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U.S. Treasury and Japan/Switzerland Announce They Will Negotiate Toward a Third Way for FATCA Compliance

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INTRODUCTION

As we have previously reported, the Foreign Account Tax Compliance Act ("FATCA") is becoming a significant concern to foreign banks, brokers and investment funds because of its potentially far reaching scope. When FATCA's "withholdable payment" rules take effect in 2014, Sections[1] 1471 through 1474 of the Code will require that a foreign financial institution ("FFI") has signed an agreement ("FFI Agreement") with the U.S. Internal Revenue Service ("IRS") in order to avoid a 30% U.S. withholding tax on U.S. source interest, dividends and sales proceeds, as well as on "passthru payments."

One of the concerns expressed by FFI's is that the exchange of information pursuant to an FFI Agreement violates privacy laws of foreign countries. Because of these concerns, in February the U.S. Treasury ("Treasury") released a joint statement from the U.S., France, Germany, Italy, Spain, and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA. The joint statement noted that the U.S. is open to adopting an intergovernmental approach to implement FATCA and improve international tax compliance and is willing to reciprocate in collecting and exchanging on an automatic basis information on accounts held in U.S. financial institutions by residents of France, Germany, Italy, Spain, and the United Kingdom (i.e., a country-to-country information sharing model).

Thus, in addition to strict compliance with Sections 1471 through 1474 (e.g., signing an FFI Agreement), the February announcement reflects a second approach designed to achieve FATCA's goal of increased compliance with U.S. tax law.

Last week, Treasury issued joint statements with Switzerland and with Japan that contemplate a third approach for implementation of FATCA. This third approach is a hybrid between the straight FFI Agreement and the intergovernmental approach referred to above, in which FFIs would satisfy their reporting requirements by reporting directly to Treasury, supplemented by exchange of information between the relevant countries upon request while at the same time simplifying the implementation of FATCA.

SWISS FRAMEWORK

The U.S.-Swiss joint statement explains that the U.S. and Switzerland would enter into an agreement pursuant to which Switzerland:

(i) would direct all non-exempt or non-deemed-compliant Swiss financial institutions to enter into an FFI Agreement with the IRS,

(ii) enable Swiss financial institutions to comply with the obligations set forth in the FFI Agreement by granting an exception to the criminal prohibition on actions for the benefit of a foreign state, and

[1] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury regulations promulgated thereunder.

(iii) provide additional information about U.S. recalcitrant accounts as requested by Treasury pursuant to the exchange of information provisions included in a protocol to the U.S.-Swiss tax treaty.

In exchange, the U.S.:

(i) will expand the categories of deemed-compliant and exempt FFIs for Swiss institutions (e.g., small, local FFIs),

(ii) eliminate U.S. withholding under FATCA on payments to Swiss financial institutions (i.e., by identifying all Swiss financial institutions as participating FFIs or deemed-compliant FFIs, as appropriate), and

(iii) agree to certain other appropriate measures to reduce burdens and simplify the implementation of FATCA.

Additionally, Swiss financial institutions would not be required to:

(i) terminate the account of a recalcitrant accountholder, and

(ii) impose foreign passthru payment withholding on payments to recalcitrant account holders, or to other financial institutions in Switzerland, or in another jurisdiction with which the U.S. has in effect either an agreement for an intergovernmental approach to FATCA implementation, or an agreement for intergovernmental cooperation to facilitate FATCA implementation.

JAPANESE FRAMEWORK

Similarly, the joint statement with Japan explains the framework that the relevant U.S. authorities (Treasury and IRS) would enter into with the relevant Japanese authorities (the Ministry of Finance, the National Tax Agency and the Financial Services Agency) under which the Japanese authorities would agree to:

(i) direct and enable financial institutions in Japan, not otherwise exempt or deemed-compliant, to register with the IRS and confirm their intention to comply with official guidance issued by Japanese authorities that is consistent with the obligations of participating FFIs under FATCA, and

(ii) provide additional information about U.S. recalcitrant accounts as requested by Treasury pursuant to the exchange of information provisions included in the U.S.-Japan tax treaty.

The relevant U.S. authorities would agree to:

(i) eliminate the obligation of each FFI in Japan to enter into a separate FFI agreement, provided that each FFI is registered with the IRS or is excepted from registration,

(ii) identify specific categories of Japanese financial institutions or entities that would be treated as deemed-compliant or exempt due to presenting a low risk of tax evasion (e.g., certain Japanese pension funds), and

(iii) eliminate U.S. withholding under FATCA on payments to financial institutions in Japan that have registered or entered into an FFI agreement with the IRS and conduct due diligence and reporting in a manner consistent with FATCA requirements or are treated as deemed-compliant or exempt pursuant to the agreed upon framework.

Similar to the U.S.-Swiss proposed agreement, financial institutions in Japan that comply with their obligations would not be required to:

(i) terminate the account of a recalcitrant account holder, or

(ii) impose passthru payment withholding on payments to recalcitrant account holders, to FFIs organized in Japan that have registered or entered into an FFI agreement with the IRS, or are otherwise exempt or deemed compliant, or to FFIs in another jurisdiction with which the U.S. has in effect either an agreement for an intergovernmental approach or an agreement for intergovernmental approach.

This third approach announced last week effectively represents a country-by-country modification of the FATCA rules. Under this system all financial institutions in the country would be identified to the IRS and either be exempted or agree to share information about U.S. account holders. (For example, the joint Swiss-U.S. statement mentions "certain small, local FFIs and institutions/schemes in the field of the Swiss pension system" that could be exempted.) In exchange, all such country's FFIs would be exempt from Section 1471 withholding tax. Also, identification of recalcitrant account holders (e.g., ones who refuse to comply with a request for information) would occur on an aggregate basis under existing treaty obligations rather than FFI-by-FFI. Finally, the participating country's FFIs would be exempt from the onerous passthru payment rules.

Interestingly, this per country approach is not uniform. Under the Swiss version, Swiss FFIs would enter into FFI Agreements with the IRS. Under the Japanese version, non-exempt Japanese FFIs would register with the IRS and confirm their intention to comply with official guidance issued by Japanese authorities that is consistent with the obligations of participating FFIs.

The joint statements merely announce an intent to negotiate or explore agreements along the foregoing lines. No date is set forth for actual agreements although presumably they would be in force beginning in 2014, when FATCA would otherwise take effect.

For all FATCA updates, including the joint statements, see our FATCA website at KNOWFatca.com.

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