Foreign Account Tax Compliance Act in 2010

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The world of international taxation becomes more transparent with every passing year. This reflects the desire of global tax authorities to achieve compliance efficiency, prevent the inappropriate avoidance of taxpaying obligations and promote equity among taxpayers.

There have been many elements of transparency in recent years, including transfer pricing documentation in more than 70 countries, FIN 48 (ASC 740) for financial reporting purposes, UTP Schedule for U.S. tax purposes, and exchange of information agreements between Organisation for Economic Co-operation and Development (OECD) member and non-member countries.

The most recent evolution of this process in the United States was enactment of the so-called Foreign Account Tax Compliance Act (FATCA) in 2010 and release of extensive proposed regulations implementing FATCA in February 2012. At the same time, the United States announced an agreement with several EU countries to exchange information with respect to foreign accounts, a common problem in all high-tax countries.

FATCA is a noteworthy evolution in U.S. and OECD tax policy with respect to so-called mobile or homeless income. While FATCA addresses U.S. accounts held for the benefit of foreign persons, the overall approach to tax base defense may find its way into the international tax reform debates that are important for the U.S. tax base. As with other evolving issues that may seem distinct, including those noted above, FATCA is actually part of the global tide of tax base defense efforts, which will be critical elements of the posture of multinational entities (MNEs) to defend their own tax base (effective tax rate planning and strategy).

OECD Evolution of Harmful Tax Competition

The process that resulted in FATCA has a long history in U.S. and OECD tax base defense efforts. Withholding taxes have long been an element of tax base protection for domestic source income, especially passive or investment income. The OECD commenced a similar process in 1996 in its highly publicized effort to address so-called “harmful tax competition,” which was a shorthand for perceived international tax avoidance by MNEs, especially relating to so-called mobile or homeless income which could easily be moved across international borders (the HTC Initiative).[1] The HTC Initiative has evolved into an information sharing process, similar in essence to FATCA.

Qualified Intermediary Regime

Foreign investors frequently use financial intermediaries to direct their investments into the United States. These intermediaries could apply for reduced withholding with respect to payments that they receive attributable to their clients provided they had received, and passed on to the U.S. withholding agents, the required documentation confirming that their clients were the owners of the payments and entitled to lower withholding rates. If U.S.-source interest was being paid, an intermediary would be required to pass along a Form W-8 from its client to obtain the portfolio interest exemption. This method, however, effectively required the intermediary to expose its client list to U.S. withholding agents, and was often disregarded. Regulations were promulgated in 1997 to address this lack of compliance and the concern of foreign intermediaries about revealing their clients by allowing them to become so-called “qualified intermediaries” (QIs).[2]

A foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other withholding agent of U.S.-source investment-type income to establish its eligibility for an exemption from, or reduced rate of, U.S. withholding tax. The cornerstone of the QI system is the QI agreement that a foreign intermediary enters into with the Internal Revenue Service (IRS), setting forth the conditions that an intermediary must fulfill to be a QI. The IRS became comfortable that “know-your-customer” procedures of several foreign countries (in particular the European countries) provided sufficient information regarding the nationality of account holders, including whether they were intermediaries, to allow intermediaries in these jurisdictions to rely on such documentation in determining the proper amount of withholding.

The U.S. tax base defense with respect to offshore accounts was assumed to have been appropriately ring-fenced by the QI arrangements. In 2008 and 2009, a variety of developments indicated that the QI regime may not have been effective from a U.S.

[1] See *OECD TP* ¶ 2.06[2].
[2] See *Int’l Prac & Proc* ¶ 7.05[1][e].

tax base protection standpoint. It became inevitable that there would be legislative and regulatory consequences from resultant congressional investigations.

FATCA Legislation

The U.S. Congress responded in 2010 by enacting the Hiring Incentives to Restore Employment Act of 2010 on March 18, 2010, commonly referred to as FATCA.[3] Specifically, FATCA added to the Code chapter 4 of Subtitle A, comprising Sections 1471 through 1474, to impose reporting requirements on foreign financial institutions (FFIs).

