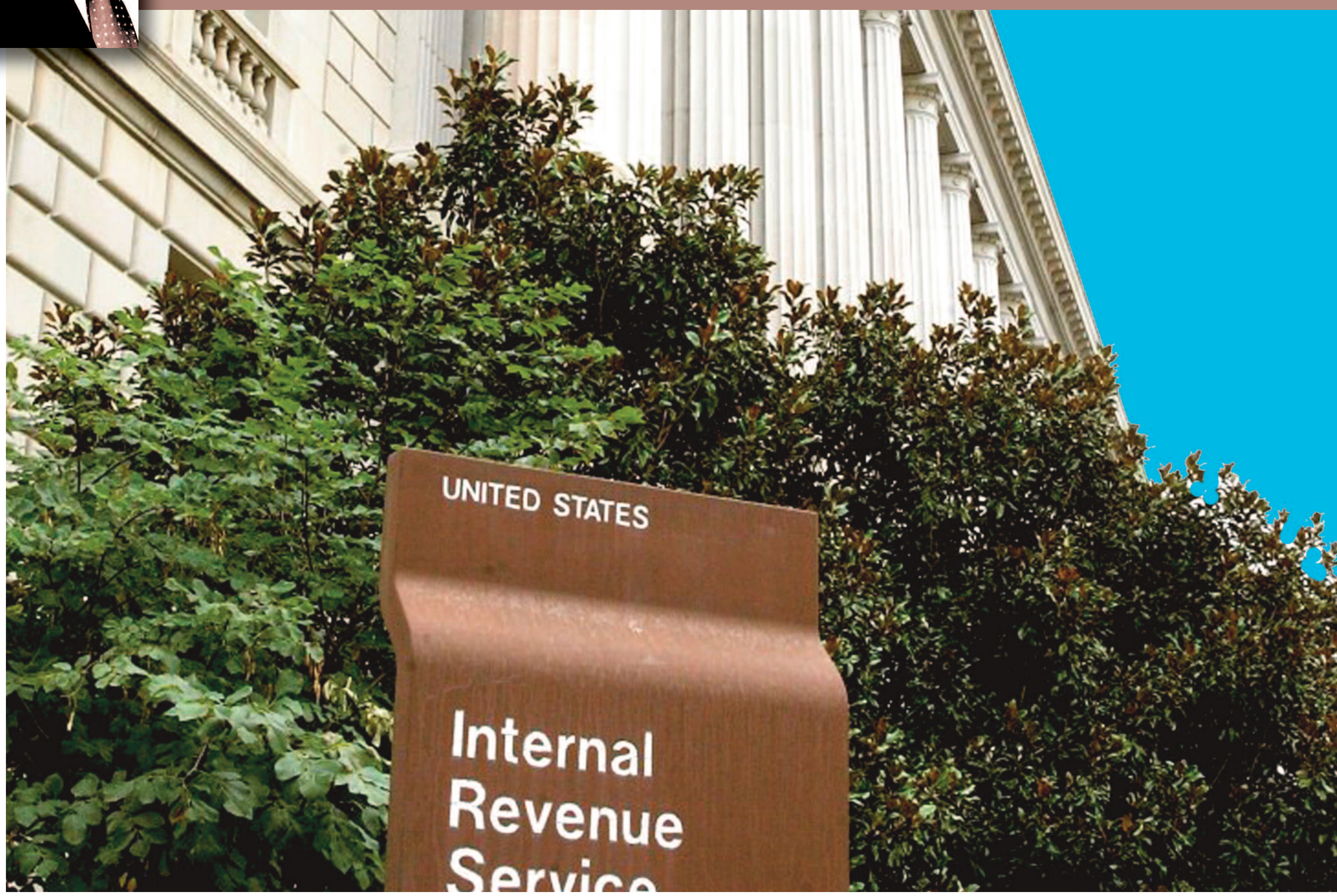
FATCA: AN EXECUTIVE SUMMARY

The primary requirement of FATCA is that all foreign financial institutions or non-financial foreign entities must:

(1) Report to the IRS information about accounts or holdings belonging to U.S. taxpayers; or,

(2) Pay a tax of 30% on the gross amount of transfers received by an FFI or a NFFE from U.S. sources.

by Timothy D. Richards



FATCA

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THE LAW AND REGULATIONS

The Foreign Account Tax Compliance Act ("FATCA") was passed by the U.S. Congress and signed into law by President Obama in March of 2010, as part of the "Hiring Incentives to Restore Employment (HIRE) Act". FATCA was added to the U.S. tax code (the "Internal Revenue Code of 1986" or "IRC") by the inclusion of sections 1471 through 1474 ("FATCA").

