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Client Alert

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U.S. Treasury Department Releases Model FATCA Intergovernmental Agreements

On July 26, 2012, the U.S. Department of Treasury released its first model intergovernmental agreement (IGA) implementing the information reporting and withholding tax provisions under the Foreign Account Tax Compliance Act (FATCA). FATCA was enacted by Congress in 2010 in an effort to combat avoidance of U.S. tax by U.S. taxpayers through the use of foreign accounts. The IGA, developed in consultation with France, Germany, Italy, Spain, and the United Kingdom, facilitates the automatic exchange of foreign account information between the United States and the foreign country (FATCA Partner). This is now referred to as the Model I approach. Please see our Client Alert of March 5, 2012 **here** for a more detailed discussion of FATCA generally and the Model I approach.

It is expected that Treasury will release a second model IGA (Model II) in consultation with Japan and Switzerland in the near future. Please see our Client Alert of July 6, 2012 **here** for a more detailed discussion of the Model II approach.

FATCA Overview

The FATCA regime is intended to promote U.S. tax compliance by natural persons and entities under their ownership and/or control. However, FATCA attempts to achieve this by creating a highly complex diligence, reporting, and withholding regime that operates in parallel to the existing complex diligence, reporting, and withholding regime. The act imposes the burden of achieving improved U.S. tax compliance on withholding agents, investment funds, and financial institutions.

FATCA operates by imposing a 30 percent gross basis withholding tax on certain U.S. source payments, on certain “passthru payments” discussed below, and on the gross proceeds from the disposition of U.S. equities and other securities (together “withholdable payments”) unless an exception applies. The FATCA withholding tax is far broader in scope than prior U.S. domestic law and is imposed on items such as “portfolio interest.”

FATCA’s burden falls primarily on foreign financial institutions (FFIs). An FFI for this purpose includes any non-U.S. entity that is a bank, broker-dealer, custodian, or trust company, or is engaged (or holds itself out as being engaged) primarily in investing or trading in securities, commodities, or partnership interests. This latter category generally applies to private equity and hedge funds. A foreign entity that is not an FFI is generally referred to as

a "non-foreign financial entity" (NFFE). An NFFE is generally only required to (i) certify that it does not have any direct or indirect "substantial" U.S. owners or (ii) provide information regarding any such U.S. owners. NFFEs that are foreign governments, publicly traded entities and certain of their affiliates, or other foreign entities identified in regulations or other guidance are exempt from this requirement.

FFIs are generally required to enter into an agreement with the Internal Revenue Service (IRS) under which the FFI agrees to identify any U.S. accounts and report account information to the IRS, including the identity of the holder, the balance in the account, and the amount of withdrawals or payments from the account. FFIs that have entered into this agreement are referred to as "participating FFIs." Participating FFIs are also required to withhold on passthru payments to noncompliant FFIs and recalcitrant account holders. A passthru payment is any payment attributable to U.S. source payments that would be subject to FATCA withholding were they not made to a participating FFI.

FATCA also authorizes Treasury to create categories of "deemed compliant" FFIs that are not required to enter into an FFI agreement to escape withholding. The deemed-compliant FFI category is intended to reduce the compliance burden on financial entities like pension funds or small local banks that might have U.S. investments but present minimal tax evasion risk.

The IRS provided preliminary guidance on the application of FATCA in Notice 2010-60, Notice 2011-34, and Notice 2011-53. Notice 2010-60 provided a preliminary list of entities that would not be required to enter into FFI agreements and gave a brief description of the diligence procedures that would be required from participating FFIs. Notice 2011-34 modified and supplemented the guidance in Notice 2010-60. Notice 2011-53 delayed the commencement of FATCA requirements and provided a timeline for the phase-in of implementation.

Overview of the Model Intergovernmental Agreements

There are two versions of the IGA, a reciprocal and a non-reciprocal version. Both versions establish a framework for FFIs to report certain financial account information of U.S. taxpayers (or of foreign entities in which a U.S. taxpayer holds a substantial ownership interest) to their respective tax authorities. The respective tax authorities then automatically exchange such information with the United States under existing bilateral tax treaties or tax information exchange agreements (TIEAs).

