

# Foreign Account Tax Compliance Act (“FATCA”) – What You Need to Know

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# Introduction



# Introduction

- What is FATCA
- What to Do?
- The Future of the US as a Financial Center
- Lessons from the VD Proam

FATCA



## Introduction

- The Hiring Incentives to Restore Employment (“HIRE”) Act of 2010 was signed into law by President Obama on March 18, 2010. Although the HIRE Act is primarily aimed at helping businesses hire and retain new employees by providing them with tax incentives, it also included the Foreign Account Tax Compliance Act (“FATCA”) provisions.
- On August 27, 2010, the IRS issued Notice 2010-60 (“Notice”) outlining proposals for future guidance on FATCA withholding and reporting provisions.



# Summary of FATCA

1. Imposes a 30% withholding tax on payments to “foreign financial institutions” (“FFIs”) and certain “non-financial foreign entities” (“NFFEs”).
2. Repeals exception to withholding on foreign-targeted bearer bonds.
3. Treats certain “dividend equivalent” payments received by foreign persons as dividends.
4. Establishes new disclosure rules with respect to “foreign financial assets” (“FFAs”).
5. Authorizes new reporting and disclosure requirements with respect to passive foreign investment companies (“PFICs”).
6. Imposes penalties for underpayments attributable to undisclosed FFAs.
7. Creates 6-year statute of limitations for significant omissions of income in connection with FFAs.
8. Establishes new rules applicable to foreign trusts.



# 1. Withholding on Payments to FFIs and NFFEs

- FATCA imposes an obligation to withhold 30% of **withholdable payments to foreign financial institutions** (“FFIs”) and certain **non-financial foreign entities** (“NFFEs”).



## 1.1 Withholdable Payments

- Any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, or emoluments from sources within the United States.
- Any other fixed or determinable annual or periodical gains, profits, and income from sources within the United States.
- Any *gross proceeds from the sale* of any property that *could* produce interest or dividends from sources within the United States.
- Payment of income effectively connected with the conduct of a US trade or business is **not** treated as a “withholdable payment.”

## 1.2 Foreign Financial Institutions

- FATCA defines an FFI as any “financial institution” that is a foreign entity. A financial institution for these purposes is:
  - any entity that accepts deposits in the ordinary course of a banking or similar business, (i.e., banks, etc.)
  - any entity that is engaged in the business of holding financial assets for the account of others, (i.e., broker dealers, clearing houses, trust companies, etc.) and
  - any entity engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, commodities, or any interest (including a futures or forward contract or option) in securities, partnership interests, or commodities. (i.e., mutual funds, fund of funds, hedge funds, private equity and venture capital funds, etc.)
- The Notice further clarifies the definitions by supplying examples within each category.



## 1.3 Exception for Qualified FFIs

- Withholding is not required if an FFI enters into an agreement with the IRS to be treated as a qualified FFI (“QFFI”) and complies with certain disclosure obligations.

## 1.3 Exception for Qualified FFIs

- A QFFI is required to:
  1. Obtain information from each account holder necessary to determine which accounts are US-owned accounts;
  2. Comply with certain verification and due diligence procedures with respect to the identification of US-owned accounts;
  3. Report annually certain information with respect to any US-owned account;
  4. Comply with requests by the US Treasury Secretary for additional information with respect to any US-owned account;
  5. Withhold 30% from any “passthru payment” that is made to: (i) a recalcitrant account holder, (ii) a non-QFFI, or (iii) a QFFI that has elected to be withheld upon with respect to the portion of the payment allocable to a recalcitrant account holder or to a non-QFFI; and
  6. Attempt to obtain a waiver in any case in which any foreign law would (but for the waiver) prevent the reporting of the required information required with respect to any US-owned account maintained by the FFI; if a waiver is not obtained, the QFFI is required to close the account.

## 1.3 Exception for Qualified FFIs

### Relying on Certification by Account Holder

- A QFFI may rely on certification from an account holder as to whether an account is a US-owned account, and with respect to the name, address and TIN of each specified US person and substantial US owner only if neither the QFFI nor any entity that is a member of its expanded affiliated group knows (or has reason to know) that any information provided by the account holder in the certification is incorrect.

## 1.3 Exception for Certain FFIs

### Excluded FFIs

- Certain foreign entities that satisfy the definition of financial institution will be specifically excluded from being FFIs, and thus not subject to FFI withholding. Although this exclusion will classify them as NFFEs, the Notice indicates that no NFFE withholding will be required either.
  - Certain holding companies
  - Start-up companies
  - Non-financial entities that are liquidating or emerging from reorganization or bankruptcy
  - Hedging/financing centers of a non-financial group

## 1.3 Exception for Certain FFIs

### Insurance Companies

- Insurance companies whose business consists solely of issuing contracts without cash value will be treated as non-financial institutions.
- Comments are being requested on appropriate treatment of insurance companies whose business includes issuing contracts which combine insurance protection with an investment component.

