



The Foreign Account Tax Compliance Act (FATCA)

I. OVERVIEW

A. What is FATCA?

FATCA, as it is colloquially known, refers to Chapter 4 of the US Internal Revenue Code, which was enacted by the Hiring Incentives to Restore Employment (HIRE) Act on March 18, 2010. FATCA requires non-US foreign financial institutions (FFIs) and non-US non-financial entities (NFFEs) to identify and disclose their US account holders and members or become subject to a new 30% US withholding tax with respect to any payment of US source income and proceeds from the sale of equity or debt instruments of US issuers (hereinafter referred to as Withholdable Payments).

B. Why Was FATCA Enacted?

This legislation is a direct result of the focus by the United States (and other industrialized and developing countries) on combating offshore tax evasion and recouping much needed tax revenues. The legislation was proposed to remedy perceived deficiencies in the current methods used by the US Internal Revenue Service (IRS) and the US Department of Justice (DOJ) to identify US persons who utilize foreign financial accounts or foreign entities and thereby provide more information to the IRS to enforce compliance. The legislation was also prompted by the well-publicized prosecution of a large and well-known Swiss bank that facilitated US tax evasion.

C. What is the Purpose of FATCA?

The overall purpose is to detect, deter and discourage offshore tax abuses through increased transparency, enhanced reporting and strong sanctions.¹ The ultimate goal of the legislation is for the United States to obtain information with respect to offshore accounts and investments beneficially owned by US taxpayers rather than to collect any tax through the new withholding regime.

D. When Will FATCA Become Effective?

FATCA will become effective with respect to payments after December 31, 2012 (subject to a limited transitional rule). The reason for the delayed effective date is to permit FFIs and NFFEs to

¹ FATCA also contains other provisions related to US tax compliance that directly impact US taxpayers, which are not discussed herein.

adapt internal procedures and information technology systems to transition into this new reporting and compliance system regime.

E. Who Will Be Affected by FATCA?

FATCA will have a direct and profound impact on FFIs that have US proprietary investments, US account holders, or US financial dealings. FATCA's impact will be magnified by the cascading of international financial transactions that flow through numerous entities. Each time a FFI receives or makes a payment that is a Withholdable Payment, it will be impacted by FATCA. Under US law, an FFI can be treated as a US withholding agent.

F. How Will Foreign Law Impact Compliance with FATCA?

FATCA is a US-centric law that imposes expansive compliance obligations on FFIs, which are subject to local-centric laws and oversight. FFIs are subject to regulatory oversight and laws in their home country and in countries in which they conduct business through branches and subsidiaries. FATCA requires that an FFI obtain, verify and transmit information to the IRS, close accounts of certain account holders referred to as Recalcitrant Account Holders and/or collect a 30% US withholding tax on Withholdable Payments made to Recalcitrant Account Holders or non-compliant FFIs. Questions will arise whether an FFI will be violating local laws in taking such actions, thereby exposing it to potential regulatory sanctions and potential lawsuits from account holders or others. Further, if an FFI has branches in other countries, it may not be possible for these branches to transmit account information to the home office based on constraints of local law in the jurisdiction in which the branch is located. These local law constraints may conflict with the implementation of FATCA unless rationalized.

G. How Will the IRS Implement FATCA?

Congress granted the IRS with broad regulatory authority to implement FATCA. The IRS has requested comments from FFIs and others as to how FATCA should be implemented and issued preliminary guidance with respect to certain issues, again, subject to comment. In drafting guidance to implement FATCA, the IRS will endeavor (1) to construct a workable information reporting and withholding system that can be effectively implemented and utilized by US withholding agents and non-US entities affected by the legislation; (2) to obtain information consistent with the purposes of the legislation and (3) in a manner that will not discourage or disrupt foreign investment in US capital markets.

