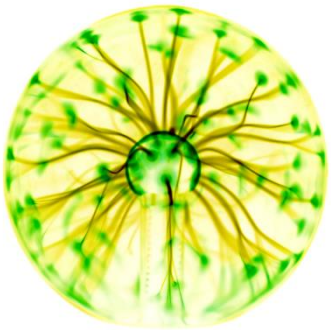

Proposed regulations reducing burden under FATCA and chapter 3

Closing the distance

On December 14, 2018, the Treasury and the IRS issued Proposed Regulations that substantially reduce the burden under FATCA and chapter 3 by eliminating withholding on the payments of gross proceeds and certain insurance premiums, deferring withholding on foreign Pass-thru payments, and introducing other relief measures.

The Internal Revenue Service ("IRS") and the Department of the Treasury ("Treasury") issued Proposed Regulations reducing the burden under chapter 4 (FATCA) and chapter 3 of the Internal Revenue Code ("Code"). The proposed rules eliminate withholding on payments of gross proceeds and certain insurance premiums, defer withholding on foreign pass-thru payments, provide additional guidance on some due diligence requirements for withholding agents, refine procedures for refunds and credits of certain withheld amounts (including changes to the withholding and reporting rules under the "lag" method), and clarify the definition of investment entities. The full text of the Proposed Regulations ("Proposed Regulations") may be found here: Regulations Reducing Burden under FATCA and Chapter 3. A brief summary of the key points under the Proposed Regulations is set out below.

Elimination of Withholding on Payments of Gross Proceeds

Under Code sections 1471(a) and 1472, withholdable payments made to certain foreign financial institutions ("FFIs") and certain non-financial foreign entities ("NFFEs") are subject to withholding under chapter 4. Section 1473(1) states that, except as otherwise provided by the Secretary, the term "withholdable payment" means: (i) Any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States; and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.

Under the Proposed Regulation, withholding on gross proceeds has been eliminated by the removal of gross proceeds from the definition of the term "withholdable payment". As a result, only payments of U.S. source FDAP that are withholdable payments under §1.1473-1(a) and that are not otherwise excepted from withholding under §1.1471-2(a) or (b) would be subject to chapter 4 withholding.

Deferral of Withholding on Foreign Pass-thru Payments

Currently, an FFI that has entered into an agreement with the IRS as described in section 1471(b) is required to withhold on any Pass-thru payments made to its recalcitrant account holders and to FFIs that are not compliant with chapter 4 (i.e., nonparticipating FFIs). For this purpose, a "pass-thru payment" is any withholdable payment or other payment to the extent attributable to a withholdable payment. The IRS believes that the implementation of withholding on pass-thru payments is integral to the success of FATCA. However, in recognition of the complexity and the time necessary for the implementation of the system for withholding on foreign pass-thru payments, the Proposed Regulations defer the withholding on Pass-thru payments to the "date that is two years after the date of publication in the Federal Register of final regulations defining the term "foreign Pass-thru payments."

Elimination of Withholding on Non-Cash Value Insurance Premiums Under chapter 4

Currently, under Treas. Reg. §1.1473-1(a)(1), a withholdable payment generally includes U.S. source premiums for insurance contracts. The final chapter 4 regulations included a transitional rule that deferred withholding on premiums paid with respect to offshore obligations until January 1, 2017. The 2014 chapter 4 regulations further extended the withholding deferral to the premiums paid by persons acting as insurance brokers with respect to offshore obligations. Additionally, the chapter 4 regulations generally allow a withholding agent to treat as a US payee a US broker receiving a payment of an insurance premium in its capacity as an intermediary or an agent of a foreign insurer. Also, the IRS generally permits non-US insurance brokers that are NFFEs to become qualified intermediaries to alleviate burden on the foreign brokers and US withholding agents.

Despite these and some other allowances, the IRS has been receiving requests for the elimination of chapter 4 withholding on premiums for insurance contracts that do not have cash value ("Non-Cash Value Insurance Premiums"). These requests were based on the claim that such withholding created burdens that were not necessary for the achievement of chapter 4 objectives and the IRS agreed to this point of view.

