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FATCA – Tax Risks for US Investments

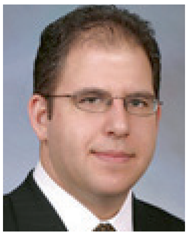
FATCA – Foreign Account Tax Compliance Act

On March 18, 2010, the U.S. government adopted the "Hiring Incentives to Restore Employment Act" (HIRE Act). It provides for tax benefits for U.S. companies, who are supposed to create new jobs in turn.

As part of its revenue offsets, the HIRE Act contains the "Foreign Account Tax Compliance Act" (FATCA). The new rules are meant to cause non-U.S. financial institutions to enter into a standardized agreement (FFI-Agreement) with the U.S. tax authorities (Internal Revenue Service, IRS), in which companies undertake to fulfill comprehensive documentation and reporting obligations concerning U.S. taxpayers. In addition, certain other non-U.S. companies will be required to disclose U.S. shareholders holding material interests in them; the conclusion of a standardized agreement is, however, not required. If all or parts of the documentation and reporting obligations stipulated in the Act are not fulfilled, income from U.S. sources, which is paid to the aforementioned institutions, is subjected to a withholding tax of 30 percent.

Dr. Ingo Kleutgens
Partner, Frankfurt
Tax
T: +49 69 7941 1591
ikleutgens@mayerbrown.com

Dr. Manfred Heemann
Partner, Frankfurt
Banking & Finance
T: +49 69 7941 1781
mheemann@mayerbrown.com



Jonathan A. Sambur
Counsel, Washington DC
Tax
T: +1 202 263 3256
jsambur@mayerbrown.com

It is the goal of the new FATCA rules to prevent U.S. taxpayers from evading all or part of their tax liability in the USA by employing foreign institutions.

The very generally worded FATCA rules are interpreted and specified through Notices published by the U.S. Treasury Department and the U.S. tax authorities (Internal Revenue Service, IRS). The Notices contain essential implementation provisions, explanations, and definitions. Three Notices have been published so far: Notice 2010-60 of August 29, 2010, Notice 2011-34 of April 8, 2011, and Notice 2011-53 of July 14, 2011. The U.S. Treasury Department and the IRS assume that preliminary binding rules will have been published by December 31, 2011 (Notice of Proposed Rulemaking), which take the requirements of the previously issued Notices into account. After inspecting and analyzing all comments received in respect to the published Notices, final guidance for the interpretation and implementation of the FATCA rules (Treasury Decisions) is to be published in the summer of 2012. The final model FFI Agreement should also be available in the summer of 2012; the same applies to the necessary forms required to comply with the reporting obligations and the tax withholding.

How Extensive is the Scope of Application of the FATCA Rules?

WHO DO THE FATCA RULES APPLY TO?

So far, the personal scope of application of the FATCA rules is very wide. Generally, all entities having a legal personality of their own are covered; this includes in addition to corporations also partnerships. For the qualification of non-U.S. institutions, it is necessary that the institution is deemed not domiciled in the USA. This means that the institution may particularly have neither its registered seat nor its management in the USA. The legal entities identified in this manner are divided into non-U.S. financial institutions (Foreign Financial Institutions, FFIs) and other non-U.S. entities, in which U.S. taxpayers may hold interests (Non-Financial Foreign Entities, NFFEs).

Foreign Financial Institutions (FFIs) and Non-Financial Foreign Entities (NFFEs)

The definition of the Financial Institution includes the three categories of institutions described below, distinguished based on their respective area of activity. For the purpose of being qualified as a Financial Institution, it is not necessary that the respective activities are carried out in the interest of a U.S. taxpayer; it is sufficient, if the institution becomes active in its own interest.

- All institutions that accept deposits in the ordinary course of a banking or similar business belong to a category of Financial Institutions. That an institution is subject to regulation under banking supervision laws can be used as an indication for the qualification as a Financial Institution; such regulation is not absolutely necessary, however (Notice 2010-60). In addition to classic banks, this first category also includes e.g. building societies and cooperative banking institutions.

- Institutions that hold and manage financial assets for the account of others form another category of Financial Institutions. This category includes in particular broker-dealers and custodial banks.

