Baker Hostetler

It Is Time for Foreign Financial Institutions to Take Action on the FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

On March 18, 2010, the U.S. Congress enacted the Foreign Account Tax Compliance Act ("FATCA") and added its provisions to the Internal Revenue Code (the "Code"). FATCA is a broad reporting and withholding regime designed to improve tax compliance involving financial assets held offshore. FATCA generally requires foreign financial institutions to report certain information on assets held by U.S. taxpayers and otherwise imposes significant withholding on payments from the U.S. The substantive provisions of FATCA will not be fully in force until January 1, 2014, but foreign financial institutions ("FFIs") must now begin planning to ensure compliance with FATCA. Treasury and the IRS have indicated that implementing regulations will be proposed in early 2012. This document summarizes FATCA's complicated legal requirements based on currently available guidance and provides some of the initial steps FFIs should take in order to ensure FATCA compliance.

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What Is FATCA?

FATCA consists of 13 sections, only two of which (sections 501 and 522) are of direct relevance to foreign financial institutions ("FFIs").[1] Section 501 of FATCA enacted a new Chapter 4 to the income tax provisions of the Code that, when effective, will impose on FFIs a broad set of extraterritorial rules and regulations aimed at ensuring the tax compliance of U.S. persons with respect to their non-U.S. investment activities. To accomplish this goal, FATCA requires that FFIs perform certain customer due diligence activities, make certain reporting to the Internal Revenue Service ("IRS"), and withhold taxes from payments to certain persons. In general, if an FFI does not agree to bear these new obligations, that FFI is subject to withholding on a broad range of payments from U.S. payors. These new obligations are in addition to withholding and reporting obligations imposed under prior law on U.S. withholding agents and U.S. offices or branches of FFIs, but do not result in double withholding. Section 501 of FATCA imposes obligations on FFIs as a whole, including on foreign offices and foreign-to-foreign transactions of FFIs, regardless of whether an FFI has any U.S. branches.

The core of Chapter 4 is the requirement imposed on U.S. payors of (i) interest, dividends, royalties, other U.S.-source income (known as "U.S.-source FDAP payments"),[2] and (ii) gross proceeds from sales of property of a type which can produce U.S.-source interest or dividends to withhold tax at a rate of 30 percent from any such "withholdable" payment made to any FFI that has not entered into an "FFI Agreement" with the IRS. The FFI Agreement will require the FFI to identify and report, and in some cases, to withhold on payments made to holders of U.S. accounts and certain other persons. Although the FATCA rules are tax rules, it is important to understand that the rules were devised largely by the same individuals in the U.S. Government responsible for the implementation and enforcement of anti-money laundering and know-your-customer rules. The objective of FATCA is not to collect tax revenue, but to coerce FFIs to enforce the compliance of U.S. taxpayers, with potentially financially devastating tax withholding consequences for refusing, which may require financial statement recognition.[3]

To Whom FATCA Most Applies

The rules of section 501 of FATCA apply to FFIs (the detailed definition of FFI is set forth below), which generally fall into the broad categories of foreign funds, banks and brokers and dealers, and trust companies.[4]

Recent Pronouncements and State of Play

The statute itself contains the overall rules for this new regime, and delegates to the Treasury Department and the IRS the authority to promulgate more detailed rules consistent with the statute. The details are to be provided by Treasury Regulations. IRS officials have announced that proposed regulations will be issued in early 2012. While the proposed regulations are expected to incorporate much of the guidance already issued, as well as substantive details which have not heretofore been available, they probably will not cover all of the details, and will be subject to modifications when they are made final, which is expected in the summer of 2012. Drafts of FFI Agreements and reporting forms are expected to be issued at that time.

The Treasury Department and the IRS have issued three guidance documents as of December 2011. On August 27, 2010, Notice 2010-60 was issued,[5] containing descriptions of a number of detailed rules that will be in the new

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[1] FATCA consists of a set of revenue-raising offset provisions enacted as part of the Hiring Incentives to Restore Employment Act of 2010, a larger bill intended to reduce unemployment and spur job growth. Pub. L. No. 111-147, Title V, Subtitle A (March 18, 2010). The other provisions of FATCA, in general, address information reporting and disclosure obligations, penalties, and certain presumptions applicable to persons and entities other than FFIs. The direct impact of these other provisions mostly fall upon U.S. taxpayers which are issuers and holders of certain non-registered bonds, persons holding certain interests in non-U.S. assets or foreign trusts, and persons receiving substitute dividends or dividend equivalent payments. Although it is possible that some of these other provisions could impact FFIs indirectly, none of the other provisions have the effect of extending the extraterritorial jurisdiction of the United States as do sections 501 and 522 of FATCA.

[2] FDAP means "fixed or determinable annual or periodical gains, profits, and income," and is the legal acronym for payments subject to withholding under pre-FATCA law.

[3] Certain rules of section 501 apply to non-financial foreign entities. These rules are discussed in this paper only to the extent of their effects on FFIs.

[4] It is likely that most foreign retirement funds and possibly foreign insurance companies will be exempted from the category of FFI, or that their responsibilities under FATCA will be greatly reduced.

[5] Notice 2010-60, 2010-37 I.R.B. 329.

regulations, as well as requests for public comments on specific questions. Notice 2010-60 addresses several key definitional issues, as well as information collection and reporting responsibilities. On April 8, 2011, Notice 2011-34[6] was issued announcing the modification of several rules in Notice 2010-60, as well as the addition of several new rules. On July 14, 2011, Notice 2011-53[7] was issued generally describing the expected contents of the proposed regulations and setting forth the timeline for the phased implementation of key aspects of regulations.