The Government entity that is responsible for administering the federal tax laws of the United States is the Internal Revenue Service ("IRS"). The IRS, in its executive capacity, has the authority to issue Regulations to clarify and manage any law that is part of the IRC.FATCA final Regulations (the "Regulations") were published by the IRS at the beginning of 2013. [1] In addition, the IRS is authorized to amend, expand and extend the Regulations at any time after the publication of final Regulations. Accordingly, the IRS has released numerous subsequent administrative notices ("Notices") [2], that together with the Regulations and FATCA will have a substantial impact on financial and non-financial institutions. The large volume of technical (and sometimes contradictory) information contained in FATCA, the Regulations and the Notices, have caused a great deal of confusion and concern in the international financial markets.

The objectives of this article are to (1) summarize FATCA and introduce the new vocabulary of FATCA terms; (2) summarize a strategy that may be followed to avoid the FATCA withholding tax; (3) briefly discuss new IRS Forms relevant to FATCA; and (4) present a list of financial institutions exempt from FATCA.

FATCA's GENERAL PURPOSE

FATCA was adopted as part of a coordinated effort by the U.S. Government to eradicate the evasion of taxes by U.S. citizens and U.S. tax residents. The primary requirement of FATCA is that all foreign financial institutions (an "FFI") or non-financial foreign entities (an "NFFE") must:

ONE: ***Report to the IRS information about accounts or holdings belonging to U.S. taxpayers; or,***

TWO: ***Pay a tax of 30% on the gross amount of transfers received by an FFI or a NFFE from U.S. sources.***

The 30% tax will apply to almost all transfers originating in, or made through the U.S. financial system ("Withholdable Payments") starting from July 1, 2014 ("effective date"). In certain cases, an FFI will also have the responsibility of withholding 30% of any transfer carried out through that respective institution (a "pass-thru payment") to other financial institutions.

Although the basic requirement of FATCA is quite simple, it imposes an enormous compliance burden as well as a prohibitive tax on institutions that do not participate in the FATCA regime. While many countries have objections to FATCA, based on the premise that FATCA represents an illegal intrusion of their sovereignty, it is hard to imagine how it would be possible to handle international transactions without access to the U.S. financial system. Therefore, almost all countries of the world are resigned to the fact that FATCA is a challenge that they will be required to face in a spirit of cooperation with U.S. authorities.

THE FINANCIAL WORLD'S REACTION

There are several elements in play that have influenced the reaction of global financial institutions to FATCA.

Firstly, FATCA affects an enormous number of transactions and, therefore, to cover all the transactions contemplated, the volume of text found within FATCA, the Regulations, and the Notices are superior to 600 pages. The sheer magnitude of the law creates the impression that FATCA will be impossible to understand and implement within the prescribed time-frames. For this reason, the financial community has expressed a great deal of concern (if not outright panic) as the FATCA effective date draws nearer.

Secondly, is a great deal of confusion among executives within the financial sector who still have not received clear professional advice, generally because their advisers are still evaluating the law in order to make informed recommendations.
The situation is worsened by the fact that there are few consultants, outside of the expensive and exclusive group of global accounting and audit firms, who have developed a specialty in the subject of FATCA. At the same time, the IRS continues to issue regulatory decrees and additional notices that have impacted financial institutions' ability to interpret and implement FATCA.

Finally, several Governments have announced their intentions to proceed with the signing of intergovernmental agreements ("IGA's") with the United States. The possibility of signing an IGA is appealing because, insofar as certain conditions described below are satisfied, if an IGA is in force on July 1, 2014, the FFI's and NFFE's located in that jurisdiction will not be subject to the 30% withholding tax.
Significantly however, the existence of an IGA will not release the FFI or the NFFE from the due diligence and reporting obligations required by FATCA.

