The Foreign Account Tax Compliance Act and Its Implications to Non-U.S. Banks and Brokerage Houses

James Barry, Thomas Delaney, Charles Triplett, and Jonathan Sambur, Mayer Brown LLP

On March 18, 2010 President Obama signed into law the Hiring Incentives to Restore Employment Act[1] (HIRE Act), economic stimulus legislation intended to spur new job creation in the U.S. economy. To partially offset the costs of this new law and without any significant debate, Congress substantially incorporated into the HIRE Act certain provisions of the Foreign Account Tax Compliance Act of 2009 (FATCA).[2]

FATCA imposes an unprecedented and sweeping set of new due diligence, information reporting and other burdens on non-U.S. financial intermediaries and investment entities, such as banks, financial institutions, insurance companies, and investment funds and other collective investment vehicles. These rules apply presumptively regardless of whether any of these non-U.S. financial intermediaries or investment entities maintain accounts for U.S. persons or, in the case of non-U.S. investment entities, are owned by U.S. persons. Failure to comply with the information reporting provisions of FATCA could result in the imposition of a 30 percent withholding tax imposed on a noncompliant institution's portfolio investments in U.S. securities. This article will focus on the due diligence, information reporting, and withholding tax burden that will affect non-U.S. financial institutions, particularly banks and brokerage houses.

Background

The Qualified Intermediary Regime

In order to entice non-U.S. financial institutions to assist the Internal Revenue Service (IRS) in collecting U.S. withholding tax imposed on U.S. source income derived by a non-U.S. person,[3] the IRS promulgated a comprehensive set of information reporting and withholding tax regulations in 1997 that became effective for payments made after December 31, 2000.[4] The cornerstone of these regulations was the concept of the "qualified intermediary" (QI). A QI is a financial intermediary (e.g., a non-U.S. bank) that has entered into an agreement with the IRS that

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effectively permits the QI to preserve the anonymity of its clients in exchange for conducting certain due diligence that would permit the QI to determine whether the beneficial owner of a payment is a non-U.S. person and whether that person qualifies for a reduced rate of withholding tax pursuant to an applicable income tax treaty.[5] In effect, the IRS deputized willing non-U.S. financial institutions by delegating certain due diligence tasks to the QI in order to enhance the ability of the IRS to collect U.S. withholding tax and generally facilitate cross-border investment. Since the QI rules were applied based on contract principles, the QI needed to enter into an agreement with the IRS in order for these rules to apply. Accordingly, financial intermediaries could conduct a cost-benefit analysis to determine whether it made sense to participate.

Under the QI rules, a QI is generally required to provide account holder information to the IRS regarding accounts beneficially owned by U.S. persons to the extent a payment to the account consists of U.S. source income (e.g., dividends from U.S. corporations) or gross proceeds from the sale of property that produces (or could produce) U.S. source income.[6] Because the QI rules are generally designed to address accounts that hold assets that produce U.S. source income, they do not generally require that a QI conduct information reporting regarding U.S. beneficial owners who maintain cash deposit accounts or securities accounts that do not hold assets that produce U.S. source income (e.g., stocks and securities of non-U.S. corporations).[7] In effect, the QI rules were knowingly designed to allow a U.S. person to invest outside the United States through a QI, provided that the investment did not trigger any of the applicable information reporting obligations of the QI. QIs and their customers took full advantage of this gap in the information reporting rules.

Prior Legislative Proposals

Prior to the recent financial crisis, non-compliance with U.S. tax obligations had been identified as a problem of fundamental unfairness by some members of Congress. In recent years, there have been a number of Congressional hearings, reports, and U.S. government investigations relating to non-U.S. financial institutions detailing instances in which offshore accounts are not reported to the IRS. In large part, these hearings, reports, and investigations focused attention on the gaps regarding a QI's obligation to provide information pertaining to its U.S. clients' accounts. The financial crisis has led to ballooning federal deficits and a federal budget that is thirsting for revenue. One easy and politically palatable source for such revenue is the undeclared earnings generated abroad by U.S. tax cheats. They have no lobby and the funds represent potentially billions of uncollected revenue.

