FATCA: Forget About Tax and Compliance Avoidance

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The Foreign Account Tax Compliance Act (FATCA) represents a paradigm shift in government's approach to international tax compliance and an innovation in eliciting voluntary compliance across sovereign borders. It is a response to the reality that offshore tax evasion remains rampant despite the existing complex diligence, reporting and withholding regime that imposes, in many cases, draconian penalties for non-compliance. While FATCA strengthens already stiff penalties for individual non-compliance, the sea change is that financial institutions are made the beast of the compliance burden. With foreign financial institutions being forced to act as "tax intermediaries" for the Internal Revenue Service (the "IRS") and report on U.S. customers, an avalanche of penalties is about to descend upon taxpayers who, until now, have successfully ducked the IRS, whether intentionally or not.

This Alert will briefly summarize some of the major rules and requirements of FATCA, as well as the proposed regulations recently issued by the U.S. Treasury and the IRS addressing its implementation.

FATCA Overview

FATCA will operate by imposing a 30% withholding tax on all "withholdable payments" made to foreign financial institutions (FFIs) and nonfinancial foreign entities (NFFEs), unless they comply with specified requirements. "Withholdable payments" are defined as payments of interest, dividends, rents, salaries, and other fixed or determinable annual or periodical (FDAP) gains, profits, and income from any U.S. source, as well as gross proceeds from the disposition of property that can produce U.S. source interest or dividends.

In order to avoid this 30% withholding obligation, FFI's are required to enter into an agreement (an "FFI Agreement") with the IRS under which they agree to identify all its account holders who are U.S. taxpayers and report account information to the IRS, including the identity of the account holder, the balance in the account, and the amount of withdrawals or payments from the accounts. The FFI Agreement will also provide a verification process for determining a participating FFI's compliance with its FFI Agreement. Among other things, a participating FFI will be required to: (1) adopt written policies and procedures governing the participating FFI's compliance with its responsibilities under the FFI Agreement; (2) conduct periodic internal reviews of its compliance (rather than have periodic external audits, as required for many Qualified Intermediaries); and (3) periodically provide the IRS with a certification and certain other information that will allow the IRS to determine whether the participating FFI has met its obligations under the FFI Agreement.

In contrast, in order for NFFE's to avoid FATCA withholding, they generally must certify to the payor that they do not have any "substantial" (generally over 10%) U.S. owners, or provide the payor with the name, address, and tax ID number of each substantial U.S. owner. Certain foreign entities (so-called "excepted NFFEs") are exempt from this withholding tax. Under FATCA, excepted NFFEs include (i) publicly traded corporations, (ii) any corporation that is a member of the same "expanded affiliated group" as a publicly traded corporation, (iii) entities organized under the laws of a U.S. territory and wholly owned by residents thereof, (iv) foreign governments or agencies or instrumentalities thereof, (v) foreign central banks, and (vi) "active NFFEs"). An active

NFFE is any NFFE if less than 50% of its gross income for the calendar year is passive income and less than 50% of its assets are assets that produce, or are held for the production of, dividends, interest, rents and royalties (other than those derived in the active conduct of a trade or business), annuities, or other passive income.

Proposed Regulations

Earlier this year, the U.S. Treasury and the IRS issued proposed regulations designed to provide detailed guidance on the U.S. account identification, withholding and information reporting requirements of FATCA (the "Proposed Regulations"). The Proposed Regulations not only incorporate guidance outlined in previous IRS notices, but also revise and refine those rules to, among other things, provide exemptions and carve-outs from FATCA where the risk of tax evasion is low and stagger timelines for implementation. A brief summary of some of the major provisions of the Proposed Regulations follows below.

Definition of Financial Account

Under FATCA, FFIs that enter into an FFI Agreement ("participating FFIs") are required to identify their "U.S. accounts" and comply with various verification and due diligence procedures. A U.S. account is defined as any "financial account" held by one or more specified U.S. persons or U.S.-owned foreign entities, subject to certain exceptions. A "financial account," in turn, generally is defined by FATCA to mean any depository account, custodial account, or equity or debt interest in an FFI, other than interests that are regularly traded on an established securities market. The Proposed Regulations refine the statutory definition of financial account to focus on traditional bank, brokerage, money market accounts, and interests in investment vehicles, and to exclude most debt and equity securities issued by banks and brokerage firms, subject to anti-abuse rules.

In particular, the Proposed Regulations provide that debt or equity that is "regularly traded" on an "established securities market" will not be treated as a financial account. A debt or equity interest in a financial institution is a financial account if the financial institution is primarily engaged in the business of investing, reinvesting, or trading securities, such as a private investment fund. If the financial institution is a bank or insurance company or holds financial assets for the accounts of others, a debt or equity interest is a financial account only if the value of those interests is determined primarily by reference to assets that give rise to withholdable payments. In addition, certain insurance and annuity contracts are considered financial accounts if they include an investment component.

