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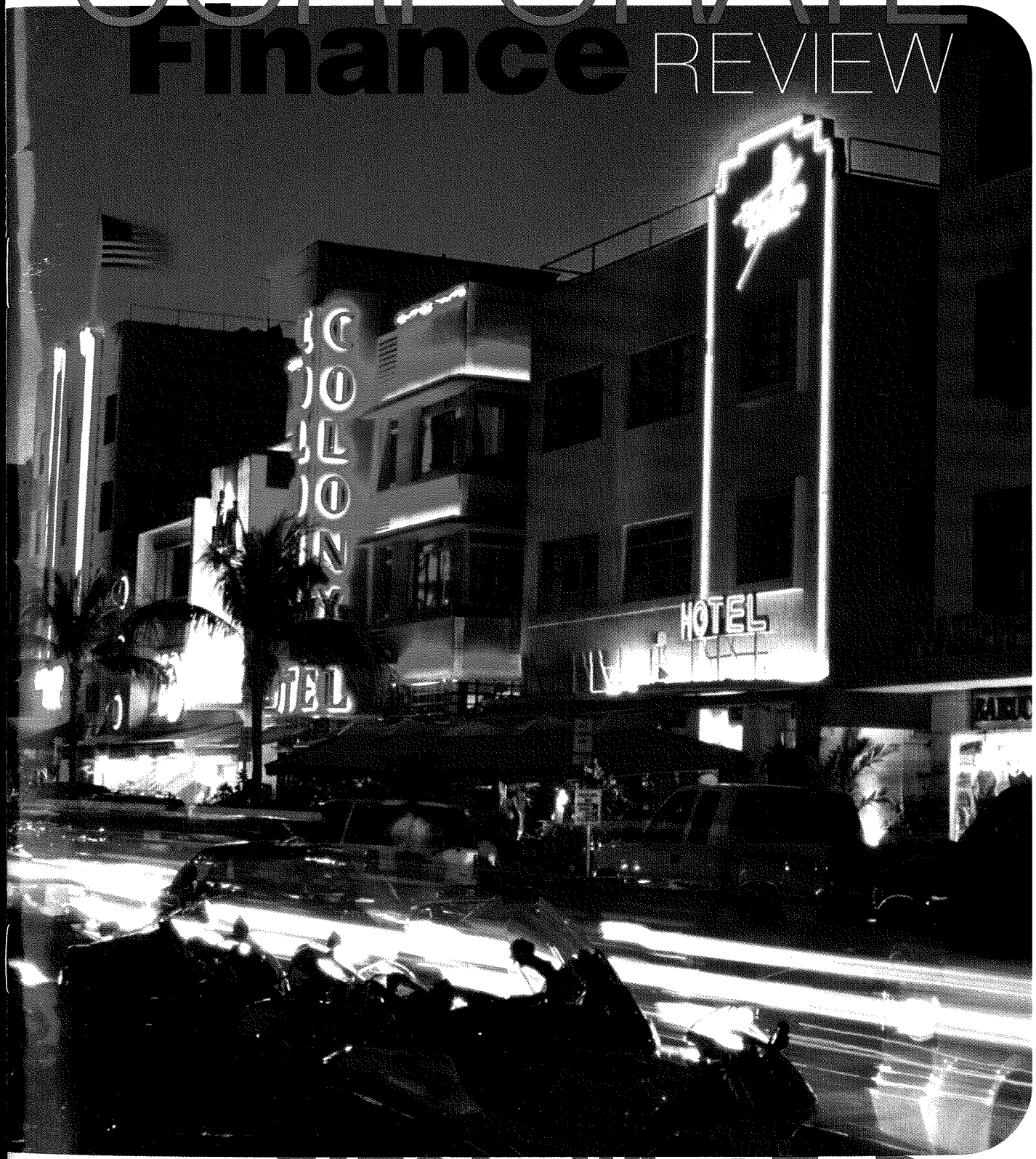

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FATCA—WHAT NON-U.S. FINANCIAL INSTITUTIONS SHOULD DO NOW

FATCA imposes substantial new reporting and withholding obligations on non-U.S. financial institutions.

