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FATCA Gaining Global Acceptance in Combatting Tax Evasion

Highlights

- ✔ New Internal Revenue Code Chapter 4 provides for 30-percent withholding tax as a means to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons, or by U.S.-owned foreign entities.
- ✔ FATCA has three core elements: enhanced due diligence, information reporting, and potential withholding on U.S. source payments.
- ✔ According to the Joint Committee on Taxation, investment vehicles such as hedge funds and private equity funds will fall within the definition of "foreign financial institution".
- ✔ IRS Notice 2013-43 delayed FATCA implementation by 6 months.
- ✔ G-20 Finance Ministers endorse the OECD proposal for multilateral and bilateral automatic exchange of tax information.

Inside

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The Hiring Incentives to Restore Employment Act (HIRE) created a vast new reporting and taxing regime for foreign financial institutions with U.S. accountholders. Title V, Subtitle A of the HIRE Act, the Foreign Account Tax Compliance Act (FATCA or the Act), casts a wide net in search of undisclosed accounts and hidden income. It adds a new Chapter 4 to the Internal Revenue Code, essentially requiring foreign financial institutions to identify their customers who are U.S. persons or U.S.-owned foreign entities and then report all payments to, or activity in the accounts of, those persons to the IRS. The legislation's principal focus is tax compliance by U.S. persons having accounts with foreign financial institutions. The legislation provides substantial flexibility to Treasury and the IRS to issue regulations detailing how the new reporting and withholding tax regime will work. Participation in the existing Treasury Qualified Intermediary program will not exempt a firm from the new reporting obligations.

Tax Compliance

The legislation's principal focus is tax compliance by U.S. persons with accounts at foreign financial institutions. The Act imposes substantial new reporting and tax-withholding obligations on a broad range of foreign financial institutions that could potentially hold accounts of U.S. persons. The legislation gives Treasury and the IRS broad authority to establish verification and due-diligence procedures. The reporting and withholding obligations imposed on the foreign financial institutions will serve as a backstop to the existing obligations of the U.S. persons themselves, who have a duty to report and pay U.S. tax on the income they earn through any foreign or domestic financial account.

New Internal Revenue Code Chapter 4 provides for 30-percent withholding tax as a means to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons, or by U.S.-owned foreign entities. The provision establishes rules for withholdable payments to foreign financial institutions and for withholdable payments to other foreign entities. The Act will essentially present foreign financial institutions, foreign trusts and foreign corporations with the choice of entering into agreements with the IRS to provide information about their U.S. accountholders, grantors and owners or becoming subject to 30-percent withholding.

The Act broadly defines "foreign financial institution" to include not only foreign banks, but also any foreign entity engaged primarily in the business of investing or trading in securities, partnership interests, commodities or any derivative interests therein. According to the Joint Committee on Taxation, investment vehicles such as hedge funds and private equity funds will fall within this definition. Firms meeting the definition must enter into agreements with the IRS and report information annually in order to avoid a new U.S. withholding tax.

Core Elements

FATCA has three core elements: enhanced due diligence, information reporting, and potential withholding on U.S. source payments. FATCA requires foreign financial institutions to enter into an agreement, which Treasury calls an FFI agreement, under which the firm agrees to conduct due diligence to identify accounts of U.S. persons and foreign entities with significant U.S. ownership to annually report information about its U.S. account holders to the IRS, to close any U.S. account if the holder refuses to waive foreign legal protections that would prevent reporting and withhold pass through payments that the FFI makes to recalcitrant account holders and to other firms that have not entered into FFI agreements.

Foreign Financial Institution

As described above, FATCA defines "foreign financial institution" broadly to include many securities firms and investment vehicles. According to the Joint Committee on Taxation, investment vehicles such as hedge funds and private equity funds will fall within this definition. Foreign banks and also any foreign entity engaged primarily in the business of investing or trading in securities, partnership interests, commodities or any derivative interests therein fall within the definition. The definition includes fund entities and fund managers who are not currently within the scope of the Qualified Intermediary program. All firms meeting the definition must enter into agreements with the IRS and report information annually in order to avoid a new U.S. withholding tax on U.S.-source dividends, interest and other income, as well as U.S.-related gross proceeds. The Act also imposes related reporting and tax withholding requirements in respect of payments made to non-financial foreign entities. The reach of the legislation goes beyond traditional financial institutions and covers virtually every type of foreign investment entity.

