

# Foreign Account Tax Compliance Act (FATCA)

Mastering the challenges  
of the new US regulation

# Introduction

FATCA, the Foreign Account Tax Compliance Act which came into effect on 18 March 2010, requires that foreign financial institutions provide the US tax authority (IRS) with tax information on US persons which goes far beyond the current Qualified Intermediary (QI) regime. Although the implementing guidances are not yet available, it is already clear that nationally and internationally active financial institutions are about to be confronted with a major task.

FATCA is not just another tax issue that affects aspects of compliance. Instead, it affects the whole value chain and requires completely new and extended information and reporting systems. Implementation of the new requirements until the start of 2013 will be considerably more intensive than under the QI regime or EU taxation. In view of the associated costs, strategic issues regarding customer segments, market segments, products and pricing must be discussed.

Our most recent experience on the market has shown that the exit from US business is a practical solution for only very few financial services providers, because even institutions which cease to do business with US securities, but continue to have customers who are US persons or US dual citizens, are confronted with the new rules. For this reason, many institutions will opt for full compliance and face the heightened information requirements. It is not surprising that some financial institutions are already considering supporting their US customers via dedicated entities which are subject to US securities law.

With FATCA, the US is effectively attempting to initiate a worldwide exchange of information on US Persons. This initiative will not be the last in efforts to provide greater tax transparency. Other nations or confederations of nations may look into similar measures. Therefore, financial institutions which undertake to implement the new US regulations should not just focus their implementation projects toward FATCA alone. Instead, they must be prepared for comparable systems in other countries.

With this publication, we are pursuing two objectives: to clarify what FATCA is essentially about, and to outline where there is a need for action. Should you have any questions, or if you would like to discuss the subject of FATCA in greater detail, please do not hesitate to contact a member of our team.

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## 1 Executive summary

The Foreign Account Tax Compliance Act (FATCA), officially signed into law on 18 March 2010 by the US president, will have significant impact on the financial sector.

### **An additional complex system**

The FATCA rules go significantly further than the current QI regulations, which remain in place. The circle of affected parties is widened considerably. Alongside banks, they also affect (for example) brokers, investment companies and fund structures - an estimated 50,000 to 100,000 financial intermediaries worldwide. Other financial market participants, such as stock exchanges and clearing houses, must also deal with FATCA. The rules for insurance institutions and their products are still unclear. The US is acting on the assumption that all financial intermediaries will sign this agreement. 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 forces US taxpayers to disclose their assets deposited abroad.

### **The challenge of customer identification**

The new regulations cover not only US investments, but also foreign investments, i.e. non-US securities, regardless of whether they are held by US persons directly or indirectly via a company or similar structure. Information and processes currently available at financial institutions are not sufficient to provide the IRS with the required data, especially as the burden of proof, regarding correct reporting to the IRS, resides with the financial institutions.

### **Clarity about the strategy**

Banks and other financial institutions must decide whether they want to continue providing services to US persons as direct or indirect customers and whether US securities are part of their product portfolio and proprietary trading. If so, an agreement has to be signed with the IRS. If a foreign financial intermediary is

unwilling to sign such a contract, a 30% withholding tax is imposed on the US revenues and on proceeds resulting from the sale of US securities of all its customers, i.e. not just the US customers.

### **Major changes, under time pressure**

In order to comply with the FATCA rules, institutions must adapt their operating models, from the identification and documentation of customers, to the product portfolio and IT systems, through to the internal processes. These changes must occur group-wide: if a financial intermediary is part of a group of companies which includes at least one other institution that has signed an agreement with the IRS ("expanded affiliated group"), it too is obliged to adhere to the FATCA provisions. However, this financial intermediary is free to enter into its own contract with the IRS, thus undertaking to operate in compliance with FATCA. There is also considerable time pressure, as the new rules will apply to payments from the start of 2013 and to some dividend-equivalent payments even as early as autumn 2010. However, the institutions should not make any hasty decisions. There are still no implementing guidances for the new act. The penalties in the event that an institution does not adhere to its agreement with the IRS are also still unclear. In view of the current conflicts between the US and various institutions, penalties of a significant nature do seem possible.

