FEELING THE FORCE OF FATCA

FATCA CAN HAVE IMPORTANT CONSEQUENCES FOR NON-FINANCIAL COMPANIES AROUND THE WORLD, SO TREASURERS NEED TO START ASSESSING ITS IMPACT, SAY JULIO CASTRO AND KARL LEE

The Foreign Account Tax Compliance Act (FATCA) is an enhanced tax information reporting regime that aims to achieve disclosure to the US tax authorities of information on offshore accounts and investments of US citizens that are tax-resident in the US (including so-called 'Green Card' holders) and US entities. By and large, FATCA targets foreign financial institutions (FFIs) and requires them to undertake due diligence to identify and document their account holders, implement monitoring and assume withholding tax (WHT) responsibilities and periodically report to the US Internal Revenue Service (IRS) information on accounts held (directly and indirectly) by covered US persons. FATCA also has implications for non-financial entities, particularly entities that conduct financial transactions, so even non-financial groups need to assess the FATCA implications of their cross-border payments.

This article draws attention to the key FATCA considerations for treasurers of non-US groups, and indicates the likely development of the international exchange of tax information that will unfold with FATCA — most notably in Europe.

Scope of FATCA

As implemented under regulations promulgated by the US Treasury Department and the IRS in January 2013 and subsequently modified by Notice 2013-43, FATCA requires FFIs to register with and enter into an 'FFI Agreement' with the IRS. An FFI that has entered into such an agreement (a 'Participating FFI') agrees to comply with certain due diligence procedures, satisfy certain withholding obligations (most of which do not apply until 2017, although intermediaries paying US-sourced income may be liable from July 2014) and report to the IRS specific information about certain US accounts they maintain, including the accounts of some non-financial foreign entities with substantial US owners. Failure to become a participating FFI results in a punitive 30% WHT on the FFIs' in-scope US-sourced payments (dividends, interest, royalties, etc) beginning in July 2014 and, from 2017, on gross proceeds from the sale of US stock and certain debt instruments. Persons making such payments are responsible for confirming participating FFI status and, where an FFI is non-participating, remitting the tax to the IRS.

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What types of entities are likely to be classified as FFIs?

There are five categories of FFIs under FATCA: depository institutions; custodial institutions; investment entities; insurance companies or holding companies of insurance companies that issue cash value insurance or annuity contracts; and holding companies and treasury centres of groups that include another financial entity. If a non-US entity falls within at least one of these categories and no exception applies, it will be an in-scope entity as an FFI and thus will be subject to FATCA requirements on account identification, reporting, etc.

Depository institutions are those that accept deposits in the ordinary course of a banking or similar business.

Custodial institutions are those that hold financial assets for the benefit of third parties and at least 20% of whose gross income for the three preceding years comprised custodial fees and certain other related types of income. Typically, this category captures broker-dealers and similar entities.

Investment entities are those that engage in trading, investing, managing or administering financial assets (including commodities, securities, interest rates and foreign currencies) on behalf of customers. They also include entities that trade or invest in financial assets on their own behalf, but are managed by entities that are FFIs. This definition is intended to encompass private equity funds, hedge funds and other collective investment vehicles in general, but, based on experience, could have a much broader reach.

Insurance companies and holding companies of insurance companies may be treated as FFIs, but only if they issue 'cash value insurance contracts' (insurance contracts with a value above $50,000 payable upon surrender, termination, cancellation or withdrawal, or when used as collateral) or annuity contracts.

Finally – and very importantly – holding companies and treasury centres that are part of an expanded affiliated group (EAG) including another FFI (or an insurance company, regardless of whether it constitutes an FFI under the above definitions) are also treated as FFIs. Loosely speaking, an EAG is a group of entities linked by common control in the form of more than 50% vote and value. The rules do not require the holding company to have a direct shareholding in an FFI – the mere fact that the holding company is part of an EAG containing at least one FFI is sufficient to bring the

holding company into scope. Likewise, a treasury centre may be treated as an FFI if it enters into investment, financing or hedging transactions with or for any members of its EAG (even non-FFIs), if the EAG contains at least one FFI.

Notwithstanding the seemingly all-encompassing reach of the FFI categories, the US Treasury regulations establish a number of deemed-compliant types of entities and carve out a series of exceptions. Certain holding companies, treasury centres and captive finance companies of a predominantly 'non-financial' group, for example, are not treated as FFIs. In order to qualify under this exclusion, certain income and assets tests must be met, looking back over a three-year testing period. In particular, no more than 25% of the gross income of the EAG may consist of 'passive income' (interest, dividends, etc), no more than 5% of the gross income of the EAG may be derived by members that are FFIs, and no more than 25% of the fair market value of the assets held by the EAG may be attributable to assets that produce or are held for the production of passive income. Furthermore, other FFIs within the group must be participating or deemed-compliant FFIs, and the tested entity cannot be a custodial institution, a depository institution, a specified insurance company or a certain type of investment entity.

In relation to the definitions of financial institutions, it is important to note that several jurisdictions – including the UK, with many more expected to follow – have entered into intergovernmental agreements (IGAs) with the US, which may contain different definitions of certain FFI categories. Multinational groups

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therefore need to monitor the development of the IGAs in the jurisdictions where their group operates. For example, in the US model IGAs, the definition of an investment entity is substantially different, and there is no concept of a holding company or treasury centre FFI. The UK, however, in implementing the IGA, has moved closer to the definitions in the US Treasury regulations (although differences remain) and, as part of its regulations, has included holding companies and treasury centres within the ambit of financial institutions. It remains to be seen whether and how the other IGA jurisdictions will address this issue. Also, other concepts, such as EAG, are captured differently under the IGAs, and interpretations of certain terms under local law may be of special importance in IGA countries.

It is important to identify the FATCA status of each entity within a group, as failure to register one FFI could cause other (otherwise compliant) FFIs in the group to also be subject to WHT. FFIs should aim to register with the IRS by 25 April 2014 to ensure they appear on the initial (safe harbour) list of participating FFIs issued by the IRS.

Withholding obligations imposed on US companies

Although the main focus of FATCA is directed at FFIs, FATCA will also affect US withholding agents that make US-sourced payments to non-US payees. Whenever a US company makes an in-scope US-sourced payment to a foreign entity, it generally would need to obtain the proper documentation in order to identify the payee's FATCA status – usually a new Form W-8BEN-E. If the US company cannot document a payee as compliant with FATCA, it will generally need to withhold the 30% FATCA tax unless the payment can qualify for an exception (under grandfathering rules or an exclusion for certain non-financial payments). This may be recoverable under tax treaties, but will involve cash flow and administrative costs. Importantly, the FATCA withholding could apply to payments between a US affiliate of a non-financial group and a non-US affiliate, if the status of the payee is not properly established.

New IRS Form W-8 series and documentary evidence

The IRS and the US Treasury will amend the IRS Form W-8 series to reflect additional information that is specifically FATCA-related. Until 2017, when FATCA withholding on gross proceeds from the sale of certain assets becomes effective, the payments affected by FATCA are generally the same as payments that are currently subject to 'chapter 3' withholding, although some of the existing exemptions will not apply (for example, the exemption on 'portfolio interest' or under a tax treaty).

Tax information transparency is an irreversible trend

With the escalation of public outcry against international tax avoidance, most governments welcome any tools that increase tax information transparency. The existing bilateral exchange of information agreements are inefficient, and discussions on new frameworks at the Organisation for Economic Co-operation and Development are very slow. Therefore, governments are enthusiastically embracing FATCA IGAs, not only to facilitate compliance with FATCA, but also as a model for new multilateral mechanisms.

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