The final Treasury IRS regulations broadly define "financial institution" and "investment entity" to effectuate the purposes of the Act to effectively and efficiently combat offshore tax evasion. The regulations define a "financial institution" as, among other things, an investment entity (§1.1471-5(d)) which, in turn, is defined as "an entity that primarily 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 instruments (checks, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures; (2) Individual or collective portfolio management; or (3) Otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons. Moreover, the entity 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." (§1.1471-5(d)(4).)

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Intergovernmental Agreements (IGAs)

Recognizing that FATCA components conflict to varying degrees with the privacy laws of other countries, Treasury was willing to arrange for government-to-government exchanges of information under reciprocal agreements. In order to avoid direct reporting, a financial institution would report the FATCA information to its home country government, which would then report the information to the IRS.

The U.S. already has a network of agreements providing for tax information exchanges with over 60 countries, either as part of an income tax treaty or in the form of a Tax Information Exchange Agreement. Treasury recognizes that bilateral solutions envision reciprocity. But the ability of the IRS to provide this information to another government is conditioned on the U.S. having in place a tax information agreement with that other government. In any event, FATCA compliance must be based on the principle of reciprocity when financial institutions based in other countries are required to provide the IRS with FATCA information.

These intergovernmental agreements with foreign governments facilitate the effective and efficient implementation of FATCA by eliminating legal barriers to participation, reducing administrative burdens, and ensuring the participation of all non-exempt financial institutions in a partner jurisdiction.

The government-to-government agreements provide an alternative means of compliance with FATCA under which a foreign financial institution, organized in a jurisdiction with an intergovernmental agreement in place, that is not exempt from FATCA as a deemed-compliant FFI or otherwise, may comply with FATCA by providing the required information to its home country government, which would thereafter provide the information to the IRS.

Generally, it is envisioned that the United States and a FATCA partner country would enter into an agreement pursuant to which the FATCA partner would agree to pursue implementing legislation to require foreign financial institutions in its jurisdiction to collect and report to the authorities of the FATCA partner the required information; enable FFIs established in the FATCA partner to diligently identify U.S. accounts; and automatically transfer to the United States the information reported by the FFIs.

In return, the United States would agree to eliminate the obligation of each FFI established in the FATCA partner to enter into a separate comprehensive agreement directly with the IRS, provided that each FFI is registered with the IRS or is excepted from registration pursuant to the agreement or IRS guidance. The U.S. would also allow FFIs established in the FATCA partner to comply with their reporting obligations under FATCA by reporting information to the FATCA partner rather than reporting it directly to the IRS and eliminate U.S. withholding under FATCA on payments to FFIs established in the FATCA partner by identifying all FFIs in the FATCA partner as participating FFIs or deemed-compliant FFIs, as appropriate. The U.S. would also identify in the agreement specific categories of FFIs established in the FATCA partner that would be treated, consistent with IRS guidelines, as deemed compliant or presenting a low risk of tax evasion. The U.S. would also commit to reciprocity with respect to collecting and reporting on an automatic basis to the authorities of the FATCA partner information on the U.S. accounts of residents of the FATCA partner.

An example of an intergovernmental agreement is one between the United States and the Federal Republic of Germany to implement the information and reporting provisions of FATCA, which introduces a reporting regime for financial institutions with respect to certain accounts. In a separate statement, the German Finance Ministry said that, with the signing of the FATCA agreement with the U.S., Germany has sent another clear signal as part of its international initiatives aimed at improving transparency and tax compliance. Germany plans to grant the authority for the enactment of a statutory instrument to implement the obligations resulting from the FATCA agreement as part of broader tax reform legislation.