The result of the combination of these elements has created an international confusion, which is easy to identify. For example, the Colombian magazine "Semana" recently published an article about FATCA saying that Colombia had already signed a bilateral treaty which will eliminate the 30% FATCA withholding tax for Colombian financial institutions. [3] This is incorrect. The only treaty recently signed between Colombia and the United States is a Tax Information Exchange Agreement (TIEA) . It is clear that the authors of the "Semana" article were simply confused.
This confusion is not limited to consultants located outside the United States. In another example, an author and lawyer from Miami, recognized as an expert in money laundering laws, published an article saying that a Notice recently issued by the IRS (Notice 2013-69) only applies to FFI's located in jurisdictions that have signed an IGA with the United States. [4] This is also a mistake, since the first page of the Notices States that it is applicable to all FFI's, regardless of their jurisdiction.

While there is no doubt that FATCA has caused a great deal of confusion, this Author will use his best efforts to demistify FATCA and explain the primary FATCA issues to his readers.

THE BASIC VOCABULARY OF FATCA:

FATCA has introduced a new vocabulary of terms that must be defined in order to properly understand their application to FATCA. Therefore, the first part of this article will be dedicated to explaining this new FATCA vocabulary in general terms. An in-depth analysis would be beyond the scope of this article.

"WITHHOLDABLE PAYMENTS"

Subject to certain important exemptions referred to in the following paragraph, any payment classified as "U.S. source FDAP" under the IRC is included in the definition of a taxable payment. [5] The IRC, and the Regulations, define FDAP as any type of payment which could be classified as "income", subject to certain specific exemptions (such as for example, gifts, which are not included in the definition of "income" under the IRC). [6]

Examples of FDAP include dividends, royalties, wages, salaries, profits and interests. If the payment is issued from the United States, it is presumed that it comes from U.S. sources. For example, a payment received by an FFI from JP Morgan Chase, New York, generated by the sale of shares from a Spanish bank will be seen as a "U.S. source FDAP" payment because the payment comes from New York. In the same way, the fee of a foreign lawyer billed for the provision of services within the United States would also be "U.S. source FDAP".

Since FATCA is oriented towards financial activities, there are certain Categories of "U.S. source FDAP" payments that are not included in the definition of Withholdable Payments. [7] This category of exemptions includes:

(a) Payments made in the course of an active business in the U.S. that generate taxable income under the ordinary rules of the IRC ("ECI"). [8] Example: payment of foreign legal expenses made by a paint factory located in the United States.

(b) Payments made in the ordinary course of a business. Example: payments made by a U.S. Distributor to an Argentine inventory supplier. [9]

Although these exemptions appear to protect transactions among international traders, it is important that these merchants channel the receipt of all payments from U.S. sources through a FATCA compliant FFI (“Participating FFI”). This is because the sender of the payment is entitled to presume that the payee is the recipient foreign bank, even when the foreign bank is, in actuality, only an intermediary of the final beneficiary of the payment. [10]

"WITHHOLDING AGENT"

The withholding agent is any entity or person (U.S. or foreign) who has possession, control or custody of taxable money and who has the obligation to withhold the FATCA tax and remit the withheld tax to the IRS. [11]

"FOREIGN FINANCIAL INSTITUTION"

A foreign financial institution ("FFI") is any financial institution located outside of the USA. The definition of an FFI is very broad including various Categories of financial institutions. [12] The three Categories of FFI's are:

Category I

Traditional banks, or any other entity involved in financial activities of banking including: maintenance of accounts for clients, acceptance of deposits, issuance of loans, lease financing, sale of insurance policies, issuance of letters of credit, purchase and sale of commercial invoices and provision of other trust services or other banking services.

Category II

This category includes entities that manage investments in financial assets on behalf of their clients. This category includes trust companies and other entities that derive more than 20% of their annual gross income from managing investments on behalf of their investors.