Excluded Entities, Deemed-Compliant Entities and Low-Risk Entities

The proposed regulations provide for three special classes of entities: (i) entities that are excluded from the definition of "financial institution" ("Excluded Entities"); (ii) "deemed-compliant" FFIs, which are not required to enter into FFI Agreements in order to avoid the FATCA tax; and (iii) entities that are exempt from the FATCA tax because Treasury and the IRS have determined that they pose a low risk of tax evasion ("Exempt Beneficial Owners"). These categories are quite narrow, and most FFIs will not qualify for one of them. For example, although certain types of foreign investment entities may be deemed-compliant FFIs, private equity and hedge fund entities will generally not qualify for this treatment.

1. Excluded Entities. Entities that will be exempt from the FATCA tax include holding companies and intercompany financing companies for non-financial groups, certain bankrupt and start-up entities, NFFEs that are publicly traded corporations and NFFEs that are engaged in active businesses.

2. Deemed-Compliant FFIs. Under the Proposed Regulations, deemed-compliant FFIs are divided into two categories: registered deemed-compliant FFIs and certified deemed-compliant FFIs. A registered deemed-compliant FFI is required to register with the IRS, satisfy certain procedural requirements, certify that it meets the requirements of its applicable Deemed-Compliant FFI category, and renew its certification every three years. This category includes (1) local FFIs, (2) members of affiliated groups, including a participating FFI, that transfer preexisting accounts of certain U.S. persons and nonparticipating FFIs to a participating FFI,

(3) investment funds of which all holders of record are participating FFIs, deemed-compliant FFIs, or exempt beneficial owners (certain entities generally exempt from FATCA, including foreign governments and their controlled entities), and (4) investment funds that are prohibited from marketing interests to certain U.S. persons and nonparticipating FFIs and that are subject to other restrictions.

A certified deemed-compliant FFI is not required to register with the IRS, but will certify to the relevant withholding agent that it meets the requirements of its Certified Deemed-Compliant FFI category on a Form W-8. This category includes (1) local banks, (2) retirement plans, (3) nonprofit organizations exempt from tax in their country of organization, and (4) FFIs with exclusively low-value accounts (i.e., accounts with balances of $50,000 or less) and that have no more than $50 million in assets on their balance sheets.

3. Exempt Beneficial Owners. The following types of FFIs will be exempt from the FATCA tax in respect of payments they receive as beneficial owners (but not in respect of payments they receive as intermediaries): foreign governments and their political subdivisions and wholly owned instrumentalities and agencies; international organizations and their wholly owned instrumentalities and agencies; foreign central banks of issue; governments of U.S. possessions; certain foreign retirement funds; and foreign investment entities that are wholly owned by one or more other exempt beneficial owners.

Due Diligence Requirements

As noted above, in order to comply with FATCA reporting requirements, participating FFIs must identify and report U.S. accounts in accordance with detailed due diligence procedures. The proposed regulations outline in detail the due diligence that participating FFIs will be required to undertake to identify their U.S. accounts, recalcitrant account holders, and accounts held by nonparticipating FFIs. These requirements rely in significant respects on participating FFIs' existing procedures, including those required by "know your customer" and anti-money-laundering ("AML") rules, and include provisions intended to minimize the administrative burden relating to pre-existing accounts.

In general, no due diligence will be required for pre-existing accounts with values up to $250,000 (if maintained for entities) or up to $50,000 (if maintained for individuals). With respect to pre-existing accounts maintained for individuals outside the U.S. with values up to $1 million, a participating FFI will be permitted to rely primarily on electronically searchable information.

In addition, a responsible officer of a participating FFI must make certain certifications to the IRS, including a certification that he or she has completed the review of its high-value accounts as required under the rules, as well as a certification that the participating FFI has not had, since August 6, 2011, any practices or procedures in place to assist account holders in avoiding FATCA.

The reporting obligations of Participating FFIs with respect to U.S. accounts will be phased in. In 2013 and 2014, participating FFIs will be required to report only the account number, identifying information about the account holders (and, in the case of account holders that are foreign entities, certain of their U.S. owners) and the value of the account. Reporting on income payable to U.S. accounts will begin with respect to 2015, while full reporting, including reporting on all gross proceeds, will begin with respect to 2016.

Withholding on Passthru Payments

The Proposed Regulations phase in the passthru payment regime in two steps. Beginning on January 1, 2014, Participating FFIs will be required to withhold 30% of any passthru payments that are withholdable payments made to a recalcitrant account holder or a nonparticipating FFI. Beginning no earlier than January 1, 2017, the scope of passthru payments will be expanded beyond withholdable payments, and FFIs will be required to withhold on such payments in accordance with future guidance. To reduce incentives for nonparticipating FFIs to use Participating FFIs to avoid the FATCA rules, the Proposed Regulations require that Participating FFIs report annually to the IRS the aggregate amount of certain payments made to each nonparticipating FFI for the 2015 and 2016 calendar years.

