

MAYER • BROWN

Managing the Risks in Serving US Clients

What Every Non-US Financial Institution
Needs to Know in Today's Environment

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October 2009

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The Perfect Storm – Why Cross-Border Services are Under Scrutiny

- New administration
- High US deficits and tough economic times
 - Search for revenue
- Energized SEC Enforcement Division
- Whistleblower
 - UBS AG has agreed to exit its US private client business and effectively comply with its obligations under its “Qualified Intermediary” agreement with the IRS.
- IRS Voluntary Disclosure Program
 - A trail of bread crumbs

What is Past is Prologue

- At a recent publicly attended conference, the lead DOJ prosecutor in the UBS AG matter noted that
 - If [non-US financial institutions] think this is just UBS, they're mistaken. UBS is not an anomaly. This is just the beginning. We're going after foreign banks and professionals. Countries the [US government] is interested in include Hong Kong, Panama, and Singapore.
- As a consequence, many non-US financial institutions are revisiting how they serve US clients in a cost-effective and compliant fashion

Know Thyself – What Non-US Financial Institutions Should Ask Themselves

- What type of investment products do we offer?
- Are the investment products being offered in the United States or otherwise using “US jurisdictional means”?
- Even if US jurisdictional means are not being used, are the products or services being offered to US persons outside the United States?
- Does the “beneficial ownership” of the products or services trigger US federal income tax reporting, withholding or other requirements?

Regulation of Financial Institutions Under US Federal Law: A Quick Primer

Why the Type of Investment Product Matters

- Notwithstanding recent proposals to consolidate regulators, the United States has a fragmented regulatory structure for financial institutions
 - No universal bank model
 - Limited federal pre-emption
- As a practical matter, the key distinction running through the US regulatory treatment of financial services is often whether the relevant investment products are securities

US Broker-Dealer Regulation

- A securities broker is “any person engaged in the business of effecting transactions in securities for the account of others”
- It is generally unlawful for any broker to use US jurisdictional means to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security unless the broker is registered with the SEC
 - Note: Broker-dealer regulation is an area of US law where federal law does not preempt state law

US Broker-Dealer Regulation (continued)

- Absent an exemption, a non-US financial institution using US jurisdictional means to effect securities transactions would be subject to registration with the SEC (and possibly with one or more US states)
- As a technical matter, this broker-dealer registration requirement does not depend upon
 - Whether the parties to a transaction are US citizens, US residents or otherwise connected to the United States
 - Whether the parties are sophisticated or unsophisticated
 - Whether the parties are natural persons or institutions
 - The nature of the securities (registered or unregistered, debt or equity, etc.)
 - Whether a transaction is large or small in size or value (no *de minimis* exception)
- The exemptions available to non-US financial institutions are fairly limited, particularly for individual clients, and can be cumbersome to utilize

US Investment Adviser Regulation

- An investment adviser is “any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities”
- It is generally unlawful for any investment adviser to use US jurisdictional means unless the investment adviser is registered with the SEC *or* a state
 - Note: Investment adviser regulation is an area of US law where federal law and state law co-exist

US Investment Adviser Regulation (continued)

- Absent an exemption, a non-US financial institution using US jurisdictional means to provide securities advice for compensation would be subject to registration as an investment adviser with the SEC (or one of the US states)
- The “private adviser exemption” may be useful to non-US financial institutions with a limited number of advised clients who are resident in the United States

What are Non-US Financial Institutions Asking Mayer Brown?

- Should we set up a US-regulated entity to serve US persons? If so, how do we isolate other operations from US regulation?
- Can we
 - Make any visits to the United States?
 - Utilize a “no US jurisdictional means” policy to serve US clients?
 - Communicate with external asset managers acting on behalf of US clients?
 - Provide custody-only services or banking-only services to US clients?
 - Use US jurisdictional means to serve non-US clients who are visiting the United States?
 - Service accounts that are structures or legal entities beneficially owned by US persons?
- How do we best exit the business?

