

TAX ALERT:

# IRS FATCA July 1 Relief Notice Does Not Eliminate Burdens Regarding Grandfathered Obligations

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On Friday, May 2nd, 2014 the IRS issued Notice 2014-33 (the "FATCA May 2014 Relief Notice") that provides a transitional period from July 1, 2014 until December 31, 2015 (but only in certain cases) and limited penalty relief in connection with certain requirements of FATCA. The Notice does not delay the July 1, 2014 effective date for FATCA compliance generally. The Notice does not include any explicit overall relief (or delay in the July 1, 2014 effective date) for a withholding agent in connection with grandfathered obligations or reference the applicable portion of the FATCA regulations dealing with grandfathered obligations (Treas. Reg. Sec. 1.1471-2(b)).

The discussion below addresses the effect of the FATCA May 2014 Relief Notice on a withholding agent's responsibilities relating to grandfathered obligations pursuant to Treas. Reg. Sec. 1.1471-2(b). The discussion set forth below does not describe or address all aspects and potential consequences of the FATCA May 2014 Relief Notice.

The FATCA May 2014 Relief Notice includes repeated use of the term "obligation." At issue is the extent to which the use of the term obligation in the FATCA May 2014 Relief Notice has significance in the context of a withholding agent's responsibilities relating to grandfathered obligations pursuant to Treas. Reg. Sec. 1.1471-2(b). The first paragraph of the FATCA May 2014 Relief Notice explicitly provides that the term "obligation" includes an "account." This parenthetical reference in the IRS Notice is noteworthy because withholding agents often focus on their reporting responsibilities with regard to accounts, and the parenthetical is a reminder that the Notice's use of the term of obligation includes accounts.

## ***Transitional 18 Month Relief for Withholding Agents That Have Made Reasonable Efforts***

The FATCA May 2014 Relief Notice provides in part that "... the IRS will take into account whether a withholding agent has made reasonable efforts during the transition period to modify its account opening practices and procedures to document the chapter 4 status of payees, apply the standards of knowledge provided in chapter 4, and, in the absence of reliable

documentation, apply the presumption rules of Treas. Reg. Sec. 1.1471-3(f)." Calendar years 2014 and 2015 constitute the transition period. The IRS Notice further provides that "...[a]n entity that has not made good faith efforts to comply with the new requirements will not be given any relief from IRS enforcement during the transition period."

The transition relief section of the FATCA May 2014 Relief Notice does not include any explicit reference or relief relating to a withholding agent's obligations with regard to grandfathered obligations (other than a possibly inclusive reference to relief from applicable "standards of knowledge"). And the transition relief section of the IRS Notice explicitly provides that its application is narrow and states that "[f]or example, the IRS will not provide transitional relief with respect to its enforcement regarding a withholding agent's determinations of the character and source of payments for withholding and reporting purposes."

## ***The Broad General Meaning of "Obligation" Under the FATCA Rules***

The Merriam-Webster dictionary generally defines "obligation" as "something that you must do because of a law, rule, promise, etc." or as "something that you must do because it is morally right." The more complete definition does include "a debt security (as a mortgage or corporate bond)" as one type of obligation. A relevant issue here is what precisely the term "obligation" as used in the FATCA May 2014 Relief Notice means: does it mean "legal duty" and exclude debt securities or does the term's use in such IRS notice include debt securities and other "grandfathered obligations" within the meaning of Treas. Reg. Sec. 1.1471-2(b)?

The underlying FATCA regulations do not appear to provide determinative guidance. "Obligation" appears to have an extremely broad meaning for purposes of Section 1471 and the FATCA rules.

- Compare references to grandfathered obligations and withholding obligation in Treas. Reg. Sec. 1.1471-1(a).
- See also reference to obligations in definition of a broker under Treas. Reg. Sec. 1.1471-1(b)(11), grandfathered obligation under (b)(58), and offshore obligation under (b)(97).

The FATCA regulations appear to suggest that “obligation” can mean different things depending upon context. For example, one significant component of FATCA is the fundamentally increased account certification process that is highly dependent upon the receipt and required withholding agent review of substantially revised Forms W-8 and W-9. Such forms (or qualifying substitute forms) must be completed and signed by account holders and provided to withholding agents. The various definitions of “account” and “U.S. account” are set forth in Treas. Reg. Sec. 1.1471-5. Treas. Reg. Sec. 1.1471-5(b)(4) includes two references to the withholding agent’s due diligence “obligations.” In this particular context, the term “obligation” appears to mean “duty” rather than a type of debt security.