Authorizing the Exchange of Information

The language of the IGA suggests that a country must have a tax treaty or TIEA in place with the United States in order to enter into an IGA, and there were concerns that this requirement would prevent many countries from participating. Treasury officials have said, however, that foreign countries that do not have a tax treaty or TIEA with the United States could use an IGA as the legal vehicle for reporting information to the IRS in order to comply with FATCA. The reciprocal agreement would require a treaty or TIEA, but the nonreciprocal agreement will be an option for countries without such agreements. Such countries will still need to pass domestic legislation in order to provide the required information. The United States is also willing to sign TIEAs in conjunction with the IGA, and in some jurisdictions, a multilateral convention may be able to serve as the legal basis for exchanging information.

Regardless of the mechanism for authorizing the exchange of information among countries, foreign governments are relied upon in the IGA to enforce reporting, and local legislation will likely be needed in order to implement the IGA. If a FATCA Partner does not pass such legislation in time for FFIs to meet the reporting deadlines, Treasury will face a difficult situation, and it is not clear how they will respond.

The Reciprocal Exchange of Information

The reciprocal version of the IGA provides for the United States to exchange information currently collected on accounts held in U.S. financial institutions by residents of FATCA Partner countries. It also includes a policy commitment to pursue regulations and legislation that would provide for equivalent levels of exchange by the United States.

Under the reciprocal agreement, U.S. financial institutions may experience greater reporting obligations in the future. The extent of such reporting is unknown, although any such reporting is likely to be less burdensome than that imposed on FFIs. Nonetheless, U.S. financial institutions will be required to aggregate certain information for the IRS to pass on to FATCA Partner countries that have signed a reciprocal agreement.

Organization of the IGA

The IGA is comprised of a base agreement and two annexes. A FATCA Partner that complies with requirements under the base agreement and annexes of the IGA will be treated as complying with, and not subject to withholding under, section 1471 of the U.S. Internal Revenue Code (the Code).[1]

The base agreement of the reciprocal version provides definitions and reporting obligations of the FATCA Partner and the United States. The base agreement for the nonreciprocal agreement is substantially the same, but it does not impose reporting obligations on the United States.

For both versions of the IGA, Annex I provides the due diligence obligations for identifying and reporting on U.S. reportable accounts and certain payments. Annex I distinguishes between pre-existing and new accounts and between individual and entity accounts. Members of the tax community have questioned whether for each section of Annex I, an FFI will be able to choose to follow the rules contained in the regulations on those in the IGA, depending on which it finds more favorable for it on a given issue.

Annex II is to be completed upon bilateral consultation of the FATCA Partner for both reciprocal and nonreciprocal versions of the IGA. Once completed, Annex II will list FFIs that will be treated as exempt beneficial owners (such as certain pension or retirement plans), deemed compliant FFIs, and exempt accounts and products that will not be treated as financial accounts.

Information Reporting

The base agreement of the reciprocal IGA provides the type of information that must be exchanged by the FATCA Partner and the United States. The reporting government may use its domestic income tax laws for purposes of determining the amount and characterization of certain payments that it must report under the IGA. It must specify the currency in which the relevant amount is denominated. For the FATCA Partner, the reportable information with respect to each U.S. reportable account of the reporting FFI includes the:

- Name, address, and U.S. Taxpayer Identification Number (TIN) of each specified U.S. person and certain non-U.S. entities,

[1] Note that under the IGA, a FATCA Partner need not withhold tax under sections 1471 or 1472 of the Code with respect to accounts held by a recalcitrant account holder, as defined in section 1471(d)(6) of the Code.

- Account number,
- Name and identifying number of the FFI,
- Account balance or value,
- Gross amount of interest, dividends, and income on custodial accounts,
- Gross proceeds from the sale or redemption of property paid or credited to a custodial account,
- Gross amount of interest on depository accounts, and
- Gross amount paid or credited to an account holder during the reporting period on accounts that are neither custodial nor depository accounts.

The information that will be reported by the United States is substantially the same, except that account balances and values and gross proceeds paid or credited to the account are not required to be provided.

Compliance Dates for Information Reporting

The timing provisions of the IGA aim to provide some flexibility as governments work to establish systems and procedures to implement the reporting obligations under the IGA. Subject to a phase-in rule and an automatic extension for reporting with respect to 2013, the reportable information generally must be provided within nine months of the end of the calendar year to which the information relates. The IGA establishes a phase-in rule with regard to the information required to be furnished by the FATCA Partner. Namely, only the owner identifying information (name, address, TIN, and account number), FFI name, and account balance are reportable for the years 2013 and 2014. All reportable information is required to be provided for 2015, except for information relating to proceeds from the sale or redemption of property paid or credited to a custodial account, which is reportable with respect to 2016 and subsequent years. The United States does not have a similar phase-in rule. Therefore, all of its reportable information must be provided with respect to 2013 and subsequent years. With regard to the information relating to 2013, however, both the FATCA Partner and the United States will have until September 30, 2015, to provide the required information.