KURT G. RADEMACHER AND SAMANTHA R. MOORE

The Foreign Account Tax Compliance Act (FATCA) has been the talk of the financial services industry since it was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act on March 18, 2010. FATCA imposes substantial new reporting and withholding obligations on non-U.S. financial institutions (including banks and trust companies). Initially, much of the industry chatter surrounding FATCA involved threats from non-U.S. financial institutions to close their doors to U.S. clients. However, once the scope of FATCA became clearer, non-U.S. financial institutions realized that even this drastic step would not extricate them from FATCA's draconian reporting and withholding regime because the reporting/withholding obligations apply to investments in U.S. securities made on behalf of clients—irrespective of whether those clients are U.S. persons.

Practically, FATCA only offers non-U.S. financial institutions two choices: (1) implement costly U.S. style reporting and account due diligence on behalf of a foreign revenue agency or (2) cease offering U.S. securities to clients. How many non-U.S. financial institutions will choose the latter option remains to be seen. Though many in the U.S. government probably failed to fully appreciate the issue, Congress and the White House in fact gambled with the U.S. financial markets in enacting FATCA.

The U.S. government's gamble was that U.S. financial markets comprise such an integral component of the portfolios of non-U.S. investors that such investors would choose not to do business with a financial institution that was unable to offer such securities—or at least unable to offer them without imposition of a 30 percent withholding tax. If the bet turns out to be a winner, the IRS will obtain substantially more information from

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non-U.S. financial institutions on U.S. tax dodgers without pushing already fragile U.S. financial markets into another tailspin. If the bet turns out to be a loser, non-U.S. financial institutions will dump their U.S. investment platforms, non-U.S. investors will flee the U.S. financial markets in droves (taking billions of dollars in shareholder value with them), and the IRS will have little more information than it already possesses about U.S. tax dodgers.

Time will tell whether the U.S. government's grand wager pays off. If it does not, ordinary Americans will see their investment/retirement plan balances plummet through no fault of their own, and the already fragile U.S. recovery could be impacted.

FATCA legislation

FATCA classifies non-U.S. entities as either foreign financial institutions (FFIs) or non-financial foreign entities (NFFEs). FFIs and NFFEs are each subject to their own set of reporting obligations and due diligence requirements in relation to the accounts that they maintain; this article focuses on FATCA's impact on FFIs. The stated goal of these due diligence and reporting requirements is to root out U.S. beneficial ownership of accounts/entities that have not been reported to the IRS. Obviously, the IRS does not have the manpower to physically audit each and every non-U.S. financial institution or entity to investigate U.S. connections. Under FATCA, this obligation rests with FFIs themselves instead of with the IRS, thus accomplishing the unprecedented step of turning non-U.S. financial institutions into a *de facto* enforcement mechanism for a foreign tax authority—the IRS.

One might reasonably ask why any financial institution in its right mind would agree to take on the audit function for a foreign tax authority. The answer is that FFIs that fail to comply with FATCA's reporting/withholding obligations will incur a 30 percent withholding tax collected at source on any dividends, interest, or sales proceeds generated from U.S. securities.[1]

Taking a simple example, if a London bank that does not enter into an FFI Agreement with the IRS invests $50 of its U.K. resident client's funds in IBM stock, that investment grows in value to $100, and the bank then sells the IBM stock for $100 at the client's direction, the sales proceeds will be subject to a 30 percent withholding tax. The client will therefore only receive $70 from the sale. The draconian nature of this result becomes only more evident when one considers that if the U.K. resident client had invested directly in the IBM stock and had realized the $50 gain personally, no portion of that gain would have been taxable in the U.S., since gains on sales of U.S. stocks are not U.S.-sourced income so long as the seller is not a U.S. citizen or resident.