FATCA generally requires FFIs to provide information to the IRS regarding their U.S. accounts. It also requires certain non-financial foreign entities (NFFEs) to provide information on their substantial U.S. owners to withholding agents. A withholding tax is imposed on certain payments to FFIs and NFFEs that fail to comply with these obligations.

FFIs provide significant investment opportunities for, and act as intermediaries with respect to, the investments of U.S. taxpayers. Like U.S. financial institutions, FFIs are typically in the best position to provide appropriate information to the Fisc concerning their U.S. customers. Accordingly, Congress concluded that it was essential that reporting of pertinent financial data be required for both the onshore and offshore accounts of U.S. taxpayers.

The purpose of the FATCA provisions is to extend the scope of the U.S. information reporting regime to include FFIs that maintain U.S. accounts, as well as NFFEs that present a high risk of U.S. tax avoidance. If FFIs and NFFEs do not comply with the reporting and other requirements, a withholding obligation is imposed upon them. Any such withholding generally may be credited against the U.S. income tax liability of the beneficial owner of the payment to which the withholding is attributable, or may be refunded to the extent the withholding exceeds such liability. On the other hand, an FFI that does not comply with the FATCA requirements and beneficially owns the payment from which tax is withheld may not receive a credit or refund of such tax except to the extent required by a U.S. treaty obligation.

These requirements and sanctions are potentially draconic on FFIs, NFEEs and beneficial owners of the payments in question.

To provide interim guidance on the myriad interpretational requirements posed by FATCA, the IRS issued Notice 2010-60. For an existing account, the Notice requires that FFIs go through electronic searchable databases to look for *indicia* of U.S. ownership, which *indicia* are listed in the Notice. If the FFI has any basis to know that information in its database is inaccurate, it must act on that knowledge. If there are any such *indicia*, the FFI must obtain a Form W-9 or W-8BEN from the account holder to establish U.S. or foreign status.

As the withholding and subsequent reporting requirements become effective, there has been an intense lobbying effort on behalf of FFIs and various specific industries to relax the reporting standards of FATCA, together with a declaration that the requirements exceed U.S. taxing jurisdiction. The OECD has agreed that FATCA may impose huge reporting burdens on financial institutions, although it has also stated that the process will generate benefits for other tax administrations in dealing with the domestic reporting of income from offshore accounts.

The second round of guidance on the expanded reporting and withholding for FFIs holding accounts of U.S. persons outlines the methodology that must be used to determine and identify U.S. accounts, with a focus on private banking and “pass-through” payments. Reporting is required for pass-through payments with respect to which an FFI may not directly hold the underlying assets. The purpose of this requirement is to prevent the use of “blockers” to avoid FATCA compliance. The definition of withholdable payments is broader than the normal fixed and determinable or periodical-type income. These requirements are intended to encourage FFIs to enter agreements even if they do not directly hold assets that produce withholdable payments, since these entities could operate through intermediaries. The U.S. Department of the Treasury does not want to have these structures avoid the FATCA requirements.

The FATCA reporting form (Form 8938, “Statement of Specified Foreign Financial Assets”) was released in June 2011. Another round of guidance was released in July 2011, detailing how the FATCA will be implemented in phases beginning in June 2013.

[3] Pub. L. No. 111-147.

In September 2011, as implementation of FATCA evolved, Republican members of Congress warned Treasury to implement it in a manner that would not damage the attractiveness of the U.S. market for investment. There are obviously mixed signals in such advice. On the one hand, Treasury is told to protect the U.S. tax base, and on the other, not to make the U.S. market less attractive for investors seeking to avoid paying U.S. tax.

In October 2011, IRS officials indicated that the IRS is focused on finding a harmonious balance between minimizing compliance burdens and achieving the goals of FATCA by coordinating the FATCA rules with other provisions of U.S. and international laws. Future guidance will include completion of W-8 forms; modernizing the QI regime by possibly implementing a secure e-mail program and allowing transmission of electronic documents; and extending QI agreements set to expire before December 31, 2012, an extra year to allow for renewal as part of foreign financial institution registration.

