tax justice network

TAX JUSTICE **BRIEFING** - April 2010

MEMORANDUM ON THE U.S. FOREIGN ACCOUNT TAX COMPLIANCE ACT

Prepared by DAVID SPENCER, Senior Adviser

The United States Will Require Automatic Exchange of Tax Information: The U.S. Foreign Account Tax Compliance Act ("FATCA")

I. Introduction

In the recently enacted U.S. Foreign Account Tax Compliance Act ("FATCA"), the United States will in effect require automatic exchange of information about U.S. Persons with foreign Financial Accounts. FATCA will achieve this by subjecting each Foreign Financial Institution (and other foreign entities) which invests its own funds or its clients' funds in the United States, to a 30 percent U.S. withholding tax on U.S. source income, unless the Foreign Financial Institution (or other foreign entity) agrees to disclose to the U.S. Government information about foreign Financial Accounts of U.S. Persons, as detailed below. This is automatic exchange of information, not between foreign governments and the U.S. Government, but between Foreign Financial Institutions (and other foreign entities) and the U.S. Government. The FATCA rules will apply to payments after December 31, 2012, except that no U.S. withholding tax will be required by FATCA on any obligation outstanding on March 18, 2012.

This raises three major issues: First, as the United States will in effect require the automatic exchange of tax information about U.S. Persons with foreign Financial Accounts, the United States can not seriously maintain that the OECD's program of exchange of information upon request is effective exchange of information.

Second, the United States has an inconsistent tax policy. Pursuant to FATCA, the United States will in effect require automatic exchange of information about U.S. Persons with foreign Financial Accounts. But the United States provides de facto bank secrecy to Foreign Persons making passive investments in the United States, especially through the U.S. Qualified Intermediary (QI) program. The U.S. QI program limits – intentionally – the ability of the U.S. Government to exchange tax information with foreign governments.

Third, as the U.S. Government will in effect require such automatic exchange of information about U.S Persons with foreign Financial Accounts, will foreign governments, especially governments which suffer from capital flight and the resulting cross-border tax evasion, also require such automatic exchange of information about their citizens and residents with foreign financial accounts, including their citizens and residents with financial accounts in the United States? Will foreign governments implement programs similar to the U.S.'s FATCA? That is, will Country X (which might be a developing country) impose a higher withholding tax on payments from sources in Country X to financial institutions and other entities based in Country Y, unless those financial institutions and other entities in Country Y agree to provide to the government in Country X information about persons (both natural and legal) in Country X who/which have financial accounts in Country Y?

II **Background: The U.S. Qualified Intermediary (QI) Program**

The United States Qualified Intermediary (QI) program which began in 2000, permits a financial institution outside of the United States which meets the QI requirements, to invest in the United States in the name of the foreign financial institution, funds of Foreign Persons without disclosing to the U.S. Government or the U.S. payor the identity of the Foreign Person. That is, pursuant to the United States QI Program, the U.S. payor and the U.S. Government do not have access to information about the identity of each Foreign Person who/which invests in the United States through a foreign financial institutions which is a QI. Therefore, the U.S. Government can not exchange the relevant tax information with the government of the foreign country where the Foreign Person is a resident or citizen. This provides to the Foreign Person de facto bank secrecy, even if the United States has an income tax treaty or tax information exchange agreement (TTEA) with the country of residence of the Foreign Person.

However, in order for a foreign financial institution to qualify as a QI, the foreign financial institution must agree with the U.S. Government to disclose to the U.S. Government the identity of U.S. Persons who have accounts at the QI with funds invested in the United States.

The U.S. Congress (U.S. Senate Permanent Subcommittee on Investigations, "Tax Haven Banks and U.S. Tax Compliance," Staff Report, July17, 2008) determined two main problems with the QI rules with regard to U.S. Persons:

(1) Foreign (Non- U.S.) Source Income: The QI rules do not require the foreign financial institution which is a QI to report to the U.S. Government the identity of U.S. Persons who had accounts at the QI with investments only outside of the United States; and

(2) Use of Foreign Entities by U.S. Persons: The QI rules do not apply explicitly to U.S. Persons who own foreign entitles (corporations, other companies, partnerships, trusts) which have accounts at the QI.

FATCA focuses on these two issues, and other offshore tax evasions issues.