### Financial Institutions Organized in U.S. Territories

- The IRS does not intend to treat such FIs as FFIs.

## 1.3 Exception for Certain FFIs

### Low Risk Exception – Retirement Plans

- Although a retirement plan may qualify as a financial institution the IRS will issuance guidance that certain retirement plans pose a low risk if they:
  - qualify as a retirement plan under the law of the country in which it is established,
  - are sponsored by a foreign employer, and
  - do not allow U.S. participants or beneficiaries other than employees that worked for the foreign employer in the country in which such retirement plan is established during the period in which benefits accrued.

## 1.3 Exception for Certain FFIs

### Deemed Compliance by an FFI

- Certain FFIs that fall under the category of primarily investing in securities but do not qualify under either of the other two categories will be treated as deemed-compliant FFIs (and thus not subject to withholding) if they:
  - specifically identify each individual, specified U.S. person, or excepted NFFE that has an interest in such entity,
  - obtain from each such person the required documentation as if they were a new account holder, and
  - report to the IRS any documented FFIs.

## 1.3 Exception for Certain FFIs

### Withholding Election by an FFI

- A FFI may elect to have a US withholding agent or a QFFI withhold on payments made to the electing FFI if the payment is allocable to accounts held by non-QFFIs or by recalcitrant account holders. This election is an alternative to acting as a withholding agent for the payments that the electing FFI makes to non-QFFIs, other electing FFIs, or recalcitrant account holders.
- The electing FFI must notify the withholding agents of its election and must provide them information necessary to determine the appropriate amount of withholding. Additionally, the electing FFI must waive any right under a treaty with respect to an amount withheld pursuant to the election.

## 1.3 Exception for Certain FFIs

### Election by an FFI to report as if a US financial institution

- A FFI may make an election to report as if the FFI were a US person.
- Under this election, the FFI is required to report on each account holder that is a specified US person or US-owned foreign entity (as defined above) as if the holder of the account were a US citizen. As a result, both US- and foreign-source amounts (including gross proceeds from securities, real estate, etc., that are currently reportable by brokers) are subject to information reporting regardless of whether the amounts are paid inside or outside the United States.
- If an FFI makes the election, it will also be required to report the following information with respect to each US-owned account maintained by it:
  - the name, address, and TIN of each account holder that is a specified US person;
  - the name, address, and TIN of each substantial US owner of any account holder that is a US-owned foreign entity; and
  - the account number of the account.
  - This election can be made by an FFI even if other members of its expanded affiliated group do not make the election.

## 1.3 Exception for Other Classes

### U.S. Branches of FFIs

- An FFI will be relieved from withholding with respect to income taken into account as effectively connected income (ECI).
- Where a U.S. branch of an FFI receives withholdable payments that are not eligible for the ECI exclusion the FFI generally will be required to execute a QFFI Agreement to avoid being subjected to withholding.

### Controlled Foreign Corporation (“CFC”)

- CFCs will remain subject to CFC reporting requirements and, if they qualify, become subject to FFI reporting requirements.



## 1.4 Interaction of the QFFI Regime with the Qualified Intermediary Regime

- QFFIs that are also Qualified Intermediaries (“QIs”) are required to meet the requirements of both the QFFI regime and the QI regime.
- Consequently, withholding agents will have to withhold under FATCA on withholdable payments to FFIs that are QIs, but not QFFIs, even though all required QI documentation has been received.

## 1.5 Withholdable Payments to NFFEs

- FATCA requires withholding agents to deduct and withhold a tax equal to 30% of any withholdable payment made to a “non-financial foreign entities” (“NFFEs”) where the beneficial owner of the payment is an NFFE, unless the NFFE provides the withholding agent with:
  - the name, address, and TIN of each substantial US owner of the NFFE, or
  - a certification that the NFFE does not have a substantial US owner.
- This withholding does not apply where the beneficial owner is a publicly traded corporation or a member of an expanded affiliated group of a publicly traded corporation.



