



**SIFMA FATCA SYMPOSIUM
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WITHHOLDING AND REPORTING PANEL

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TIMETABLE FOR IMPLEMENTING FATCA WITHOLDING

Timetable for Implementing FATCA Withholding

- Impact of IRS Announcement 2012-42
 - Withholding on U.S. source FDAP income
 - Begins 1/1/2014 for new accounts opened after 2013
 - Begins 7/1/2014 for pre-existing prima facie FFIs
 - Begins 1/1/2015 for pre-existing high value individuals
 - Only if accounts are maintained by PFFIs
 - Begins 1/1/2016 for all other pre-existing accounts
 - For recalcitrant individual accounts, only if maintained by PFFIs
 - For pre-existing accounts documented as NPFFIs before the applicable due diligence period have expired, withholding begins immediately
 - Withholding on gross proceeds from U.S. obligations
 - Begins 1/1/2017
 - Withholding on foreign pass-thru payments (income and gross proceeds)
 - Begins no earlier than 6 months after final regulations published
- Caution:** Intergovernmental Agreements (IGAs) may eliminate some of these withholding requirements for USFIs and PFFIs located in the IGA country

GRANDFATHERED OBLIGATIONS

Grandfathered Obligations Definition

- U.S. obligations outstanding on January 1, 2013 are “Grandfathered Obligations”
 - Payments on grandfathered obligations are exempt from FATCA withholding when paid to recalcitrant accounts, non-participating FFIs (including limited FFIs), non-compliant NFFEs, or electing PFFIs
 - Applies both to U.S. source income payments and gross proceeds from the sale, redemption, or termination of the U.S. obligation (“withholdable payments”).
- Outstanding on January 1, 2013 means:
 - Debt issued before January 1, 2013
 - Contracts executed and legally binding before January 1, 2013
- U.S. obligations will lose their grandfathered status if they are materially modified after 12/31/2012
 - Such obligations are considered new obligations as of the modification date
- Foreign obligations that may produce foreign pass-through payments will be grandfathered if they are outstanding 6 months after the date the final regulations on foreign pass-through payments published

Application of the Grandfather Rules

- The term “U.S. obligation” includes both **debt obligations and contractual obligations** that produce or could produce a withholdable payment.
- Examples of affected obligations:
 - Debt obligations issued by U.S. corporations, the U.S. government or its agencies, regular interests in REMICs, U.S. trusts, or U.S. partnerships.
 - A binding agreement to extend credit for a fixed term (e.g., line of credit or revolving credit facility) to a U.S. borrower.
 - Repos where the collateral seller is a U.S. legal entity.
 - A derivatives transaction entered into under an ISDA Master Agreement and evidenced by a confirmation issued before January 1, 2013, if it produces or could produce a withholdable payment.

Exceptions from Grandfathered Obligations

- U.S. grandfathered obligations do not include:
 - An instrument treated as an equity for U.S. tax purposes.
 - An agreement that lacks a definitive expiration or term (e.g., savings deposits or demand deposits)
 - A brokerage, custodial, or similar agreement to hold financial assets for others and collect income.
 - A master agreement that merely sets forth standard terms and not the specific terms of a particular transaction.

IRS Ann. 2012-42 Expands Grandfathered Status

- The grandfather date for U.S. obligations from notional principal contracts (NPCs) entered into and confirmed prior to 1/1/2013 remains unchanged
- But Ann. 2012-42 includes any obligation to make a payment with respect to, or to repay, collateral posted to secure obligations under an NPC that is a grandfathered obligation
 - The grandfather status of collateral for an NPC then depends whether the NPC is a grandfathered obligation
 - Means U.S. source interest on cash collateral that itself cannot be grandfathered because it lacks a definitive term can be grandfathered by reference to NPC
 - Also means that collateral securities are grandfathered if they relate to a grandfathered NPC, even if the securities were not outstanding on 12/31/2012
 - Operational challenge is to identify and track collateral (including substituted securities) associated with a grandfathered NPC
- Ann. 2012-42 treats an instrument that pays U.S. source “dividend equivalent payments” as grandfathered if it is outstanding 6 months after such instruments first become subject to withholding under section 871(m)
 - Means Chapter 3 withholding (but not FATCA withholding) applies to payments equivalent to U.S. source dividends under a securities loan or a total return swap that is entered into up to 6 months after the final regulations on such obligations are published

Business Approach to Grandfathering

- **Decide Approach:** Honoring grandfathered obligations is mandatory. Treasury regulations do not indemnify withholding agents from claims for tax overwithheld from payments on grandfathered obligations. However, each business need to decide as to how they will approach grandfathering and may differ depending on the type and volume of financial instruments involved. The two basic approaches would be:
 - **No withholding at the time of payment:** Requires up-front identification/flagging of U.S. grandfathered obligations on the relevant debt securities or contractual obligations and establish a procedure for monitoring material modifications made after the grandfathered date.
 - **Withholding at source and refund:** Before withholding begins, must establish approach for handling requests / refunds on overwithheld tax.