### **Shorter Six Month Relief Period for Obtaining and Reviewing Forms from Entities But Not Individuals**

The FATCA May 2014 Relief Notice focuses in significant part on relief relating to the receipt and review of newly updated IRS Forms W-8 that were substantially revised in connection with new FATCA requirements for withholding agents. Financial intermediaries, other financial market participants and vendors and their advisors have complained that the delays in releasing final versions of these forms and instructions to only a few months before the initial effective date for FATCA compliance has made timely compliance impossible. The FATCA May 2014 Relief Notice does *in part* respond to these complaints and provides limited compliance relief in the context of a withholding agent’s new accounts from July 1, 2014 through December 31, 2014 (note that this is a shorter six-month relief period compared to the 18 month relief period through December 31, 2015 for transition period relief) but only for accounts and obligations relating to those *held by an entity* rather than for those held by an individual. The FATCA May 2014 Relief Notice says that the reason why post-July 1, 2014 relief does not apply to accounts or obligations of individuals is “...because the procedures for documenting individual accounts are less complex than those for documenting entities for chapter 4 purposes and the Form W-8BEN (for withholding agents to document individuals) and its accompanying instructions were published in final form on March 3, 2014.”

The technical and legal manner by which the FATCA May 2014 Relief Notice provides relief relating to a withholding agent’s reporting, withholding and other related obligations under FATCA for accounts and obligations held by an entity is by treating an obligation “...that is issued, opened, or executed on or after July 1, 2014, and before January 1, 2015, as a *pre-existing obligation*...” (emphasis added). Although it is typical to refer to accounts and account holders in connection with assessing compliance with the FATCA rules, the term “pre-existing account” is defined by reference to the term “obligation.” Treas. Reg. Sec. 1.1471-1(b)(104)(ii) provides that “[t]he term pre-existing 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...” See also the definition set forth in

Temp. Treas. Reg. Sec. 1.1471-1T(b)(104)(i): “The term pre-existing obligation means any account, instrument, contract, debt, or equity interest maintained, executed, or issued by the withholding agent that is outstanding on June 30, 2014.”

### **Understanding the Definition of Obligation in the Context of Grandfathered Obligations**

A “grandfathered obligation” is generally defined in Treas. Reg. Sec. 1.1471-2(b)(2)(i)(A) as:

- (1) 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) and the regulations thereunder, provided that the obligation is executed on or before the date that is six months after the date on which obligations of its type are first treated as giving rise to dividend equivalents; and,
- (2) Any agreement requiring a secured party to make a payment with respect to, or to repay, collateral posted to secure a grandfathered obligation. If collateral (or a pool of collateral) secures both grandfathered obligations and obligations that are not grandfathered, the collateral posted to secure the grandfathered obligations must be determined by allocating (pro rata by value) the collateral (or each item comprising the pool of collateral) to all outstanding obligations secured by the collateral (or pool of collateral).

For this purpose, “obligation” specifically includes in Treas. Reg. Sec. 1.1471-2(b)(2)(ii), (before considering certain specified exclusions):

- (1) A debt instrument (for example, a bond, guaranteed investment certificate, or term deposit);
- (2) An agreement to extend credit for a fixed term (for example, a line of credit or a revolving credit facility), provided that the agreement as of its issue date fixes the material terms (including a stated maturity date) under which the credit will be provided;
- (3) A derivatives transaction entered into between counterparties under an ISDA Master Agreement that is evidenced by a confirmation;
- (4) [Reserved]. For further guidance, see Treas. Reg. Sec. 1.1471-2T(b)(2)(ii)(A)(4).
- (5) An immediate annuity contract payable for a period certain or for the life of the annuitant.

Contrast this narrow and explicit definition of “obligation” for purposes of defining a “grandfathered obligation” with the broad general definition used elsewhere in FATCA (both in the context of the definition of accounts and pre-existing obligations as well as other legal duties of withholding agents).

Under the tax law, explicit definitions generally override broader definitions in specific context.

## Conclusion

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“Obligation” has a narrower, prescribed definition for purposes of defining grandfathered obligations that differs from the use of the term “obligation” in other FATCA contexts. The FATCA May 2014 Relief Notice does not include any reference to grandfathered obligations or the related grandfathered obligations FATCA regulation provisions. Without explicit reference, withholding agents face a risk that the FATCA May 2014 Relief Notice could be construed as *not providing any relief* for a withholding agent’s obligations with regard to grandfathered obligations that begins on July 1, 2014. This conclusion appears consistent with the FATCA May 2014 Relief Notice’s explicit statement that “...the IRS will not provide transitional relief with respect to its enforcement regarding a withholding agent’s determinations of the character and source of payments for withholding and reporting purposes.” Alternatively, even if the term “obligation” as used in the FATCA May 2014 Relief Notice was broadly construed to include grandfathered obligations, it appears that the relief would only relate to the IRS Notice’s shorter six month relief period for obtaining and reviewing Forms W-8BEN-E, W-8IMY, etc. from entities. The FATCA May 2014 Relief Notice does not appear to support any relief beyond July 1, 2014 relating to obtaining and reviewing Forms W-8BEN from individuals.

These are our initial observations. We will continue to monitor and analyze related developments going forward.

## About the Authors

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