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PRACTITIONERS' CORNER

The Current State of FATCA and Its Likely Impact on QIs in Europe

by Andrew R. Wilson

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By now everyone in the financial services industry has heard of the Foreign Account Tax Compliance Act, the new U.S. withholding tax regime that will take effect on January 1, 2013. FATCA was passed into law in 2010 and since then the U.S. Treasury, through the IRS, has issued limited guidance, all in the form of administrative notices. The latest, Notice 2011-53, states that the IRS intends to issue draft FATCA regulations by the end of 2011 and final regulations in the summer of 2012.

The purpose of this article is to put the collection of administrative guidance issued to date together with the FATCA legislation and review the main aspects of the FATCA regime. Examples of FATCA withholding further expand on the concepts presented. The goal is twofold: first, to suggest that although FATCA is a complex regime, qualified intermediaries are in a relatively good position to meet the implementation challenges; and second, to reinforce that financial intermediaries, including QIs and non-QIs, need to address how they are going to overcome the obstacles of FATCA compliance sooner rather than later.

Overview of FATCA

The FATCA regime introduces a new 30 percent U.S. withholding tax on payments to non-U.S. financial institutions (foreign financial institutions, or FFIs) and non-U.S. nonfinancial entities (nonfinancial foreign entities, or NFFEs). Under the legislation, the term ''FFI'' is broadly defined and includes not only financial intermediaries, such as banks and asset management firms, but also funds, investment vehicles, and some insurance companies. FFIs can avoid FATCA withholding by entering an agreement with the IRS (FFI agreement), thus becoming a participating FFI (PFFI) or, in limited situations, an FFI may qualify as a deemed compliant FFI (DCFFI). NFFEs can avoid FATCA withholding by disclosing its ''substantial U.S. owners,'' defined as U.S. persons holding more than 10 percent ownership of the entity, or in case the NFFE qualifies as an ''excepted NFFE,'' such as publicly traded companies and their affiliates.

The FFI Agreement

The primary requirements of the FFI agreement will include identification procedures of clients holding ''financial accounts,'' withholding on passthrough payments to noncompliant clients, and reporting information to the IRS regarding U.S. customers. Upon entering the FFI agreement, the FFI must be able to identify and classify new individual clients as U.S. or non-U.S., and for entity clients whether those are FATCA compliant (for example, PFFIs and compliant NFFEs or nonparticipating FFIs and noncompliant NFFEs). For existing clients, the FFI must perform due diligence procedures to identify and classify individual and entity clients under the FATCA scheme, with additional review procedures required for private banking accounts and financial accounts with balances of $500,000 or more. FATCA withholding will apply to payments to noncompliant customers (recalcitrant accounts), nonparticipating FFIs, and FFIs that elect to

be subject to FATCA withholding. Recalcitrant individual accounts are account holders that fail to provide documentation necessary to be identified as U.S. or non-U.S. and U.S. clients that refuse to waive any local privacy protection that would bar disclosure and reporting to the IRS. Recalcitrant entity accounts include NFFEs that fail to disclose shareholders that are substantial U.S. owners or who fail to certify they have none.

FATCA Withholding

PFFIs must apply 30 percent FATCA withholding on passthrough payments that are paid to nonparticipating FFIs and recalcitrant accounts. U.S. Internal Revenue Code section 1471(d)(7) defines passthrough payments as comprising two categories of income. The first is ''withholdable payments,'' which include:

- U.S.-source investment type income, such as dividends, interest, and royalties; and
- gross proceeds from the disposition of assets that can produce U.S.-source dividends or interest (that is, U.S. stocks, bonds, shares in U.S. mutual funds, and real estate investment trusts).

The second category is defined as any other payment to the extent attributable to a withholdable payment. This second category of income, payments attributable to a withholdable payment, is by far the most controversial aspect of FATCA.