Dr. Simon G. Grieser
Partner, Frankfurt
Banking & Finance
T: +49 69 7941 2751
sgrieser@mayerbrown.com

Heiko Penndorf
Partner, Frankfurt
Tax
T: +49 69 7941 2791
hpenndorf@mayerbrown.com

Dr. Benedikt Weiser
Partner, Frankfurt
Private Investment Funds
T: +49 69 7941 1681
bweiser@mayerbrown.com

Susan Köhler
Associate, Frankfurt
Tax
T: +49 69 7941 1293
skoehler@mayerbrown.com

- The third and last category is comprised of those institutions that are primarily engaged in the business of investing, reinvesting, or trading in securities, partnership interests, or commodities or other participations in such investments. According to Notice 2 010-60, the term "business" is very wide. It is particularly not required that the institution is considered an economically independent entity in the sense of other tax provisions. Accordingly, this third category also includes in addition to insurance companies e.g. investment funds, hedge funds, and private equity funds.

If a, from the perspective of the U.S., foreign entity does not fall into any of the aforementioned categories and if it is therefore not qualified as a Financial Institution, it is generally considered a Non-Financial Foreign Entity (NFFE). Taking into account the intent and purpose of the FATCA rules – avoiding tax evasion by U.S. taxpayers – this covers all non-U.S. institutions in which U.S. taxpayers may hold interests as investors or shareholders/partners. Non-U.S. corporations, whose shares are generally traded on a public stock exchange, are explicitly not considered NFFEs. The same applies to non-U.S. governments and institutions and public agencies wholly-owned by such governments.

Exemptions from the Personal Scope of Application
In addition to the aforementioned exemptions, Notice 2010-60 provides for additional restrictions to the personal scope of applications of the FATCA rules, particularly for the following institutions.

- Holding companies, whose primary purpose is to act as a holding company for a subsidiary or group of subsidiaries, which primarily engage in a trade or business other than that of a Financial Institution. This would not include, however, e.g. private equity funds.

- Start-up companies that intend to operate a business other than that of a Financial Institution are excluded from the scope of application for the first 24 months after their organization.

- Unlike previously announced, insurance companies are not generally excluded from the personal scope of application. Such institutions are generally classified as FFIs. Only insurance companies that offer insurance products without a cash value, such as e.g. pure risk insurance, are subject to the exemption and are not considered as FFIs.

- Investment funds and other entities are not subject to the definition of FFI, if they only have a small number of direct or indirect unit holders which themselves do not qualify as FFIs. Accordingly, particularly special funds, whose investors are NFFEs, are not qualified as FFIs.

The term "securities" is to be understood very broad and includes particularly shares in corporations.

Note: If uncertainties exist, whether and to what extent the personal scope of application of the FATCA rules applies to a non-U.S. institution, it remains to be seen, whether and under which conditions a binding tax ruling can be obtained from the U.S. Treasury Department or the IRS.

IN WHICH CASES AND TO WHICH PAYMENTS DOES THE TAX WITHHOLDING APPLY?

If a non-U.S. institution is subject to the scope of application of the FATCA rules and if it does not meet the resulting documentation and reporting obligation, a withholding tax of 30 percent has to be withheld on all of its gross revenue from U.S. sources. For this purpose, gross revenue means, in addition to interest payments and dividend distributions from U.S. securities, also gains on disposals from U.S. sources from which interest or dividends may be generated. In addition, other regular payments from U.S. sources, such as rental payments, salaries, bonuses, and extra income, as well as other fixed or determinable income is covered. Such gross revenue from U.S. sources is in each case referred to as Withholdable Payments.

If the non-U.S. institution generally fulfills the documentation and reporting obligations imposed upon it under the FATCA rules, withholding tax is to be withheld on gross revenue from U.S. sources only, if the payments are forwarded to non-cooperating U.S. taxpayers, who refuse a disclosure of their data (Recalcitrant Account Holders), or if payments are forwarded to FFIs, who did not conclude an FFI Agreement (Non-Participating FFIs, NPFFIs). Such payments are also referred to as Passthru Payments. In these cases, the withholding tax must be withheld not by the U.S. source itself but by the forwarding institution.

WHEN DO THE FATCA RULES BEGIN TO APPLY?

Originally the FATCA rules were meant to be enacted as of January 1, 2013. Due to the necessary comprehensive change to the IT systems, particularly of the FFIs and of the IRS, the most recent Notice 2011-53 postponed the application of the rules further into the future. Accordingly, the following step-by-step implementation of the FATCA rules is planned.