Under the agreement, each reporting German financial institution must be treated as complying with, and not subject to withholding under, Section 1471 of the Internal Revenue Code if the Federal Republic complies with its obligations with respect to reporting German financial institutions, to identify U.S. Reportable Accounts and report annually to the German Competent Authority the name of each nonparticipating financial institution to which it has made payments and the aggregate amount of such payments and complies with the registration requirements applicable to Financial Institutions in Partner Jurisdictions.

The IGAs contain a provision, colloquially referred to as the "most favored nation" provision, providing that, with respect to certain terms of the IGA, including the due diligence rules, a partner jurisdiction is entitled to the benefit of any more favorable provision agreed to in a comparable IGA with another partner jurisdiction, subject to certain conditions.

A financial institution resident in a jurisdiction that is treated as having an IGA in effect will be permitted to register on the FATCA registration website as a registered deemed-compliant FFI. In addition, a financial institution may designate a branch located in such jurisdiction as "not a limited branch." A jurisdiction may be removed from the list of jurisdictions that are treated as having an IGA in effect if the jurisdiction fails to perform the steps necessary to bring the IGA into force within a reasonable period of time. If a jurisdiction is removed from the list, financial institutions that are residents of that jurisdiction, and branches that are located in that jurisdiction, will no longer be entitled to the status that would be provided under the IGA, and must update their status on the FATCA registration website accordingly.

FATCA Implementation Delayed

Very recently, in order to allow for a more orderly implementation of FATCA, Treasury and the IRS postponed by six months the start of FATCA withholding, and made corresponding adjustments to various other time frames provided in the final regulations. *IRS Notice 2013-43*. A primary reason for extending the deadline was that certain elements of the phased timeline for the implementation of FATCA were presenting practical problems for both U.S. withholding agents and foreign financial institutions. In addition, while comments from foreign financial institutions overwhelmingly supported the development of intergovernmental agreements as a solution to the legal conflicts that might otherwise impede compliance with FATCA and as a more effective and efficient way to implement cross-border tax information reporting, some comments noted that, in the short term, continued uncertainty about whether an IGA will be in effect in a particular jurisdiction hinders the ability of foreign financial institutions and withholding agents to complete due diligence and other implementation procedures.

Withholding agents generally will be required to begin withholding on withholdable payments made after June 30, 2014, to payees that are foreign financial institutions with respect to obligations that are not grandfathered obligations, unless the payments can be reliably associated with documentation supporting an exemption.

According to IRS Notice 2013-43, the FATCA registration website became available in August 2013. Financial institutions are now able to begin the process of registering by creating an account and inputting the required information for itself, for its branch operations, and, if it serves as a lead financial institution, for other members of its expanded affiliated group. Other key dates for registration, however, will be extended by six months.

All information entered will be saved automatically in the registration system and associated with the financial institution's account. For the period from the opening of the FATCA registration website through December 31, 2013, a financial institution will be able to access its account to modify or add registration information, including indicating the appropriate registration status, once established, for example, by the signing of an IGA.

Prior to January 1, 2014, however, any information entered into the system, even if submitted as final, will not be regarded as a final submission, but will merely be stored until the information is submitted as final on or after January 1, 2014. Thus, financial institutions can use the remainder of 2013 to get familiar with the registration process, input preliminary information, and refine that information. On or after January 1, 2014, each financial institution will be expected to finalize its registration information by logging into its account on the FATCA registration website, making any necessary additional changes, and submitting the information as final.

A U.S. branch of a participating FFI that is not treated as a U.S. person is required to fulfill the general requirements set forth in §1.1471-4 for withholding, due diligence, and reporting.

Draft Form 8957 Released

The IRS has released a draft FATCA *Form 8957* for public review and comment. The IRS cautioned that the form should not be printed and submitted by a financial institution in an attempt to register for FATCA. FATCA registration can be accomplished most efficiently and effectively through an electronic online process, said the IRS, which will avoid the need to print, complete, and mail paper forms. The questions that will be presented in the online process will look very similar to the questions shown on the draft form, but they will be presented differently to make electronic completion of the process as simple as possible. Financial institutions registering through the online process will receive notice of registration acceptance and obtain the Global Intermediary Identification Number (GIIN) needed to demonstrate FATCA compliance on an expedited basis.