Proposed FATCA Regulations

The proposed FATCA regulations were issued in early February 2012, seeking to implement the FATCA requirements for a reporting and withholding regime by establishing adequate lead time to allow system development and minimize overall compliance burdens. The proposed regulations sought to accomplish this goal by incorporating guidance in pre-proposed regulations notices, as refined by further experience and focus, and addressing additional topics that have arisen.

The essence of the content of the proposed regulations (spanning some 380 pages) follows:

MODIFICATIONS AND ADDITIONS TO FATCA NOTICES

1. Expanded scope of “grandfathered obligations” to those outstanding on January 1, 2013, and any gross proceeds from the disposition of such an obligation.

2. Transitional rules for affiliates with legal prohibitions on compliance. Recognizing that some jurisdictions have in place laws that prohibit FFI compliance, full implementation of the pertinent requirements is delayed to January 1, 2016.

3. Additional categories of deemed-compliant FFIs.

4. Modification of due diligence procedures for identification of accounts to facilitate FFI processes, including electronic and intake procedures.

5. Guidance on procedures required for FFIs to verify identification of U.S. accounts where the account holder is an FFI, a passive investment entity or has U.S. *indicia*.

6. Refinement of the definition of financial account to focus on traditional bank, brokerage, money market accounts and interests in investment vehicles, and excluding most debt and equity securities issued by banks and brokerage firms, all subject to an anti-abuse rule.

7. Extension of transition period for the scope of information reporting to phase in beginning in 2016 (with respect to the 2015 calendar year), with reporting on gross proceeds to begin in 2017 (with respect to the 2016 calendar year). FFIs may elect to report information either in the currency in which the account is maintained or in U.S. dollars.

8. Pass-thru payment reporting will not be required with respect to foreign pass-thru payments before January 1, 2017, though FFIs must report annually to the IRS the aggregate amount of certain payments made to each non-participating FFI.

Obligations of FFIs

Section 1471(b) imposes six obligations on FFIs:

1. Obtain information necessary to determine if it has U.S. accounts.

2. Comply with U.S.-specified due diligence requirements with respect to U.S. accounts.

3. Annually report the specified information on its U.S. accounts.

4. Withhold on U.S. source payments made to recalcitrant account holders, non-compliant FFIs and other FFIs that have elected not to withhold on their own recalcitrant account holders.

5. Comply with IRS requests for additional information.

6. Attempt to obtain waivers of any foreign law that would prevent transmission of required information to the IRS and, if such waiver cannot be obtained, close such accounts.

The proposed regulations provide a more detailed explanation of how an FFI can satisfy its obligations and therefore avoid withholding:

1. **Due Diligence Required to Identify U.S. Accounts**. FFIs must identify U.S. accounts, which include both accounts held by U.S. individuals and certain U.S. entities, and accounts held by foreign entities with substantial U.S. owners (generally, owners with a greater than 10 percent interest). The proposed regulations distinguish between the due diligence required for individual accounts versus entity accounts, as well as between pre-existing accounts and new accounts. If the requirements are satisfied, an FFI will be treated as compliant and not be held to a strict liability standard for failure to comply. The standards include specific balance or value thresholds.

2. **Deemed-Compliant FFIs**. In exercising the authority to deem certain FFIs to be compliant, Notice 2011-34 identified certain types of FFIs. The proposed regulations implement these exclusions and expand the categories to include certain banks and investment funds conducting business only with local clients, low-risk entities or participating FFIs, all subject to restrictions designed to prevent the FFIs from being used for U.S. tax evasion. The proposed regulations also expand the category of retirement plans that are exempted.

3. **Transitional Rule for Affiliated Groups**. Until January 1, 2016, a non-participating FFI or branch that is subject to foreign laws that prohibit the FFI or branch from complying with the FATCA requirements will not disqualify an otherwise participating FFI group with which it is affiliated, provided that such FFI or branch complies with the due diligence procedures. Such “limited FFI affiliates” and “limited branches” will be subject to withholding upon receipt of withholdable payments.