Determining which payments are classified as withholdable payments uses traditional sourcing principles (that is, tracing). The method to identify other payments ''attributable to a withholdable payment,'' at least according to the latest indication from the IRS, is, however, to be made using fungibility concepts. A PFFI must determine its passthrough payment percentage, which is the ratio of U.S. to non-U.S. assets on its balance sheet. The PFFI must then multiply *any* payment received from another FFI (excluding withholdable payments) made to a financial account held by a recalcitrant client or nonparticipating FFI by the passthrough payment percentage and apply FATCA withholding to the resulting product. Note that the IRS appears to be still developing this aspect of FATCA, and given the overwhelming objection from the international financial community and the obvious impracticalities that the proposed method creates, it cannot be ruled out that this approach will change in future guidance.

Phase-In of FATCA Provisions

According to the latest information published by the IRS, Notice 2011-53, some breathing room from the January 1, 2013, deadline has been granted to allow time for implementing the required changes to systems and procedures. Under the recently announced phase-in of the main FATCA provisions, FFI agreements will be ready by early 2013 with the earliest effective date of July 1, 2013. The IRS has indicated that an FFI that enters into an FFI agreement by June 30, 2013, will be identified as a PFFI in time to avoid suffering FATCA withholding from its delayed start date. The phase-in of FATCA withholding begins on January 1, 2014, when U.S.-source investment income becomes subject to FATCA withholding, while gross proceeds and payments attributable to withholdable payments become subject to FATCA withholding from January 1, 2015.

Impact on Groups

The obligations of PFFIs and FATCA's impact on group companies are more stringent than under the QI regime. The FATCA client identification, due diligence, and reporting requirements apply to all ''financial accounts'' of a PFFI; for a group of companies the FATCA regime requires all affiliated FFIs in the group to become PFFIs or qualify as DCFFIs. In contrast, the QI regime allows QIs and non-QIs in the same group and the QI obligations extend only to ''QI designated accounts'' that receive U.S.-source income.

Currently, the IRS envisions that the process to apply for PFFI status by group affiliates will be conducted on a coordinated basis, with a lead FFI appointed for the group that will also serve as a central contact point with the IRS regarding ongoing certifications and other compliance matters.

Forthcoming Draft FATCA Regulations

In Notice 2011-53, the IRS indicated it would issue draft FATCA regulations by the end of 2011 and final regulations in the summer of 2012. Given the number and complexity of the issues to be dealt with, I believe the draft regulations will not be comprehensive, but rather will be intended to lay down a sufficient framework of rules that realistically can be embodied in, and approved as, final regulations by the summer of 2012. This necessarily will leave some issues unaddressed to be dealt with on a separate time frame, but this seems to be the only way to give FFIs the confidence needed to justify moving ahead with FATCA implementation plans and leave the U.S. Treasury with credibility to insist on the implementation phase-in set forth in Notice 2011-53.

What can we expect to find in the next installment of FATCA administrative guidance?

- Definition of FFI.
- Reporting on U.S. accounts.
- Documentation due diligence procedures. The ''private banking'' procedures to be extended to include entity (that is, NFFE) accounts and clarification that these procedures apply to nearly any non-retail financial account (for example, asset management firms, or trust companies).
- Verification procedures. An issue not addressed yet and crucial to implanting FATCA is that the

Examples — FATCA Withholding

Example 1. Documented Non-U.S. Individual Client (Italian Tax Resident)

USA Inc. Stock

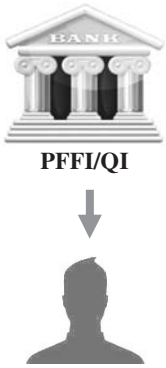
- Purchase price: $100
- Sales price: $200
- Dividend: $10

FATCA Withholding

$0

QI/Section 1441 Withholding

Dividend	$10.00
Withholding (e.g., Italy-U.S. treaty)	x 15%
Total U.S. QI/section 1441 withholding	= $1.50



PFFI/QI

Non-U.S. Account (Documented)

Notes: As a documented non-U.S. person, PFFI/QI has no FATCA reporting or withholding obligation. The U.S.-source income is taxed in the same manner as under current section 1441 rules.