When FATCA Applies and Some Key Dates

The rules under section 501 were originally slated to apply to payments made after December 31, 2012, but this implementation date has now been deferred until after December 31, 2013. The IRS has recently affirmed its intention to issue proposed regulations early in 2012. Notice 2011-53 sets forth expected effective dates with respect to withholding on payments to FFIs and non-financial foreign entities ("NFFEs"). The application of section 501 does not extend to certain preexisting accounts and to payments made with regard to certain grandfathered "obligations" which were outstanding on March 18, 2012. For this purpose, grandfathered "obligations" do not include accounts that lack a definitive expiration or term, such as equity, savings and demand deposits, or brokerage and custodial agreements to hold financial assets for the account of others.

The critical dates for implementation of the main requirements are as follows:

1. **Execution of FFI Agreements**. The IRS will begin accepting applications to enter into FFI Agreements on January 1, 2013. The last date to enter into an FFI Agreement to preclude withholding beginning on January 1, 2014 is June 30, 2013. The effective date for all FFI Agreements entered into before July 1, 2013, will be July 1, 2013. The effective date for FFI Agreements entered into on or after July 1, 2013, will be the date the FFI enters into the FFI Agreement.

2. **Due Diligence**. With regard to new accounts, "Participating FFIs" (i.e., those entering into an FFI Agreement) must implement account opening procedures to identify U.S. accounts on the effective date of the FFI Agreement. With regard to preexisting accounts, which are large private banking accounts with balances or values greater than $500,000, the first phase of due diligence (discussed below) must be completed within one year of the effective date of the FFI Agreement and the second phase within two years of that date. With regard to smaller private banking accounts, with balances of less than $500,000, due diligence procedures must be completed by the later of December 31, 2014, or the date that is one year after the effective date of the FFI Agreement. Due diligence for all other preexisting accounts require completion of due diligence two years after the effective date of the FFI Agreement.

3. **Reporting of U.S. Accounts**. The information required to be reported by Participating FFIs for accounts for which it has received a Form W-9 by June 30, 2014, which generally include certain new accounts, documented U.S. accounts, and certain private banking accounts, is limited (as discussed below) and must be reported to the IRS by September 30, 2014. Reporting for post 2013 years will be more expansive in accordance with Notice 2011-34 as implemented in future regulations.

4. **Withholding**. The withholding implementation dates differ for various types of withholdable payments. Payments made with regard to certain obligations in existence on March 18, 2012, are not subject to withholding, although they are subject to reporting. With respect to non-grandfathered U.S.-source FDAP payments (interests, dividends, royalties, rent, etc.), withholding applies to payments made on or after January 1, 2014. With regard to gross proceeds from sale of assets that can produce U.S.-source interest or dividends, withholding applies to payments made on or after January 1, 2015. With regard to passthru payments (described below), withholding applies to payments made on or after January 1, 2015. In the case of an overlap between a passthru and an FDAP payment, the FDAP effective date of January 1, 2014, applies.

[6] Notice 2011-34, 2011-19 I.R.B. 765.

[7] Notice 2011-53, 2011-32 I.R.B. 124. Notice 2011-53 was revised on July 25, 2011.

What FFIs Should Be Doing Right Now to Comply, Generally

The recent pronouncements from the IRS have committed the IRS to a course of action and a specific timeline for the phased implementation of FATCA and systems integration. Absent Congressional action to the contrary, it is unlikely that there will be major deviations from this timeline.[8] Although some may initially assume that FATCA is merely a "compliance effort," in reality it involves significant and far reaching implications for every affected company. As discussed in more detail below, FFIs should begin their planning now for addressing the requirements of FATCA and integrating its mandates with company systems and procedures. This should be done methodically and in a phased approach in synchronization with the key implementation dates in order to assure that both tax and financial audit consequences will be minimized and timely addressed. In our opinion, FFIs should begin this process early in 2012 because there are certain decisions that should be addressed well before actual implementation, which may require data gathering and careful consideration across certain company functions, including legal compliance, operations, IT, and tax.

In general, the following are the steps that we believe should be taken by all FFIs:

1. Become educated as to the requirements of FATCA and implications on the FFI and your customers. This must include the awareness of top management and the Board of Directors or equivalent body, both of which should be kept informed and approve of key decisions made as time goes by.
2. Identify those individuals in your organization who will be responsible for FATCA compliance. In that regard, it should be noted that the chief compliance officer of a Participating FFI is required to certify its compliance periodically.
3. Perform a legal and operational analysis sufficient to formulate a plan for initial compliance with FATCA. Specifically, this means that an FFI must determine whether it is certain that it must enter into an FFI Agreement, whether there is a way to restructure its business operations in a manner that would minimize the negative consequences of not entering into such an agreement to an acceptable level, and what would be the relative cost-benefit of these alternatives. Similarly, an FFI must determine whether it meets deemed-compliant status or could easily restructure to do so, or if there is a beneficial election that might be available.
4. Timely plan and implement the required initial compliance activities, in particular those relating to preexisting accounts. Those activities should be conducted in parallel with the systems and procedures development described in the following step, in order to utilize new systems for the new compliance activities.
5. Develop systems and procedures in order to comply with the due diligence, reporting, and withholding requirements.
6. Train personnel in using the developed systems and procedures and in integrating them into the operations of the FFI.
7. Implement ongoing compliance activities.

[8] While we cannot rule out the possibility that multi-governmental actions through the OECD or other organization, or bilateral tax treaty discussions, may have the effect of altering the FATCA rules, we believe it is unlikely that such a process would produce results immediately. Thus, it is important for FFIs to begin the necessary steps for compliance as soon as possible. Although it is possible that Congress may repeal FATCA in whole or in part, that possibility may not be relied on because of the serious consequences of noncompliance.