Material Modifications of Grandfathered Obligations

- A U.S. security or contract that qualifies for grandfathering will cease being a grandfathered obligation if it is materially modified on or after 1/1/2013.
- How to identify material modifications
 - Significant amendment of terms of debt obligation
 - Large consent payments made to holders of loans or debt securities in exchange for acceptance of new terms of debt
 - Rely on federal tax disclosure on modifications to public debt
 - Rely on loan modification documents for whole loans
- Examples of material modifications
 - Issuance of a new CUSIP for a modified obligation
 - Taxable deemed exchanges (reportable on Form 1099-B)
- Key considerations
 - Will withholding agents be able to rely on the debtor or its counsel?
 - Will vendors of tax services track material modifications on public securities?

TO BUILD OR NOT TO BUILD A WITHHOLDING SYSTEM

The Withholding Quandary

- FATCA requires withholding on payments of U.S. source income (beginning on 1/1/2014) made to non-compliant account holders.
 - For PFFIs – non-compliant account holders include NPFFIs, non-compliant NFFEs, electing PFFIs and recalcitrant individual account holders.
 - For USFIs – non compliant account holders include NPFFIs, electing PFFIs and non-compliant NFFEs.
- If a withholding agent did not require a withholding system to comply with Chapter 3 requirements, is a withholding system now required to comply with Chapter 4 requirements?

The Withholding System

- Effective FATCA implementation plans should include a withholding system (whether automated or manual).
 - Stakes are larger than with Chapter 3 – a PFFI not capable of effectively withholding on payments of U.S. source income to non-compliant account holders could jeopardize FATCA compliance of expanded affiliated group.
 - Payments not previously classified as U.S. source income are resourced under FATCA – e.g. bank deposit interest paid by foreign branches of USFIs.

Solution – Avoid Non-Compliant Account Holders?

- Is deciding not to accept non-compliant account holders a solution to not having to build a withholding system or apply withholding?
- Drawbacks of this approach:
 - Too big to lose client.
 - PFFIs can elect to be withheld upon.
 - Annual checks (FFI-EIN, owner documented FFIs, etc.)
 - Changes in circumstance result in prior compliant accounts becoming non-compliant.
 - FATCA Partner FIs who are not withholding QIs, WFPs, or WFTs pass up withholding responsibility on NPFFIs.

Developing Withholding Capability

- There are various options when determining how to develop withholding capability.
 - Build withholding system
 - Buy withholding system
 - Outsource withholding responsibilities.
- Consider benefits of centralized withholding facility.

Centralized Withholding Function

- A centralized withholding function is for managing the withholding processes (whether automated or manual).
- Benefits:
 - Center of Excellence.
 - Cost management.
 - Minimize impact of change management.

REPORTING UNDER FATCA

U.S. Payor Election to Complete 1099 Reporting

- PFFIs which are U.S. Payors can elect to complete Form 1099 reporting in order to meet U.S. account requirements.
- This election would apply for reporting on accounts held by:
 - Specified U.S. persons;
 - NFFEs with substantial U.S. owners; and
 - Owner-documented FFIs with specified U.S. owners
- The advantage of making this election is to avoid building a new system to meet special PFFI reporting requirements for U.S. accounts.

Special Issues to Consider for FATCA Reporting

- FATCA significantly expands Form 1042-S reporting responsibilities:
 - Payments of FATCA reportable payments, even if no withholding is required.
 - Impact of bank deposit interest resourcing rule for foreign branches of USFIs.
 - Transitional reporting of payments to NPFFIs.
- Impact of reporting both Chapter 3 and Chapter 4 on same Form 1042 for U.S. payors.
 - Reconciliation nightmares.

Details of Election

- PFFI must affirmatively make election to complete enhanced 1099 reporting as opposed to full reporting in accordance with IRS procedures.
- Election would be made separately by each PFFI by PFFI basis, not the expanded affiliated group basis.
- Election can be revoked during subsequent calendar year by completing default reporting requirements.

Reporting Solutions

- Centralized reporting facilities are an option for meeting reporting requirements.
 - Still could be costly depending on Model 1 versus Model 2 versus regulations breakout.
- Benefits:
 - Center of Expertise.
 - IRS systems becoming more robust and have the ability to identify inconsistent information which raises red flags.
 - Cost effective.
 - Minimize impact of change management.