Category III

The last category includes investment entities that receive capital from clients, managed collective investment vehicles, or individual portfolios of investments in any kind of assets and maintain accounts for customers. Within this definition, mutual funds, "hedge funds", stockbrokers, insurance companies, managers of funds and financial advisors who have discretionary authority, in whole or in part, over the accounts of their customers. [13]

"NON-FINANCIAL FOREIGN ENTITY"

The purpose of FATCA is to discover accounts and financial assets which belong to citizens and income tax residents of the United States. The IRS recognizes that American taxpayers oftentimes use non-financial entities constituted outside the United States to hide their accounts and other financial assets. Therefore, a non-financial foreign entity (a "NFFE") is subject to reporting and withholding obligations under FATCA.

An NFFE is any foreign entity not covered by the definition of an FFI and that is not otherwise specifically exempt from FATCA. Exempt entities are defined later in this article.

The definition of an NFFE includes the following foreign entities: certain types of trusts, limited liability companies, tax transparent entities, corporations, foundations, cooperatives, cuentas en participacion and other forms of entities recognized as such in its jurisdiction of incorporation.

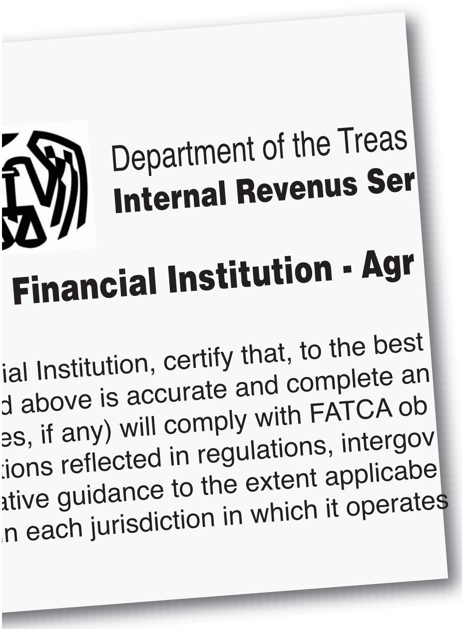
Entities, and their affiliates, whose shares are listed on an established stock exchange are exempt from the definition of NFFE. [14] Similarly, certain entities, including government entities, entities in liquidation, and nonprofit entities are excluded from the definition of an NFFE. [15]

"NON-FINANCIAL FOREIGN ENTITY"Cont.

FATCA makes an important distinction between "active" and "passive" NFFE's. An "active" NFFE is not subject to the 30% withholding tax. In general, an "active" NFFE generates more than 50% of its gross income from the development of a commercial activity. [16] In contrast, a passive a NFFE generates more than 50% of its income from passive sources such as the receipt of dividends, royalties, interest, rents and occasional profits. [17]. An example of a "passive" NFFE would be an insurance company or an investment company. "Passive" NFFEs are required to report to the IRS its U.S. shareholders, members, or U.S. beneficiaries who hold a greater than 10% interest in such NFFE. A 'passive' NFFE which does not comply with the FATCA reporting requirements will be subject to the 30% withholding tax on any taxable payment received.

It is clear that passive NFFE's include entities constituted and managed by agents registered in jurisdictions such as Panama, British Virgin Islands, Uruguay, Cayman and other tax havens that do not otherwise develop commercial businesses.

"U.S. Account"
Any account in which a United States tax resident or citizen has, directly or indirectly, an interest of more than 10% is included in the definition of a U.S. Account. [18]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HOW TO AVOID THE FATCA TAX

The FATCA effective date of July 1, 2014 is getting closer and now is the time to develop a proper strategy to avoid the FATCA tax. In general, FATCA obligates the withholding agent to withhold 30% of any taxable payment made to an FFI, except where the FFI has signed an agreement with the IRS (an "FFI Agreement"). An FFI that enters into (and maintains) an FFI Agreement will be treated as a 'participating' FFI ("PFFI") and is not subject to the 30% withholding.

The FFI Agreement contains several commitments on the part of the PFFI, including: (1) the obligation to act as a withholding agent in certain cases; (2) the obligation to adopt and implement internal procedures related to the opening of new accounts and the maintenance of existing accounts; (3) the obligation to report annually to the IRS its U.S. Accounts; and (4) certain obligations related to FFIs that form part of the same affiliated group. The final version of the FFI Agreement was published on January 13, 2014.