What Is an FFI?

Under the FATCA regime, a withholding agent must deduct and withhold tax on any withholdable payment to a foreign financial institution that does not meet certain requirements. To meet the requirements and avoid the withholding tax, the FFI is generally required to enter into an FFI Agreement, as further discussed below. In general terms, an FFI is defined as any financial institution which is a foreign entity. A financial institution is defined as any entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the account of others as a substantial portion of its business, or (iii) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, or commodities.

Also included in this definition are certain insurance companies, investment funds and other collective investment vehicles (whether treated as a corporation, partnership or trust under U.S. or non-U.S. law), regardless of whether any of these non-U.S. financial intermediaries or investment entities maintain accounts for U.S. persons or, in the case of non-U.S. investment entities, are owned by U.S. persons. Under the regime, a foreign entity that is excluded from the definition of a financial institution (i.e., a NFFE) is subject to certain documentation and reporting requirements different than those imposed on FFIs. As discussed below, there are certain FFIs which are designated as "deemed-compliant FFIs" which are treated as having met the requirements of a Participating FFI.

In general, the requirements are applied to all foreign financial institutions (including foreign partnerships) commonly owned over 50 percent ("Expanded Affiliated Group").

Exemptions

Treasury intends to issue regulations providing that certain foreign entities which satisfy the definition of a financial institution solely because they are primarily engaged in investing, reinvesting, or trading in securities will be nonetheless excluded from being FFIs. In particular, the exemptions cover: (i) a foreign entity, the primary purpose of which is to act as a holding company for a subsidiary or group of subsidiaries that primarily engages in a trade or business other than that of a financial institution; (ii) a foreign start-up entity that is investing capital into assets with the intent to operate a business other than that of a financial institution, but is not yet operating such a business; (iii) a foreign entity that is in the process of liquidating its assets or reorganizing with the intent to continue or recommence operations as a non-financial institution; and (iv) a foreign entity that primarily engages in financing and hedging transactions with or for members of its Expanded Affiliated Group that are not FFIs.

Payments to certain beneficial owners are exempt from the provision in its entirety. These beneficial owners are foreign governments, their political subdivisions and agencies, international organizations, foreign central banks, and any other class of person identified by the IRS as posing a low risk of U.S. tax evasion. It is probable that sovereign wealth funds will be exempted to the extent that such funds do not engage in commercial business, under rules similar to the rules governing general tax exemptions for sovereign wealth funds.

Certain other FFIs may be deemed compliant provided that certain requirements are met. A "deemed-compliant" FFI is excepted from the reporting and withholding requirements of FATCA. To be a deemed-compliant FFI, the FFI must either (i) comply with certain procedures to ensure it does not maintain U.S. accounts and meet certain other requirements prescribed by the IRS with respect to the accounts of other FFIs, or (ii) be a member of certain excluded classes of institutions. Regulations are forthcoming as to the requirements to be treated as a deemed-compliant FFI, but the IRS has indicated that a deemed-compliant FFI will be required to: (i) apply for deemed-compliant status; (ii) obtain an FFI identification number identifying it as a deemed-compliant FFI; and (iii) certify every three years that it meets the requirements for such treatment. Moreover, the IRS intends to issue regulations under which each FFI in an Expanded Affiliated Group licensed as a local bank, certain local FFI members of Participating FFI groups, and certain collective investment vehicles may be treated as deemed-compliant FFIs. The IRS is also considering treating certain foreign investment retirement plans as deemed-compliant, but has indicated it will not automatically treat U.S.-controlled foreign corporations as deemed-compliant. FFIs without significant U.S. account holders may significantly benefit from structuring their operations so as to achieve deemed-compliant status. In particular, we believe deemed-compliant status may be the most cost effective way for certain smaller FFIs to comply with FATCA.

In addition, the IRS will require a Qualified Intermediary that is an FFI and not deemed compliant to enter into an FFI Agreement.

The Choice and the Consequences of Not Entering Into an FFI Agreement

In General

An FFI has a choice of (i) entering into an agreement with the Treasury Department under which the FFI agrees to undertake certain due diligence, reporting, and withholding responsibilities discussed below, or (ii) suffering the withholding and remitting to the IRS 30 percent of every "withholdable" payment made to it.

Effect of No Agreement

If an FFI chooses not to enter into an agreement, U.S. withholding agents must withhold 30 percent on every withholdable payment made to the FFI. This includes all U.S.-source payments of interest, dividends, annuities and other payments of income subject to the withholding tax rules currently enforced, including U.S.-source payments of derivatives. It also includes gross proceeds from the sale of property which produces U.S.-source dividends or interest. For example, proceeds from the sale of stocks and bonds issued by U.S. companies constitute withholdable payments because the stock and bonds produce U.S.-source dividends and interest. Withholdable payments do not include payments constituting income effectively connected with the conduct of a trade or business within the United States. However, the fact that an FFI avoids doing business with U.S. customers or holding investment assets that produce withholdable payments does not necessarily exclude the FFI from withholding tax on withholdable payments. Under the rules regarding passthru payments, a non-Participating FFI is generally subject to withholding on payments from Participating FFIs to the extent attributable to withholdable payments. With regard to avoiding U.S. customers, an FFI's plan to exclude future new customers from the U.S. does not necessarily mean that it will not be responsible for withholding and reporting on certain preexisting accounts.