III **The Foreign Account Tax Compliance Act (FATCA)**

The reason for FATCA is described in the U.S. Congress News Release, dated October 7, 2009:

As a tax enforcement tool, the United States requires U.S. financial institutions to file annual returns disclosing and reporting on the activities of bank accounts held by

U.S. individuals. Many U.S. individuals looking to evade their tax obligations in the United States have sought to hide income and assets from the [U.S.] Internal Revenue Service ("IRS") by opening secret foreign bank accounts with foreign financial institutions. Some foreign financial institutions have voluntarily agreed to provide information on the U.S. assets of U.S. account holders as part of the "Qualified Intermediary" program since 2000. However, many of the foreign financial institutions that hold U.S. accounts are outside the reach of U.S. law [because those foreign financial institutions have decided not to become Qualified Intermediaries]. As a result, the ability of the United States to require foreign financial institutions to disclose and report on U.S. account holders is significantly limited. Although these foreign financial institutions are outside the direct reach of U.S. law, many of them have substantial investments in U.S. financial assets or hold substantial U.S. financial assets for the account of others.

FATCA expands (1) the type of U.S. Persons about whom automatic exchange of information is required; (2) the type of foreign financial institution which must provide information automatically to the U.S. Government, and (3) the type of income about which automatic exchange of information with the U.S. Government is required.

(1) Type of U.S. Persons covered by FATCA

FATCA applies to a Financial Account which is a United States Account. That is, a Foreign Financial Institution subject to FATCA must report to the U.S. Government information about a Financial Account which is a United States Account at that Foreign Financial Institution, whatever the source (U.S. or foreign) of the income earned in that Financial Account.

The term "Financial Account" is broadly defined by FATCA, with regard to any Foreign Financial Institution, as (a) any depository account, (b) any custodial account, and (c) any equity or debt interest in such Foreign Financial Institution such as interests in foreign hedge funds and foreign private equity funds (other than interests which are traded regularly on an established securities market). (Any equity or debt interest which constitutes a Financial Account with respect to any Foreign Financial Institution is to be treated as maintained by such Foreign Financial Institution.)

The term "United States Account" means any Financial Account which is held (a) by one or more specified United States Persons or (b) by a "United States Owned Foreign Entity." FATCA defines U.S. Persons as U.S. citizens, U.S. residents, domestic corporations (other than a publicly traded company and its more than 50% controlled affiliates), domestic partnerships and domestic trusts.

FATCA defines the term "United States Owned Foreign Entity" as any foreign entity which has one or more "Substantial United States Owners." The term "Substantial United States Owner" is defined by FATCA: (i) with respect to any corporation, any specified United States Person which owns, directly or indirectly, more than 10 percent of the stock of such corporation (by vote or value), (ii) with respect to any partnership, any specified United States Person which owns, directly or indirectly, more than 10 percent of the profits interests or capital interests in such partnership, and (iii) in the case of a trust, any specified United States Person treated as an owner of any portion of such trust, or holds more than 10 percent of the beneficial interests of such trust. This would require the Foreign Financial Institution to determine the beneficial owners of each such foreign entity. This resolves the issue emphasized by the U.S. Senate Permanent Subcommittee on Investigations, of a U.S. Person trying to evade U.S. income taxes by owning a foreign entity and investing assets through that foreign entity ("Tax Haven Banks and U.S. Tax Compliance," Staff Report, July 17, 2008). The 10 percent ownership test does not apply to a foreign entity that is a corporation, partnership or trust that is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, commodities or any interest (including a futures or forward contract or option) in such securities, interests in partnerships or commodities. This would include investments in foreign hedge funds, foreign private equity funds and other foreign investment vehicles. That is, any investment by a U.S. Person in such foreign entities would constitute a United States Owned Foreign Entity and is subject to FATCA, even if the investment is 10 percent or less.

(2) Type of Foreign Financial Institutions and other Foreign Entities Covered by FATCA

The term "Foreign Financial Institution" generally means any "financial institution" which is a foreign entity. The term "Financial Institution" means any entity that

> (A) accepts deposits in the ordinary course of a banking or similar business; (B) is engaged in the business of holding financial assets for the account of others; or (C) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities(as defined in [U.S. Internal Revenue] Code section 475(c)(2))…., partnership interests, commodities…., or any interest (including a futures or forward contract or option) in such securities, partnership interests or commodities. This would include foreign banks, foreign brokerage firms, and also foreign private equity funds, foreign hedge funds, and other foreign investment vehicles.

FATCA also applies to a foreign entity which is not a Foreign Financial Institution ("Non-Financial Foreign Entity") if that Non-Financial Foreign Entity is the beneficial owner of the payments, unless the Non-Financial Foreign Entity certifies that the Non-Financial Foreign Entity does not have a Substantial U.S. Owner, or provides to the U.S. Government the required information about any Substantial U.S. Owner of that Non- Financial Foreign Entity. The definition of Non-Financial Foreign Entity excludes (a) publicly traded corporations; (b) foreign governments or a political subdivision or wholly owned agency of any foreign government; (c) international organizations; and (d) any foreign central bank of issue.