The IRS has collaborated with several Governments in the development of two Model IGAs in order to cover cases in which the domestic law of an FFI would prevent it from satisfying its obligations under the FFI Agreement.

Under IGA Model I, an FFI may satisfy its reporting requirements by delivering the required information on its U.S. accounts to the FFI's own government, which in turn, will report this information automatically to the IRS.

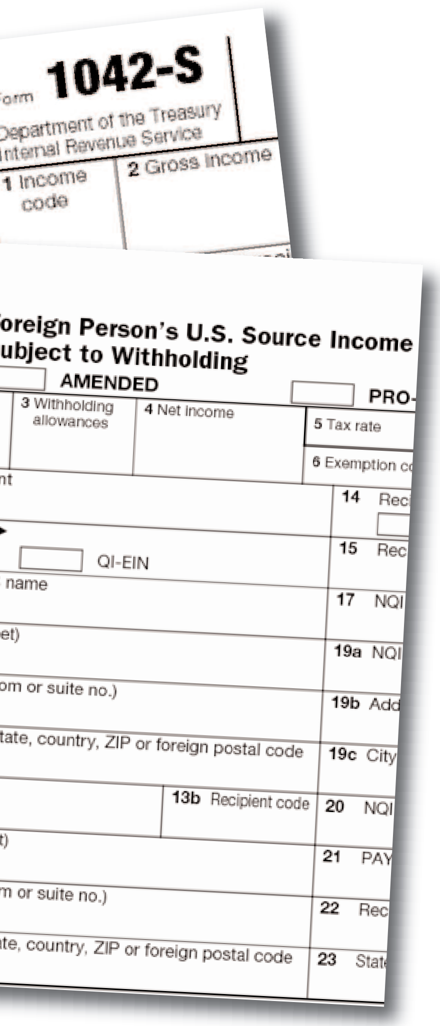
Under IGA Model 2, an FFI will report the information required directly to the IRS and be obligated to cooperate with any request for information requested by the IRS under the bilateral treaty for the exchange of information.

The IGA Model 2 incorporates various terms of the FFI Agreement, subject to certain specific modifications. A jurisdiction may only qualify for the Model 2 IGA if it has entered into a bilateral treaty for the exchange of information with the United States.

NEW IRS FORMS

Starting from the effective date, FATCA imposes withholding obligations equal to 30% on Withholdable Payments. The withholding agent is liable to the IRS for proper withholding. This means that, if the withholding agent fails to withhold as required, the IRS will charge the FATCA tax directly to the withholding agent.

Understandably a withholding agent will insist on receiving proper documentation from the recipient party confirming whether it is FATCA compliant (and therefore not subject to the 30% withholding), prior to transferring any funds



If the withholding agent does not receive satisfactory verification, it will withhold the 30% FATCA tax and remit the payment to the IRS.
The withholding agent will thereafter remit the remaining 70% payment to the non-participating FFI ("NFFI") or to the non-participating NFFE ("NNFFE") accompanied by IRS Form 1042-S reflecting the name and address of the recipient, the total payment subject to withholding, and the withheld amount. In general, an NFFI or NNFFE will not be eligible to obtain a tax credit on the FATCA withholding tax paid and reported on IRS Form 1042S. In cases of excessive withholding, a NFFI or NNFFE may request a refund of the excess amount withheld from the withholding PFFI. However, an NFFI or NNFFE not may not claim a refund from the IRS.

PRE-FATCA REGIME

Foreign financial institutions are already accustomed to asking for customer information to determine whether they are Americans or foreigners. For example, under the regime of "back-up withholding" [19] foreign financial institutions were required to obtain certifications from their customers through a number of forms such as IRS W-8 (customer certification confirming Foreign Status) and IRS W-9 (customer certification confirming U.S. resident or citizen status. These documents are generally kept in the customer files of the foreign banking institution and are re-certified every 3 years. The forms are not delivered to anyone except in cases in which a U.S. financial institution or the IRS explicitly requests them.

In cases where a foreign financial institution would not reveal the identity of their existing customers they could sign a Qualified Intermediary Agreement with the IRS to be designated as a Qualified Intermediary ("QI"). [20] A QI normally assumes responsibility for reporting to the U.S. withholding agent, on an aggregate basis and anonymously, which payments of U.S. source FDAP were subject to withholding. The QI's also had the obligation to obtain and maintain in their files Forms W-8 and W-9.

