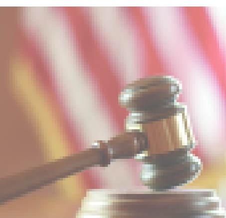


The trouble with FATCA…

GRAHAM BUCK EXAMINES THE CONSEQUENCES – THE UNFORESEEN AS WELL AS THE INTENDED – OF NEW US LEGISLATION THAT WILL TAKE EFFECT FROM 2013.

While it is only now beginning to attract attention on this side of the Atlantic, a new US law threatens to create increasing ripples over the months ahead. The Foreign Account Tax Compliance Act (FATCA), which was enacted in March 2010, will be introduced in stages over the coming months and be fully effective from 1 January 2013.

FATCA was hatched in October 2009 as a way to achieve stricter implementation of US tax laws applicable to assets outside the US. It followed the passing of the US Hiring Incentives to Restore Employment Act, of which it is part. FATCA is generally seen as having already added to the burden and expense of regulation and tax compliance for European institutions managing investments for US clients.

The aim of the legislation is to crack down on individuals who evade paying US taxes by not filing tax returns. Many have evaded payment by making investments via foreign vehicles, such as offshore accounts and entities. However, FATCA spreads the tax net much wider – quite possibly far wider than intended by its proponents.

FATCA subjects foreign financial institutions (FFIs) that offer their clients US investments to the same sort of reporting requirements as apply to US financial services providers. These requirements include providing the US Internal Revenue Service (IRS) with a level of tax information about US residents and citizens that extends significantly beyond the existing Qualified Intermediary (QI) regime.

WIDESPREAD REPERCUSSIONS The Act defines an FFI as any non-US financial institution (including the overseas subsidiaries of US financial institutions) that:

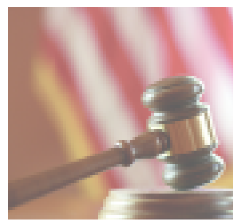
- accepts deposits in the ordinary course of a banking or similar business;
- holds financial assets for the account of others as a substantial portion of its business; or
- is engaged primarily in the business of investing, reinvesting or trading in securities, partnership interests or commodities.

FATCA has repercussions not only for European banks but also brokers, investment companies, intermediaries, stock exchanges and clearing houses as well as (potentially) funds, insurance companies and some non-financial institutions.

The IRS has already twice published guidance on a number of issues related to FATCA to clarify which categories of business will be exempt from its requirements. They include "certain holding companies, start-up FFIs for the first 24 months of their operation, hedging/financial centres of a non-financial group, and the issuers of financial contracts that have no cash value".

According to Hans-Joachim Jaeger, a partner at Ernst & Young's Zurich office, between 100,000 and 200,000 institutions outside the US could be affected by the legislation, although the impact on many will be marginal. "One of the drawbacks of the legislation is its very broad definition of an FFI," he says.

His colleague Rod Roman, head of the firm's EMEIA banking tax practice in London, adds that UK companies as well as multinationals should review whether FATCA could apply to them. In some cases, their treasury operation could qualify as an FFI.



CONTRACT WITH THE IRS The extra cost of complying with FATCA is substantial. FATCA "invites" all FFIs to enter into a contract with the IRS whereby they agree to reveal the identities of their US customers as well as their assets. They must provide names, addresses and taxpayer identification numbers (TINs) of individual account holders. If the account holder is a US-owned foreign entity, then the name, address and TIN or each "substantial" US owner of that entity must be disclosed and reported to the IRS. In all cases, account numbers, account balances and details of different categories of payment received (such as dividends, interest and other income) must be supplied.

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These customer identification requirements extend beyond existing anti-money laundering legislation, such as the Bank Secrecy Act and USA Patriot Act, by including the US residency/citizenship status of an FFI's customers. Any FFI that fails to enter into such an agreement with the IRS will have to pay a withholding tax of 30% on all US-sourced payments, as well as on all sales proceeds of US securities.

The tax will be levied by an upstream participating FFI or a US withholding agent. As a result, all the clients of non-participating FFIs, whether US residents/citizens or not, will be penalised by this 30% withholding tax.

Jaeger, who with colleague Bruno Patusi co-authored a review of the Act's implications, says: "The alternative of a 30% withholding tax on all payments from US sources primarily serves as a strong incentive for financial institutions to enter into an agreement with the IRS and to force US taxpayers to have their assets disclosed which are deposited abroad."

He adds that a number of concepts require further clarification, particularly "pass-thru payments" (withholdable payments made by an FFI to a recalcitrant account holder or a non-compliant FFI).

The review describes FATCA as an attempt by the US to initiate a worldwide exchange of information on its citizens. Jaeger and Patusi predict that its attempt to force a greater degree of tax transparency is likely to be emulated by other countries. They therefore recommend that financial institutions should not restrict their implementation projects to FATCA alone but be prepared for other countries to introduce similar systems.

"From the banks' perspective this is a very major exercise, as they are being forced to penetrate the corporate veil in order to check on the identity of US persons," adds Roman. "So the message is, review your business model and determine whether your organisation is impacted by FATCA."

UK CORPORATES TO BECOME FFIs Jaeger expects the vast majority of affected UK corporations to become participating FFIs, in view of their banking relationships. "Most FFIs will think about their business models. Do they want to work with non-participating FFIs? This will force them to think about restructuring the relationship," he suggests. "FATCA is targeted at the wealth business of banks, but its unintended consequences may fall into the corporate arena. At some point the treasurer's work programme will mean that he or she needs to check where their company stands as regards the legislation."

Even companies that qualify as non-financial foreign entities (NFFEs) are required by FATCA to report any "substantial" US owners with a holding of 10% or more, or certify they have no significant US ownership.

The Act has triggered protest. According to the group American Citizens Abroad, FATCA is a "reporting monster". It says it "will cost billions of dollars for foreign financial institutions to comply" and sharply increase the reporting compliance costs of individual Americans who live outside the US and have a foreign bank account.

Beyond the rhetoric, it appears that the extra tax revenue raised by the legislation – estimated at around $850m a year – will be disproportionate to the heavy implementation costs that will fall on FFIs affected. The additional administrative, legal, compliance and IT costs of identifying US clients and reporting the data in a format that meets IRS requirements is estimated at $5m to $10m for each FFI, with higher operating costs also likely. Several of the largest international banks estimate that they face a compliance bill of $100m.

Jaeger says the IRS is in a difficult situation: "Congress initiated FATCA and wanted to give the legislation as many teeth as possible, but as the IRS will have to handle some 100,000 to 200,000 additional reports its own administrative costs will rise massively."

Other likely repercussions include a reduction in financial and direct investment in the US, regulatory conflicts and a reluctance for FFIs to take on US citizens living abroad as clients. There are already reports of European private banks closing their doors to wealthy expatriate Americans rather than risk falling foul of FATCA. Some are no longer willing to service US offshore clients and are closing their accounts, while a few have decided to withdraw completely from US securities. UK wealth managers Brewin Dolphin and Williams de Broë have opted to close the portfolios of wealthy US clients residing in Britain.

"I've never known a tax that has resulted in such a degree of lobbying," says Roman. "The IRS has at least indicated that it is aware of the unintended consequences and asked the finance industry to submit comments."

The Investment Management Association and other European asset manager bodies are strongly lobbying the IRS to amend the new regime. Senior EU officials wrote to US treasury secretary Timothy Geithner expressing concern over the impact of FATCA on Europe's financial services industry. With just over 18 months until the regime takes effect, a great deal of further guidance, as well as dialogue, can be expected.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org