Example 2. Recalcitrant Individual Account

USA Inc. Stock

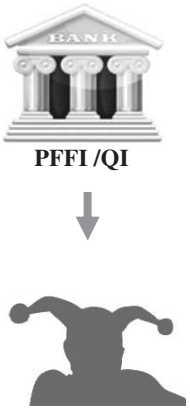
- Purchase price: $100
- Sales price: $200
- Dividend: $10

FATCA Withholding

Gross proceeds	$200
Dividend	+ $10
Total passthrough payment	$210
FATCA	x 30%
Total FATCA withholding	= $63

QI/Section 1441 Withholding

$0



PFFI /QI

Client X
Recalcitrant Account

Notes: The recalcitrant account holder, Client X, could claim a refund for the difference between the $63 FATCA withholding and the proper withholding under an applicable U.S. income tax treaty, provided: PFFI/QI gives the client proof of U.S. withholding (likely Form 1042-S), and Client X follows the U.S. tax refund mechanism by filing a U.S. income tax return and can prove he was/is a non-U.S. person and qualified resident under the relevant U.S. income tax treaty at the time the withholding was applied. Assuming a reduced treaty rate of 15 percent on dividends, the maximum refund would be $61.50 as the dividend would be subject to 15 percent withholding and the gross proceeds would not be subject to tax under the treaty.

No refund would be available if Client X resides in a country that does not have an income tax treaty with the U.S.

Note that unlike the QI rules, there is no possibility for PFFI/QI to claim a refund on behalf of Client X — there is no ''collective refund'' mechanism under FATCA.

Lastly, if Client X were an NFFE, a refund would be possible only if *all* of its U.S. shareholders are disclosed to the IRS.

draft regulations *must* set out suggested verification procedures so they can be commented on and implemented in the final regulations in the summer of 2012 (or soon thereafter).

- Rules for insurance companies.
- Rules relating to funds.
- DCFFIs. The draft regulations likely will include the existing DCFFI concepts contained in current guidance, but further progress in this area likely will be reserved for the finalization process.

Examples — FATCA Withholding *(continued)*

Example 3. ''Attributable to'' Type Passthrough Payment

Assume

- PFFI-1 transfers €200 to PFFI-2 for credit to Client Y
- PFFI-2's passthrough payment percentage is 25 percent

FATCA Withholding

Gross payment	€200
PFFI-2's passthrough payment percentage	x 25%
Total passthrough payment	€50
FATCA	x 30%
Total FATCA withholding	€15

QI/Section 1441 Withholding

$0

Notes: A refund for Client Y in this instance is technically possible. Client Y must have proof of U.S. withholding (likely Form 1042-S issued by PFFI-2), file a U.S. income tax return, and prove that it is the beneficial owner of the income and that a treaty rate of less than 30 percent applies to the income (likely if non-U.S.-source income).

Example 4. ''Custodial'' Passthrough Payment

Assume

- PFFI-1 is a non-U.S. fund
- PFFI-1 distributes €400 to PFFI-2 for credit to Client Z
- PFFI-1's passthrough payment percentage is 20 percent

FATCA Withholding

Gross payment	€400
PFFI-1's passthrough payment percentage	x 20%
Total passthrough payment	€80
FATCA	x 30%
Total FATCA withholding	€24

QI/Section 1441 Withholding

$0

Notes: Potential refund available as discussed in Example 3. The applicable passthrough payment percentage is that of PFFI-1 because it is an FFI *and* issuer of the security giving rise to the passthrough payment.

- A draft FFI agreement as well as draft FATCA reporting forms (for example, relating to U.S. accounts).

What will the draft regulations not address?

- Do not expect any postponement or phase-in beyond that provided in Notice 2011-53.
- Passthrough payments (that is, ''attributable to'' a withholdable payment). This is so complicated and such a hot button that any new formulation of this now would surely derail any hope of issuing final regulations by the summer of 2012. The IRS probably will include in the draft regulations

the same concepts formulated in Notice 2011-34 (for example, fungibility) and leave this to be settled at a later date. It is possible that the IRS will use this as an opportunity to formulate a sort of ''ordinary course of business'' payment exception that limits the scope of what payments are ''attributable to'' a withholdable payment.

- DCFFIs. These carveouts are important but not critical to the FATCA framework as a whole; thus, new deemed compliant categories at this point are unlikely.

DCFFI Status

The DCFFI concept will allow some FFIs to be wholly or partially exempted from the requirement to enter an FFI agreement, although in some cases the FFI will need to perform procedures and certifications in order to establish and maintain DCFFI status. To date the IRS has formulated four classes of FFIs that may qualify for DCFFI status:

- FFIs with specific identified owners (for example, the small family trust);
- certain local banks;
- local FFI members of participating FFI groups; and
- certain investment vehicles.