The introduction to the Proposed Regulations also notes that until a recent change in law, section 1297(b)(2)(B) passive foreign investment companies ("PFICs") that were "predominantly engaged" in an insurance business were exempt from the US owner reporting and anti-deferral rules. In light of this exemption, chapter 4 withholding on non-cash value insurance premiums underpinned IRS' enforcement efforts with respect to the use of the exemption under section 1297(b)(2)(B) by requiring reporting of the US owners to avoid withholding on Non-Cash Value Insurance Premiums. However, on December 22, 2017, the Tax Cuts and Jobs Act amended section 1297(b)(2)(B) to provide a more limited exception to PFIC status and the US owner reporting obligations and thereby mitigated the need for chapter 4 reporting of the US owners of these companies.

In light of these factors, the Treasury and the IRS recognize the limited usefulness of the chapter 4 withholding on Non-Cash Value Insurance Premiums; therefore, the Proposed Regulations exclude such premiums from the definition of withholdable payments and accordingly from chapter 4 withholding.

Clarification of Definition of Investment Entity

Under Treas. Reg. §1.1471-5(e)(4)(i)(B), an entity is an investment entity (and therefore a financial institution) if the entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets and the entity is "managed by" another entity that is a depository institution, custodial institution, insurance company, or an investment entity described in Treas. Reg. §1.1471-5(e)(4)(i)(A) ("Type B Investment Entity.") Generally, an entity will meet the "managed by" test if there is a discretionary mandate. A discretionary mandate is an agreement whereby a financial institution (FI) manages and invests the client's funds in accordance with the client's goals.

The Proposed Regulations clarify that an entity is not "managed by" another entity for purposes of definition of Type B Investment Entity just because it invests all or portion of its assets in another entity that is a mutual fund, an exchange, or a collective investment entity that is widely held and is subject to investor-protection regulations. In contrast, an investor that has provided a discretionary mandate to another FI is "managed by" the financial institution under Treas. Reg. §1.1471-5(e)(4)(i)(B).

Elimination of Withholding on Payments of Gross Proceeds

A. Treaty statements provided with documentary evidence for chapter 3

Under chapter 3, a withholding agent must generally obtain either a withholding certificate or documentary evidence and a treaty statement to apply a reduced rate of withholding based on a payee's claim for benefits under a tax treaty. When a treaty statement is provided with a documentary evidence, the treaty claimant must also identify the specific limitation on benefits ("LOB") provision relied upon. The current regulations require withholding agents to obtain a treaty statement meeting the new LOB requirements for accounts that were documented with the documentary evidence before January 6, 2017 ("Preexisting Accounts") by January 1, 2019. Also, similar to a Form W-8, a three-year validity period applies to a treaty statement that is provided with the documentary evidence.

The Proposed Regulations provide several changes to these requirements. Specifically, the proposed rules extend the time for withholding agents to obtain treaty statements with the specific LOB provision for Preexisting Accounts until January 1, 2020. Also, under the Proposed Regulations, the three-year validity period will not apply to the treaty statements provided by tax exempt organizations (other than tax-exempt pension trusts or pension funds),

governments, and publicly traded corporations, because their qualification under an applicable treaty is unlikely to change.

Generally, a withholding agent is allowed to rely on the treaty claim stated on the withholding certificate (including the statement made about LOB provisions) provided the withholding agent does not have an actual knowledge that such statement is incorrect. The Proposed Regulations extend the application of this actual knowledge standard to the treaty statement.

Importantly, the proposed amendments described above will also be incorporated in the 2017 Qualified Intermediary ("QI") Agreement and 2017 Withholding Foreign Partnership ("WP") and Withholding Foreign Trust ("WT") Agreements.

B. Permanent residence address subject to hold mail instruction for chapters 3 and 4

The chapter 3 regulations allow an address to be treated as a permanent residence address despite being subject to a hold mail instruction provided the relevant person gives documentary evidence establishing residence in the country in which the person claims to be a resident for tax purposes. With respect to this rule, the Proposed Regulations clarify that:

- Such documentary evidence includes a document that supports the person's claim of foreign status or, for a person claiming treaty benefits, a document that supports the person's residence in the country where the person is claiming treaty benefits;
- Regardless of whether the person actually claims treaty benefits, the documentary evidence on which a withholding agent may rely is the documentary evidence described in Treas. Reg. §1.1471-3(c)(5)(i) (e.g., certificate of residence, individual government identification, QI documentation, entity government documentation, third party credit report), without regard to the requirement that the documentation contain a permanent residence address;
- A hold mail instruction does not include a request to receive all correspondence (including account statements) electronically.

