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TAX ALERT – JANUARY 23, 2019

IRS Issues Proposed Regulations Eliminating the FATCA Withholding Tax on Certain Sales Proceeds and Reducing Other Withholding Tax Related Burdens

On December 14, 2018, the IRS issued Proposed Regulations (the **"Proposed Regulations"**) to reduce the burden under the Foreign Account Tax Compliance Act (**"FATCA"**). FATCA generally requires that foreign financial institutions (**"FFIs"**) and certain other non-financial foreign entities (**"NFFEs"**) report on the foreign assets held by their United States (**"US"**) account holders or be subject to 30% withholding on certain payments (**"Withholdable Payments"**).

FATCA withholding operates alongside, but is separate from, withholding which may be reduced by an applicable tax treaty (**"Chapter 3 Withholding").** FATCA withholding is not subject to reduction by treaty, and its scope as enacted is broader than the scope of Chapter 3 withholding. Both FATCA and traditional withholding apply generally to US source payments of "fixed and determinable annual and periodic income" (**"FDAPI"**) (e.g., dividends, interest, and royalties). However, FATCA's scope as enacted is broader in that Withholdable Payments include not only FDAPI but also gross proceeds from the sale of property of a type that produces US source dividends or interest **("Covered Gross Proceeds"**).

Although FATCA was enacted in 2008, the IRS extended several FATCA related effective dates and in particular extended until January 1, 2019, the effective date for the imposition of FATCA withholding on Covered Gross Proceeds. As part of the Trump Administration initiative to review and revise or eliminate burdensome regulations, the IRS reviewed the FATCA Regulations and Chapter 3 Regulations and issued Proposed Regulations intended to reduce some of the potential burdens.

The most notable provision in the Proposed Regulations is the exclusion of Covered Gross Proceeds from the definition of "Withholdable Payments" and therefore, from FATCA withholding tax. The Preamble to the Proposed Regulations states that given the existence of many FATCA Intergovernmental Agreements and the level of FATCA compliance, it is no longer necessary to impose withholding tax on Covered Gross Proceeds as a means to enforce FATCA. The Preamble provides further that taxpayers may rely on the Proposed Regulations except as otherwise noted until final regulations are issued. Thus this provision of FATCA has for now effectively been eliminated.

Other FATCA related provisions in the Proposed Regulations are:

- **<u>Clarification of the Definition of Investment Entity</u>:** An entity is an investment entity (and therefore an FFI) if its income is primarily attributable to investment, reinvesting or trading in financial assets **<u>and</u>** it is "managed by" another entity. These Proposed Regulations clarify that an investing entity is not "managed by" a third entity solely because the investing entity invests all or a portion of its assets in a third entity being a mutual fund, an exchange traded fund, or a collective investment entity that is widely held and is subject to investor-protection regulation. Per the Preamble, the "managed by" category of investment entities generally covers entities that receive specific professional management advice from an advisor that is tailored to the investment needs of the investing entity and is similar to the OECD's definition of "managed by" under the Common Reporting Standard.

- **<u>Deferral of FATCA Withholding on Foreign Pass-thru Payments</u>**: "Foreign Pass-thru Payments" are special payments to an FFI that has an agreement with the IRS requiring such FFI to withhold on certain payments made to non-compliant US account holders or a non-compliant FFI. The IRS decided to further extend the time for withholding on Foreign Pass-thru Payments to a date two years after the issuance of final regulations concerning such payments.

- **<u>Elimination of FATCA Withholding on Non-Cash Value Insurance Premiums</u>:** The Proposed Regulations provide that premiums for insurance contracts that do not have cash value are not subject to FATCA withholding.

The Proposed Regulations also liberalize some of the procedures under traditional Chapter 3 Withholding (these provisions may not be relied upon until 2019) including:

- **<u>Elimination of "Lag Reporting" For Partnership Withholding</u>:** Heretofore, the IRS instructions have required a domestic partnership to report any withholding that occurs with respect to an amount that a partnership received but did not distribute to a partner in a calendar year (preceding year) on the partnership's Form 1042 for the following calendar year (subsequent year) (**"Lag Reporting"**). Lag Reporting can result in a mismatch between the income allocated to the partner on a Schedule K-1 and the withholding on that income. The Proposed Regulations would effectively eliminate Lag Reporting by requiring earlier reporting on Forms 1042 and 1042-S (i.e., in the preceding year) and extend the Form 1042-S due date to September 15 in such cases.

- **<u>Extension of Deadline for Refunds under the Reimbursement and Set-Off Procedures for Overwithholding</u>**: Reimbursement and set-off procedures have been instituted to remedy over-withholding of taxes on US source income, but the adjustments had to be made prior to the original due date of the Form 1042-S. Under the Proposed Regulations such adjustments can now be made until the extended due date of the Form 1042-S. This extension could allow recipients of overwithheld tax to file fewer claims for credit or refund with the IRS.