The process to obtain DCFFI status is expected to require the FFI to:

- apply to the IRS for deemed compliant status;
- obtain an IRS-issued FFI identification number; and
- certify to the IRS every three years that the FFI meets the requirements for DCFFI status.

Perhaps the most interesting of these for QIs in Europe is the ''certain local bank'' DCFFI category, which if applicable would provide FATCA compliance cost savings. As currently formulated, the requirements to qualify for the certain local bank deemed compliant status apply to an FFI group where *all* affiliate FFIs:

- are licensed as banks (or similar business that is authorized to accept deposits);
- are formed in the same country;
- do not maintain operations outside the country of formation;
- do not solicit accounts from outside the country of formation; and
- implement procedures to ensure no accounts are opened or maintained for nonresidents, nonparticipating FFIs, or NFFEs other than excepted NFFEs.

Presumably a stand-alone FFI that meets these requirements would likewise qualify for DCFFI status. One should expect that as a condition to obtain DCFFI status the FFI would have to perform the existing account holder due diligence procedures that will be contained in the FFI agreement, although this requirement was not included by the IRS in its initial formulation.

Are there any real benefits offered by the ''local banks'' DCFFI status? In theory, the only two advantages are not having to perform annual account retesting (applicable for ''high value'' accounts) and avoiding FATCA withholding and reporting responsibilities, although this second benefit is a product of the prohibition against nonresident and accounts of nonparticipating FFIs. This deemed compliant class, as formulated, has virtually no possible application in Europe for three reasons. First, the IRS appears to have formulated this DCFFI class with collective or savings banks in mind, but the prohibition against having NFFE accounts (other than excepted NFFEs formed and operating in the same country as the FFI) means that the FFI would be prohibited from having commercial clients. This would be contrary to one of the main missions of collective banking, the servicing of local businesses. Second, the ''benefit'' of not performing FATCA withholding and reporting is illusionary because even a PFFI that has no U.S. or nonparticipating FFI clients would not have to withhold or report under FATCA. Last, the prohibition against nonresident clients means that in order to qualify for the certain local bank DCFFI status QIs in the EU would be required to deny banking services to EU residents from other EU countries, a clear violation of EU principles.

In a time of financial crisis real attempts should be made to ease compliance burdens when a low risk of tax evasion is presented. The recent focus by the IRS on private banking and high value accounts should be applauded, but the ''relief'' offered thus far for collective banks is too limited in scope as to provide any real compliance cost savings to conceivably any EU collective or savings bank. These rules need to be further developed and expanded by the IRS is order to provide compliance cost savings for EU's ''local banks.''

Conclusion

Many of the dire warnings of alarmingly high costs to become FATCA compliant probably are exaggerated, although it is true that existing systems and procedures will need remediation to ensure FATCA compliance. QIs in Europe are relatively well positioned for FATCA because of the existence of robust know-your-customer and tax reporting regimes; thus, compliance with many aspects of FATCA should require modification of existing compliance systems but probably will not require wholesale systemic changes. One FATCA carveout provides DCFFI status for ''local banks,'' which may further ease compliance costs for some small collective or savings banks, although further development of this concept by the IRS is needed for it to have any relevant application in Europe. The effect for non-QIs and non-intermediary FFIs, such as funds, will be a different story. Non-QIs that do not become PFFIs may not survive, and the best advice to non-QIs

that become FATCA compliant would be to also obtain QI status. For non-intermediary FFIs, such as funds and trust companies, FATCA compliance will present serious challenges because these entities have for the most part never had to deal with client identification and reporting procedures of the type mandated by FATCA.

At this point, every entity that will be affected by FATCA should already have a general FATCA compliance plan and informed its decision-makers and department heads regarding the FATCA deadlines and anticipated systems changes. QIs also should make sure budgets include funds necessary to deal with FATCA, perform an analysis of operations, and prepare an initial FATCA implementation plan. QIs would be prudent to delay finalizing implementation plans or undertaking costly operational changes until the FATCA regulatory framework becomes clearer. ◆