The IRS is in the process of seeking comments from FFIs, NFFEs and other interested parties and has issued a Notice (Notice 2010-60) providing some preliminary thinking as to how it may implement FATCA; interested parties are in the process of commenting on this recently issued notice. The IRS encourages interested parties, including FFIs to submit comments and meet personally with the IRS to discuss open issues.

H. What Options Are Available to FFIs and NFFEs?

FFIs and NFFEs affected by FATCA will have a simple choice to make as to whether they agree to comply with FATCA or not. FFIs and NFFEs that would like to continue to invest on their

own behalf or on behalf of clients in the US capital markets will have to agree to comply with the new provisions. Those that do not agree to comply with the new provisions will suffer a 30% withholding tax and thus will be unable to compete with those FFIs and NFFEs that are compliant. Certain FFIs, rather than incurring the new U.S. withholding tax, may simply choose to cease to hold US securities for their own account and not have US account holders or, alternatively, cease to maintain accounts on behalf of US persons unless they hold only non-US securities. Even for those FFIs that cease to have a direct involvement in the United States, FATCA may impact them through the Passthru Payment rule discussed below. However, for those FFIs and NFFEs in countries that hold substantial amount of US dollars, engage in significant trade with the US or otherwise want to expand their commercial relationships with the United States, disengaging from the United States capital markets is not an option and it will be necessary to work with the IRS in crafting workable rules to implement and comply with FATCA. Many FFIs no longer are accepting US account holders or making it very expensive for a US account holder to open an account. Other FFIs are structuring their affairs to seal off US account holders in a separately incorporated entity to function as an investment advisor that is US SEC compliant and compliant with local regulatory provisions and walling off US account holders from all other subsidiaries and branches. This technique may facilitate compliance with FATCA in a less expansive way than if the FFI had to determine US account holders on a global basis.

I. What Are the Challenges for an FFI to Implement FATCA?

An FFI will face a significant challenge in implementing FATCA since FATCA requires the adoption of new protocols apart from the know your customer and anti-money laundering procedures and other locally-mandated protocols that FFIs currently utilize in vetting new account holders and customers. The adoption of internal procedures and information technology to implement FATCA will require knowledge of the IRS rules that will be applied, a significant lead time to draft new procedures and software and educating personnel in these new procedures. This will require an enormous expenditure of resources and funds, particularly for FFIs with a large customer base. For smaller FFIs, the costs associated with complying with FATCA may not be commensurate with the benefits to be derived from compliance and these entities may opt not to comply.

II. How FATCA Works

A. What is a Withholdable Payment?

1. General Rule. A Withholdable Payment, except as otherwise provided by the IRS pursuant to its broad grant of regulatory authority, means (1) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments and other fixed or determinable annual or periodical gains, profits and income from sources within the United States; (2) interest paid on deposits by foreign branches of domestic banks (which normally would be foreign source income); and (3) gross proceeds from the sale or other disposition of US stocks and securities.

- Note, the gross proceeds concept can result in a US withholding tax under FATCA even though an FFI or NFFE has a loss on the sale or exchange of a US stock; for example, an FFI purchases US stock for 1,000, the stock depreciates to 600 and a

non-compliant FFI sells the stock for 600. The FFI will suffer a 180 US withholding tax even though it has a loss on the transaction.

2. Exceptions.

- An FFI is not subject to US withholding on a Withholdable Payment if such payment is made to the FFI's US branch and treated as effectively connected with the FFI's US trade or business; *i.e.*, the US branch of the FFI is required to file a US tax return and report the income. However, even in this case, an FFI that has a US branch to which this exception applies may still have to enter into an IRS agreement.
- Notice 2010-60 also likely will extend an exemption from withholding to holding companies, certain foreign retirement plans and certain insurance/reinsurance companies.

B. How FATCA Applies to FFIs.

1. **Overview.** An FFI that derives a Withholdable Payment is subject to a 30% US withholding tax unless:

- The FFI enters into an IRS agreement and complies with its terms and conditions; *i.e.*, Participating FFI.
- The FFI is deemed to meet the IRS reporting requirements; *i.e.*, a Deemed Compliant FFI.
- The FFI is excepted from application of the FATCA rules; *e.g.*, such as a governmental entity.