### **Specific need for action**

Financial institutions must act quickly. In the first phase, up to autumn 2010, it is essential to gain a detailed understanding of the new act and to analyse the effects on the business model and the operating model thoroughly. External experts can support this process systematically. Fundamental strategic decisions must be made by the end of 2010, including decisions on the future business strategy regarding US persons and US securities. Otherwise, there will not be enough time left to adapt processes and systems to the new regulations.

## 2 What FATCA is all about

On 18 March 2010, President Obama signed the "Hiring Incentives to Restore Employment Act" (HIRE). With this the US president enacted at the same time the Foreign Account Tax Compliance Act (FATCA). Subsidies (to the tune of billions) granted to the banking sector and record-high budget deficits form the backdrop of the new regulations. The USA has thus set itself the task to discourage tax abuses. The FATCA rules resemble the existing Qualified Intermediary (QI) regime only in nature. They in fact significantly extend and intensify the requirements imposed on foreign financial institutions. The challenges facing all financial intermediaries around the globe are correspondingly high.

### Closing the gaps in the QI regime

With the QI regime, the US became one of the first countries to set their sights on taxpayers' assets deposited abroad, in order for these to be disclosed and taxed. However, the existing QI rules only cover certain assets, namely US securities which are held directly by US persons who have been disclosed as such to the financial intermediary (W-9 form).

In the past, the IRS was disturbed by the fact that many US persons interposed foreign companies in order to avoid reporting under the QI regime. FATCA shall close these gaps and oblige US persons to disclose their investments and the revenues which they obtain from them, regardless of whether US persons hold the assets in US or non-US securities, or via entities in which they have a direct or indirect holding. Meanwhile, the QI rules remain in place.

### How FATCA works

FATCA "invites" all foreign financial institutions (FFIs) to enter into a contract with the IRS. With this agreement, the institutions undertake to identify US customers and to report their assets. According to initial estimates, FATCA affects 50,000 to 100,000 financial intermediaries worldwide; alongside banks, these also include brokers, investment companies and fund structures. Contrary to an initial proposal, the new regulations do not apply to material advisors, such as asset managers, or advisors like family offices which advise customers regarding US structures.

FATCA gives the US tax authority a powerful instrument with which to force financial institutions to cooperate. Any FFI who does not identify US persons and forward customer data faces severe consequences. In such cases, withholding agents are required to impose and deduct a 30% withholding tax from non-cooperative institution, and indeed not only from US revenues (e.g. interest or dividends received) but also from all sales proceeds from instruments which yield revenues from US sources. It remains unclear whether FATCA also applies to certain insurance products (e.g. insurance wrappers).

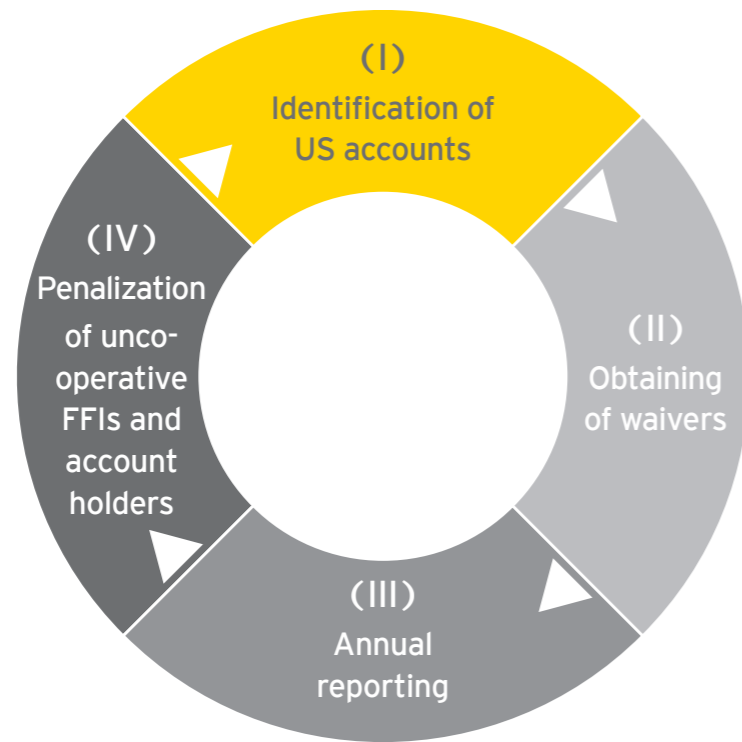
### An overview of the most important changes