(3) Type of Income Subject to FATCA

FATCA would apply to any Financial Account owned by a U.S. Persons, whether the Financial Account has U.S. source income or foreign source income. This modifies the treatment under the present QI rules, which apply only to U.S. Persons with an account at the QI if that account has U.S. assets and derives U.S. source (but not foreign source) income.

IV How FATCA Implements Automatic Exchange of Information: A 30 Percent U.S. Withholding Tax

(1) Increased Disclosure of U.S. Beneficial Owners of Foreign Accounts

FATCA would impose a U.S. withholding tax of 30 percent on U.S. source "Withholdable Payments" to (1) Foreign Financial Institutions (including foreign hedge funds, private equity funds, and other foreign investment vehicles) and (2) Non-Financial Foreign Entities, unless the Foreign Financial Institution or Non-Financial Foreign Entity cooperates with the U.S. Government pursuant to a written agreement in providing to the U.S. Government specific information annually about U.S. Persons.

That is, in order for Foreign Financial Institutions and Non-Financial Foreign Entities to have access to U.S. capital markets without being subjected to that 30 percent U.S. withholding tax, those foreign entities would have to provide annually to the U.S. Government information about their U.S. Accounts. This in effect constitutes automatic exchange of information, not by a foreign government to the U.S. Government, but by Foreign Financial Institutions, and Non-Financial Foreign Entities, to the U.S. Government. These disclosure and reporting requirements could be in addition to any requirements imposed under the requirements imposed under the Qualified Intermediary program. It is expected that Foreign Financial Institutions would comply with these disclosures and reporting requirements in order to avoid this U.S. withholding tax, and be able to access the U.S. capital markets.

The term "Withholding Payment" is defined as (A) "any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income, if such payment is from sources within the United States and (B) any gross proceeds from the sale of any property of a type which can produce interest or dividends from sources within the United States (as determined in the U.S. Internal Revenue Code), except income effectively connected with the conduct of a trade or business in the United States.

That 30 percent withholding tax does not apply if the Foreign Financial Institution or Non-Financial Foreign Entity, as the case may be, agrees with the U.S. Treasury to determine whether each account at the institution (or the institution's affiliates) is a "United States Account" and to report annually to the United Sates information about that account: (1) the name, address and U.S. taxpayer identification number (TIN) of the account holder who is a U.S. Person and in the case of a Financial Account owned by a foreign entity which is a United States Owned Foreign Entity, the same information about each Substantial United States Owner; (2) the account number; (3) account balance or value; (4) receipts (U.S. source and foreign source) in the Financial Account; and (5) withdrawals/payments from the Financial Account.

(2) Secrecy Jurisdictions and Waivers

FACTA confronts the issue of secrecy/confidentiality laws in the jurisdiction where the Foreign Financial Institution maintains the Financial Account: In any case in which any foreign law would (but for a waiver described below) prevent the reporting to the U.S. Government of any required information…..with respect to any United States Account maintained by such Foreign Financial Institution, the Foreign Financial Institution must attempt to obtain a valid and effective waiver of such law from each holder of such account, and if such a waiver is not obtained from each such account holder, the Foreign Financial Institution must close such account.

(3) FATCA and Expanded Affiliated Groups

The FATCA requirements apply in certain cases to the "Expanded Affiliated Group" of the Foreign Financial Institution. FATCA defines the term "Expanded Affiliated Group". That is, a Foreign Financial Institution could not avoid FATCA by not investing any of its own funds or its clients' funds in U.S. source income, but by having a separate subsidiary or affiliate which is part of the Expanded Affiliated Group with Financial Accounts of U.S. Persons.

However, if (a) a Foreign Financial Institution which is not part of an Expanded Affiliated Group does not have any Withholdable Payments, or (b) a Non-Financial Foreign Entity does not have any Withholdable Payments, then FATCA would not apply. Therefore, the Foreign Financial Entity or the Non-Financial Foreign Entity, as the case may be, would not be required to report to the U.S. Government any information about Financial Accounts of U.S. Persons. This might result in foreign Financial Institutions or Non-Financial Foreign Entities having U.S. Accounts but not investing its funds or its clients' funds in the United States in order to avoid the 30% U.S. Withholding tax.

However, the Foreign Financial Institutions may rely on a certification from an account holder as to whether the account is a United States account… if neither the financial institution nor any entity which is a member of the same expanded affiliated group as such financial institutions knows, or has reason to know, that any information provided in such certification is incorrect. That certification procedure could result in compliance problems.

(4) FATCA and Income Tax Treaties

The 30 percent U.S. withholding tax would be imposed even if a U.S. income tax treaty would otherwise apply to reduce any U.S. withholding tax. If a U.S. income tax treaty would otherwise apply, the Foreign Person who is the beneficial owner of such income would have to file with the U.S. Government a request for a refund and provide information to justify that he/she/it is a Foreign (non-U.S.) Person and qualifies for the U.S. income tax treaty benefits. The legislative history of FATCA states explicitly that this is consistent with U.S. obligations under existing U.S. income tax treaties.