2. What is an FFI?

The term FFI is broadly defined and includes three categories of non-US entities:

- ***Entities that accept deposits in the ordinary course of a banking or similar business***, to include commercial banks, savings banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions.
- ***Entities that as a substantial portion of their business hold financial assets for the account of others***, to include broker-dealers, clearing organizations, trust companies, custodial banks and entities acting as custodians with respect to the assets of employee-benefit plans.
- ***Entities that are engaged or hold themselves out as being primarily engaged in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any derivative interest therein***, to include mutual funds (or their non-US equivalents), hedge funds, private equity and venture capital

funds, other managed funds and investment vehicles whether widely held or privately owned (hereinafter defined as a Foreign Investment Vehicle).

- The definition of FFI is sufficiently broad to encompass certain insurance/reinsurance companies.
- In Notice 2010-60, the IRS indicated that it does not view the issuance of insurance/reinsurance contracts without cash value as implicating FATCA; *e.g.*, property or casualty insurance/reinsurance contracts, term life insurance contracts.
 - However, other contracts such as life insurance (other than term life insurance without cash value or annuity contracts) typically combine insurance protection and investment components. These types of contracts may be covered by FATCA.

3. What is a US Account of an FFI?

- **Accounts Covered.** In order for an account to be covered by FATCA, it must constitute a *financial* account that is owned, directly or indirectly, by a US person (US Account).
- **Financial Account.** This term, except as otherwise provided by the IRS, means with respect to an FFI: (1) any depository account maintained by the FFI; (2) any custodial account maintained by the FFI; and (3) a non-publicly traded debt or equity interest in an FFI.
- **US Account.** A US account is a financial account which is held by one or more Specified US Persons or US Owned Foreign Entities, as those terms are defined below.
 - **Exception to US Account.** A US Account held by a US individual citizen or resident is not a US account if, with respect to each individual holder of such account, the aggregate value of all depository accounts held (in whole or in part) by such holder and maintained by the FFI **does not exceed US\$ 50,000**. An FFI can elect not to apply to this exception if it would be too difficult to apply.
 - Note, an important issue is the application of this rule where an FFI has branches in other countries (which are treated as part of the FFI) and the home office based on the law of the countries in which the branches are located is unable to obtain information from such branches in order to apply this exception with respect to the identity of US account holders.

4. Which US Persons Are Covered?

- **Specified US Person.** A specified US person includes: a US citizen and resident, a privately owned domestic corporation (*but does not include a publicly traded company and*

its more than 50 percent controlled affiliates), a domestic partnership, and a domestic trust, and excludes certain other US entities.

- **US Owned Foreign Entity.** A foreign entity which has one or more Substantial US Owners. A Substantial US Owner means, with respect to a corporation, any specified US person that owns, directly or indirectly, *more than 10%* of the stock of such corporation by vote or value. Comparable rules are provided for ownership in partnerships and trusts. For Foreign Investment Vehicles, the 10% ownership rule does not apply, which means an investment by a US person below 10% is reportable.

5. IRS Agreement. The IRS agreement requires that the FFI (to include its more than 50% owned affiliates, unless an affiliate enters into a separate IRS agreement) to agree:

- To obtain such information regarding each holder of each account maintained by the FFI as is necessary to determine which accounts (if any) are US Accounts;
 - Notice 2010-60 provides preliminary but lengthy and detailed guidance with respect to this requirement. The Participating FFI will need to determine:
 - Whether individual account holders are to be treated as US persons or other persons and
 - Whether account holders that are entities are to be treated as US persons, Participating FFIs, Deemed Compliant FFIs, Non-Compliant FFIs, non-US persons excepted from FATCA, Recalcitrant Account Holders, NFFEs excepted from FATCA, other NFFEs and other accounts.
 - Separate screening rules will apply for *pre-existing* financial accounts held by individuals, *new* financial rules held by individuals, *pre-existing* financial accounts held by other entities and *new* financial accounts held by other entities.
- To comply with IRS verification and due diligence procedures with respect to the identification of U.S. accounts;
 - Notice 2010-60 requests comments regarding the procedures performed about how to perform verification and due diligence with respect to the identification of US accounts.
- To annually report US Account information to the IRS;
 - The FFI is required to report information with respect to accounts for:
 - Specified US Persons.
 - US Owned Foreign Entities.