Refunds

If an FFI decides not to enter into an FFI Agreement, it will be subject to 30-percent withholding on all withholdable payments that it receives for its account or for the account of others. In that case, it may be entitled to a refund of the withheld taxes, but only in narrow circumstances. In general, there will be no advance exemptions from this withholding, including for items otherwise exempt under the Code or subject to treaty benefits. Instead, the FFI would be entitled to a refund for tax withheld on any payment which it can document as foreign source (*i.e.*, not a withholdable payment), exempt under the Code (e.g., portfolio interest), or subject to a rate lower than 30 percent under a tax treaty (to the extent of the rate differential). Under a special rule, however, if an FFI does not enter into an FFI Agreement, amounts properly withheld from payments it receives for its own account will be credited or refunded only upon application for relief under a tax treaty, and no interest will be allowable on such refunds.

In general, it is intended that the documentation and information required to be provided in connection with claims for relief under a tax treaty will be consistent with the terms of the relevant treaty. However, no credit or refund will be allowed with respect to any tax properly withheld under FATCA, unless the IRS is provided with information sufficient to determine whether the ultimate owner of the payment is a U.S.-owned foreign entity and the identity of any substantial U.S. owners of that entity. There is no interest payable on a refund paid within 180 days of the date of the refund claim. Thus, suffering withholding and subsequently requesting a refund does not appear to be a viable solution to the problem of FATCA withholding.

Timing of Choice

The opening of registration for FFIs will begin no later January 1, 2013. If an FFI fails to register prior to June 30, 2013, it will be subject to withholding beginning on January 1, 2014. Agreements which are entered into before June 30, 2013, will be treated as having an effective date of July 1, 2013. Agreements entered into after June 30, 2013 will carry effective dates of the actual date of entering into the agreement. The effective date is the date that the entity must abide by when implementing the due diligence requirements discussed below.

An FFI which registers after July 1 will presumably be entitled to refund of withheld taxes for itself and any non-recalcitrant account holders once the registration is made. It is expected that a large number of FFIs will apply within a short timeframe, and the IRS will be required to process a large number of applications within the relevant six-month period. Presumably the IRS will possess the resources enabling it to timely process the vast number of expected applications. Finally, we believe it would be prudent for any FFI not to wait until 2013 to begin evaluating its options. It is our sense that financial institutions should begin to make an initial assessment of their situation no later than the first quarter of 2012, with a view to making final decisions on the basic FATCA planning no later than the third quarter of 2012.

The FFI Agreement and Its Responsibilities

In general, FFIs that enter into FFI Agreements are required under the terms of the FFI Agreements to do the following:

1. Obtain information regarding each of its account holders as is necessary to determine which accounts are "United States accounts" ("U.S. accounts");
2. Obtain this information in accordance with certain required verification and due diligence procedures;
3. Report certain information on an annual basis regarding identified U.S. accounts and provide additional information with respect to such accounts as requested by the IRS;
4. Deduct, withhold, and remit to the IRS a tax equal to 30 percent of any passthru payment made to an uncooperative ("recalcitrant") account holder,[9] to a non-Participating FFI, or, to certain Participating FFI's which elect to be withheld on rather than to withhold, to the extent of the amount of such payments that are allocable to accounts of recalcitrant holders or non-Participating FFIs; and
5. Obtain from the holder of a U.S. account a valid and effective waiver of any foreign law that would prevent the reporting of such account, or close the account within a reasonable period of time.

U.S. Accounts and Other Key Definitions

The definition of "U.S. accounts" is a key technical definition of FATCA. A U.S. account is any financial account held by one or more "specified United States persons" or "U.S.-owned foreign entity." A "specified United States person" is any U.S. citizen or resident and any domestic (U.S.) corporation or partnership, other than:

1. Publicly traded corporations and their affiliates;
2. Exempt organizations and individual retirement plans;
3. The United States, its political subdivisions and possessions, and any of their wholly-owned agencies or instrumentalities;
4. Any U.S. bank or common trust fund maintained by a U.S. bank as trustee or custodian;
5. U.S. real estate investment trusts or mutual funds; and
6. Charitable trusts, in general.

Notwithstanding the foregoing, unless an FFI elects otherwise, U.S. accounts exclude accounts held only by individuals if the aggregate account amount held for the individual by the FFI and its Expanded Affiliated Group does not exceed $50,000. For purposes of determining the balance or account value, an FFI must treat as a single account all accounts maintained by the FFI or its affiliates that are associated with one another due to partial or complete common ownership of the accounts under an existing recordkeeping system of the FFI.

A "U.S.-owned foreign entity" is any foreign entity with one or more substantial U.S. owners. For these purposes, the threshold for "substantial" U.S. ownership is generally direct or indirect ownership over 10 percent. However, in the case of funds, any ownership is generally sufficient.

A U.S. account must be a "financial account." A financial account is a depository or custodial account maintained by a financial institution or an equity or debt interest in the financial institution (other than interests that are publicly traded).

Due Diligence of Participating FFIs

In General

Participating FFIs have a responsibility to identify U.S. accounts in accordance with certain required verification and due diligence procedures. Participating FFIs will be required to identify and report holders of financial accounts that are specified U.S. persons or U.S.-owned foreign entities. Participating FFIs may rely upon Forms W-9 (from U.S. persons) and W-8 BEN (from foreign persons) received for U.S. tax purposes other than Chapter 4, and will be required to collect such forms from limited groups of account holders. Thus, Participating FFIs will be required to determine whether each account holder is an individual or an entity; whether or not the individual is a U.S. person; or whether the entity is a U.S. person, FFI, NFFE, or is otherwise exempt (such as a government). Then, FFIs will be required to make several additional determinations, such as: whether an entity that is a U.S. person is a "specified United States person;" whether or not an

[9] A recalcitrant account holder is one who fails to comply with reasonable requests for information by a Participating FFI or who fails to provide a waiver of foreign law which would prevent the reporting of any required information.

entity that is an FFI is a Participating FFI or is deemed compliant (as discussed above, there are several categories of deemed-compliant FFIs, each with its own qualifying rules and exceptions); and whether an NFFE is exempted or is a U.S.-owned foreign entity. Exempted NFFEs include publicly traded corporations and their affiliates; entities organized in a U.S. possession that are wholly-owned by bona fide residents of that possession; and a foreign government or international organization, its political subdivisions, agencies and instrumentalities. It is expected that Participating FFIs will receive special IRS employer identification numbers, which will be called "FFI EINs," to identify themselves to withholding agents.