Service Bureau – Solution for End to End Compliance

- FATCA Service Bureaus are beginning to be developed to address end to end FATCA compliance needs from registration process to due diligence, reporting, and withholding.
- Examples include transfer agents, fund administrators, third party providers, etc.
- PFFIs will still be responsible for supervision; however, service bureau concept minimizes need to develop costly infrastructure or develop (costly) internal FATCA expertise.

SERVICING INTERMEDIARY CLIENTS

Servicing Intermediary Clients

General Rule:

Withholding agents are required to withhold 30 percent of any ***withholdable payment*** made after December 31, 2013 to a payee that is a FFI, unless the withholding agent can reliably associate the payment with documentation which substantiates an exemption from withholding.

Special rules exist for payments made to intermediaries:

- ***U.S. source FDAP income payments made to participating FFIs (PFFIs) who are NQIs, NWP, and NWT*** are subject to 30% withholding tax if they do not provide a proper withholding certificate (W-8IMY) and withholding statement that establishes the portion of the payment that is allocable to “a class of payees for which no withholding is required under Chapter 4.”
 - By default the withholding agent is required to impose 30 percent withholding on the remaining portion of the payment which is allocable to recalcitrant accounts and non-participating FFIs (NPFFIs).
 - If no percentage is provided, the withholding agent must presume the entire amount is paid to a NPFFI and subject the entire amount to FATCA withholding.

Servicing Intermediary Clients (Continued)

Withholding on Payments Made to QIs:

- If a PFFI that is a QI makes an election under 1471(b)(3) to be withheld upon, a withholding agent is required to withhold on any withholdable payment or portion of a withholdable payment that is **U.S. source FDAP income** made to the participating FFI (PFFI) after December 31, 2013.

Issue – Inconsistent withholding treatment for payments of gross proceeds:

- Gross proceeds paid to a PFFI that has provided allocable amounts for its recalcitrant accounts and nonparticipating FFIs are not subject to FATCA withholding.
 - *The stick to encourage account holders to comply is gone (if paid through a PFFI).*
 - *If assets for recalcitrant accounts and nonparticipating FFIs are held in a pool or separate accounts, U.S. withholding agents could impose FATCA withholding on all sales processed in that account.*
- Conversely, a U.S. withholding agent must impose FATCA withholding on gross proceeds payments made to NPFFIs and withholds (backup withholding) on gross proceeds paid to a U.S. person who does not provide a W-9.

Solving for IGA Withholding (and Exemptions)

Withholding Under the IGA (UK used as an example)

- A Reporting Financial Institution (RFI) **who is acting as a QI and that *has assumed primary withholding under Chapter 3***, must withhold 30 percent tax on any U.S. source withholdable payment to any Non-participating Financial Institution (NPFIs).
 - **Withholding is not required on payments made to recalcitrant accounts** (nor must the account be closed) if the required information is reported to the U.S. Competent Authority.
 - Withholding is not required on payment of gross proceeds.
- A RFI **who is a QI and *has not assumed primary withholding under Chapter 3***, must provide the necessary information to the withholding agent so that the withholding agent can properly withhold on payments the RFI makes to NPFIs.
 - If the RFI does not provide the necessary information to the withholding agent, **it is not subject to withholding under section 1471**, unless it has been identified by the IRS as a Nonparticipating Financial Institution (NPFIs) under the Agreement.
- The U.S. shall treat **each Non-Reporting FI as a deemed-compliant FFI or as an exempt beneficial owner** for purposes of section 1471.

Solving for IGA Withholding (and Exemptions) (Cont'd)

Exempt Beneficial Owners	Deemed-Compliant Financial Institutions	Exempt Products
<ul style="list-style-type: none"> ▪ UK Governmental Organizations ▪ Central Bank ▪ International Organizations ▪ Retirement Funds 	<ul style="list-style-type: none"> ▪ Non-profit Organizations ▪ Financial Institutions with a Local Client Base 	<ul style="list-style-type: none"> ▪ Certain Retirement Accounts or Products ▪ Certain Other Tax-Favoured Accounts or Products

Issue:

- If RFIs and the entities above are not required to provide documentation to the U.S. withholding agent, how will we know that they are, without doubt, exempt?
 - How do we know that the account holder meets the definition of “Reporting Financial Institution” (under each IGA) rather than a Non-Participating Financial Institution?

SPECIAL ISSUES IN WITHHOLDING AND REPORTING