REGIME POST-FATCA

A PFFI must review all of its accounts and classify them into four Categories (the "FATCA Categories") as follows:

1. U.S. Accounts- accounts in which a citizen or U.S. resident owns, directly or indirectly, an interest of 10% or more in such a count. [21]

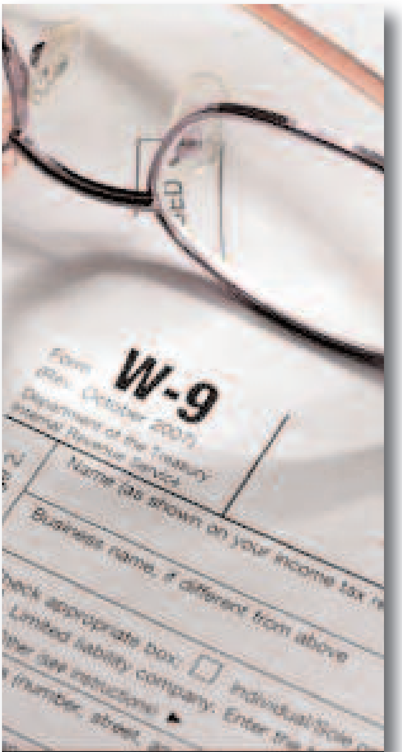
2. Non-U.S. Account- accounts in which a citizen or US resident does not have, directly or indirectly, an interest of more than 10% in such a count.

3. NFFI Account -accounts that belong to a FFI that is not FATCA compliant.

4. Recalcitrant Account- accounts whose owners refuse to provide information to the FFI (within the prescribed period of time) [22] that would allow the FFI to classify the account into one of the Categories 1 to 3 above. [23]

Forms W-8 and W-9 series have been expanded to, among other purposes, assist with the classification of the accounts. FFIs should take note of the new documentation including formats W-8IMY, W-8BEN, W-8ECI, W-8EXP, and W-8BEN-E. In addition, PFFI may not rely solely on these certifications to determine the classification of an account.

If the FFI suspects or has knowledge through the executive responsible for the account, that the information in the certificate is incorrect, the FFI should investigate the case, interview the relationship manager responsible for the account, and ask the customer for additional proof. [24]



ANNUAL STATEMENTS TO THE IRS

PFFI's who have signed an FFI Agreement, or report under a Model 2 IGA, must submit an annual declaration to the IRS on March 15 of each year (starting on March 15, 2015) for every account that has been maintained during the previous calendar year (i.e., 2014 for the first reporting). FFI's must make this declaration by submitting IRS Form 8966 and report accounts classified in FATCA Categories 1,3, 4, as well as accounts belonging to NFFEs whose owners include U.S. persons with an interest of more than 10%.

REGISTRATION of FFI's and NFFE's with the IRS
In general, an FFI wanting to avoid the 30% withholding tax on transfers from the United States, will have to:

(a) Register with the IRS;

(b) Sign an agreement with the IRS (an "FFI Agreement") or be located in a jurisdiction that has signed an IGA;

(c) Obtain a Global Intermediary Identification Number (a "GIIN"); and,

(d) Appoint a responsible officer (a "RO") who be required to sign periodic compliance certifications attesting that the FFI has complied with the due diligence procedures established by FATCA with respect to the opening and maintenance of accounts. [25]

he IRS will keep an official Registry of FFI's and NFFE's that are not subject to the 30% tax (the "Registry"). The Registry will be published on the Internet. If the FFI is registered in the Registry, the withholding agent will not be required to withhold. The Registry will accept applications after January 1, 2014. An FFI must complete the registration process before April 25, 2014 to be registered in the first edition of the Registry. The date for the initial publication of the Registry is June 2, 2014. Therefore, an FFI that is entered in the Registry on July 1, 2014 will not be encumbered with 30%withholding tax.

An FFI can file its application for enrollment in the Registry by two means. The FFI can manually submit its application in accordance with IRS Form 8957. Alternatively, an FFI can submit its application through the Internet portal: www.irs.gov/ fatca (the "website") and obtain a "GIIN".