- The FFI Agreement to be concluded with the IRS has to be concluded by June 30, 2013 at the latest (and no longer by January 1, 2013); by that time, the FFI must also have registered as a Participating FFI (PFFI). The IRS accepts corresponding applications for the conclusion of the FFI Agreement in an electronic filing process until January 1, 2013 at the latest.

- The tax must be withheld on Withholdable Payments by the Withholding Agent, (definition see page 9 “Tax Withholding”) from January 1, 2014 (no longer from January 1, 2013).

- The planned withholding obligations of the Participating FFIs in respect to Passthru Payments become effective as of January 1, 2015 at the earliest.

Note: In spite of the partial slowdown of the implementation of the FATCA rules, the need to act exists already now due to the extensive and complex implementation steps. Accordingly, it first has to be examined, whether non-U.S. institutions fall into the personal scope of application of the provisions. If this is the case, the necessity and the extent of the documentation and reporting obligations have to be determined based on an internal due diligence. Furthermore, the technical preconditions to fulfill the existing obligations have to be established. Depending on the nature, size, and affectedness of the respective institution, the necessary steps and measures may vary – an individual analysis of the actual situation in this regard is necessary already now.

Which Obligations Exist for the Affected Institutions?

If the personal scope of application of the FATCA rules is opened, the documentation and reporting obligations differ depending on whether the respective institution is qualified as a Foreign Financial Institution (FFI) or as a Non-Financial Foreign Entity (NFFE).

SCOPE OF DUTIES – FFIs

FFIs may elect how they will act taking the existing FATCA rules into account:

- Achieve the status of a Participating FFI (PFFI)

- Achieve the status of a “Deemed Compliant” FFI

- Accept the tax withholding of 30 percent (Non-Participating FFI, NPFFI)

Note: Accepting the tax withholding of 30 percent by the U.S. source may be a viable alternative only in exceptional cases. This could e.g. be the case, if the U.S. income qualified as Withholdable Payments constitutes a negligible portion of the overall income of the respective institution. In this case, a complete withdrawal from the U.S. business may also be considered.

Participating FFI

Conclusion of the FFI Agreement

In order to avoid the tax withholding on Withholdable Payments, an FFI will regularly decide to enter into a standardized agreement with the U.S. Treasury Department (FFI Agreement), in which it undertakes to identify all accounts of U.S. taxpayers maintained by it and to comply with predetermined documentation and reporting obligations. In addition, the FFI has to agree to withhold tax on Passthru Payments, if they are forwarded to non-cooperating account holders (Recalcitrant Account Holders) or to Non-Participating FFIs. If the FFI enters into the FFI Agreement, it is considered a Participating FFI (PFFI) and may be registered as such.

Note: Old Qualified Intermediary (QI) and other withholding agreement, which expire as of December 31, 2012, are automatically extended until December 31, 2013.

Definition of US Accounts

The identification, documentation, and reporting obligations pertain only to accounts of U.S. taxpayers (US Accounts). The term US Accounts includes all money or depositary accounts and any participation in the capital or the liabilities of an FFI, unless regular trade at a recognized stock exchange occurs, which is maintained for one or several US Persons or U.S.-owned institutions. Exempt from the scope of duties are generally US Accounts of individuals with an account balance not exceeding USD 50,000.00. If the respective FFI is part of a corporate group, this limit pertains to the total value of all investments of the individual within the framework of this group of companies.

Definition U.S. Taxpayer

U.S. taxpayers in this sense are defined as persons having their tax domicile in the USA; this includes persons having their registered seat in the USA and persons who are U.S. citizens (this also applies in the case of dual citizenship). A U.S.-owned non-U.S. institution is regularly any corporation, partnership, or trust in which a U.S. taxpayer directly or indirectly holds an interest of more than 10 percent (voting rights or nominal capital) in the profits or trust income (Substantial US-Owner).

Scope of the Documentation and Reporting Obligations

After Notice 2010-60 has outlined the scope of the reporting obligations for FFIs in respect to US Accounts in more detail, these parts of these statements were modified in Notice 2011-34. Pursuant to the current status, the reports must contain the following information concerning the U.S. account holders:

- Name, address, and U.S. tax identification number (TIN),

- Account balance at the end of the year, and

- Gross income (interest, dividends) and gross revenue from the disposal or redemption of assets (if PFFI are acting as depositary agent, broker, or trustee), which were credited to the account; if the PFFI is a fund or other investment vehicle, the gross amounts of all distributions, interest, and similar amounts credited to the account as well as the redemption prices paid out during the year have to be reported.