The required due diligence procedures for Participating FFIs for making the necessary determinations and verifying customer account information vary depending on whether the accounts are preexisting or new, and are held by individuals or entities. The procedures are very detailed and specific; therefore only the procedures for preexisting individual accounts are set forth in detail below. Analogous procedures are required with respect to new individual accounts and preexisting and new entity accounts, except that in the case of entity accounts, in general, any specified United States person which is a direct or indirect owner of an NFFE (that is not excepted) must be identified, and the related account treated as a U.S. account. With respect to new entity accounts, Participating FFIs are required to take into account all information collected, including information collected pursuant to locally required anti-money laundering and know-your-customer requirements.

Preexisting Individual Accounts—Specific Procedures

Preexisting accounts are those held as of the effective date of a Participating FFI's FFI Agreement. Certain rules apply for purposes of this due diligence and verification inquiries. In general, an FFI can rely on any documentation maintained in its files or which is collected for these purposes, unless it knows or has reason to know it is unreliable or incorrect. Documentation is considered to be maintained in its files if a copy is retained or there is a record of its examination that includes the type of document and the name of the examining employee. However, in the case of a W-8 BEN, a copy must be retained in the file. Finally, for purposes of determining the balances in accounts, all of the accounts maintained by the FFI and its affiliates on their systems that are associated with one another due to complete or partial ownership are treated as a single account. Each owner of a jointly-held account is attributed the full balance or value of that account.

Existing Documentation and Account Balances Screening

For preexisting individual accounts, account holders already documented as U.S. persons for other tax purposes are to be treated as specified United States persons and their accounts as U.S. accounts. Notwithstanding, unless the FFI elects otherwise, a depository account is considered to be a non-U.S. account if each holder of the account is an individual and if the account balance or value at the end of the calendar year preceding the effective date of the FFI Agreement does not exceed $50,000. Similarly, an account not previously identified as a U.S. account may be treated as a non-U.S. account if the account balance or value at the end of the calendar year preceding the effective date of the FFI Agreement does not exceed $50,000.

Private Banking Accounts Diligence

In the case of a "private banking account" not otherwise excluded under the balance filter, several additional and detailed time consuming diligence steps are required to be performed by "private banking relationship managers." A private banking account is any account maintained or serviced as part of a private banking relationship or by a private banking department, including entity and nominee accounts. A private banking department is a part of an FFI that (i) focuses on servicing accounts and investments of individual clients whose finances exceed certain thresholds or are identified by the FFI as high-net-worth individuals, (ii) is referred to by the FFI as a private banking, wealth management, or similar department, (iii) that is considered to be a private banking department under the anti-money laundering or know-your-customer (AML/KYC) requirements applicable to the FFI, or (iv) in which FFI employees provide personalized services to individual clients, such as banking, investment advisory, trust and fiduciary, estate planning, etc., not generally provided to account holders, or gather information about individual clients' personal, professional, and financial histories not ordinarily gathered with respect to the FFI's retail customers. These latter services and information gathering functions (described in (iv)) give rise to a "private banking relationship." A "private banking relationship manager" is an officer or other employee of an FFI who is assigned responsibility for specific account holders, advises account holders, and recommends or arranges for the provision of financial products or services for the account holders.

With respect to private banking accounts not screened out by existing documentation or account balance, each of the FFI's private banking relationship managers must take the following steps:

1. Identify his client known to be a U.S. person and request a Form W-9 from such client.
2. Diligently review all files (including paper and electronic files) for his client and identify each client and associated family members who have U.S. indicia:
    a. Are U.S. citizens or green card holders, or were born in the U.S.;
    b. Have a U.S. residence or mailing address;
    c. Have standing instructions to transfer funds to an account in the U.S., or directions regularly received from a U.S. address;
    d. Have an "in care of" or "hold mail" address; or
    e. Have granted power of attorney or signatory authority to a person with a U.S. address.
3. For any client identified in #2, above, depending on the situation, request a Form W-9, W-8 BEN, or other evidence (set forth in guidance) to establish the U.S. or non-U.S. status of the individual.
4. Request from any client providing a Form W-9 establishing U.S. status a waiver of applicable restrictions, if any, on reporting of the client's information to the IRS.
5. Treat all accounts associated with a client as a U.S. account if the client is identified as a U.S. person, or has U.S. indicia and does not establish non-U.S. status.[10]
6. Create and retain lists of existing clients whose accounts are U.S. accounts, non-U.S. account or recalcitrant accounts.
7. Retain requests and responses relating to this diligence for ten years.

For preexisting accounts with a balance of $500,000 or greater on the effective date of the FFI Agreement, these procedures must be completed within one year of the effective date. For preexisting accounts with a balance of less than $500,000 on the effective date of the FFI Agreement, these procedures must be completed by December 31, 2014 (or, if later, within one year of the effective date).