- Note, a Foreign Investment Vehicle that is owned by a Specified US Person is a US Owned Foreign Entity irrespective of the level of ownership in that entity by the Specified US Person and thus the Specified US Person's interest is subject to reporting.

➤ Information to be reported:

- (1) The name, address and taxpayer identification number (TIN) of each account holder that is a Specified US Person and, in the case of any account holder that is a US Owned Foreign Entity, the name, address and TIN of each Substantial US Owner of such entity;
 - (2) The account number;
 - (3) The account balance or value determined at such time and in such manner as the IRS may prescribe; and
 - (4) Except to the extent provided by the IRS, the gross receipts and gross withdrawals or payments from the account (as determined by IRS regulations).
 - Alternative reporting method. The FFI may elect to be subject to the same reporting as a US financial institution (which requires broad information reporting). If this election is made, the FFI must provide the information specified in (1) and (2) above but does not have to report the information specified in (3) and (4) above. Under this election, the FFI is required to report the information as if each US Account holder were a natural person and citizen of the United States.
 - Note: if this option is elected, the FFI must report US and foreign source income and gross proceeds, irrespective of whether the amounts are paid inside or outside the US.
 - The IRS is developing a new form for information reporting to be filed electronically.
- To withhold 30% on Passthru Payments; *i.e.*, Withholdable Payments made by an FFI to a Recalcitrant Account Holder or a Non-Compliant FFI (as defined below);
- A Passthru Payment is any Withholdable Payment or other payment to the extent attributable to a Withholdable Payment and includes a Withholdable Payment to a Recalcitrant Account Holder and a Non-Compliant FFI.
- A Recalcitrant Account Holder is (1) an account holder that fails to comply with reasonable requests for information pursuant to IRS mandated verification and due diligence procedures to identify US Accounts, (2) that fails to provide a name, address and taxpayer

identification number or (3) fails to provide a bank secrecy waiver upon request.

- A Non-Compliant FFI is an FFI that does not enter into an IRS agreement and otherwise does not satisfy any other exception to entering into an IRS agreement.
- Purpose of Passthru Payments. The purpose of a requiring withholding on Passthru payments is to permit a Participating FFI to continue to remain in compliance with its agreement, even if some of its account have failed to provide the FFI with the information necessary for the FFI to properly determine whether the accounts are US accounts and perform the required reporting, or, in the case of account holders that are FFIs, are Non-Compliant FFIs. The rule also encourages FFIs that do not invest directly in the US or that do not hold US assets that produce Withholdable Payments, but which benefit from investments that produce payments that are attributable to Withholdable Payments, to enter into an IRS agreement.
 - The IRS is requesting comments on the methods an FFI should use to determine whether payments it makes are attributable to Withholdable Payments.

➤ Foreign Law Implications.

- Under local law, can an FFI withhold the 30% US tax without the consent of the account holder? Under the laws of many jurisdictions, an FFI would not have that authority.
 - Notice 2010-60 proposes that the IRS requires reporting of financial accounts held by Recalcitrant Account Holders and Non-Compliant FFIs; query, whether that type of reporting would violate local law restrictions on disclosure?
- To comply with additional IRS information requests with respect to US Account Holders; and
 - To attempt to obtain a waiver in any case in which any foreign law would (but for the waiver) prevent the reporting of information as required under this provision, and if a waiver is not obtained within a reasonable period of time, to close the account.
- Note, under local law, it may not be possible for an FFI to close an account for this reason.