Some members of Congress, including then-Senator Obama, initially proposed legislation that would have blacklisted specific countries, including Singapore, Hong Kong, and Luxembourg as non-cooperative in international tax matters and would subject U.S. persons who receive anything of value from entities located in such jurisdictions to the presumption that such receipts are unreported income.[8] That proposal was regarded by others in Congress as setting a dangerous foreign policy precedent and was not passed into law. In order to avoid a similar result, the Treasury teamed with the leaders of the Senate Finance Committee and the House Ways and Means Committee to develop FATCA, legislation that attacked the perceived weakness of the QI program—the failure to require QIs to report income earned by U.S. persons who invested abroad and whose accounts contained investments that did not produce U.S. source income.

FATCA Information Reporting and Withholding Tax Regime

FATCA Begins Where the QI Regime Ends

As a preliminary matter, FATCA creates a new chapter of the Code, which effectively requires a foreign financial institution (FFI) to fully disclose information to the IRS concerning certain accounts maintained directly or indirectly by a U.S. person or a withholding tax imposed at a rate of 30 percent would be imposed on all Withholdable Payments made to the FFI.[9] These provisions are generally not associated with the QI regime and compliance with the FATCA provisions does not ensure that a QI is in compliance with its QI Agreement.[10] Unlike the QI regime, these provisions are mandatory and unless the FFI either certifies that it has no United States accounts (U.S. Accounts) or enters into (and complies with the terms of) an agreement with the IRS (FFI Agreement), discussed further below, each of the untold thousands of FFIs around the world will be subject to U.S. withholding tax.[11] FATCA's definition of FFI results in these provisions applying to a broad class of non-U.S. entities, including traditional financial institutions, such as banks and brokerage houses, but also includes any non-U.S. entity engaged primarily in the business of investing, reinvesting or trading in securities (e.g., investment funds, hedge funds, private equity funds and other collective investment vehicles organized outside the United States, investment trusts and insurance companies).[12]

Provide Information to the IRS or an FFI and Its Customers Suffer Collective Punishment

An FFI that either fails to certify that it does not maintain U.S. Accounts or does maintain U.S. Accounts but fails to enter into an FFI Agreement will be subject to U.S. withholding tax imposed at a 30 percent rate with respect to all Withholdable Payments made to the FFI.[13] This tax is imposed irrespective of whether the payment is beneficially owned by the FFI or a customer of the FFI. The FFI and non-U.S. beneficial owners that qualify for a reduced rate of withholding tax pursuant to an applicable income tax treaty may file a claim for a refund.[14] Each claimant would be required to file a U.S. federal income tax return as part of its refund claim.[15] Further, the FFI would not be entitled to collect any interest payment that otherwise would relate to the overpayment. As part of the refund claim, the non-U.S. beneficial owner would need to provide sufficient proof to the IRS that he or she is not a U.S. person.[16] If the FFI is a QI, this result would effectively negate the FFI's QI status by no longer providing anonymity to its clients.

FATCA's use of collective punishment strongly suggests that the drafters expected that FFIs will undertake a cost-benefit analysis resulting in the determination that they must enter into an FFI Agreement, particularly if the FFI holds investments for itself or clients that produce Withholdable Payments. While this may be true for large banks and brokerage houses, it highlights the possibility that smaller FFIs may determine that disinvestment from the U.S. capital market is preferable to minimize compliance burdens associated with entering into an FFI Agreement and to otherwise minimize U.S. regulatory burden.

Terms of the FFI Agreement: Identify U.S. Persons, Report Their Account Information to the IRS, and Withhold Tax When Identification or Reporting Is Impeded

As discussed above, FFIs that maintain U.S. Accounts will be required to enter into an agreement with the IRS to provide information relating to certain U.S. persons that directly or indirectly maintain an account at such financial institution. The FFI Agreement will, at a minimum, require the FFI to:

