# Facing up to FATCA

Since its enactment in U.S. tax law in March 2010, the Foreign Account Tax Compliance Act (FATCA) has generated significant controversy amongst financial institutions across the globe. However, despite repeated calls for its repeal, financial institutions everywhere are having to accept the inevitable: FATCA is here to stay.

Against the backdrop of growing focus on perceived tax abuse through offshore accounts, FATCA is being introduced to obtain information from foreign financial institutions on US persons with foreign accounts. FATCA will impact all Middle Eastern financial institutions and their customers. Indeed, it presents significant financial and operational risks for them which require urgent consideration.

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### Global impact

FATCA will apply to any non-U.S. financial institution that receives U.S. source payments from 1 January 1st, 2014. The provisions impose a 30% withholding tax on all income and capital payments received by the Foreign Financial Institution (FFI) from U.S. sources, unless they enter into an agreement with the Inland Revenue Service (IRS) to report specified U.S. customers.

It will be the responsibility of U.S. withholding agents that make U.S. source payments to FFIs to withhold the 30% tax on the payment made to a non-U.S. person under FATCA. This will require the U.S. entities to maintain documentation on those non-U.S. persons and also track how those persons are classified under FATCA.

The definition of FFIs that are captured by FATCA is broad and includes any non-U.S. entity that:

- Accepts deposits in the ordinary course of a banking or similar business,
- As a substantial portion of its business, holds financial assets for the account of others, or
- Is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities.

Therefore, the criteria include not only entities that are normally recognized as financial institutions such as banks, broker dealers and custodians, but also insurance companies, pension plans, mutual funds, hedge funds and family investment vehicles. Given this wide-ranging definition, it is clear that FATCA will impact the majority of institutions operating in financial services across the globe, including those in the Middle East.

However, the impact of FATCA does not stop at financial institutions. The new law also requires a U.S. withholding agent to withhold a tax equal to 30% on the U.S. source payment made to a non-financial foreign entity (NFFE), unless it provides certain information regarding its U.S. owners. A NFFE is defined as any foreign entity that is not an FFI.

### Onerous operational and administrative provisions

There are a number of key definitions that are important to fully understand FATCA's impact. The application of FATCA to a FFI is determined by whether that FFI

receives U.S. source payments or "withholdable" payments (rather than if the FFI has US accounts). Withholdable payments are defined as:

- Any payment of interest (including any portfolio interest and original issue discount), dividends, rents, royalties, salaries, wages, annuities, licensing fees and other fixed or determinable annual or periodical (FDAP) income, gains and profits, if such payment is from sources within the United States.
- Any gross proceeds from the sale or disposition of U.S. property of a type that can produce interest or dividends.
- Interest paid by foreign branches of U.S. banks.

Furthermore, certain "passthru" payments will also be subject to FATCA from January 1st, 2015 (a passthru payment generally includes any portion of a payment that is not a withholdable payment multiplied by the entity's so-called "passthru payment" percentage.)

The FFI will be required to obtain information to determine which of its accounts are held by U.S. persons (including U.S. citizens, U.S. dual citizens, U.S. resident, and U.S.- born), using specified U.S. indicia which are very comprehensive. For example, if the account holder has a power of attorney granted to a person with a U.S. address then that account should be investigated to prove it is not a U.S. account holder.

In order to become a participating FFI and avoid FATCA withholding on the payments it receives, the FFI will need to enter into an agreement with the IRS. In guidance released in July 2011, the IRS advised that all agreement applications should be submitted by June 30th, 2013 so that they may be processed in time for the January 1st, 2014 implementation date.

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Generally, an FFI Agreement requires a determination of its U.S. accounts, compliance with verification and due diligence procedures with respect to each account holder, annual reporting on those U.S. accounts, compliance with additional IRS reporting requests, and withholding 30% where applicable (for example, on recalcitrant account holders.)

With regard to those countries that have privacy or secrecy law and that prohibit sharing customer information with the U.S. government, FATCA rules require that the institution in question ask any U.S. customer to waive their rights under the privacy or secrecy rules so that their information can be provided to the U.S. Government. If they refuse to provide this waiver then the institution is required to close their account.

## Mixed reactions

Given the wide-ranging impact of FATCA and the comprehensive information that is likely to collect for the U.S. Government, it is not surprising that U.S. senator Carl Levin has described FATCA as "a major new and positive development in the efforts to stop offshore banks from using secrecy laws to help U.S. taxpayers evade their taxes."

However, many financial institutions have not reacted so positively and there has been significant lobbying from financial institutions and their associations and advisors with regard to the specific provisions of FATCA. This has covered a wide range of areas, but one common area of concern has been the cost of implementation for FFIs, which will require significant up-front and ongoing investment in their resources, training, processes and IT systems in order to comply with FATCA's requirements.

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In response to this pressure, the U.S. has made a number of concessions, including delaying the date of implementation by one year to January 1st, 2014. Furthermore, a number of transitional reliefs have been announced including the delay in applying withholding for certain payments until 2015. The industry has generally welcomed the concessions but continue to press for more reliefs.

On the whole, most foreign Governments have not actively participated in the lobbying effort, preparing to leave this to the private sector. However, the extra-territorial reach of FATCA has led to suggestions in some quarters that other jurisdictions may follow the U.S. footsteps and seek to introduce similar legislation in the future.

FATCA has, to date, received less publicity in the Middle East than some of the other major financial hubs around the world. However, some financial institutions have already started taking active steps to analyse the impact of FATCA and put in place mechanisms to deal with its consequences. It is expected that activity in the Middle East will only increase as the timescale until implementation decreases. Indeed, given that there are many individuals in the Middle East who have a U.S. education and/or a Green Card or a U.S. passport – and therefore may be captured by the U.S. residence and indicia rules – there is likely to be a substantial amount of work to ensure Middle Eastern FFIs are ready to meet the FATCA requirements.

### The way forward

At present, aside from the primary legislation that was passed last year and a number of notices, the IRS has not provided extensive guidance as to how the regime will operate in practice. It is anticipated that further draft regulations will be released by the end of this year.

Many financial institutions are currently reviewing the potential impact of the proposed legislation and attempting to ascertain the potential cost and resources required to enable them to comply. This has typically involved a detailed review at business-unit level to ascertain the incidence of U.S. customers and counterparties, the types of payments received from the U.S. and the current procedural and systems capabilities for identifying and documenting U.S. persons.

Following this, an implementation plan can be developed to identify and address the gaps that currently exist to enable an institution to comply with FATCA. The key to success is to ensure awareness across the affected business units, identify responsibilities and harness key stakeholders in operation, tax, compliance, systems and legal departments to review existing processes and then move to developing and executing an appropriate implementation plan.

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