The IRS may terminate the agreement if the FFI is out of compliance with the agreement.

6. Certain FFIs Deemed to Meet Reporting Requirements (Deemed Compliant FFIs). The statute provides two procedures for FFIs to avoid having to enter into an IRS agreement because, for example, the FFI may not have US Accounts:

- First, if the FFI complies with such procedures as the IRS may prescribe to ensure that the FFI does not maintain US Accounts *and* the FFI meets such other requirements as the IRS may prescribe, with respect to accounts of other FFIs maintained by the first FFI.
- Second, if the FFI is a member of a class of institutions with respect to which the IRS has determined that the application of the agreement/withholding provisions is not necessary.

7. Exceptions. Any payment beneficially owned by any :

- Foreign government (to include political subdivisions) and wholly owned agencies or instrumentalities of a foreign government.
 - There is an issue as to whether a sovereign wealth fund is covered by this exception.
- International organizations (or wholly owned agencies or instrumentalities thereof).
- Foreign central bank of issue.
- Any other class of persons identified by the IRS as posing a low risk of tax evasion.

8. Refunds.

- Entitlement to Refund.
 - An FFI that is subject to withholding could obtain a refund with appropriate documentary support that reflects:
 - The FFI is the beneficial owner of the payment that has been subject to withholding;
 - The FFI is entitled to a reduced rate of tax with respect to such payment by reason of a US bilateral income tax treaty obligation; and
 - The beneficial owner of the payment provides the IRS with such information as the IRS may require to determine whether such beneficial owner is a US Owned Foreign Entity and the identity of any Substantial US Owners of such entity. (It is not entirely clear how this requirement would apply to an FFI.)

- No Interest. If an FFI is due a credit or refund, no interest shall be allowed or paid with respect to such credit or refund.
- No Entitlement to Refund. If an FFI is not a treaty beneficiary, the FFI is not entitled to obtain a credit or refund.

C. How FATCA Applies to NFFEs.

1. General Rule. Under a companion provision, a foreign entity (to include a foreign company, partnership or trust) other than an FFI (an NFFE) that derives Withholdable Payments can avoid the New US Withholding Tax Regime if the NFFE (or the beneficial owner) satisfies the foregoing requirements:

- The NFFE (or beneficial owner) provides the withholding agent either: (a) with a certification that the NFFE does not have Substantial US Owner (*i.e.*, a Specified US Person that owns more than 10% of the foreign entity) or (b) the name, address and TIN of each Substantial US Owner to the IRS;
- The withholding agent does not know, or have no reason to know, that any information provided above is incorrect and;
- The withholding agent reports the information to the IRS in such manner as the IRS may provide.
 - Note, NFFE reporting under this companion provision does not require that the FE enter into an agreement with the IRS.

2. Exceptions. The general rule above does not apply to any payment (except as otherwise provided by the IRS) beneficially owned by:

- Any corporation, the stock of which is regularly traded on an established securities market;
- Any corporation which is a member of the publicly traded controlled group (more than 50 % ownership);
- Any entity which is organized under the laws of US possession and which is wholly-owned by one or more *bona fide* residents;
- Any foreign government (political subdivision), or any wholly-owned agency or instrumentality of the foregoing;
- Any international organization or any wholly owned agency or instrumentality;
- Any foreign central bank of issue; and

- Any other class of foreign persons identified by the IRS as posing a low risk of tax evasion.

3. Refunds.

- A beneficial owner may obtain a refund with appropriate documentary support.
- In order to obtain a refund, either as a result of the application of a rate reduction in a US bilateral income tax treaty or an Internal Revenue Code exemption (such as the interest portfolio interest), the beneficial owner of the payment must provide the IRS with such information as the IRS may require to determine whether such beneficial owner is a US Owned Foreign Entity and the identity of any Substantial US Owners of such entity.
- An NFFE that is entitled to a refund or credit is entitled to interest.