- ▶ Foreign financial institutions are required to enter into an agreement with the IRS; otherwise they will force imposition of a 30% withholding tax
- ▶ The withholding tax is set at 30% and shall apply as of 2013 to interest, dividends and sales returns paid to uncooperative institutions and customers from US sources
- ▶ Products previously exempt from withholding tax, such as total return swaps or securities lending, which are referenced to US securities, now qualify as US source payments
- ▶ Foreign (non-US) securities held directly or indirectly by US persons are now also included in reportings
- ▶ The definition of foreign financial institutions (FFIs) is wide-ranging, such that FATCA applies to between 50,000 and 100,000 institutions
- ▶ Completely new reporting and withholding obligations in addition to (and further-reaching than) those of the existing QI regime
- ▶ Identification and documentation of customers becomes considerably more laborious, whereby the burden of proof partly resides with the financial institutions
- ▶ Annual (very detailed) reporting to the IRS

	US persons	Non-US persons	Non-US entities with US ownership
US securities	W-9 1099 reporting  QI non-designated	DTT access via pooling	To be covered by FATCA regulations
Non-US securities	To be covered by FATCA regulations	Currently not covered	To be covered by FATCA regulations

**Sec. 1471 of the Internal Revenue Code**

Sections 1471 to 1474 of the Internal Revenue Code, which are included in the chapter entitled "Taxes to Enforce Reporting On Certain Foreign Accounts", constitute a core component of FATCA. Of primary concern to foreign financial intermediaries is sec. 1471. Application of the provisions in this section requires four recurring steps, as shown in the following graphic.



**I Identification of all US accounts**

The foreign financial institutions to which the new act applies must identify all US accounts, i.e. those accounts held directly or indirectly by a US person. The current QI system is generally limited to direct account holders, be they natural person or legal entity. FATCA now also applies to US persons who directly or indirectly control more than 10% of a foreign company, i.e. also US persons linked to complex structures like foundations or trusts. Identification of customers also becomes considerably more laborious because the burden of proof is reversed: if the withholding tax is not to be imposed on a financial intermediary, the financial intermediary must prove that it has no US customers. FATCA does not apply to US persons who hold less than a total of USD 50,000 in an FFI or in its affiliated companies. However, in such cases, it is questionable as to whether an FFI is at all capable of accessing the required information on its affiliates without breaching the applicable local laws.

**II Obtaining waivers from account holders**

Foreign financial institutions must obtain a waiver from each account holder, so that they can report the required customer data to the US tax authority. In such cases, banking secrecy is lifted for the US tax authority and the exchange of information is approved. If a customer refuses the waiver request, the act requires that the financial institution close the corresponding account or abstain from entering into a new business relationship, respectively. It is still unclear as to what happens if the local law does not allow for unilateral termination of the business relationship on the part of a bank.

**III Annual reporting**

By signing the contract, foreign financial institutions undertake to provide the IRS with the following information on US accounts annually:

- ▶ Name of the account holder or the US persons with holdings in companies and trusts
- ▶ Address, TIN (taxpayer identification number) and (in indirect relationships) those of intermediary companies
- ▶ Account and custody numbers
- ▶ Account balance and custody holdings
- ▶ Gross receipts and gross withdrawals according to the definition yet to be provided by the treasury
- ▶ Further information as requested by the IRS (follow-up requests)

The annual reporting generally occurs in electronic form, requiring major adjustments to the internal systems of banks and financial services providers.