(5) Relationship of FATCA and the U.S. QI Program

Foreign Financial Institutions which are Qualified Intermediaries (QI) must also comply with FATCA.

(VI) Other FATCA Issues

(1) Foreign Financial Institutions Complying with U.S. Reporting Requirements

A Foreign Financial Institution can elect to fulfill the information reporting requirements under the U.S. Internal Revenue Code (Code sections 6041(information at source), 6042 (payments of dividends and corporate earnings), 6045 (brokerage transactions), and 6049) (payments of interest) with regard to each United States Account maintained by that institution, as if such Foreign Financial Institution were a U.S. financial institution and each holder of such Account which is a specified United States Person or United States Owned Foreign

Entity were a natural person and citizen of the United States.

(2) Registered Obligations

With regard to the issuance of bearer instruments to foreign persons, FATCA would (1) repeal the interest deduction for the issuer of the bearer bonds to foreign persons (the foreign targeted debt obligations, the TEFRA rules) and impose an excise tax (Code sections 165 (f), 16S (j)(2)(A) and 1287 (b)(1); (2) permit the portfolio interest exemption only for registered obligations, (Code section 871 (h)(2); and (3) require that U.S. Treasury obligations be in registered (non-bearer) form (31 USC 3121 (g)). This attempt to limit non-registered (bearer) obligations would also impact foreign persons trying to avoid foreign income taxes.

(3) Foreign Financial Asset Reporting.

FATCA would require any individual who is a U.S. person who holds any interest in a "Specified Foreign Financial Asset" to provide certain information on his/her annual income tax return if the aggregate value of all such assets exceeds US$50,000. The term "Specified Foreign Financial Asset" means (a) any Financial Account maintained at a Foreign Financial Institution, and (b) any of the following assets which are not held in an account maintained in a financial institution (whether or not foreign): (i) any stock or security issued by a non-United States Person; (ii) any investment that has an issuer or counterparty which is a non-United States person; and (iii) any financial instrument or contract or other interest in a "foreign entity". This reporting requirement is separate from the obligation to file FBAR TD F 90-22.1.

The US Treasury Secretary has the authority to determined that "the provisions of this section shall apply to any domestic [U.S.] entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets, in the same manner as if such entity were an individual:.

FATCA would impose penalties for failure to disclose such information, and penalties for underpayments attributable to undisclosed foreign financial assets, and in certain situations (such as in case of substantial omissions of gross income derived from assets) would extend the statue of limitations from three to six years.

(4) Substitute Dividends and Dividend Equivalent Payments

FATCA will treat certain substitute dividends and dividend equivalent payments under notional principal contracts (such as total return equity swaps) received by Foreign Persons as U.S. source income. This problem was analyzed in a report prepared by the U.S. Senate Permanent Subcommittee on Investigations ("Dividend Tax Abuse : How Offshore Entities Dodge Taxes on U.S. Stock Dividends," Staff Report, September 11, 2008).

(5) FATCA and Foreign Trusts

FATCA has special rules about the reporting requirements with regard to foreign trusts.

(6) FATCA and Passive Foreign Invest Companies

FATCA requires U.S. shareholders of passive foreign investment companies (PFICs) to file annual information returns with the U.S. Government.

(7) Exclusions from FATCA

Certain provisions which had been proposed were not included in FATCA, such as: (1) the reporting by U.S. financial institutions of cross border wire transfers; (b) the "blacklasting" of certain foreign jurisdictions; and (c) the treatment of foreign corporations managed and controlled in the United States (such as some offshore hedge funds) as domestic U.S. corporations subject to U.S. income tax.

VI FATCA Effective Date

Different provisions of FATCA are subject to different effective dates. With regard to the 30 percent U.S. withholding tax on payments to Foreign Financial Institutions or Non-Financial Foreign Entities, the effective date is January 1, 2013. However, no amount must be deducted or withheld from any payment under any obligation outstanding on March 18, 2012. The delayed effective date of this major provision of FATCA will provide sufficient time for preparation by the U.S. Government of the documentation necessary for Foreign Financial Institutions and Non-Financial Foreign Entities to comply with FATCA.

VII Conclusion

In the process toward more efficient international tax cooperation, FATCA may be a significant step toward automatic exchange of information. First, it may presage the greater involvement of financial institutions in the mechanics of automatic exchange of information. Second, as the United States requires such automatic exchange of information about U.S. Persons with Foreign Financial Accounts, will other countries also require automatic exchange of information?

IMPORTANT: This memorandum is only a general discussion of FATCA. The specific facts of each particular situation should be carefully reviewed