Under FATCA, a $50 gain that would have been tax-free if realized directly becomes subject to $30 of tax (a 60 percent effective U.S. federal tax rate) when realized through a non-participating FFI. When faced with such dire U.S. federal income tax consequences, clients who wish to maintain some U.S. equity exposure in a single portfolio will have no economic alternative to investing with a qualified FFI.

THE STATED GOAL OF THESE DUE DILIGENCE AND REPORTING REQUIREMENTS IS TO ROOT OUT U.S. BENEFICIAL OWNERSHIP OF ACCOUNTS/ ENTITIES THAT HAVE NOT BEEN REPORTED TO THE IRS.

FATCA guidance

In addition to the FATCA legislation itself, the IRS has issued three notices explaining how the provision will apply to non-U.S. financial institutions.

Notice 2010-60. The HIRE Act grants the U.S. Treasury Department authority to exempt certain entities from reporting/withholding as FFIs. Notice 2010-60 describes the U.S. Treasury Department's intention to issue regulations exempting the following entities, among others, from FFI treatment:

- Traditional holding companies that hold interests in operating companies that are not themselves engaged in the financial services industry (but not including private equity funds, venture capital funds, or leveraged buyout funds);
- Non-U.S. start-up companies investing capital for the purpose of

establishing a business other than a financial institution for a period of 24 months after organization (but not including a venture fund or other start-up fund that invests in non-U.S. entities);
- Certain non-financial institutions that are in the process of reorganizing or emerging from bankruptcy;
- An entity primarily engaged in hedging transactions for members of its affiliated group, so long as the members of the affiliated group are not primarily financial institutions;
- Insurance companies that issue policies without cash value, such as property and casualty insurance and term life insurance (treatment of cash value life insurance and annuity product issuers was not provided);
- "Small family trusts" settled by a single person for the sole benefit of his or her children (treatment of more complex trust structures was not provided);
- Investment entities that obtain information about their owners and report to the IRS (under guidance to be issued) any owner who is a U.S. person; and
- Certain non-U.S. retirement plans that qualify as such under local law, are sponsored by non-U.S. employers, and only allow U.S. persons who are employees to contribute.

CONTROLLED FOREIGN CORPORATIONS WERE NOT EXEMPTED FROM THE FFI TREATMENT.

Controlled foreign corporations were not exempted from the FFI treatment, despite the fact that they are already subject to substantial information reporting.

Notice 2010-60 also specifies the due diligence requirements that FFIs must apply in determining which new or pre-existing bank accounts it must report to the IRS. The rules differ for pre-existing individual accounts, pre-existing entity accounts, new individual accounts, and new entity accounts.

For certain pre-existing individual accounts, FFIs are required to identify, from electronically searchable data, any "indicia of potential U.S. status" including:
- Whether an account holder has been identified as a U.S. person;
- Whether the account holder has a U.S. address;
- Whether the account holder's place of birth is in the U.S.;
- Whether the account lists an "in care of" address or P.O. box as its sole address;
- Whether a power of attorney or signature authority is granted to a person with a U.S. address; and
- Whether the account is subject to standing directions to transfer funds to an account in the U.S.

For new entity accounts, the FFI is required to determine whether they are U.S. accounts from all available information—even if such information is not electronically searchable.

Notice 2010-60 also describes the information that FFIs must report in relation to U.S. accounts and noted that FFIs will be required to provide account-related information to the IRS upon request (including copies of account statements).

The notice requested comments (but did not provide guidance) on whether non-U.S. collective investment schemes that prohibit U.S. investors should be excepted from reporting/withholding.

Notice 2011-34. On April 8, 2011, the IRS issued Notice 2011-34. Notice 2011-34 expands on Notice 2010-60 by singling out the private banking industry for special scrutiny and placing significant reporting responsibilities on private banking relationship managers (RMs) for all pre-existing accounts that do not meet a limited *de minimis* threshold.