**IV Penalization of uncooperative FFIs and account holders**

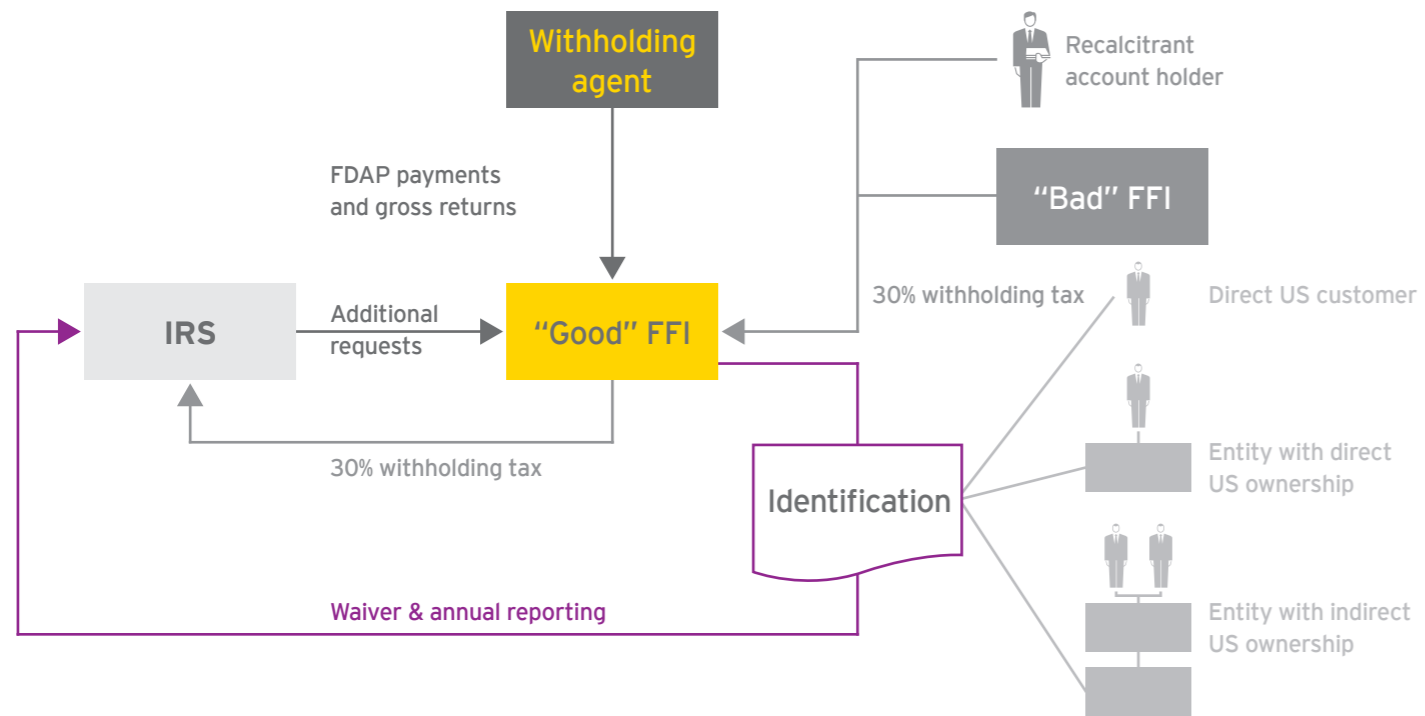
A 30% withholding tax is deducted from payments to foreign financial intermediaries which do not enter into a contract with the IRS ("bad" FFIs) and to recalcitrant account holders who do not sign a waiver. It is to be noted that this withholding tax is not applied as a final withholding tax and thus does not primarily serve as a new source of income. Instead, it is a strong incentive for financial services providers to enter into the agreement with the IRS and to report the assets of US persons. The US is acting on the assumption that all financial intermediaries will sign the agreement. The withholding tax deduction does not represent an alternative to compliance with the disclosure obligations; if a customer does not adhere to the new information regulations, the business relationship with that customer is to be terminated.

**FFIs with “election” - an alternative?**

The text of the act offers foreign financial institutions an alternative to the aforementioned procedure. Instead of deducting the withholding tax for uncooperative institutions or account holders, they can decide that an upstream FFI shall deduct the withholding tax. In this case, the upstream custodian requires all information on account holders and the corresponding payments (“passthru payments”) so that the withholding tax can be deducted in advance. It is still unclear whether these payments can be combined, or whether this has to occur separately for each payment. This option is suitable for small financial institutions, although it similarly calls for major adjustments to internal processes and systems. Furthermore, an FFI with “election” is not relieved of the heightened customer identification obligations. Whether this approach is a feasible alternative in practice, particularly for large banks, is questionable.