Consequences of the Participating FFI

If the FFI signs the standardized FFI Agreement, withholding tax no longer needs to be withheld on Withholdable Payments to the extend that the FFI itself is the economic beneficiary of the payments. As a consequence, the FFI itself is no longer in the focus of the IRS, but initially only the customer or participant in the FFI. Accordingly, the possibility to withhold tax is limited to those accounts, which belong to U.S. taxpayers that did not act cooperatively (Recalcitrant

Account Holders). This includes those U.S. taxpayers, who have taken measures that make it impossible for the FFI to act in accordance with the FFI Agreement. This may occur by not providing the information required for the FFI or by refusing the consent to the disclosure and forwarding of data to the IRS.

Note: Particularly the disclosure and forwarding of data of the affected U.S. taxpayer to the IRS must be subjected to a review based on German data protection issues. By forwarding potentially confidential data, the protective scope of German data protection is generally open. However, it should usually be possible to overcome this hurdle by entering into an agreement with the respective account holder, in which the U.S. taxpayer consents to the disclosure of the data to the IRS.

Deemed Compliant FFI

In exceptional cases, the FFI may be treated as compliant with the FATCA rules even without having concluded an FFI Agreement and thus avoid a tax withholding on Withholdable Payments. These exceptional cases are provided for constellations where it can be ruled out that U.S. taxpayers have "interposed" non-U.S. institutions for the purpose of avoiding the taxation of their income in the USA. Insofar, the wording of the statute particularly provides exemptions for the case that the respective FFI does not have any US Accounts or that a tax evasion may be ruled out by the U.S. Treasury Department due to the nature of the institution. According to the statements in Notice 2011-34, the U.S. Treasury Department particularly assumes in the case of the following institutions that the latter precondition is fulfilled. Accordingly, the following institutions may apply for a Deemed Compliant status:

- Nationally operating banks and banking associations, whose members are all conducting classical banking business, who have a corresponding license, and are established, operating, and active exclusively in a single country. Furthermore, no customers having their seat outside of the country of organization or domicile may exist or be solicited. This must be ensured by observing predetermined policies and procedures.

- For investment vehicles, Notice 2011-34 provides that these are considered Deemed Compliant FFIs, if all direct investors are Participating FFIs or Deemed Compliant FFIs and if these hold the interests for their customers, or if the interests are held by institutions that are exempt from the FATCA rules. The respective investment vehicle must prohibit the acquisition of interests for investors other than those mentioned and confirm that the provisions concerning Passthru Payments are observed.

The FFI must apply for the Deemed Compliant status with the IRS. Furthermore, it must be certified every three years that the preconditions for this status are still fulfilled.

Note: The U.S. Treasury Department and the IRS are currently reviewing to what extent additional funds and fund structures, which exclude certain holders of interests (particularly U.S. taxpayers), may be classified as Deemed Compliant FFIs. It is furthermore under review, whether certain types of old-age benefit plans should also be exempt from the scope of application of the FATCA rules.

SCOPE OF DUTIES – NFFEs

NFFEs are not supposed to be obligated under the FATCA rules to enter into a standardized agreement with the U.S. Treasury Department. These institutions are subject to the 30 percent withholding tax only, if they do not provide the following information to the IRS:

• Declaration that no Substantial US-Owner holds any interest in them, or

• Name, address, and tax identification number of the Substantial US-Owner.

Which Sanctions Must be Expected for Non-Compliance with the FATCA Rules?

The tax penalty of 30 percent on all gross U.S. revenue, which was introduced by the FATCA rules, becomes relevant subject to the following precondition, which also require a distinction between FFIs and NFFEs.

FOREIGN FINANCIAL INSTITUTIONS (FFIs)

The tax withholding fully applies to Withholdable Payments in any case, if the FFI does not enter into the standardized agreement issued by the U.S. Treasury department and is not awarded the status of a Deemed Compliant FFI. In this case, a withholding tax of 30 percent must be withheld on all gross U.S. revenue.

It is irrelevant for this purpose, whether the FFI is the beneficial owner of the collected U.S. revenue, or whether the U.S. revenue is collected for customers of the FFI.

This distinction affects only the possibility to receive a refund of withheld tax (see page 9 "Refund of withheld tax").