Multi-National Corporations

The IGA attempts to ease burdens on multinational corporations with respect to certain reporting obligations. It provides a special rule in the case of a branch or related entity of an FFI that, because of the laws of the jurisdiction in which it operates, cannot be a participating FFI or deemed compliant FFI. Such FFI is treated as being in compliance with the IGA to the extent that the branch or related entity (i) is treated by the FFI as a separate institution that identifies itself to withholding agents as a nonparticipating financial institutions, (ii) identifies its U.S. accounts and reports the information with respect to those accounts as required under section 1471 of the Code, and (iii) does not specifically solicit U.S. accounts held by persons that are not resident in that jurisdiction.

It is unclear whether the IGA provides a multinational corporation with an easier means of complying with FATCA's requirements than simply following the rules of the proposed regulations. The IGA differs from the proposed regulations in a number of ways. Among other changes, it expands the definition of "financial institution," requires activities or operations to be performed "for or on behalf of a customer" in order to fall under the scope of activity that must be reported, introduces the concept of a "FATCA partner financial institution," contains a more specific definition of "financial account" for insurance companies and some savings and pension plans, modifies other insurance-related

definitions, provides for decreased obligations with respect to recalcitrant account holders, omits an obligation to withhold on passthru payments, decreases the diligence requirements, and delays the initial reporting deadline. Some of these attributes were described in greater detail above, and significantly more exist.

On the whole, the IGA seems to make compliance significantly easier for small FFIs that are only present in FATCA Partner countries. For larger multinational FFIs, however, it could make compliance more difficult. Because the IGA contains different deadlines, terminology, and requirements than the proposed regulations and potentially those that will be provided under Model II, FFIs that operate in a number of countries, each of which seek to satisfy the requirements of FATCA through different means, will be required to satisfy the demands of FATCA though different processes. This prevents an FFI from adopting an integrated reporting system and will lead to greater confusion and implementation costs.

The extent of the differences in timing and requirements will depend on details of the Model II and the final regulations, neither of which have been released. There are some questions as to whether the differences between the IGA and the proposed regulations will remain or whether the IGA provides an indication of how the final regulations are likely to differ from the proposed version.

Procedures for Non-compliance

The IGA also provides for procedures in the case of non-compliance and correction of certain errors. In the case of minor or administrative errors, the United States or the FATCA Partner may contact the non-compliant FFI in the other jurisdiction in an effort to resolve such misinformation. In the case of a significant non-compliance with the IGA, the United States or the FATCA Partner will notify the other of such non-compliance. The non-compliant FFI may be subject to penalties, and if it does not resolve the non-compliance within 18 months, the FFI will be treated as a nonparticipating financial institution. In an effort to alleviate the compliance burden, FFIs are permitted under the IGA to outsource their information and reporting obligations to third party service providers. In order to prevent avoidance strategies, the United States and the FATCA Partner agree under the terms of the IGA to implement the necessary requirements to prevent FFIs from adopting practices that would circumvent the reporting required under the agreement.

Moving Forward

Treasury is expected to release Model II in the near future. Model II will reflect joint statements issued by the United States with Japan and Switzerland on July 21, 2012, that express the countries' intent to pursue a framework for intergovernmental information sharing under FATCA. It is expected to differ from the first model IGA in that FFIs will provide information directly to the IRS, with the national tax authorities in the foreign jurisdiction agreeing to provide additional information upon request by the IRS. A draft of the FFI Agreement and the final Treasury Regulations under FATCA are also expected to be released in the coming months.

The United States will also begin to negotiate specific Model I agreements with Spain, France, Germany, Italy, and the United Kingdom and then with other countries interested in entering into a Model I IGA as well. Although Treasury has made clear that it does not intend to negotiate different agreements with each country, as discussed above, Annex II will vary from one agreement to the next. Therefore, the negotiation process will be somewhat time consuming and Treasury will have to prioritize negotiations.

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