The IRS will also accept registrations that are made on paper forms. Financial institutions should not, however, use the draft form to submit a paper registration. A final paper registration form that can be used for registration is also available, but the IRS strongly encourages using the online registration process. The IRS advised that paper registration forms will not be processed until January 2014 and financial institutions may experience a delay in receiving notice of registration acceptance and obtaining the GIIN needed to demonstrate FATCA compliance.

Endorsement by G-20 Leaders and Finance Ministers

In the final communique from their recent meeting, the G-20 Finance Ministers, including U.S. Treasury Secretary Jacob Lew, commended the progress recently achieved in the area of tax transparency and fully endorsed the OECD proposal for a truly global model for multilateral and bilateral automatic exchange of tax information. The Finance Ministers are committed to the automatic exchange of tax information as the new, global standard and fully support the OECD work with G-20 countries aimed at setting such a new single global standard for automatic exchange of information. The Finance Ministers asked the OECD to prepare a progress report, including a timeline for completing this work in 2014 and called on all jurisdictions to commit to implement this standard.

Ensuring that all taxpayers pay their fair share of taxes is a high priority in the context of fiscal sustainability, promoting growth, and the needs of developing countries to build capacity for financing development. Thus, the Finance Ministers emphasized that tax avoidance, harmful practices and aggressive tax planning have to be tackled. The spread of the digital economy also poses challenges for international taxation. The G-20 Finance Ministers fully endorsed the ambitious and comprehensive Action Plan submitted at the request of the G-20 by the OECD aimed at addressing base erosion and profit shifting with a mechanism to enrich the Action Plan as appropriate.

In a recent Q&A at a Carnegie Foundation seminar, Lael Brainard, Under Secretary of the Treasury for International Affairs, said that FATCA has been widely taken up to address longstanding problems of tax avoidance and evasion. Allowing the automatic exchange of tax information will make it impossible for domestic residents to move their accounts offshore and not pay taxes on the accounts. In that sense, the move towards what the Treasury official called "FATCA for all" is a positive development. The Organization for Economic Co-operation and Development (OECD) and the G-20 have an interest in concluding agreements for the automatic exchange of tax information to reduce tax evasion. Thus, there is a positive development in the delay of the FATCA timetable, noted the Treasury official, as FATCA is a continuing subject for discussion on the automatic exchange of tax information and preventing base erosion and profit shifting.

As part of the growing global consensus on tax evasion and tax avoidance, the G20 Leaders in the final communiqué from the St. Petersburg Russia Summit commended the progress recently achieved in the area of tax transparency and fully endorsed the OECD proposal for a truly global model for multilateral and bilateral automatic exchange of tax information. Calling on all other jurisdictions to join them by the earliest possible date, the G20 committed to automatic exchange of tax information as the new global standard.

They fully support the OECD work with G20 countries aimed at presenting a new single global standard for automatic exchange of tax information by February of 2014 and to finalizing technical modalities of effective automatic exchange by mid-2014. In parallel, they expect to begin to exchange information automatically on tax matters among G20 members by the end of 2015.

The Leaders asked the Global Forum to establish a mechanism to monitor and review the implementation of the new global standard on automatic exchange of tax information.

Senatorial Concerns

In response to *a letter* of concern from four U.S. Senators, Treasury officials said that Treasury and the IRS are committed to implementing FATCA in a way that eases burdens on financial institutions while still achieving FATCA's compliance objectives. The letter was sent by Senators Rand Paul (R-Ky.), Saxby Chambliss (R-Ga.), Mike Lee (R-Utah) and former Senator Jim DeMint (R-S.C.). In their letter, the Senators questioned the scope and authority of an intergovernmental framework for FATCA compliance featuring an arrangement under which the U.S. is willing to reciprocate in collecting and exchanging information on accounts held in U.S. financial institutions by residents in five EU countries. The Treasury assured the Senators that neither the OECD nor the European Union would be a party to any bilateral agreement for FATCA implementation and neither organization would have any say about whether the U.S. concludes a bilateral agreement with a particular country.