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US Federal Tax Law: A Quick Primer

US Tax Treatment of US Persons and Non-US Persons

- US persons are subject to US federal income tax on their worldwide income
 - US persons are defined for this purpose as US citizens, corporations and partnerships organized in the United States, US estates and US trusts, and those individuals who are considered US residents for tax purposes
- The United States limits the basis on which it taxes non-US persons
 - US tax may be withheld from certain payments to non-US persons
 - Non-US persons may be subject to US federal income tax with respect to certain income effectively connected with the conduct of a trade or business in the United States

The IRS Balancing Act

- IRS wants information relating to US persons
 - Does not want US persons to masquerade as non-US persons and improperly avoid US tax
- IRS wants to provide non-US persons the ability to obtain income tax treaty reduced rates of withholding tax
 - Many non-US persons do not want their personal information shared with the IRS

The Result: Qualified Intermediary Program

- A Qualified Intermediary or “QI” is:
 - A non-US financial institution or a foreign clearing organization;
 - A non-US branch or office of a US financial institution or office of a US clearing organization;
 - A non-US corporation (limited to treaty claims on behalf of its shareholders); or
 - Any other person acceptable to the IRS;
- Located in a country with approved “know your customer” rules;
- And, enters into a contract with the IRS governing its obligations to conduct certain information reporting and tax withholding, a “QI Agreement.”

A QI's Obligations

- Provide certain US customer information to the IRS
- Report payments of US source income to non-US persons on an aggregate basis
- Withhold tax on payments to non-US persons as necessary
- Conduct “backup withholding” with respect to certain payments to US persons that are not adequately identified to the IRS

With the Good Comes the Bad

- The Good: Benefits of QI Status
 - QI generally audited by an outside accounting firm and not the IRS
 - Information reporting and withholding obligations differ from that of a US withholding agent
 - US withholding agents can rely on documentation provided by a QI for US withholding tax purposes
 - Different rules would apply to payments to non-QIs
 - Maintain non-US person client privacy

With the Good Comes the Bad

- The Bad: Burdens of Being a QI
 - Document intensive
 - Requires training of employees to manage the system, collect the necessary information, and review the information
 - External auditor costs can be substantial in comparison to the income derived from the clients
 - QIs can be held liable for US tax that is not withheld and information reporting errors may subject the QI to tax penalties, and possibly, loss of QI status

Issues Relating to US Persons

- QI Due Diligence to “root out” hidden US persons
 - Conflict between KYC rules and US tax rules regarding beneficial ownership
 - Reliance on presumptions in lieu of obtaining documentation
 - “Structures” to disguise beneficial ownership for US tax purposes
- Reporting on non-US source income derived by US persons

Test Cases:
Applying What We've Learned
So Far

Test Case # 1 (Beneficial Ownership)

Smith is a US citizen who resides in Country A (not the United States). Smith creates SmithCo under the laws of Country A, and SmithCo is treated as a corporation for US federal income tax purposes. SmithCo opens an account at Bank, a non-US financial institution that has entered into a QI agreement with the IRS. Smith prepares and signs a Form W-8BEN that indicates that SmithCo is the beneficial owner of the account.

- Can Bank accept the Form W-8BEN from SmithCo? Is Smith the beneficial owner of the account for which he should provide Bank a Form W-9?
- Does the answer change if Smith transferred US securities to SmithCo's account? What if the securities are non-US securities?
- May Bank effect securities transactions for SmithCo or provide securities advice to SmithCo without registering as a broker-dealer or investment adviser?

Test Case # 2 (US Person)

In 1979, Smith was visiting the United States where she gave birth to Junior. Smith and Junior departed the United States shortly thereafter to return to Country A. Thirty years later, Junior wants to open an account at Bank, a non-US financial institution that has entered into a QI agreement with the IRS. Junior wants to provide a W-8BEN as documentation of his non-US status.