**An overview of payment and information flows**

The following graphic summarizes the payment and information flows under FATCA. They start with payments (fixed or determinable annual or periodical income, FDAP) and sales proceeds which are forwarded by a custodian (withholding agent) to a cooperative financial intermediary (“good” FFI). The institution has to identify the US customers and to inform the IRS accordingly. For uncooperative recipients (“bad” FFIs or recalcitrant account holders), 30% of the payments are redirected to the IRS as withholding tax.



### 3 Strategic and operational challenges: what has to be done

For financial intermediaries worldwide, FATCA represents a major challenge. The scope is significantly broader than that of the current QI regime and the act cannot be adhered to with today's processes and systems. We expect that the implementation will be more laborious than that of the QI regime or EU interest taxation was. In addition to this, there is time pressure, as the requirements must be implemented by the start of 2013.

The following graphic shows how comprehensive the issues and the resulting tasks are, which confront the institutions at strategic and operational levels.



First and foremost, the new basic principles established by FATCA have to be understood, even though the act's implementing guidances are still being prepared. In an early phase, particular attention must be paid to derivative financial instruments: dividend-equivalent payments from derivatives which are referenced to US securities are now treated as dividends from a US source, thus triggering a 30% withholding tax. These provisions will already come into effect in mid-September 2010, 180 days after the act was signed, although there are a number of possibilities for deferral until March 2012. In particular, total return swaps and securities lending, among others, are affected.

In a subsequent step, the strategy and operating model must be examined. The risks and specific effects which the new legal provisions entail for the business model and the operating model can be identified in the course of a business impact assessment.

#### Putting the business strategy to the test

Foreign financial intermediaries must gain a clear understanding of how their business should look in the coming years and how they want to position themselves in the new environment. Should US persons still belong to the clientele? Will US securities be included in the product portfolio? If an institution answers these basic questions with "yes", this requires it to enter into an agreement with the IRS and to adapt its operating model accordingly. Otherwise, this effectively means that the institution must abstain from doing business with US persons, US securities or both. In the event of a complete withdrawal, it is also advisable to check whether continuation of the QI agreement is still appropriate.

In view of the opportunity costs and the risks to reputation associated with withdrawal from US business, we expect that most

institutions will opt for full compliance. Some financial institutions are even considering going one step further and supporting their US customers via dedicated entities which are subject to US securities law (SEC-registered investment advisors). No matter what decision is made on this strategic issue, an institution must inform its customers about the changes in good time. If it complies with FATCA, a waiver is to be obtained from US account holders, otherwise all customers are to be notified of the deduction of withholding tax.

From all the numerous issues, that of belonging to an "expanded affiliated group" should be highlighted, as this has far-reaching effects. If a financial intermediary is part of a group of companies that includes at least one other FFI which has signed the agreement with the IRS, it too is obliged to adhere to the requirements of FATCA. However, this financial intermediary is free to enter into its own agreement with the IRS. Such a contract would oblige the financial intermediary to implement the requirements of FATCA and to adhere to the corresponding provisions. In principle, membership of an expanded affiliated group is assumed if at least 50% of a company is controlled directly or indirectly. In order to enable adherence to these requirements, the flow of information between the various companies in a group must be expanded considerably and the processes must be harmonized.

At first, countries with major private banking markets will be those most affected by FATCA. However, as not only direct US customers are identified under the new rules, but also indirect account holders, other business models will also be affected. In particular, players in markets traditionally characterised by investment banking, who mainly concentrate on corporate customers, must address FATCA and assess their customers.