## 1.5 Exception for Certain NFFEs

- Investment funds and other entities that have a small number of direct or indirect account holders all of whom are individuals or NFFEs will not be subject to withholding. (i.e., small family trust settled and funded by a single person for the sole benefit of his or her children)
- Also, certain entities excluded from FFI status will also be exempted from NFFE withholding—
  - Certain holding companies
  - Start-up companies
  - Non-financial entities that are liquidating or emerging from reorganization or bankruptcy
  - Hedging/financing centers of a non-financial group

## 1.6 Credits and Refunds

- Beneficial owners may file a US tax return to claim a refund (or credit) for overpayment if applicable.
- If a beneficial owner of a payment is entitled under an income tax treaty to a reduced rate of withholding tax, that beneficial owner may be eligible for a credit or refund of the excess of the amount withheld.
- If a payment is of an amount not otherwise subject to US tax (because, for instance, the payment represents gross proceeds from the sale of stock or is interest eligible for the portfolio interest exemption), the beneficial owner of the payment generally is eligible for a credit or refund of the full amount of the tax withheld.
- Additionally, no credit or refund is allowed with respect to tax properly withheld unless the beneficial owner of the payment provides the Treasury Secretary with information to determine whether the owner is a US-owned foreign entity and the identity of any substantial US owners of the entity.



## 1.7 Liability and Indemnity

- A person required to deduct and withhold on any withholdable payment and fails to do so automatically becomes liable for any tax due.
- Conversely, a withholding agent is indemnified against claims based on the amounts withheld under FATCA.



## 1.8 Identification of Persons by FIs

### Preexisting Accounts

- \$50K threshold
- Must search electronically searchable information for indicia of U.S. status

### New Accounts

- \$50K threshold
- Must search all documentation for indicia of U.S. status

## 1.9 Reporting Requirements

### Annual Reporting Requirements by QFFIs

- A QFFI is subject to annual information reporting requirements. These requirements obligate the QFFI to report the following information in respect of US-owned accounts annually:
  - The name, address, and TIN of each account holder that is a specified US person;
  - The name, address, and TIN of each substantial US owner of any account holder that is a US-owned foreign entity;
  - The account number;
  - The account balance or value; and
  - The gross receipts and gross withdrawals or payments from the account.



## 1.10 Effective Date

- The FATCA provisions on withholding and QFFIs will apply to withholdable payments made after December 31, 2012.

## 2. Repeal of Foreign-Targeted Obligation Exception

- FATCA repeals the foreign targeted obligation exception to the denial of a deduction for interest on bonds not issued in registered form.
- Interest will only qualify as portfolio interest (with 0% withholding) if it is paid on an obligation that is issued in registered form. Accordingly, interest paid to a foreign person on an obligation that is not issued in registered form is subject to US withholding tax at a 30% rate (subject to reduction under an applicable treaty).

### Effective Date

- The provision will apply to debt obligations issued more than two years after the date of enactment (issued after March 18, 2012).

### 3. Dividend-Equivalent Payments Treated as Dividends

- FATCA treats a “dividend-equivalent” as a dividend from US sources for certain purposes, including the US withholding tax rules applicable to foreign persons.
- A “dividend equivalent” is:
  - any substitute dividend;
  - a payment made under a “special notional principal contract” that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from US sources; or
  - any other payment that the Treasury Secretary determines is substantially similar to the payment above.
- The payments that are treated as US-source dividends will be the gross amounts that are used in computing any net amounts transferred to or from the taxpayer. For purposes of withholding of tax on nonresident aliens and foreign corporations and the new withholding imposed under FATCA, each person that is a party to a contract or other arrangement that provides for the payment of a dividend equivalent is treated as having control of the payment, and thus will be required to withhold.

#### Effective Date

- The provision is effective for payments made on or after the date that is 180 days after the date of enactment. (September 14, 2010)

## 4. Disclosure of Foreign Financial Assets

- FATCA requires individual taxpayers with an interest in a specified “foreign financial asset” (“FFA”) during the taxable year to attach a disclosure statement to their income tax returns for any year in which the aggregate value of all such assets is greater than \$50,000.
- The information to be included on the statement includes:
  - identifying information for each asset and its maximum value during the taxable year;
  - for an account, the name and address of the institution at which the account is maintained and the account number;
  - for a stock or security, the name and address of the issuer, and any other information necessary to identify the stock or security and terms of its issuance;
  - for all other instruments or contracts, or interests in foreign entities, the information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counterparties.

### Effective Date

- The provision is effective for taxable years beginning after the date of enactment. (For individuals, 2011)

## 5. New Reporting Requirements for PFICs

- FATCA requires each person who is a shareholder of a PFIC to file an annual information return. The substance of such returns is not specified in the legislation.

### Effective Date

- The provision is effective as of the date of the enactment, but since no information is specified in the legislation, as a practical matter it will not be effective until the IRS promulgates such regulations. The Notice did not cover this provision.



## 6. Penalties for Underpayments for Undisclosed FFAs

- FATCA adds a new accuracy related penalty of 40% on any understatement attributable to undisclosed foreign financial assets.