If the FFI does enter into the FFI Agreement with the U.S. Treasury Department properly, but does not fulfill the documentation and reporting obligations agreed therein, the agreement may be terminated by the U.S. Treasury Department. It is currently still unclear here, whether such a termination right exists already for technical deficiencies in the implementation of the Agreement (e.g. no proper electronic transmission of the required data) or whether a gross violation of the agreed duties is required.

If the FFI is unable to fulfill the documentation and reporting obligations incumbent upon it, since it has one or several non-cooperating U.S. taxpayers (Recalcitrant Account Holders) as its customers, it is currently still unclear, to what extent the U.S. Treasury Department has the right to terminate the FFI Agreement in this case, too. According to Notice 2011-34, a Participating FFI is automatically classified as a Non-Participating FFI, if it has several Recalcitrant Account Holders among its customers. It is currently being discussed, what can be done against persistent Recalcitrant Account Holders and whether and under which circumstances the FFI Agreement may be terminated due to a certain number of Recalcitrant Account Holders, who still exist after a reasonable period of time.

NON-FINANCIAL FOREIGN ENTITIES (NFFEs)

If NFFEs do not fulfill the duties of reporting their Substantial Owners incumbent upon them, a withholding tax of 30 percent on all Withholdable Payments must be withheld in their case, too. In respect to the implementation of the withholding, the principles described for FFIs apply.

Who has to Withhold the Tax? To what Extent may Withheld Tax be Refunded?

TAX WITHHOLDING

The tax is withheld by the so-called Withholding Agent. This is, irrespective of the respective function, any person, who is involved in controlling, collecting, keeping, and making dispositions over the disbursement of a Withholdable Payment.

Normally, the Withholding Agent is the source of the gross U.S. revenue and thus responsible for the tax withholding. In this case, the U.S. source is also liable for the withholding tax to be withheld by it.

In the case of Passthru Payments, i.e. if a payment is forwarded to a Recalcitrant Account Holder or to a Non-Participating FFI, the FFI itself is generally the Withholding Agent. Thus, the non-U.S. institution itself is required to withhold the withholding tax and pay it to the IRS. In this case, the non-U.S. institution is liable for the withholding tax to be withheld by it.

REFUND OF WITHHELD TAX

If the FFI is the beneficial owner of the U.S. revenue, it may demand a refund of the withheld tax to the extent that it falls into the protective scope of an existing double taxation treaty. A refund of withheld tax to an FFI is out of the question, if the U.S. taxpayer is beneficial owner of the U.S. revenue.

The withholding tax refund procedure is comparable to the usual tax refund procedure in the case where non-U.S. persons demand a refund of other withheld tax. This means in particular that a tax declaration must be filed in the USA. Generally, the amount of withholding tax to be refunded does not bear interest.

Outlook

Even though Notice 2011-53 postpones the effectiveness of the FATCA rules further into the future, the institutions falling into its scope of application have to initiate numerous steps and measures already now.

The most important one is the continuing information about current developments concerning the specification and interpretation of the FATCA rules, parts of which are still very general. Accordingly, the directives announced for the end of 2011 and mid-2012 have to be taken into account, since changes to the personal and factual scope of application of the FATCA rules may result from these and since the nature and scope of the documentation and reporting obligations may be modified further.

In addition to the analysis, whether and to what extent the FATCA rules apply to the relevant institution, it is also decisive, particularly for financial institutions, to review existing contractual relationships with U.S. taxpayers and to adapt these, if necessary. Accordingly, special termination rights or (supplementary) gross-up clauses may be agreed for the case of a tax withholding by the Withholding Agent. Also, it should be considered to what extent the scope of application of the FATCA rules may be limited through internal restructurings, e.g. by separating the U.S. business from other businesses in other jurisdictions.

For institutions that do not fall under the FATCA rules without doubt, it is first necessary to achieve a corresponding understanding with the competent U.S. authorities, in order to achieve certainty as to whether the rules apply in order to determine the scope of the resulting obligations in a second step.

What can Mayer Brown Do for You?

Continuing information about current developments in the area of the FATCA rules through (individualized) newsletters, in-house presentations, or in-house training.

Internal due diligence to determine the applicability of the FATCA rules to your company from a personal and factual perspective. In cases of doubt, preparation of legal opinions or consultation with the IRS.

Structuring and contractual advice, which includes in particular the conclusion of the FFI Agreement with the IRS and the conclusion of necessary agreements with U.S. account holders. In addition, internal restructuring considerations to limit the scope of application of the FATCA rules and review of existing contractual relationships.

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