Diligence Steps for Other Accounts

With respect to accounts that have not been identified as U.S. accounts, non-U.S. accounts, or private banking accounts under the preceding steps, the FFI must search its electronically searchable information associated with those accounts for the following U.S. indicia (the same as in #2 immediately above with respect to private banking accounts):

- Identification of an account holder as a U.S. citizen or green card holder, or having a U.S. birthplace;
- A U.S. residence or mailing address;
- Standing instructions to transfer funds to an account in the U.S. or directions regularly received from a U.S. address;
- Having an "in care of" or "hold mail" address; or
- Having granted power of attorney or signatory authority to a person with a U.S. address.

For any client identified with U.S. indicia above, depending on the situation, the FFI must request a Form W-9, W-8 BEN, or other evidence (set forth in guidance) to establish the U.S. or non-U.S. status of the individual, within one year of the effective date of the FFI Agreement. Account holders who have not provided appropriate documentation within two years of the effective date of the FFI Agreement must be treated as recalcitrant until such documentation is received.

Accounts of $500,000 or More

With respect to accounts that have not been identified as U.S. accounts, non-U.S. accounts, private banking accounts or accounts with U.S. indicia according to the steps described above, and had a balance of $500,000 or more at the end of the year preceding the effective date of the FFI Agreement, a diligent review of account files must be performed searching for the U.S. indicia described above. If any are present, appropriate documentation (as described above) must be obtained within two years of the effective date, or the account holder must be classified as recalcitrant until such information is received. Beginning in the third year after the effective date, this test must be performed annually to all preexisting individual accounts that did not previously satisfy the balance standard but would as of the last day of the preceding year.

[10] However, an account held solely by a family member of a client who provides a Form W-8 BEN will not be treated as a U.S. account unless the private banking relationship manager knows or has reason to know that the family member is acting as a nominee for the client.

Certification

Certification to timely completion of the due diligence steps relating to preexisting accounts is required to be provided to the IRS by the chief compliance officer of the FFI. The chief compliance officer is also required to certify that the FFI did not engage in any activities or maintain policies intended to undermine tax compliance of U.S. persons.

Withholding

Participating FFIs must also agree to withhold tax on withholdable payments to non-Participating FFI's and recalcitrant account holders. Thus, Participating FFIs must be able to identify relevant payments to non-Participating FFIs and recalcitrant account holders and to implement withholding and reporting procedures for such payments. In addition, Participating FFIs must withhold on payments to other Participating FFIs that elect to be withheld on rather than withhold on relevant payments to non-Participating FFIs and recalcitrant account holders.

Passthru Payments

The statute defines the term "passthru payment" as "any withholdable payment or other payment to the extent of attributable to a withholdable payment." A withholding agent is required to withhold 30 percent of any passthru payment made to a non-Participating FFI. The underlying purpose of the passthru payment rule is to encourage FFIs to enter into FFI Agreements if they hold investments that produce payments that are attributable to withholdable payments, even if an FFI does not directly hold an investment asset that produces a withholdable payment. The concern is that, without a broad passthru payment rule, non-Participating FFIs could use Participating FFIs as intermediary "blockers" that would allow circumvention of the rules. The IRS believes that, absent a passthru rule, a Participating FFI would incur the costs and burdens of being a participating entity while the nonparticipating entity would not be subject to reporting and withholding and not bear any of the costs and burdens.

Notice 2011-34 provides that payment made by an FFI will be a passthru payment to the extent of: (i) the amount of the payment that is a withholdable payment (i.e., payable to an account holder that is directly traceable to a withholdable payment made to the FFI); plus (ii) the amount of the payment that is not a withholdable payment, multiplied by (a) in the case of a custodial payment, the "passthru payment percentage" of the entity that issued the interest or instrument, or (b) in the case of any other payment, the passthru payment percentage of the payor FFI. In order to comply with this requirement, the IRS will require Participating FFIs to publish their passthru payment percentages on a quarterly basis. There is an exemption for payments made under certain grandfathered obligations. The scope of what constitutes a passthru payment has not been finally delineated, however, and there may be changes made to this complex part of the law as the IRS continues to evaluate comments. In addition, the IRS is continuing to develop and refine the methodologies for calculating the passthru payment percentage.

In reviewing its compliance options, an FFI could make a financial decision not to invest in the U.S. capital markets in order to avoid the payment of U.S.-source income and gains which trigger the application of the FATCA rules. Notwithstanding, under the passthru rule, an FFI could be removed from the payment of U.S.-source income or gain by two or more other FFI's between it and the U.S. payor and still be subject to withholding. As long as one FFI in another FFI's payment chain receives U.S.-source income or gain, the non-Participating FFI will still be subject to the withholding provisions to the extent of the passthru payment percentage of the other FFIs in its chain. Exposure to passthru payments is a real, and possibly high, cost of being a non-Participating FFI. Compliance with the passthru payment requirement also may prove a significant burden for Participating FFIs. Systems must be established to identify U.S. assets and non-U.S. assets for purposes of calculating the passthru payment percentage. Moreover, systems must be established to identify outgoing payments to Participating FFIs and to identify and update such Participating FFIs' passthru payment percentages.

Reporting

In general, the FATCA statute requires that a Participating FFI must report certain information with respect to each U.S. account. A new electronic form will be provided for such reporting. In general, the following information will be required to be reported (with amounts required to be provided in U.S. currency):

- the name, address and TIN (taxpayer identification number) of each account holder which is a specified U.S. person;
- if any account holder is a U.S.-owned foreign entity, the name, address and TIN of each substantial U.S. owner of such entity;
- the account number;

- the account balance or value, reported in U.S. dollars. Notice 2011-34 states that future regulations will generally require year-end information;
- the gross receipts and withdrawals or payments from the account. Notice 2011-34 states that future regulations will generally require annual reporting of—
    - the gross amount of dividends paid or credited;
    - the gross amount of interest paid or credited;
    - other income paid or credited;
    - gross proceeds from the sale or redemption of property paid or credited to the account;
    - certain other information; and
    - the retention of certain existing documentation; and
- the identification of the FFI branch that maintains the reported account.