4. **Phase-In of Reporting Obligations**. There is a phase-in of the reporting obligations of FFIs between 2014 and 2017.

5. **Phase-In of Scope of Pass-Thru Payments**. A material element of the base protection function of the FATCA rules is potential withholding on so-called pass-thru payments, which are U.S. source payments made to an FFI that are passed-thru to other payees. The pass-thru rules are imposed in two steps. On January 1, 2014, FFIs will be required to withhold on pass-thru payments that are withholdable payments, and report on payments to non-participating FFIs in 2015 and 2016. On January 1, 2017, the scope of pass-thru payments will be expanded beyond withholdable payments. The treatment of pass-thru payments will be critical in a variety of contexts to prevent the use of “blocking” entities between a U.S. payor and a non-participating FFI (NPFFI), which will presumably be addressed in future regulations or guidance.

6. **Refunds**. FATCA provides that, to the extent withholding exceeds the beneficial owner’s underlying U.S. tax liability, it may claim a refund of the over-withheld amount. No refund is available with respect to payments beneficially owned by non-participating FFIs, except as required under an income tax treaty. The proposed regulations impose certain information provision requirements upon NFFEs claiming a refund (other than a refund attributable to a reduced rate of tax under a U.S. tax treaty obligation).

Finally, the proposed regulations provide that a credit is to be provided against FATCA withholding if the payment in question is otherwise subject to U.S. withholding (such as the Foreign Investment in Real Property Tax Act or partnership allocations relating to a U.S. trade or business).

FATCA Implementation

Recognizing that there are costs associated with the implementation of any new reporting regime, Treasury and the IRS advise that they have undertaken to develop an implementation approach that appropriately balances policy objectives and minimizes the burdens imposed on stakeholders. They will also continue to engage with such stakeholders, including foreign governments, in finalizing the proposed regulations. Consideration is being given, in consultation with foreign governments, to an alternative approach to implementation whereby an FFI could satisfy the FATCA reporting requirements if the FFI collects the required information and reports this information to its residence country government, and the residence country government enters into an agreement to report this information annually to the IRS pursuant to a U.S. income tax treaty, tax information exchange agreement or other agreement.

Impact of Tax Treaties or Other Agreements

The proposed FATCA regulations confirm that FATCA withholding can be reduced pursuant to provisions of applicable income tax treaties. Of course, this leaves open the question of whether a specific FFI is entitled to the benefits of an income tax treaty.

In addition, the provisions of the proposed regulations leave open the question of whether an NPFFI is subject to gross proceeds withholding. Given the recent vintage of the FATCA requirements and regulations, it is unlikely that a treaty would specifically address this issue. Accordingly, it seems unlikely that withholding could be avoided under the "other income" or other provisions of existing treaties.

In the absence of a ruling or other appropriate protection, a withholding agent would presumably withhold on such a basis. The NPFFI would then be in the posture of having to seek a refund of such taxes if it believed that withholding was not required because of treaty or other provisions. This situation is similar to the current situation relating to withholding on payments that the payee believes not to be fixed, determinable, annual or periodic (FDAP).[4]

Commentators and foreign governments have suggested that bilateral information exchange agreements could eliminate many of the legal and compliance burdens associated with the FATCA regime. As time goes on, it is apparent that the issue of tax base protection for deposits of domestic taxpayers in foreign accounts is an issue for all governments. In this regard, the IRS has issued a model agreement for government-to-government information sharing agreements, as well as a draft agreement for banks to participate under FATCA.

The broadly perceived need for multi-lateral handling of cross-border investment income payment was underscored by the Joint Statement of six countries (France, Germany, Italy, Spain, the United Kingdom and the United States) at the time the proposed regulations were issued to find inter-governmental means of handling the issue. Other agreements have been announced in the interim.