It is important to note that FFI's operating under a Model 2 IGA are also required to register with the IRS and obtain a GIIN to avoid the 30% withholding.

EXEMPT FINANCIAL INSTITUTIONS

CENTRAL BANKS

Central banks that control the issuance and circulation of the currency of a country are exempt from FATCA. This result applies even in cases where the bank is not a direct subsidiary of a Government, such as the U.S. Federal Reserve. Institutions such as the World Bank are also exempt from the FATCA rules.

INTERNATIONAL ORGANIZATIONS

Intergovernmental entities and their subsidiaries are exempt from FATCA. For example, the OECD, OAS, the United Nations and the European Union and all their subsidiary institutions are exempt from FATCA.

ENTITIES ORGANIZED UNDER THE LAWS OF THE UNITED STATES POSSESSIONS

Financial institutions organized as "Possessions of the United States", such as Guam or Puerto Rico, are generally exempted from FATCA, however, they are required to comply with FATCA's applicable withholding regulations.

GOVERNMENT PENSIONS

In general, pensions and retirement funds organized by any of the exempt entities mentioned above are exempt from FATCA.

CONCLUSIONS

The hope of this author is that the reader will now see that the challenges of complying with FATCA prior the effective date are perfectly attainable. In reality, the development and maintenance of a database capable of identifying the FATCA Categories, for example, is a much larger and complex work. Similarly, training personnel and client relationship advisors in order to properly comply with the new due diligence procedures will be a critical and ongoing process.

At the end of the day, for a banker, lawyer or accountant the most important step towards FATCA compliance is an open line of communication with his or her client. When there is darkness and confusion, it is the responsibility of the FATCA professionals to recommend steps towards practical solutions with confidence and certainty. The contents of this article represents only an introduction to the many relevant details of FATCA. However, based on this author's experience, while FATCA requires a great deal of study and analysis, the challenges presented are not insurmountable.

Finally, there is no doubt that for some customers FATCA represents a threat to their privacy rights, and they may desire to seek ways to minimize disclosure of personal and corporate information. It is extremely important for bankers and financial professionals to be aware that it is strictly forbidden to collaborate with their clients to develop strategies to avoid or minimize the disclosure of information required by FATCA.
This issue should be treated exclusively between clients and their legal advisers. [27]

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[1] Reg. Secs. 1.1474 1.1471-2-6.

[2] IRS Notices 2010-60, 2011-64, 2011-53, IRS Announcement 2012-42, IRS Notices 2013-43 & 2013-69.

[3] "With tax no tax havens" magazine week, date 2/10/13.

[4] Association of Certified Financial Crime Specialists, Press Release, Dated 10/31/13.

[5] Sec. 1473 (1).

[6] Reg sec. 1.1441-2.

[7] Reg. Sec. 1.1473-1 (a) (4).

[8] Reg sec. 1.1441-4.

[9] Reg. Sec. 1.1473-1.

[10] Reg. Sec. 1.1471-2 (a) (1).

[11] Reg. Sec. 1.1473-1.

[12] Sec. 1471 (d) (5) (A), (B) and c.

[13] Reg. Sec. 1.1471-5 (e) (4) (v) Example 1.

[14] Reg. Sec. 1.1472-1 (c) (1).

[15] Reg. Sec. 1.1472-1 (c) (1).

[16] Reg. Sec. 1.1472-1 (c (1) (iv).)

[17] Reg. Sec. 1.1472-1 (c) (1) (iv) (A).

[18] Reg. Sec. 1.1471-5 (a).

[19] Sec. 3406

[20] Reg Sec.1-1441 (e) (5).

[21] Reg. Sec.1.1471-5 (a).

[22] Reg.Sec.1.1471-4 (c), (d) (3) (4) (c) (5).

[23] Reg. Sec. 1.1471-5 (g).

[24] Reg. Sec. 1.1471-4 (c) (2).

[25] Reg.Sec.1.1471-1 (b) (108) and Reg. Sec. 1.1471-4 c.

[26] Reg.Sec.1.1471-6 (b) to (g).

[27] Reg. Sec. 1.1471-4 (c) (7).

[28] www.irs.gov/ Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-(FATCA)