- Determine whether an account is a U.S. Account;
- Comply with certain to-be-determined verification and due diligence procedures that relate to the identification of U.S. Accounts;[17]
- Report certain information annually to the IRS relating to the FFI's U.S. Accounts;[18]
- Withhold taxes at a 30 percent rate on any "passthru payment"[19] to
    - any U.S. or non-U.S. account holder that has not provided information necessary for the FFI to comply with its verification and due diligence obligations, or to a U.S. Account that has not waived local bank secrecy rules, thereby prohibiting the FFI from complying with its information reporting obligations (Recalcitrant Account Holder),[20]
    - another foreign financial institution that has not entered into an FFI Agreement with the IRS, or
    - another FFI that has entered into an FFI Agreement and that has elected to have an FFI "up the chain of payment" withhold tax attributable to the portion of such payment made to a Recalcitrant Account Holder or an FFI that has not entered into an FFI Agreement;[21]
- Comply with requests by the IRS for additional information relating to any U.S. Account maintained by the FFI; and
- Obtain appropriate waivers of local privacy laws from the owners of U.S. Accounts or, to the extent not provided, close the account.[22]

The legislation authorizes the IRS to terminate an FFI Agreement, and thereby subject an institution to withholding tax imposed at a 30 percent rate, if a determination is made that the FFI is not in compliance with its agreement.[23] Although it is unclear under what circumstances such a determination would be made (e.g., whether a technical default would result in such a determination or whether some type of gross noncompliance is required), it is anticipated that FFIs that do not engage in some level of information reporting are likely to risk termination of their respective FFI Agreements.[24]

Due Diligence and Other Compliance Burdens

Arguably, the biggest uncertainty relating to implementing FATCA relates to the due diligence requirements that must be developed by the Treasury and the IRS. FATCA does not specify how an FFI is to demonstrate its basis for differentiating U.S. Accounts from non-U.S. Accounts. In a report that accompanied FATCA, the Joint Committee on Taxation (JCT) indicated that the Treasury could allow FFIs to rely on KYC procedures currently in place in many institutions in order to comply with local AML, anti-terrorist financing or sanctions laws as a basis for distinguishing U.S. Accounts from non-U.S. Accounts.[25] In this regard, it is presumed that an FFI "knows" their customer and would be able to ascertain whether the beneficial owner of the account is a U.S. person.

One particular area of concern is whether the requirement for an FFI to identify U.S. Accounts would compel the FFI to ascertain whether a seemingly non-U.S. client is a U.S. person. To the extent that an FFI is required to obtain certifications or specified documentation from all of its customers, there are likely to be instances in which non-U.S. persons will fail to provide the required information. It remains unclear whether these practical challenges could result in a disproportionate number of FFI customers being treated as Recalcitrant Accounts Holders to the extent that an FFI does not receive the required certification or documentation.

In some cases, identifying U.S. persons might not be a challenging task; however, identifying dual citizens and non-U.S. citizens that are residents of the United States (e.g., persons who satisfy the substantial presence test or possess a "green card") could present certain unique challenges and represent a significant departure from the nominal purpose of this legislation. Dual citizens present a compliance risk because they could knowingly or unknowingly fail to disclose that they are U.S. citizens and present legitimate non-U.S. documentation to the FFI.[26] With respect to those persons resident outside the United States that might not even have known of their U.S. citizenship (e.g., children born outside the United States who have at least one U.S. citizen parent), it is unclear whether it was ever intended for FATCA to be used as a mechanism to identify these individuals and bring them into the U.S. tax system.

It is also unclear whether due diligence standards could be approved on a country-by-country basis or whether a uniform standard would need to be adopted. One rather significant challenge of utilizing local KYC procedures or AML laws to identify U.S. Accounts, particularly U.S. owned foreign entities, is the degree to which owners of foreign companies must be identified. Under FATCA, an FFI must be able to identify whether a U.S. person owns 10 percent or more of a non-U.S. entity in order to determine whether it is a U.S. owned foreign entity for which information reporting much occur. Many countries' KYC procedures and AML laws, however, only require the financial institution to collect information regarding persons who own 25% or more of the stock or ownership interests of the foreign company. In order to comply with FATCA, if an FFI must collect new information from clients or try to locate information that is not retrievable in a systemic manner, then compliance costs will increase dramatically.

Effective Date Issues and Next Steps

FATCA's information reporting and withholding tax provisions will become effective with respect to payments made after December 31, 2012 (subject to limited exceptions for certain existing instruments).[27] Prior to the time FATCA was enacted, the Treasury and the IRS publicly stated that they had begun preparations for developing and issuing the significant amount of guidance that would be necessary for implementation. Recently, the IRS has indicated that preliminary guidance will be issued by the end of summer. Despite these efforts, many commentators consider the statutory effective date to be ambitious, in light of the number of FFI Agreements that will need to be entered into between the IRS and FFIs prior to the effective date. By way of comparison, the withholding tax regulations that created the QI program were first announced in 1996 and they did not take effect until 2001.

