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BLOG POST

Final FATCA Regulations Impact Foreign Oil and Gas Traders

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On January 28, 2013, the Treasury Department issued its final regulations under Sections 1471, *et seq.* of the Internal Revenue Code of 1986, as amended (the "Code"), otherwise known as the Foreign Account Tax Compliance Act ("FATCA"). There is now a clear timetable for foreign financial institutions ("FFIs"), as defined in Code Section 1471(d)(4), to enter into a FATCA agreement with the IRS by the end of 2013 unless they are located in countries with a Model 1 intergovernmental agreement ("IGA") in place with the U.S. Treasury. FFIs located in countries with a Model 2 IGA must still enter into a FATCA agreement with the IRS.

Pursuant to Code Section 1471(d)(5)(C), a financial institution is any entity that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in "financial assets." The term "financial assets" includes securities, partnership interests, commodities, or any interest in securities, partnership interests or commodities. Physical commodities that are actively traded fall within this definition, as well as forward, future and other derivative contracts in commodities. The final regulations include the additional defined term "investment entity."

The three types of foreign investment entities, all FFIs, are defined as follows:

1. any entity that primarily conducts as a business (meaning its gross income from the trading activity equals or exceeds 50% of its gross income for the three prior years or since its existence) one or more of the following activities or operations for or on behalf of a customer: (i) trading in money market instruments, foreign currency, foreign exchange, interest rate and index instruments, transferable securities or commodity futures; (ii) individual or collective portfolio management; or (iii) otherwise investing, administering, or managing funds, money, or financial assets;

2. an entity with gross income primarily attributable to investing, reinvesting, or trading in financial assets if the entity is managed by another financial institution, including an entity described in (A) above; and

3. an entity that functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.

For this purpose, the term financial assets include commodities that are actively traded. Thus, any foreign investment entity that trades in, or holds itself out as trading in, oil and gas, whether physical or cash settled contracts, is required to register as an FFI and agree to report certain information about its investors and activities to the IRS because it is trading in "financial assets."

The U.S. Treasury also plans to enter into Model IGAs with most, if not all, of America's tax treaty partners who have already agreed to share tax information with the IRS pursuant to the terms of those treaties. The purpose of the Model IGAs is to reduce the burden of FATCA compliance on FFIs in those countries. However, the definitions contained in such IGAs do not conform with the definitions contained in the final treasury regulations. In the Model 1 and 2 IGA, for example, definition of "financial assets" is more narrowly defined and it is unclear whether oil and gas traders located in a jurisdiction that has executed a Model 1 or 2 IGA will be required to comply with FATCA's information reporting requirements. In the Model 1 and 2 IGAs, the term "investment entity" means any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer: (1) trading in money market instrument, foreign exchange, exchange, interest rate and index instruments, transferable securities or trading in commodities futures; (2) individual and collective portfolio management; or (3) otherwise investing, administering, or managing funds or money on behalf of other persons. There is no mention of "financial assets" or "commodities that are actively traded" and, therefore, the definition may exclude an entity that trades physical commodities.

Based on the distinction between commodities futures contracts and physical commodities, a foreign oil and gas trader in a country with a Model 1 or 2 IGA in place with the IRS could argue that it is not required to comply with FATCA. An oil and gas trader in a jurisdiction with a Model 2 IGA in place could take the position that since it is not an FFI pursuant to the Model 2 FATCA Agreement, it is not required to enter into an agreement with the IRS. On the other hand, a foreign oil and gas trader located in a country without a Model IGA would have to comply with FATCA (because it is an FFI under the final Treasury Regulations) or incur a 30% withholding tax on certain U.S. source payments and certain passthru payments, *i.e.*, payments from another FFI. Treasury has not yet issued final regulations with respect to foreign passthru payments.

Treasury Regulation Section 1.1473-1(a) defines a "withholdable payment" as any U.S. source FDAP income, which means fixed or determinable annual or periodical income (generally passive investment income). It is unclear whether a trader of commodities would generate any U.S. source FDAP income related to its trading activities, since its income would consist of gains on the purchase and sale of commodities and FATCA withholding arising from the gross proceeds of sales only applies to the sale of assets that produce dividends or interest. However, if a foreign trader of commodities posted collateral related to such trading activities in an account with a U.S. broker/dealer, payments of interest on such collateral could be subject to FATCA withholding. Thus, other than certain payments on collateral the foreign oil and gas trader may post with a U.S. counterparty, it is unlikely that such trader would receive any "withholdable payments."

Nevertheless, mistakes are often made. A withholding agent may impose FATCA withholding on a payment to an oil and gas trader based on a lack of documentation or a misunderstanding as to whether an entity is managed by another financial institution or holds itself out as a collective investment vehicle. When mistakes are made, the injured party has to apply for a refund. If the mistake is discovered before the final Form 1042 is filed by the withholding agent (generally within the first quarter of the following year), the agent can adjust its deposits and reimburse the injured party directly. However, if the mistake is not discovered in time, or is not adjusted in time, the beneficial owner of the income must apply to the IRS for a refund. A foreign oil and gas trader, for example, would have to apply for a taxpayer identification number and then apply for a refund on a Form 1120-F. As part of the process, the party seeking the refund must prove that it is in fact the beneficial owner of the income from which the tax was withheld. That may be difficult to do if the withholding agent withheld for lack of documentation or because of a mistake. There may be no way of tracing the income received by a beneficial owner to the tax deposited with the IRS by a withholding agent without a tracing mechanism in place that the IRS has approved which would work for indirect owners.

Additionally, as noted above, no Treasury regulations were issued with respect to foreign passthru payments. One common problem that occurs with foreign-to-foreign payments in another area of withholding is the "cascading withholding" problem. Recently, Validius Reinsurance Ltd., based in Bermuda, filed suit to claim a refund because of the IRS' position in Revenue Ruling 2008-15 that the federal excise tax on insurance premiums paid to foreign insurance companies applies on a "cascading basis." Despite tax court decisions concluding that withholding tax should be collected only once, Revenue Ruling 2008-15 contends that the excise tax applies on reinsured and retroceded U.S. risks when the risk is transferred from one foreign reinsurer to another. Treasury Regulations Section 1.1474-4 provides that the FATCA withholding tax should only be applied once. However, similar to the issue involving the "cascading insurance excise tax," over withholding is likely to occur, and the beneficial owners of the income be will forced to sue for refunds. Without an effective mechanism to trace tax deposits to withholdable payments that occur outside of the United States, the refund procedures outlined in the final regulations may prove inadequate.

Thus, foreign oil and gas traders should contact their banks, brokers and tax professionals to ensure that if required, they are FATCA compliant. Even if a foreign oil and gas trader is not an FFI, it may be viewed as a passive non-financial foreign entity which is required to provide additional information on its Form W-8BEN to avoid FATCA withholding. Foreign oil and gas traders should take steps now to ensure that they are on the correct path to compliance.

On the other hand, Treasury should issue additional guidance allowing withholding agents to apply for refunds on behalf of the recipients of withholdable payments. Otherwise, taxpayers from Argentina to China could be required to file for refunds, in English, and obtain a U.S. taxpayer identification number. The administrative burden on doing that may be too much, creating a tax windfall for the Treasury. Alternatively, it may result in trading activity in U.S. commodities markets moving abroad to foreign markets.