The two most difficult reporting requirements with which to comply are the reporting of account balances and gross receipts and withdrawals. In response to public comments, Notice 2011-34 significantly loosened the reporting requirements (proposed in Notice 2010-60) with respect to account balances or values. The approach outlined in Notice 2011-34 would require a Participating FFI to report the year-end account balances or values, as determined for purposes of reporting to the account holder, or, in the case of certain funds, as determined for the purpose that requires the most frequent determination of value.

Notice 2011-34 also outlined certain methods of calculating amounts of income and gross proceeds paid to the account and withdrawals and payments paid from the account. Depository and custodial accounts are generally subject only to reporting of income and gross proceeds, and account closures. FFIs are required to report such information under the same principles that the FFI uses to report information on its resident account holders to the jurisdiction in which the FFI is located. If no such requirement exists, the FFI can use the method it uses to report the information to the account holder. Interests in funds are subject to reporting of amounts credited and redemption payments, as well as closed accounts. It appears, based on these rules, that the IRS is attempting to minimize the reporting burden for Participating FFIs, although it is unclear in what format reports must be prepared and how currency translations will be performed, and these requirements may increase the burden on Participating FFIs.

In addition, a Participating FFI may elect to report account balances, values, gross receipts and withdrawals as if the FFI were a U.S. person, with certain modifications. The details of this election have not yet been made public.

U.S. Branches of FFIs

U.S. branches of an FFI are considered part of the FFI.[11] Thus, even if an FFI were to receive all its U.S.-source payments through its U.S. branches, the FFI would be required to execute an FFI Agreement to avoid being subject to 30-percent FATCA withholding. However, the U.S. branches are exempt from this withholding for payments that the branches receive and take into account as effectively connected income.[12] This exemption does not apply to payments received by a U.S. branch on behalf of an account holder.

The Treasury Department and IRS are considering whether to permit a U.S. branch to document its account holders under requirements generally applicable to U.S. financial institutions and, if so, how to coordinate such documentation and related tax reporting requirements with other U.S. tax reporting requirements. Under FATCA, U.S. financial institutions are required to make similar determinations as Participating FFIs regarding payments made to FFIs and NFFEs.

In addition, FATCA requires all withholding agents, including U.S. branches of FFIs, to withhold 30 percent from a withholdable payment made to a non-exempt NFFE, unless the NFFE certifies that it has no substantial U.S. owners or provides identifying information for each substantial U.S. owner. U.S. branches of FFIs must have procedures in place to make these necessary determinations and withholdings.

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[11] Notice 2010-60 at sec. II.D.1.

[12] There will be no presumption (allowed for certain payments under the law currently in force) under FATCA that any payments to a U.S. branch are effectively connected income. Therefore, it is possible that U.S. branches will be potentially subject to yet-to-be-determined FATCA documentation obligations in connection with payments of such effectively connected income.

Foreign Law Compliance Challenges of Participating FFIs

Some FFIs may find compliance with FATCA difficult due to certain local legal restrictions. As indicated in comments submitted to the Department of Treasury, FFIs have concerns regarding compliance with local laws on protection of privacy and on restrictions on termination of relationships with existing account holders. Many foreign countries have domestic laws protecting the confidentiality of customer information. Some national laws prohibit FFIs from disclosing customer information to third parties without consent by the account holder. It may be difficult to obtain consent from passive recalcitrant account holders.

Additionally, the requirement of compulsory closure of recalcitrant accounts under FATCA may put certain FFIs in a legal dilemma. In Europe, the law does not allow FFIs to terminate relationships with account holders until after an extended period of time, and in some cases, termination is strictly prohibited. In Japan, accounts may be involuntarily closed by FFIs only in the event of illegal acts conducted by the account holders or if the accounts are held by certain "anti-social" organizations. Thus, certain FFIs are concerned about facing a high risk of litigation outside the U.S.

The Treasury Department is considering an intergovernmental approach to information sharing in such cases. IRS and Treasury Department officials have suggested, for example, that such an intergovernmental approach could require an FFI to meet the reporting requirements of FATCA by submitting the required information to its local government, which could then forward the information to the IRS, perhaps under the information exchange provisions of a tax treaty. It currently is unclear with which countries the Treasury Department is discussing an intergovernmental approach and what other approaches are being discussed to overcome the conflict of FATCA with local law.

Electronic Filing

In addition to the broad foreign account compliance requirements discussed above, Section 522 of FATCA permits the Treasury Department and the IRS to require financial institutions, such as FFIs, to electronically file foreign withholding returns (including any required under FATCA) regardless of whether the number of returns required to be filed by the financial institution is less than 250 per calendar year. Under current law, the authority to require electronic filing is limited for these smaller financial institutions. Notice 2010-60 announced that the Treasury Department and the IRS intend to issue regulations that will require electronic filings for all FATCA withholding returns, as well as "regular" withholding on U.S.-source payments, by all financial institutions regardless of the number of returns filed, beginning with returns filed for taxable years ending after December 31, 2012.[13] However, it is possible this could be delayed, possibly until sometime in 2014 (or thereafter), consistent with the expected effective dates for FFI reporting. The primary impact of these new rules on an FFI's U.S. branches may be to require such electronic filing for prior law Chapter 3 withholding, beginning with its fiscal year ending in 2013 (if not already in place before then). It is expected that FATCA and other reporting will be required to be made by electronic reporting in the case of FFIs.