Even then, the IRS faced a significant backlog in reviewing and approving various countries' KYC regimes and entering into QI agreements with FFIs.

Even assuming the Treasury and the IRS are able to develop the guidance needed to implement FATCA prior to its effective date, if those regulations require significant changes to IT systems or other operations, FFIs may be hard-pressed to meet the statutory deadline. Accordingly, it is anticipated that, during the consultative process that will precede the promulgation of final regulations, organizations representing the interests of FFIs will, among other things, seek additional flexibility concerning compliance with FATCA. It is unclear whether the Treasury and the IRS believe they possess authority to extend the effective date.[28]

Conclusion

One might suggest that the FATCA is a well-designed set of requirements that provide the IRS with absolute certainty that it will obtain information pertaining to U.S. Accounts or the presumed tax evader would suffer significant consequences. Others might suggest that FATCA represents a clear example of an extraterritorial application of U.S. law, uniquely designed to circumvent local laws and avoid information exchange mechanisms negotiated with U.S. income tax treaty partners. FATCA does not, unfortunately, only apply to FFIs that assist U.S. persons by improperly avoiding U.S. federal income tax. It is far more likely that the burdens and resulting costs of complying with FATCA will fall most heavily on FFIs whose client base consists predominantly of non-U.S. persons whom are not U.S. owned foreign entities. Accordingly, many FFIs will restrict, as many have already done, the provision of banking and brokerage services to U.S. persons and forcibly exit those relationships. Thus, FFIs are likely to approach FATCA not with compliance as a goal but instead will aim for avoidance or a minimization of FATCA's burdens. These FFIs will circumvent FATCA by certifying that the FFI maintains no U.S. Accounts.

Other FFIs may decide to take a different approach and will divest all property that produces Withholdable Payments. In this case, an FFI could avoid entering into an FFI Agreement because there would be no payments upon which withholding tax would be imposed. This approach also clearly identifies what may be the greatest risk of the entire FATCA regime: the possibility that U.S. Accounts could be maintained by an FFI, without any resulting information reporting obligations. If a significant number of FFIs effectively opt out of FATCA by disinvesting from the U.S. capital market, FATCA will be a costly legislative failure. Improper U.S. tax avoidance would continue much in the same way as it occurs today, beyond the reach of the United States. This failure would not result from Congress' failure to make the penalties for non-compliance sufficiently strong, but from the failure to provide a sufficient incentive to compel FFI participation. Due to the legislative constraints placed on the Treasury and the IRS, it remains to be seen whether the implementing regulations and the forthcoming guidance will be crafted such that sufficient incentives are provided to FFIs to ensure widespread FFI participation.

James Barry is a partner and one of the firm's practice leaders of the Tax Transactions group at Mayer Brown LLP. He represents U.S. corporations and individuals in tax planning for foreign and domestic operations, as well as foreign corporations and individuals in tax planning for U.S. operations. He can be reached at jbarry@mayerbrown.com.

Tom Delaney is a partner at Mayer Brown LLP whose practice is concentrated on banking and financial services matters, and especially on issues associated with the federal and state regulation of financial institutions. He advises clients on formation, acquisition, compliance, and cross-border concerns, with particular emphasis on anti-money laundering, the USA Patriot Act, OFAC, and international funds transfer matters. He can be reached at tdelaney@mayerbrown.com.

Charles Triplett is a partner at Mayer Brown LLP whose practice focuses especially on matters of international tax. He served for 16 years with the US Internal Revenue Service, where his primary concentration was placed on international tax issues, and particularly on transfer pricing. He can be reached at ctriplett@mayerbrown.com.

Jonathan Sambur is an associate at Mayer Brown LLP whose practice focuses on international tax issues relating to the financial services industry, including withholding taxes and information reporting. Prior to joining Mayer Brown LLP, he was an attorney at the US Internal Revenue Service, Office of Associate Chief Counsel (International) where he concentrated on inbound and outbound international tax issues. He can be reached at jsambur@mayerbrown.com.