The above clarifications will apply for purposes of chapters 3 and 4; QIs, WPs, and WTs may rely upon these proposed modifications until the modifications are incorporated into the 2017 QI Agreement and 2017 WP and WT agreements.

Revisions Related to Credits and Refunds of Overwithheld Tax

A. Addressing issues caused by the application of "Lag Method".

Generally, a U.S. partnership is required to withhold on distributions subject to chapter 3 withholding. If, however, the U.S. partnership does not actually make such distribution to its foreign partners during a calendar year, the U.S. partnership must withhold on the partner's distributive share of the income on the earlier of: (i) when the Schedule K-1 (Partner's Share of Income, Deductions, Credits, etc.) is mailed to the partner or otherwise provided to the partner; or, (ii) the due date for furnishing the Schedule K-1. Similar withholding rules apply for chapter 4 purposes. For a partnership that files its return on a calendar year ("Calendar-Year Partnership"), generally the deadline for furnishing the Schedule K-1 is March 15 following the close of the taxable year. Notably, this deadline may be extended up to six months to September 15.

In addition to Schedule K-1, a partnership must report any amount subject to withholding that is allocable to a foreign partner for a calendar year on a Form 1042-S. The Form 1042-S filing deadline is March 15 of the calendar year following the year in which the partnership receives the amount subject to withholding. This deadline may be automatically extended by 30 calendar days and an additional 30 days at the discretion of the IRS. Amounts that are reportable on Forms 1042-S are also reportable on the withholding agent's income tax return, Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons). The deadline for filing Form 1042 is March 15 subject to an extension up to six months.

Based on these deadlines, the extended due date for filing a Form 1042-S generally occurs before the extended due date for furnishing a Schedule K-1 to a foreign partner. Thus, under certain circumstances a partnership may be required to report an amount subject to withholding on a Form 1042-S before the partnership actually completes withholding on such amounts. The Form 1042 Instructions address this by requiring a domestic partnership to report any withholding

completed during the calendar year ("Preceding Year") on an undistributed amount of a partnership income that is allocable to a foreign partner on the partnership's Form 1042 for the following calendar year ("Subsequent Year"). This method of reporting of partnership income is often referenced as a "Lag Method". The following example illustrates how the Lag Method operates: a calendar year domestic partnership receives U.S. source dividends in 2017 but does not distribute such income to its foreign partners; although the partnership income is not distributed to the foreign partners, the partnership must withhold on the foreign partners' share of the undistributed dividend income by the time the partnership issues 2017 Schedules K-1 to the foreign partners, which could be as late as September 15, 2018. The Lag Method further requires the partnership to report the withholding on the Forms 1042-S and 1042 for the 2018 year which are issued and filed in 2019.

The Lag Method causes some issues when a partner claims a credit or refund based on the withholding that the partnership applied. Specifically, pursuant to the Lag Method, the partnership issues a Form 1042-S to the Partner for the Subsequent Year that generally reflects the income received by the partnership in the Preceding Year. At the same time, the partnership reports partner's income on Schedule K-1 for the Preceding Year thus causing a mismatch between the income allocated to the partner and the withholding on that income. To claim a credit or refund for overwithholding, a partner must attach to its income tax return a Form 1042-S that it receives from a partnership; however, the partner is not able to support the claim for credit or refund with the Form 1042-S until after the year in which the partner is required to report the income shown on the Schedule K-1.

To address the above issue, the Proposed Regulations generally require a withholding agent (including a partnership and a trust) that withholds in a subsequent year to designate the tax deposit as attributable to the Preceding Year and report the amount on Forms 1042 and 1042-S for the Preceding Year. This proposed rule has an exception for a partnership that is not a calendar-year partnership ("Fiscal-Year Partnership"). Under this exception, a Fiscal-Year Partnership may designate a deposit as made for the Subsequent Year and report the amount on Forms 1042 and 1042-S for the Subsequent Year. This rule gives flexibility to Fiscal-Year Partnership to determine the year for reporting that will result in the best matching of the income and the related withholding.

In addition to above, the Proposed Regulations set September 15 of the Subsequent Year as a revised due date for filing and furnishing Form 1042-S where the partnership withholds tax after March 15 of the Subsequent Year that it designates as deposited for the Preceding Year. The revised due date allows sufficient time for the partnership to determine the amount of withholding due and also to coordinate with the extended due date for furnishing the Schedule K-1.