A non-U.S. bank or trust company that chooses to participate in the FFI program to avoid withholding tax liabilities on U.S. securities must ensure that its private banking RMs screen all existing private banking accounts for any U.S. indicia. The screening process includes: (1) identifying those clients whom the RM has actual knowledge are U.S. persons and (2) performing a "diligent review of the paper and electronic account files and other records for each client" of the RM to identify "each client (including any associated family members) who, to the best of the knowledge of the private banking relationship man-

ager, has" any indicia of U.S. person status.

U.S. indicia for these purposes include:

- U.S. citizenship or green card for the account holder;
- U.S. birthplace for the account holder;
- U.S. residence or mailing address (including a U.S. post office box) for the account;
- Standing instructions to transfer funds to an account maintained in the U.S. or directions regularly received from a U.S. address;
- An "in care of" address or a "hold mail" address that is the sole address with respect to the client; or
- A power of attorney or other signatory authority granted to a person with a U.S. address.

If the RM identifies an account with any U.S. indicia, he or she must undertake a second level of due diligence to establish whether the account in question is a U.S. account. Procedures required to establish U.S. account status vary based upon the U.S. indicia present, but generally the RM must obtain from the client an IRS Form W-9 (if the client is a U.S. person) or an IRS Form W-8BEN (if the client is not a U.S. person). In addition to IRS Form W-8BEN, the RM must obtain documentary evidence of non-U.S. status (such as a copy of a non-U.S. passport) for a non-U.S. person. If a client who was born in the U.S. provides the RM with IRS Form W-8BEN, the RM must also obtain a written explanation from the client describing the client's renunciation or other loss of U.S. citizenship. The RM must complete these procedures by the end of the first year in which an FFI agreement is in place between the private bank or trust company and the IRS.

Notice 2011-34 places a tremendous administrative burden on the shoulders of RMs at private banks and trust companies. First, an RM must review his or her client list to consider whether he or she has actual knowledge of any U.S. persons. The RM must then perform a "diligent review" of "paper and electronic account files and other records" for each client. The process of wading through client files and "other records" for any U.S. indicia promises to be a tedious and time-consuming exercise. Inclusion of the phrase "other records" in the notice would also seem to include recorded telephone conversations with clients that many private banks maintain, meaning that the notice may force RMs to review many hundreds of hours of recorded telephone conversations, listening for the slightest hint of U.S. indicia.

Financial institutions and trust companies that sign FFI agreements must mandate these steps as part of their policies and procedures. RMs will therefore face the daunting challenge of maintaining client relationships (and building new ones) on top of the additional time required to review voluminous account information and "other records" for each existing client.

The notice authorizes outsourcing of the review of existing client files for U.S. indicia, though primary responsibility for any errors remains with the financial institution or trust company. RMs and the institutions for which they work may find themselves with no practical alternative to outsourcing, particularly for voluminous client files where the RM does not have any reason to believe that a U.S. connection is present. Affected institutions should take care to ensure that any such outsourced review occurs within the scope of a legally privileged engagement to provide maximum privacy for client information.

NOTICE 2011-34 PLACES A TREMENDOUS ADMINISTRATIVE BURDEN ON THE SHOULDERS OF RMS AT PRIVATE BANKS AND TRUST COMPANIES.

Notice 2011-53. On July 14, 2011, the IRS issued Notice 2011-53, which provides more time for non-U.S. banks and trust companies to implement FATCA's information reporting, withholding, and documentation requirements. As originally published, Notice 2011-53 applied only to FFIs and not NFFEs. This omission left many to speculate that the phased-in implementation would simply not apply to payments made to NFFEs. However, on July 25, 2011, the IRS revised the notice to clarify that the phased-in approach would apply to NFFEs as well as FFIs.