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[1] Pub. L. No. 111-147, 124 Stat. 71 (March 18, 2010).

[2] Title V of H.R. 4213, 111th Cong. (2009). Note that H.R. 4213 was signed into law on July 22, 2010 (Pub. L. No. 111-205, 124 Stat. 2236). FATCA was set forth in earlier versions of H.R. 4213. It was struck from H.R. 4213 at the time it was incorporated into the HIRE Act.

[3] The term "U.S. person" is defined in section 7701(a)(30) of the Internal Revenue Code (Code) and means (i) United States citizens and residents of the United States, (ii) corporations and partnerships that are formed or organized in the United States, (iii) certain trusts, the administration of which is primarily supervised by a United States court and one or more United States persons have the authority to control all substantial decisions of the trust, and (iv) estates that would be subject to U.S. federal income tax.

A non-U.S. person is any person that is not a U.S. person.

All section references herein are to the Internal Revenue Code of 1986, as amended and the regulations issued thereunder.

[4] In Treasury Decision (T.D.) 8734 (62 Fed. Reg. 53387 (Oct. 14, 1997)), the U.S. Treasury Department (Treasury) and the IRS issued comprehensive regulations (final regulations) under chapter 3 (sections 1441-1464) and subpart G of subchapter A of chapter 61 (sections 6041-6050S) of the Code. Those final regulations were amended by T.D. 8804 (63 Fed. Reg. 72183 (Dec. 31, 1998)) which delayed the effective date of the final regulations to payments made after December 31, 1999. The effective date of the regulations was again extended by T.D. 8856 (64 Fed. Reg. 73408 (Dec. 30, 1999)) to payments made after December 31, 2000.

[5] The agreement, known as a "QI Agreement," is a standardized contract between the IRS and the QI. Each QI Agreement is based on the Model QI Agreement, Rev. Proc. 2000-12, which sets forth the obligations and duties of a QI.

[6] For this purpose, a beneficial owner of an account is the person required, under U.S. federal income tax principles, to include the income derived from the account in their gross income. One major criticism of the QI regime is the problem of determining beneficial ownership when the account holder is a non-U.S. corporation that is owned by a U.S. person. A discussion of this issue is beyond the scope of this article.

Rev. Proc. 2000-12, § 3, 2000-1 C.B. 387 (withholding and information reporting obligations). The term broker proceeds means the gross proceeds from a sale of an asset to the extent that the gross proceeds would be subject to Form 1099 reporting if paid to a U.S. non-exempt recipient (e.g., a U.S. citizen or resident of the United States). Rev. Proc. 2000-12, § 2.07.

[7] Rev. Proc. 2000-12, § 3.05(B) (limitation on information reporting and backup withholding for non-U.S. payor QI).

[8] S. 681, 110th Cong. (2007).

[9] These provisions are now contained in chapter 4 of the Code, sections 1471 through 1474.

The term "Withholdable Payment" is defined to mean any U.S. source payment (e.g., including, but not limited to, interest paid by U.S. borrowers, dividends paid by U.S. corporations, rents for the use of property located in the United States, or royalties from the use of intangible property in the United States) and the gross proceeds from the sale or other disposition of property that produces U.S. source income. Section 1473(1).

Generally, depository accounts with balances of less than $50,000 that are maintained by U.S. citizens and residents are not subject to reporting under FATCA. Section 1471(d)(1).

[10] Section 1471(c)(3).

[11] Section 1471(a). Section 1471(d)(1) defines the term U.S. Account to generally mean a deposit or custody account that is owned by "specified U.S. persons" or "U.S. owned foreign entities." The term also includes any equity or debt interest in such financial institution that is not regularly traded on an established securities market. This broad definition of U.S. Account is intended to address the challenges of identifying the beneficial owner of an account when the account is opened in the name of a non-U.S. corporation.

The term "specified U.S. persons" means all U.S. persons other than certain identified persons, such as publicly traded corporations and tax exempt entities. Section 1473(3).

The term "U.S. owned foreign entities" means any non-U.S. entity owned by one or more "substantial U.S. owner." Section 1471(d)(3).