A "passthru payment" generally is defined as any (a) withholdable payment or (b) other payment made by a participating FFI to the extent attributable to a withholdable payment received by the FFI. The Proposed Regulations provide that the IRS is still considering rules for when a payment will be treated as attributable to a withholdable payment. A "recalcitrant account holder" is any account holder that fails to provide the information required to determine whether the account is a US account, or the information required to be reported by the FFI, or that fails to provide a waiver of a foreign law that would prevent reporting.

Transitional Rules for FFI Affiliated Groups

An FFI will generally not be permitted to be a Participating FFI unless all of its branches are FATCA-compliant and every other FFI with which it is affiliated is either a Participating FFI or a deemed-compliant FFI. The proposed regulations provide that until January 1, 2016, an FFI may become a Participating FFI even if it has branches or affiliates that are not FATCA-compliant, provided that those branches or affiliates (i) are subject to laws that prohibit various aspects of FATCA compliance and (ii) agree to comply with certain due diligence and other requirements. During the transition period, withholding agents will be required to treat the relevant branches or affiliates as non-participating FFIs. Thus, until January 1, 2016, an FFI affiliate in a jurisdiction that prohibits reporting or withholding under FATCA will not prevent the other FFIs in its affiliated group from becoming Participating FFIs, provided that the FFI in the restrictive jurisdiction agrees to certain due diligence, record-keeping, and other requirements with respect to its U.S. accounts.

Expanded Scope of Grandfathered Obligations

Under FATCA, payments with respect to obligations that are issued or held by funds and were issued and outstanding on or before March 18, 2012, are permanently exempt from the FATCA withholding regime. The proposed regulations extend this relief to obligations issued and outstanding on January 1, 2013. In either case, however, material modifications to an instrument's terms after the relevant date may result in a deemed exchange of the grandfathered instrument for a newly issued instrument that would not be grandfathered.

Intergovernmental Approach Announced

In connection with the Proposed Regulations, the U.S. Treasury released a joint statement with France, Germany, Italy, Spain, and the United Kingdom outlining a possible intergovernmental approach to implementing FATCA and automatic information exchange between partner countries. Under the proposed framework, the U.S. and a partner country would enter into an agreement in which the partner country would agree to collect information required by FATCA and transfer that information to the IRS. This would allow FFIs in the partner country to avoid having to enter into an agreement with the IRS and would eliminate U.S. withholding on payments to FFIs established in the partner country. The agreement would also include a commitment by the U.S. to reciprocity regarding automatic collecting and reporting on the U.S. accounts of residents of the partner country.

On July 26, 2012, the U.S. Treasury released two model agreements to be entered into by the U.S. and partner countries that reflect the intergovernmental approach outlined in the joint statement. The idea behind the model agreement framework is to resolve the concern that FATCA's reporting requirements conflict with the privacy laws in many countries that prohibit divulging customer information. In partner countries that enter into the model agreement, covered FFIs would not be required to report information directly to the Treasury. Instead, such FFIs would report certain information to their own governments, which would automatically provide such information to the U.S. pursuant to an existing tax treaty or tax information exchange agreement. Because FFIs will be required to participate and obtain information as required under FATCA, such FFIs will generally be treated as participating FFIs and therefore not subject to FATCA withholding.

Foreign Financial Asset Reporting Requirements

In addition to imposing a host of complex reporting obligations on FFIs, FATCA also significantly expands international reporting requirements for individuals and trusts who own foreign assets. As if taxpayers are not already overwhelmed by the plethora of foreign account disclosure requirements – most notably, the Report of

Foreign Bank and Financial Accounts (FBAR) on Form TD F 90.22-1 – now certain U.S. individuals holding specified foreign accounts in excess of $50,000 are required to file Form 8938 (Statement of Specified Foreign Assets). The information required to be reported on Form 8938 largely overlaps with the information required to be disclosed on an FBAR, but it covers a far broader range of foreign assets than the FBAR. For instance, certain private equity assets held through hedge funds that were exempted under the FBAR rules will now have to be reported on the Form 8938.

Due to concerns that U.S. taxpayers are using foreign trusts to avoid U.S. tax, FATCA also makes a number of changes in the rules governing foreign trusts. For example, FATCA expands the classes of persons considered trust U.S. grantors and U.S. beneficiaries, thus bringing more foreign trusts under U.S. tax jurisdiction.

Conclusion

When FATCA goes live next year, it will have a significant impact on foreign banks, funds, and other foreign persons, as well as on most U.S. taxpayers with offshore connections. Foreign entities subject to these new rules should put mechanisms into place now that will enable them to comply with the various due diligence and reporting requirements and avoid an unnecessary US withholding tax burden. Individuals with foreign assets should immediately consult with practitioners familiar with international tax compliance rules, as the odds of avoiding IRS scrutiny have plummeted under FATCA. ■

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