits, Overwithholding and Reporting**

The Proposed Regulations also make certain changes to the procedures governing credits and refunds of overwithheld tax.

1. **Withholding and reporting in a subsequent year.** In some situations, domestic partnerships or withholding foreign partnerships (“WPs”) and withholding foreign trusts (“WTs”) earn income subject to withholding in a prior year but it is not distributed until the subsequent year. Withholding of the prior year tax may be reported in some cases on a partnership’s IRS Form 1042 for the subsequent calendar year (the so-called “lag method” of reporting). In these cases, there may be a mismatch between the year of withholding (the subsequent year) and the year of K-1 reporting to the partners (the prior year).

   The Proposed Regulations address this issue by requiring a withholding agent (including a partnership or trust) that withholds in a subsequent year to designate the deposit as attributable to the preceding year and report the amount on Forms 1042 and 1042-S for the preceding year. This treatment extends the existing rule for other withholding agents to partnerships and trusts as well. An exception applies to non-calendar year partnerships.

   Further, the Proposed Regulations extend the due date for a partnership to file and furnish IRS Form 1042-S until September 15 when it withholds tax after March 15 of the subsequent year that it designates as deposited for the preceding year. This revised due date corresponds to the due date for filing Form 1042 with an extension and the due date to furnish a Schedule K-1 to a partner with an extension. Thus, the partnership should have sufficient time to determine the withholding amount and coordinate with the extended due date to furnish the Schedule K-1 to a partner.

2. **Adjustments to overwithholding under reimbursement and set-off procedures.** A withholding agent that has overwithheld and deposited the tax may adjust the overwithheld amount under either the reimbursement procedure or the set-off procedure. If it cannot apply either of these procedures, the beneficial owner or payee must file a claim for credit or refund with the IRS in order to recover any overwithheld amount.

   In response to comments to expand the situations where a withholding agent may use the reimbursement or set-off procedures, the Proposed Regulations allow a withholding agent to use the extended due date for filing Forms 1042 and 1042-S to make a repayment and claim a credit and to conform the requirements for the set-off procedures to those applicable to the reimbursement procedures. Also, a withholding agent will no longer be required to include with its Form 1042 a statement that
the filing constitutes a claim for credit when it applies reimbursement in the year following the year of the overwithholding, which is no longer needed due to changes to Form 1042. A withholding agent may not, however, apply the reimbursement and set-off procedures after the date on which Form 1042-S has been furnished to the beneficial owner or payee (no longer limited to the date the Form 1042-S is filed with the IRS).

3. Reporting of withholding by nonqualified intermediaries. In some cases, nonqualified intermediaries (“NQIs”) find it difficult to provide documentation to withholding agents regarding their underlying payee documentation, or may decline to do so where, for example, US payees charge fees for the administrative burden required in reviewing such additional documentation. In these cases, the NQI provides its own FATCA-compliant status, but the withholding agent must treat underlying payees as non-participating FFIs and withhold for FATCA purposes. Comments to the IRS stated that, in some cases, other jurisdictions may not permit their taxpayers to claim foreign tax credits based on FATCA withholding as they do not consider such FATCA withholding tax as a creditable income tax.

In response, the Proposed Regulations address the situation where an NQI receives a payment where a withholding agent has withheld at the 30 percent withholding rate under FATCA and reported the payment on IRS Form 1042-S as made to an unknown recipient. An NQI that is a participating FFI or registered deemed-compliant FFI may report such withholding as Chapter 3 withholding to the extent that the NQI determines it is not an amount for which FATCA withholding is required based on the underlying payee’s FATCA status. This change may assist in foreign tax credit claims on such withholding in other jurisdictions of residence of the payees. This treatment is limited to participating FFIs and registered deemed-compliant FFIs only, based on their requirements to document account holders for FATCA purposes and other FATCA compliance requirements under FATCA regulations or an applicable IGA.

The IRS intends to amend the 2019 Forms 1042 and 1042-S and corresponding instructions to implement these changes. Taxpayers may not rely on the corresponding changes until such forms are updated. With respect to requirements of WPs and WTs, the IRS also intends to amend the WP and WT agreements to implement these changes. A WP or WT may rely on such revised procedures for purposes of filing and deposit requirements until implemented in the WP and WT agreements.

Planning and Implementation for Withholding Agents and FFIs

The Proposed Regulations provide significant immediate relief from what many withholding agents and FFIs have viewed as, in some cases, overly
burdensome withholding and due diligence requirements. With regard to most of the changes, including relief from withholding on gross proceeds and on non-cash value insurance contract premiums, withholding agents and FFIs can rely on these provisions from December 13, 2018. The changes affecting credits and refunds of withheld tax will not be applicable until the IRS updates Forms 1042 and 1042-S, as needed to implement these changes for the 2019 calendar year.

With respect to the changes in withholding requirements, most withholding agents and FFIs should not have to make any changes at this time. Those that have worked toward implementation of gross proceeds will not have to complete such implementation unless there is a future change in direction. The further suspension of withholding on foreign passthru payments also means that FFIs should have adequate time to process and implement any necessary changes if final regulations for foreign passthru payments are ever developed.

The updates to due diligence requirements with respect to treaty statements and hold mail addresses are minor and should not require any new or significantly different procedures. Affected withholding agents should note these changes in their existing documentation procedures, and Qualified Intermediaries may include these already in their existing compliance programs.

Withholding agents and FFIs should carefully monitor future Chapter 3 and FATCA withholding and due diligence developments to ensure their procedures, systems and compliance programs remain up to date. Qualified Intermediaries in particular should also watch for anticipated changes to the QI agreement and ensure that they remain compliant with these changes. NQIs, WPs and WTs may also want to take advantage of the procedural changes to credits, overwithholding and reporting that could benefit them and their payees.

This client alert was prepared by Gregory Walsh (Zurich) and Joshua Odintz (Washington).