Notice 2011-53 provides the following timetable/deadlines for FFIs to implement FATCA:

FFI Registration Timeline:

- No later than January 1, 2013: IRS will begin accepting electronic FFI applications;
- June 30, 2013: Deadline for FFIs to enter into FFI agreements to be identified as "participating FFIs" that will not be subject to FFI withholding from January 1, 2014;
- July 1, 2013 through December 31, 2013: FFIs entering into FFI agreements during this timeframe will be identified as participating FFIs for 2014 but may not be identified in time to prevent withholding beginning January 1, 2014.

Due Diligence:

- New accounts: FFIs will be required to implement account opening procedures aimed at identifying U.S. accounts beginning on the effective dates of their FFI agreements;
- Pre-existing accounts containing at least $500,000 and associated with a private banking relationship: Within one year of the effective date of the FFI agreement, an FFI must complete pre-existing account due diligence procedures described in IRS Notice 2011-34 for those accounts opened prior to the effective date of the FFI agreement;
- Pre-existing accounts containing less than $500,000 and associated with a private banking relationship: By the later of December 31, 2014 or one year after the effective date of the FFI agreement, an FFI must complete the pre-existing account due diligence procedures described in IRS Notice 2011-34 for those accounts opened prior to effective dates of the FFI agreement;
- All other pre-existing accounts: An FFI must complete required due diligence within two years of the effective date of the FFI agreement;
- The notice states that additional guidance will be provided relating to the scope of private banking due diligence procedures and the associated search of account holder files.

THE IRS HAS PROVIDED ADDITIONAL TIME FOR FINANCIAL INSTITUTIONS TO READY THEMSELVES BEFORE FATCA WITHHOLDING BEGINS.

Reporting:

- June 30, 2014: An FFI must obtain IRS Form W-9 from accounts having U.S. indicia;
- September 30, 2014: An FFI must report all accounts for which it obtained IRS Form W-9. Additionally, FFIs must report all accounts having U.S. indicia for which they were not able to obtain the required information;

Withholding:

- January 1, 2014: Withholding on U.S. sourced FDAP payments begins;
- January 1, 2015: Withholding on all withholdable payments to FFIs and NFFEs begins (including U.S.-sourced FDAP payments and gross proceeds from sales of U.S. securities);
- No sooner than January 1, 2015: FFI withholding on passthru payments to non-participating entities and recalcitrant account holders begins.

Further Guidance:

- Early 2012: IRS anticipates issuing proposed regulations;
- Summer 2012: IRS anticipates issuing final regulations, draft FFI agreements, and reporting forms for use by withholding agents and participating FFIs.

What five steps should FFIs take now?

As outlined above, the IRS has issued a substantial amount of guidance on implementation of FATCA. In recognition of the herculean effort that financial institutions face in complying with this published guidance, the IRS has provided additional time for financial institutions to ready themselves before FATCA withholding begins. Nevertheless, the substantial lead time necessary to build proper reporting/due diligence mechanisms that interface with current information technology means that financial institutions should take the following steps now:

1. FFIs should take a hard look at whether their business models require them to offer U.S. securities to their clients and whether offering a U.S. investment platform is worth

the price of substantial FATCA compliance costs;

2. FFIs should realize now that that they cannot avoid FATCA compliance obligations by closing their doors to U.S. customers;
3. FFIs that choose to offer a U.S. investment platform should enter into FFI agreements so that they become "participating FFIs" before June 30, 2013;
4. FFIs should begin investigating and then integrating tracking/reporting software into their information technology systems so that U.S. accounts can be monitored and the proper IRS reports can be generated;
5. FFIs in the private banking arena should identify a law firm with sufficient para-professional support staff and experience in reviewing voluminous documentation to assist in completing due diligence on all pre-existing accounts before the later of December 31, 2014 or one year from the effective dates of their FFI agreements. A law firm should provide this review (as opposed to a non-legal service provider) so that if the review uncovers questionable activities by any RM or other employee, this information will remain legally privileged. ■

NOTES

[1] Technically, FDAP withholding is broader than interest and dividends, but these are likely to be the most common types of non-sale payments upon which FATCA requires withholding.