[13] Notice 2010-60, 2010-37 I.R.B. 329, section V. F.

SYSTEMS AND PROCEDURES NEEDED

This memorandum is summary in nature. In the interest of brevity, most of the details of the FATCA statute and the Notices have been omitted. All of the procedures mentioned in this memorandum are described in greater detail in the Notices. The legislation delegates much of the responsibility of issuing detailed rules to the Treasury Department and the IRS, and the resulting regulations are likely to be voluminous and even more complex than the Notices. It is clear, however, that FATCA will require a significant effort on the part of participating FFIs in organizing systems and procedures to address the FATCA compliance requirements.

Notwithstanding, some general observations are appropriate. It will be necessary for Participating FFIs to establish electronic and manual systems and procedures that are consistent with the type of business, as well as consistent with the existing systems and procedures for intake, maintaining customer files, and AML/KYC rules. Some types of FFI businesses, such as funds, may have a high percentage of relevant files in electronic searchable format. Other types of FFI businesses, such as trust companies, may operate more like private banking and have a higher percentage of paper files. Banks and brokerage houses may have a mix of retail and private banking customers and may have numerous and varied systems across different business segments and geography. Banks or brokers may also have dealer functions that are closer in profile to funds. In developing these systems and procedures, FFIs should consider a risk management perspective similar to that ingrained in AML/KYC systems.

It will also be necessary for U.S. withholding agents and Participating FFIs, including U.S. branches of FFIs (whether Participating FFIs or non-Participating FFIs), to develop systems and procedures to address withholding and reporting requirements for FATCA, as well as electronic reporting systems for Chapter 3 withholding. To some extent, the operation of these systems will depend on the various categories of FFIs that are implemented, as well as the final rules for passthru payments and all the required forms and formats for electronic reporting.

RECOMMENDED COURSE OF ACTION

The recent pronouncements from the IRS have committed the IRS to a course of action and a specific timeline for the phased implementation of FATCA and systems integration. Absent Congressional action to the contrary, it is unlikely that there will be major deviations from this timeline. Although some may initially assume that FATCA is merely a "compliance effort," in reality it involves significant and far-reaching implications for every affected company. As discussed in more detail below, FFIs should begin their planning now for addressing the requirements of FATCA and integrating its mandates with company systems and procedures. This should be done methodically and in a phased approach in synchronization with the key implementation dates in order to assure that both tax and financial audit consequences will be minimized and timely addressed. In our opinion, FFIs should begin this process early in 2012 because there are certain decisions that should be addressed well before actual implementation, which may require data gathering and careful consideration across certain company functions, including legal compliance, operations, IT, and tax.

In general, the following are the steps that we believe should be taken by all FFIs:

1. Become educated as to the requirements of FATCA and implications on the FFI and your customers. This must include the awareness of top management and the Board of Directors or equivalent body, both of which should be kept informed and approve of key decisions made as time goes by.

2. Identify those individuals in your organization who will be responsible for FATCA compliance. In that regard, it should be noted that the chief compliance officer of a Participating FFI is required to certify its compliance periodically.

3. Perform a legal and operational analysis sufficient to formulate a plan for initial compliance with FATCA. Specifically, this means that an FFI must determine whether it is certain that it must enter into an FFI Agreement, whether there is a way to restructure its business operations in a manner that would minimize the negative consequences of not entering into such an agreement to an acceptable level, and what would be the relative cost benefit of these alternatives. Similarly, an FFI must determine whether it meets deemed-compliant status or could easily restructure to do so, or if there is a beneficial election that might be available. In completing this requirement, an FFI should perform an initial analysis of its systems to determine the programming needs in order to comply with the withholding and reporting requirements of FATCA. There is likely a significant expense to the extent systems need to be modified, but software vendors and service providers are already preparing software packages for FATCA implementation. Some software providers are creating flexible processing systems to allow compliance with FATCA without significant modification to the account database management system through separate software components that operate independently of primary database systems.

4. Timely plan and implement the required initial compliance activities, in particular those relating to preexisting accounts. Those activities should be conducted in parallel with the systems and procedures development described in the following step, in order to utilize new systems for the new compliance activities.

5. Develop systems and procedures in order to comply with the due diligence, reporting, and withholding requirements. This step may involve other IT service providers that specialize in FATCA programming to the extent it is necessary to modify primary systems, or acquisition of separate software components if possible. The systems should be thoroughly tested and independently reviewed prior to implementation to ensure that they will meet all of the requirements.

6. Train personnel in using the developed systems and procedures and in integrating them into the operations of the FFI. Training programs must be designed and customized for personnel responsible for client interaction, especially those personnel with significant responsibility in the account opening process.

7. Implement ongoing compliance activities.

For More Information

For more information about the Foreign Account Tax Compliance Act, or if you have questions about how this legislation may impact your business, please contact any of the following Baker Hostetler attorneys:

Paul M. Schmidt
National Tax Group Chair
pschmidt@bakerlaw.com
202.861.1760

James N. Mastracchio
Tax Controversy Team Leader
jmastracchio@bakerlaw.com
202.861.1650

Scott M. Dayan
sdayan@bakerlaw.com
202.861.1584

Allen J. Littman
alittman@bakerlaw.com
202.861.1686

Patrick Hannon
phannon@bakerlaw.com
202.861.4640

Stuart E. Horwich
shorwich@bakerlaw.com
202.861.1764

Michael W. Nydegger
mnydegger@bakerlaw.com
202.861.1688

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