- Can Bank accept the Form W-8BEN from Junior?
 - No, dual citizens, green card holders and persons who satisfy the “substantial presence test” are all US persons, even if they currently reside outside of the United States, so he must provide a Form W-9
- May Bank effect securities transactions for Junior or provide securities advice to Junior without registering as a broker-dealer or investment adviser?

Test Case # 3 (Deemed Sales)

Jones is a US citizen resident in the United States. Several years ago, Jones opened an account at Bank, a non-US financial institution that has entered into a QI agreement with the IRS. Jones' account only holds investments that produce non-US source income (non-US investments).

- May Bank effect securities transactions for Jones or provide securities advice to Jones without registering as a broker-dealer or investment adviser?
- Does Bank have information reporting obligations with respect to the account?
 - What if confirmation of trades or account statements are sent to Jones in the United States?
 - What if she phones Bank to make trades?
 - What if the account only holds US securities?

Possible QI Developments: How the Landscape May Change

Proposed Changes to Model QI Agreement – Announcement (2008-98)

- Generally, proposes three changes to the Model QI Agreement and QI external Audit Guidance
 - Amends the QI Agreement to provide that a QI must notify the IRS whenever the QI becomes aware of a material failure of internal controls relating to its performance under the QI agreement (“Material Failure of Internal Controls”);
 - Amends the QI audit guidance to add an audit procedure testing certain accounts for characteristics that suggest a US person has signature or other authority over the account (enabling the IRS to evaluate the risk of a failure of controls and if necessary to request that the external auditor perform additional audit procedures), and to add additional procedures for fact gathering by the external auditor relating to the IRS’s evaluation of the risk of a material failure of controls (e.g., identifying the person charged with oversight of performance under the QI agreement) (“Fact Finding for U.S. Signature Authority”); and
 - Amends the QI audit guidance to require the external auditor to associate a U.S. auditor (which would assume joint responsibility) with the QI external audit (“U.S. External Auditor Requirement”).
- These proposals are rather technical and do not change the underlying information reporting rules

Legislative Proposals Relating to the QI Program

- The Obama Administration proposed comprehensive amendments to the QI program in its FY 2010 Budget (the Greenbook), on May 11, 2009
 - No legislation adopting these proposals has yet been introduced in Congress
 - Press reports suggest that action will not be taken regarding “international tax reform” until next year
- The core of the Administration’s proposals in this area would be to strengthen the existing regime for registering financial intermediaries, which hold US securities on behalf of customers, as QIs
- The overall goal would be to make it easy for individuals to comply with US tax law, and make the intermediaries who facilitate the flow of funds across borders partners of IRS in ensuring people pay the right amount of tax by ensuring that US and non-US source income derived by a US person is reported to the IRS
- The other part of the proposal would be to create *disincentives* for those US taxpayers who chose to do business with a financial institution that has chosen not to be a QI

The Proposed Stop Tax Haven Abuse Act

- The Stop Tax Haven Abuse Act (Levin-Doggett Bill – 5.506. reintroduction of February 2007 prior bill) has proposals of interest to QIs
 - Initial Tax Haven List and Creation of Rebuttable Evidentiary Presumptions (§101)
 - Tax havens defined as foreign jurisdictions with secrecy laws and no information exchange agreement with the United States
 - Three presumptions in tax litigation
 - Tax haven financial account contains \$10,000 and so triggers FBAR reporting
 - Transfers to/from a tax haven accounts are of unreported income
 - U.S. person who transfers money to tax haven account controls the account
 - Increased Reporting Obligation of QIs
 - QIs would be required to file Forms 1099 and backup withhold if they know that a U.S. person is the beneficial owner of an account held in the name of a foreign account holder. (new IRC section 6045C)
- Senator Baucus's Offshore Tax Compliance Bill introduced March 11, 2009 (Does not directly apply to QIs)

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Any questions?

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