### Effective Date

- The provision is effective for taxable years beginning after the date of enactment. (For individuals, 2011)

## 7. Statute of Limitations for Significant Omissions of Income from FFAs

- FATCA authorizes a new six-year limitations period for assessment of tax on understatements of income attributable to FFAs.
- FATCA also suspends the limitations period for assessment if a taxpayer fails to provide timely information returns required with respect to passive foreign investment corporations and the new self-reporting of FFAs.

### Effective Date

- The provision is generally effective for returns filed after the date of enactment.



## 8. New Rules for Foreign Trusts

## 8.1 US Beneficiaries Presumed for Foreign Trust with US Grantors

- A foreign trust is presumed to have a US beneficiary unless the US person that directly or indirectly transfers property to a foreign trust submits information and demonstrates to the satisfaction of the US Treasury Secretary that:
  - under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a US person, and
  - if the trust were terminated during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a US person.
- The provision applies to transfers of property after the date of enactment. It is important to note that the provision applies only if a US person has transferred property to the trust; it does not apply to other foreign trusts.



## 8.2 Uncompensated Use of Trust Property

- FATCA provides that any use of trust property by the US grantor, US beneficiary or any US person related to a US grantor or US beneficiary is treated as a distribution of fair market value of the use of the property to the US grantor or US beneficiary.
- The use of property is not treated as a distribution if the trust is paid the fair market value for the use of the property within a reasonable period of time. A subsequent return of property treated as a distribution is disregarded for tax purposes.
- The provision applies to loans made and property used after the date of enactment.



## 8.3 Reporting Requirement for US Owners of Foreign Trusts

- FATCA requires a US person who is treated as an owner of any portion of a foreign trust to provide information as may be required with respect to the trust, in addition to ensuring that the trust complies with its reporting obligations.
- The provision is effective for taxable years beginning after the effective date.

## 8.4 Minimum Penalty for Failure to Report

- The initial penalty for failing to report is the greater of \$10,000 and one of the following: (i) 5% of the value of the portion of a grantor trust owned by a US person who fails to cause an annual return to be filed for the trust by the trustee, (ii) 35% of the value of the property transferred to a foreign trust by the US person who then fails to report the creation of the trust or the transfer to it, or (iii) 35% of the amount distributed to a distributee who fails to report distributions.
- The provision applies to notices and returns required to be filed after December 31, 2009.

What to do?



## What to do?

- *Identify High-Risk Businesses*
- *Identify High-Risk Assets*
- *Identify KYC and U.S. Tax Mismatches*



## Guidance for Banks

- Under FATCA, the world is pretty much divided into FFIs and NFFEs. This definition includes multinational corporations and partnerships that have subsidiary entities likely to meet this definition, which will be required to put systems into place--unless the institutions:
  - Block all U.S. persons from being clients of the institution; or
  - Block all U.S. investments on behalf of their clients.
- For SEC, Even Clearer, Block US Persons



## Guidance for Trust Companies

- The first issue is that trustees and trust companies are caught by FATCA.
- Trustees caught by Dodd-Frank
- Given these facts, trustees should, as a minimum, start identifying all trust arrangements that have U.S. persons connected to them. This will take time as most trusts have wide classes of beneficiaries and identifying them has never been a part of the documentation process for establishing their U.S. status.



## Guidance for Funds

- No industry will be hit harder by FATCA than the fund management industry.
- There are two major reasons for this: **<NL>**
  - Most funds were the beneficial owner of their assets from a U.S. tax perspective, allowing them to provide a Form W-8BEN; and
  - Most funds do not know who their investors are, as this is specifically permitted by most country anti-money laundering rules.



## Guidance for Funds

- At this point, we suggest the following:
  - Fund prospectuses should prohibit investment by U.S. persons as defined not only under the U.S. securities definition, but also the tax definition.
  - Contractual agreements should be signed by all distributors to ensure the same standard is maintained.
  - A system for annual compliance should be developed to ensure there are no U.S. persons in the fund.



## Circular 230 Disclosure

Pursuant to requirements related to practice before the Internal Revenue Service, any tax advice contained in this presentation is not intended to be used, and cannot be used, for purposes of (i) avoiding penalties imposed under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another person any tax-related matter.

# The Future of the US as a Financial Center



## The Future?

- Still a HUGE internal market
- Still a the largest capital market, but is becoming harder to work with it
- Still the largest investment banking center
  - None of this will change



## The Future?

- As a Wealth Management Center for Europeans
  - Arguable a less onerous place to have an account
  - Is Disclosure Risk Less?
  - Pasquantino?

# The VD Penalty Program



# The 2009 Penalty Framework

- Badly Managed
- Badly Administered
  - IRS informally admits this
- The Database Created



## Questions?

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