**The operating model under pressure to adapt**

If a foreign financial intermediary decides to comply with FATCA and to enter into an agreement with the IRS, it must closely examine its operating model. This analysis applies (as demonstrated above) to all entities within the “expanded affiliated group”. It entails a series of laborious tasks, as can be gathered from the diagram on page 12. Here, the identification and documentation of customers, as well as reporting, are central. The products offered must also be assessed with regard to US source and flagged accordingly in the systems. Anyone offering their own products must also check the sales restrictions which apply to US persons.

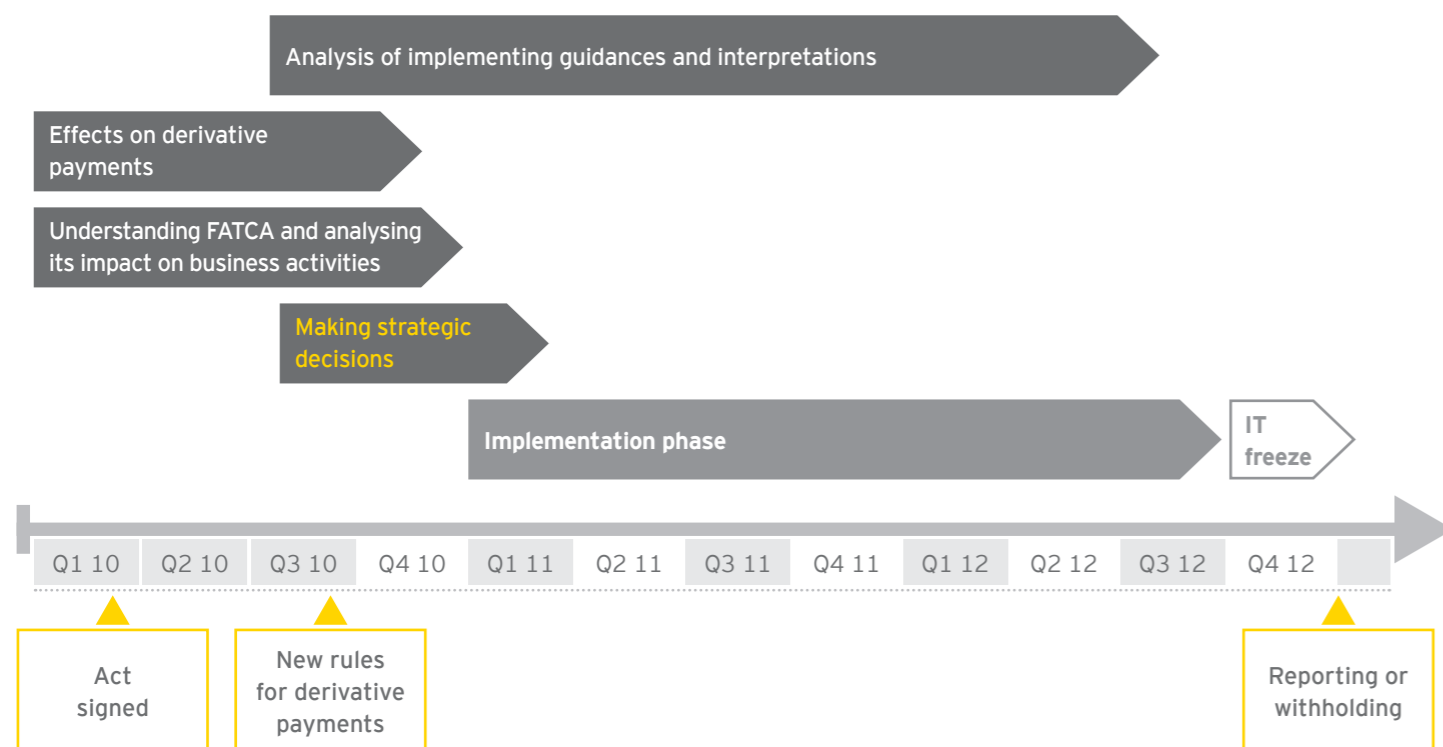
The identification of US persons is very challenging. This is because not only US citizens and persons residing in the US are included in this group, but also green card holders or persons who have stayed in the US for several consecutive days during the past three years, thus meeting the “substantial presence test”. The institutions must also decide whether, and in what form, the processes should differ between new and existing customers. The means with which indirect account holders are identified and documented must also be clarified. The forms and procedures used to date are inadequate for providing the tax authority with the data required by FATCA. In fact, a new set of processes and forms is required. Finally, the training of compliance officers, relationship managers and staff in the middle and back office is an essential task.