The term "substantial U.S. owner" means (i) with respect to a corporation, any specified U.S. person that owns, directly or indirectly, more than 10 percent of the corporation (by vote or value), (ii) with respect to a partnership, any specified U.S. person that owns, directly or indirectly, more than 10 percent of the profits or capital interest in such partnership, and (iii) in the case of any trust, any specified U.S. person that is treated as an owner of any portion of the trust under the grantor trust rules. In the case of an FFI that is engaged in investing or trading activities, a substantial U.S. owner is any specified U.S. person that owns any interest in such corporation, partnership or trust regardless of the size of the ownership interest. Section 1473(2).

[12] This article does not address the complexities of applying FATCA's due diligence and information reporting requirements to insurance products, investment funds, hedge funds or other collective investment vehicles.

FFIs include "any [foreign] entity that (1) accepts deposits in the ordinary course of a banking or similar business; (2) as a substantial portion of its business, holds financial assets for the account of others; or (3) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities." Given the breadth of this definition, it is expected that FFIs would include investment vehicles such as CDOs, CLOs, certain foreign securitization vehicles, and other foreign investment funds as entities engaged "primarily in the business of investing, reinvesting, or trading in securities…" and that such investment vehicles would be pulled within the new information reporting and withholding regime. Section 1471(d)(5).

It is unclear whether an entity that is disregarded as separate from its owner, pursuant to the regulations issued under section 7701, could be considered an FFI.

[13] Section 1471(b)(2) (exception for no U.S. Accounts). Section 1471(a), (b) (general rule).

[14] The amount of the refund would be limited to the difference between the tax withheld and what would have been withheld if the applicable treaty rate were applied to the payment.

[15] Section 1474(b).

[16] Section 1474(b)(3).

[17] These requirements will be specified by regulation, but one possibility is that these rules may be based on the "know your customer" (KYC) standards for identifying U.S. persons, including indirect account holders, that apply in the anti-money laundering (AML) context. See, Joint Committee on Taxation, Technical Explanation Of The Revenue Provisions Contained In Senate Amendment 3310, The "Hiring Incentives To Restore Employment Act," Under Consideration By The Senate, JCX-4-10, at 40.

We understand that representatives of non-U.S. banking organizations are advocating that the IRS base these rules on KYC standards.

[18] This annual reporting may take place by providing account statement information to the IRS that details the flow of funds into and out of the U.S. Account or by conducting Form 1099 information reporting in the same manner as a U.S. financial institution. It is likely that the owners of U.S. Accounts would prefer Form 1099 information reporting occur in order to facilitate the preparation of their U.S. federal income tax returns.

[19] The term "passthru payment" is defined to mean a Withholdable Payment or other payment to the extent it is attributable to a Withholdable Payment. It is unclear under what circumstances a payment would be considered attributable to a Withholdable Payment. Section 1471(d)(7).

[20] Section 1471(d)(6) (definition of Recalcitrant Account Holder).

[21] Section 1471(b)(3).

[22] Section 1471(b).

[23] Section 1474(b) (flush language).

[24] For example, if an FFI contends that it is only obligated to withhold tax when it provides banking services to Recalcitrant Account Holders and, thus, does not provide any information to the IRS regarding any U.S. Accounts maintained by the FFI, such FFI is likely to have its FFI Agreement terminated or not approved in the first instance.

[25] Joint Committee on Taxation, Technical Explanation Of The Revenue Provisions Contained In Senate Amendment 3310, The "Hiring Incentives To Restore Employment Act," Under Consideration By The Senate, JCX-4-10, at 40.

[26] It has been the authors' experience that some dual citizens are unaware of their status as a U.S. citizen. The person's exuberance relating to this new-found U.S. citizenship is generally diminished after the individual is informed about his or her U.S. federal income tax obligations, including the obligation to file U.S. federal income tax returns and pay U.S. federal income tax with respect to all income, including income derived from sources outside the United States.

[27] Pub. L. No. 111-147, § 501(a), (d)(2) (effective date and grandfather rule for certain outstanding obligations).

[28] For instance, it is unclear whether the Treasury and the IRS could apply the December 31, 2012, effective date only to new accounts and allow FFIs additional time to perform due diligence with respect to accounts existing as of that date. Similarly, the FATCA provisions could first be applied to those U.S. persons that are resident in the United States and later expanded to those U.S. persons resident outside the United States.