Areas of Controversy

FATCA imposes a rather amazing range of obligations on FFIs, with potentially draconic consequences for failing to withhold. Such consequences have always been the case with respect to U.S. withholding agents making FDAP payments,[5] in the sense that the failure of a withholding agent to withhold imposes upon it potentially strict or unconditional liability for the under-withholding. In the FATCA context, the same potential responsibility is imposed upon an FFI and others down the account chain. Not surprisingly, the scope of coverage of FATCA is fuzzy at the edge:

- Who is an FFI? Or an NFFI or NFFE?
- What about insurance or other forms of financial transaction payments that do not necessarily qualify as FDAP?
- What about treaties at each step in the process?

[4] See *Int'l Prac & Proc* ¶ 7.01.
[5] See *Int'l Prac & Proc* ¶ 7.05[1][e].

- Should different rules be imposed with respect to pass-thru payments?

- How can an FFI or other party with potential withholding responsibility in the chain of payment be assured that its due diligence requirements have been satisfied? What must an independent auditor report provide, and who is eligible to issue such reports?

Not surprisingly, there has been a virtual waterfall of comment since the proposed regulations were issued in February 2012. A summary of the critical comments, or proposed modifications of the proposed regulations, follows:

1. There should be more time allowed to develop compliance regimes for the complex new international payment requirements.

2. Certain country banking officials advise that the FATCA regulations, in effect, make their banks enforcement arms of the IRS. Of course, it may be that such country tax authority will follow the lead of the United States with respect to its own accounts.

3. FATCA creates serious problems for firms that may not be the actual targets of the regime.

4. Bilateral information exchange agreements could eliminate many of the legal and compliance burdens associated with the FATCA regime.

5. The regulations should be simplified to avoid unintentional regulation of certain foreign businesses, including subsidiary businesses that should be exempt (and even though exempted may not actually be so as a result of other provisions in the proposed regulations).

6. Insurance companies have sought clarification of when insurance contracts will be deemed U.S. accounts, as others suggest that non-financial institutions may not perceive that they could be caught in the FATCA web (such as a financial center member of a MNE group).

7. The regulations should exclude pass-thru payments made before the 2017 effective date of such provisions in the proposed regulations. The issue was reserved in the proposed regulations, pending determination of how many FFIs will participate in the program (as noted in Notice 2011-34).

8. FATCA reporting requirements should be coordinated with other requirements, such as anti-money-laundering processes.

Implication of FATCA Regime on International Tax Reform Circa 2012 and Beyond

The FATCA legislation and regulations address U.S. tax base protection relating to investment income from U.S. sources. In essence, the compliance and information reporting requirements of FATCA are intended to ensure that appropriate U.S. income tax is paid on such income, consistent with U.S. treaty commitments. The tax is collected via withholding because it would otherwise be cumbersome and inefficient for the Fisc to seek to collect U.S. income tax from foreign persons.

At the time FATCA emerged (2010–2012), tax base defense was the front-and-center business of all countries. This was true for OECD members as well as non-OECD members, such as the so-called BRICS countries (Brazil, Russia, India, China and South Africa). For example, in its 2012 Tax Bill, India plainly signaled its intention to defend its tax base. At the same time, the BRICS countries and others were beginning to suggest a need to develop a model tax treaty that reflected their own interests as opposed to the those reflected in the OECD and UN model treaties.[6]

FATCA achieves its objectives (U.S. tax base protection) with respect to U.S. accounts held for the benefit of foreign persons by information reporting requirements and, ultimately, U.S. withholding of the tax that is due in specific circumstances.

[6] See *Int'l Prac & Proc* ¶ 9.01[1][c].

In a world in which tax base defense is a critical issue for all governments (at any level), and the process of assessing and collecting tax is a problematic exercise, especially with taxpayers located in other countries, a reasonable question is to contemplate whether the overall approach of FATCA to tax base defense could find its way into more general international tax regimes as a result of frustration with the status quo. For example, the U.S. Congress might impose some type of surtax or other regime on all types of cross-border payments, with a pre- or post-payment clearance process to assess the appropriate level of tax due on U.S. activities.

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