Senator Paul has introduced legislation, *S. 887*, to repeal the anti-privacy provisions of FATCA, which, in his view, infringe upon basic constitutional rights. He pointed out that, under FATCA, anyone considered a U.S. person would have details of their financial assets provided to the IRS without a warrant requirement, suspicious activity report (SAR), or any allegation of wrongdoing.

Senator Paul is troubled that the implementation of FATCA has allowed the Treasury Department to make independent decisions with respect to the sovereignty of foreign nations and the privacy of United States citizens. In order to implement FATCA, Treasury has initiated intergovernmental agreements, citing the intent to engage in reciprocal information sharing with other nations. Senator Paul believes that the Treasury Department, without the consent and authority of Congress, will force U.S. financial institutions to provide the bank account information of private customers to foreign nations. In his view, FATCA violates important privacy protections, disregards the sovereign laws of other nations, and will cost the U.S. economy hundreds of billions of dollars in compliance costs.

Hong Kong Monetary Authority advises on FATCA compliance

With the issue of tax evasion assuming increasing prominence within the international community and various countries having introduced or contemplating changes to their tax regimes, the Hong Kong Monetary Authority (HKMA) has advised financial institutions to ensure compliance with FATCA and other applicable overseas regulatory requirements by critically assessing the implications of such changes for their customers and operations, taking into account their scale and nature of business and geographical areas of operation. As a case in point, the HKMA specifically mentioned FATCA, which requires foreign financial institutions to report to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. To properly comply with these reporting requirements, noted the Authority, foreign financial institutions will have to enter into a special agreement with the IRS. Non-participating foreign financial institutions may be subject to withholding taxes on relevant payments received by the firms.

In a *letter* to CEOs of financial institutions authorized to operate in Hong Kong, the HKMA advised that, if the financial firms conclude that any overseas tax regime changes may have implications for their customers and operations, they should put in place processes and controls to ensure compliance and develop good practices through industry collaboration if appropriate. In the case of FATCA, the financial firms should ensure compliance by implementing controls, which among other things may include legal, compliance and operational implications, including customer communication of the foreign financial institution agreements with the IRS, and resources implications, for FATCA implementation.

The agreements require foreign financial institutions to perform additional due diligence and provide information about customers who are U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest. During this process, advised the HKMA, financial firms may obtain further information from their customers to identify those accounts maintained by U.S. persons. Whenever there is a need, advised the Authority, foreign financial firms should inform customers and obtain their specific consent before reporting the requested information to the IRS. At all times, they should ensure that they comply with all provisions of the Hong Kong Personal Data (Privacy) Ordinance and adequate preparation should be made to respond to customer inquiries, taking into account the Ordinance.

Potential Market Impact

FATCA is very broad and comprehensive in scope and is significantly impacting the banking, securities and financial industries as well as the financial markets. There may be unintended consequences that will not be apparent for years to come. The postponement is evidence of compliance issues and concerns around intergovernmental agreements. But more broadly, FATCA has recently risen to a level of global significance beyond tax and regulatory authorities to become part of the larger G-20 effort to combat tax avoidance and evasion on a cross-border basis. FATCA is being viewed through a global lens and its approach viewed as a model worthy of emulation. While not expressly mentioned, it may become tied into the OECD Action Plan on tax transparency and the creation of a truly global model for multilateral and bilateral automatic exchange of tax information, recently endorsed by the G-20 Finance Ministers.

On August 9, 2013 in the Federal Register, the IRS provided a notice with regard to Section 6039G of the Internal Revenue Code, which deals with information on individuals losing United States citizenship. This listing contains the name of each individual losing United States citizenship within the meaning of Section 877(a) of the Code, which deals with expatriation to avoid tax, and Section 877A, dealing with the tax responsibilities of expatriation, with respect to whom the Secretary received information during the quarter ending June 30, 2013. For purposes of this listing, long-term residents, as defined in Section 877(e)(2), are treated as if they were citizens of the United States who lost citizenship. Commentators noted that there was a dramatic increase over the same period a year ago, speculating that the implementation of FATCA was partially responsible for the increase. ■

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