Further to the above proposed rules, the IRS intends to amend the Instructions for both the 2019 Form 1042 and Form 1042-S. After the amendments, the Instructions to Form 1042 will not require the partnership or trust to apply the Lag Method. Also, where a partnership will be filing Form 1042-S after March 15 for a partner's distributive share of an amount received by the partnership in the preceding year, amended Instructions to the 2019 Form 1042-S will require the partnership to file and issue a separate Form 1042-S for such amount for the Preceding Year. The partnership will be required to complete such filing in addition to any Forms 1042-S filed and issued to the partner for amounts that are withheld when distributed to the partner before March 15 and reported for the Preceding Year.

The Treasury Department and the IRS also intend to amend the WP and WT agreements to incorporate the above described proposed rules, and until such time, a WP or WT may rely on the Proposed Regulations for purposes of its filing and deposit requirements.

B. Adjustments to overwithholding under the reimbursement and set-off procedures

Currently, under Treas. Reg. §1.1461-2(a), a withholding agent that has overwithheld tax may adjust the overwithheld amount under either the reimbursement or the set-off procedures.

Under the reimbursement procedure, a withholding agent may repay the beneficial owner or payee the amount of tax overwithheld and then reimburse itself by reducing, by the amount of such repayment, any deposit of withholding tax otherwise required to be made before the end of the calendar year following the year of overwithholding. The withholding agent must make any repayment to the beneficial owner or payee before the earlier of the due date for filing Form 1042-S (without extensions) (i.e., March 15) for the calendar year of overwithholding or the date on which the Form 1042-S is actually filed with the IRS. In addition to this, the withholding agent must state on a timely filed Form 1042 (without extensions) for the calendar year of overwithholding that the filing constitutes a claim for credit in accordance with Treas. Reg. §1.6414-1.

Under the set-off procedure, withholding agent may apply the overwithheld amount against any amount which would otherwise be subject to withholding that is paid to the beneficial owner or payee before the earlier of the due date for filing Form 1042-S (without extensions) for the calendar year of overwithholding or the date that the Form 1042-S is

actually filed with the IRS. A beneficial owner or payee may file a claim for credit or refund with the IRS to recover the overwithheld tax if the withholding agent could not apply the reimbursement or set-off procedure.

The Proposed Regulations amend the reimbursement procedure and 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. The Proposed Regulations remove the requirement that a withholding agent include with its Form 1042 a statement that the filing constitutes a claim for credit when it applied reimbursement in the year following the year of the overwithholding.

Under current rules, the withholding agent may not apply the reimbursement and set-off procedures after the date on which Form 1042-S has been filed. The Proposed Regulations extend these restrictions and prohibit the withholding agent from applying the reimbursement and set-off procedures after the date on which Form 1042-S has been furnished to the beneficial owner or payee.

C. Reporting of withholding by nonqualified intermediaries

The Treasury and the IRS received comments about the issues that nonqualified intermediaries face when receiving a payment for which a withholding agent has applied chapter 4 withholding and reported the payment on Form 1042-S as made to an unknown recipient. To address these issues, the Proposed Regulations modify rules for reporting by a nonqualified intermediary under Treas. Reg. §§1.1461-1(c)(4)(iv) and 1.1474-1(d)(2)(ii). Specifically, the Proposed Regulations permit a nonqualified intermediary that is a participating FFI or registered deemed-compliant FFI to report the withholding applied to the nonqualified intermediary on a Form 1042-S as chapter 3 withholding to the extent that the nonqualified intermediary determines that the payment is not an amount for which withholding is required under chapter 4 based on the payee's chapter 4 status.

Under the current reporting requirements, the nonqualified intermediary is required to file a Form 1042 and receive a copy of the Form 1042-S filed by the withholding agent to substantiate the credit against its withholding tax liability for the withholding applied by its withholding agent. The Proposed Regulations change this rule; specifically, under the proposed rules the nonqualified intermediary that is a participating FFI or registered deemed compliant FFI would be permitted to substantiate the credit even though the Form 1042-S furnished to it reports chapter 4 withholding and the corresponding Forms 1042-S that the nonqualified intermediary issues reports chapter 3 withholding. This change is introduced to help the account holders using Form 1042-S to claim foreign tax credits in their jurisdictions of residence in these cases.