# 4 Approach and success factors

Financial intermediaries should already be addressing FATCA now: firstly because of the scope and complexity of the tasks faced and secondly in view of the time frame, as the new regulations come

into effect for payments as of 1 January 2013. The following graphic shows the most important steps in sequence.



## Understanding FATCA:

Workshops and other instruments with external experts provide assistance in obtaining an understanding of the new regulations and in analyzing the effects on business activities. Here, it is not enough to merely have the QI officers present. Instead, an interdisciplinary approach is to be taken, including front staff and responsible personnel from the back office and IT. It is also essential that top level management be involved, so that strategic decisions can be prepared and made in good time.

## Identification of derivative payments:

Derivative payments must be identified quickly, as the relevant provisions already come into effect in mid-September 2010, 180 days after the signing of FATCA.

## Making strategic decisions:

Financial intermediaries must decide whether US persons are still among the clientele and whether US securities shall be included in the product range. If an institution says "yes" to these basic questions, an agreement with the IRS must be entered into.

## Analysis of the implementing guidances:

The implementing guidances for this act and the actual specifics of the requirements must be continually analyzed and the operating model must be adapted accordingly.

## Implementation:

Based on experience gathered upon introduction of the QI regime and EU taxation, we expect that financial institutions will need about 18 months to adapt their processes and systems to the new regulations. The systems must usually be ready three months before the new FATCA regulations apply (IT freeze).

## Success factors

In view of the time pressure and the complexity of the tasks which FATCA entails for financial institutions, external support makes sense. Here, it is to be noted that FATCA is not just about taxes, because the withholding tax only comes into play if customers are unwilling to cooperate or if other institutions do not enter into a contract with the IRS. It is thus all the more important that the support teams are of an interdisciplinary nature, i.e. comprising not only tax consultants, but also experts from the fields of IT, business advisory and business risk services.

Ernst & Young has the know-how and resources necessary in order to put together such teams quickly and thus to support institutions in the implementation of the imminent changes. This support

includes workshops, scenario analyses, business impact assessments, "heat maps" and "compliance check tools", which enable the effects on various lines of business to be identified and specific strategic decisions to be made.

Despite the demanding time frame, institutions should not act hastily. It would be inadvisable to adjust processes and systems before analysis has been conducted and the strategy has been clarified. Some points are still unclear, particularly as the implementing guidances for FATCA are still being prepared.

Thanks to our worldwide network and a direct connection to the authorities in Washington, we can fill these gaps, as we are informed at a very early stage about decisions on the implementing guidances

and issues regarding the interpretation and handling of FATCA. We can directly pass this advance knowledge on to our customers. Furthermore, with a representative at the IRS, we can voice customers' concerns at the right place and thus exert an influence on the formulation of the implementing guidance.

## Open questions about FATCA

- ▶ The act's implementing guidances
- ▶ Number of financial institutions affected
- ▶ Specifics of the identification process
- ▶ Identification of the counterparty ("good" or "bad" FFI)
- ▶ Frequency with which customer identification is updated
- ▶ Changes to W-8 identification
- ▶ Assurance of compliance within the "expanded affiliated group"
- ▶ Penalties for infringements of FATCA

# Conclusion

FATCA will have considerable effect on the financial sector. The new act forces financial institutions all over the world to submit detailed information on their customers to the US tax authority. The US is thus introducing a system which effectively equates to an information exchange and which is also being discussed in other national and supranational committees.

Financial institutions will need to make major adjustments and the time pressure is intense, as the new regulations apply to payments from the start of 2013 and in some cases even earlier. Nevertheless, the institutions should not make any hasty decisions. Instead, in the first phase, a detailed understanding of the new act should be obtained and the effects on the operating model should be thoroughly analyzed. In this process, and also later during the actual adjustment of systems, it makes sense to bring in external support, like that which Ernst & Young, with know-how and the necessary resources, can offer.

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