Reliance on Proposed Regulations

The Proposed Regulations expressly state that the taxpayers may rely on the Proposed Regulations until final regulations are issued, except the following instances:

- elimination of withholding on non-cash value insurance premiums under Proposed Reg. §1.1473-1(a)(3)(iii);
- clarification of the definition of a "managed by" investment entity under Proposed Reg. §1.1471-5(e)(4)(i)(B); and
- revised allowance for a permanent residence address subject to a hold mail instruction under Proposed Reg. §§1.1441-1(c)(38) and 1.1471-1(b)(99).

In addition, taxpayers may not rely on sections of the Proposed Regulations relating to the credits and refunds of withheld tax until Form 1042 and Form 1042-S are updated for the 2019 calendar year.

For more information please click here or contact:

Denise Hintzke
Managing Director, Global FATCA/CRS Tax Leader
Deloitte Tax LLP
+1 212 436 4792

Anne Mericle
Senior Manager, Global Information Exchange PMO
Deloitte Tax LLP
+1 212 436 3908

Susan Schultz
Managing Director, FATCA Global Delivery Center (GDC) Operations Leader
Deloitte Tax LLP
+1 612 397 4604

Susan Segar
Managing Director, Global Information Reporting
Deloitte Tax LLP
+1 703 885 6328

Americas

Phillip Brunson
Partner, Global Leader – Information Reporting
Deloitte Tax LLP
+1 212 618 4041

Steve Chapman
Partner, Global Information Reporting
Deloitte Tax LLP
+1 212 436 2339

David Charlton
Principal, Global Information Reporting
Deloitte Tax LLP
+1 617 437 2118

James Dockeray
FATCA Leader
Deloitte Caribbean and Bermuda
Deloitte Ltd.
+1 441 299 1399

Patty Florness
Partner, Global Information Reporting
Deloitte Tax LLP
+1 212 436 7413

Andrea Garcia Castelao
Principal, Global Information Reporting-CRS
Deloitte Tax LLP
+1 212 436 3785

Peter Larsen
Managing Director, Global Information Reporting
Deloitte Tax LLP
+1 415 783 4575

Anthony Martirano
Managing Director, Global Information Reporting
Deloitte Tax LLP
+1 973 602 6986

Richard Marcovitz
FATCA/CRS Leader
Deloitte Canada
Deloitte LLP
+1 416 775 4760

Robert Schlock
Managing Director, Global Information Reporting
Deloitte Tax LLP
+1 212 436 3541

Michael Shepard
Principal
Deloitte Transactions and Business Analytics LLP
+1 215 299 5260

Kristen Starling
Managing Director, Global Information Reporting
Deloitte Tax LLP
+1 212 436 4281

Sagun Vijayananda
Partner, Global Information Reporting
Deloitte Tax LLP
+1 212 436 7329

Asia-Pacific

Troy Andrews
FATCA/CRS Partner
Deloitte New Zealand
Deloitte
+64 93030729

Alison Noble
FATCA/CRS Leader
Deloitte Australia
Deloitte Services Pty Ltd
+61 3 9671 6716

Radish Singh
Forensic SEA for FATCA/CRS
Deloitte Singapore
Deloitte & Touche FAS
+65 6530 8077

Michael Velten
FATCA/CRS Leader, Asia-Pacific
Deloitte Singapore
Deloitte & Touche LLP
+65 6531 5039

Europe, Middle East & Africa

Brandi Caruso
Tax Transparency Leader
Deloitte Switzerland
Deloitte AG
+41 58 279 6397

Eric Centi
FATCA/CRS Tax Partner
Deloitte Luxembourg
Deloitte Tax & Consulting
+352 45145 2162

Karim Ousta
FATCA Tax Leader, Middle East
Deloitte United Arab Emirates
Deloitte LLP
+971 4 5064700

Owen Gibbs
UK FATCA/CRS/DAC Director
Deloitte United Kingdom
Deloitte LLP
+44 20 7007 4819

Alex Law
FATCA Leader, Middle East
Deloitte United Arab Emirates
Deloitte LLP
+971 4 506 4700

Jason McGarvey
UK FATCA/CRS/DAC Director
Deloitte, United Kingdom
Deloitte LLP
+44 20 7303 0412

Chris Tragheim
EMEA Operational Tax Leader
Deloitte United Kingdom
Deloitte LLP
+ 44 20 7303 2848

Markus Weber
Financial Services Industry Tax Leader
Deloitte Switzerland
Deloitte AG
+41 58 279 7527