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FATCA's Legal Issues

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To address concerns that US taxpayers were failing to report income generated in offshore accounts, the US Congress adopted Sections 1471 through 1474 of the Internal Revenue Code, commonly referred to as "FATCA," in early 2010. FATCA constitutes an attempt by the US to recruit the assistance of non-US financial institutions to obtain information on offshore accounts held by US persons. The leverage employed by the US to encourage or compel information sharing with respect to such accounts is a requirement that persons making "withholdable payments" to a foreign financial institution or "FFI" generally withhold 30% of such withholdable payments, unless such FFI enters into an agreement with the IRS to provide information with respect to accounts maintained by US tax residents and by non-US entities that have substantial US ownership.

The term FFI is defined quite broadly, and includes banks, entities holding financial assets on behalf of others, mutual funds, private equity funds, among other institutions. Certain financial institutions, however, will be treated as deemed compliant with the provisions of FATCA (including certain non-US pension plans, tax exempt entities, non-US banks conducting solely a local business, among others). The deemed compliant FFIs would be exempt from the new FATCA withholding tax and would not be required to enter into a FATCA reporting agreement with the IRS.

FFIs subject to FATCA would, subject to certain exceptions, be required to conduct specified due diligence with respect to the identity of account holders in such FFIs in order to enable a determination whether such account holders are US persons.

The FFIs would be required to report identifying information with respect to US persons maintaining accounts in such FFIs, as well as information with respect to the level of deposits, withdrawals and income in the US-owned accounts. In addition, FATCA would require FFIs to impose a 30% US withholding tax on passthru payments (payments made by an FFI that are determined by reference to or are attributable to a withholdable payment received by the FFI) made to persons who either (i) do not agree to provide information necessary to determine whether such account holders are US persons, or (ii) do not consent to the FFI providing such identifying information to the IRS. The current proposal is that FATCA withholding on passthru payments would not commence until January 1, 2017.

The new potential FATCA withholding tax applies to "withholdable payments", including interest income, dividends, rents, compensation and other fixed or determinable income from sources with the US, and to the proceeds on sale of instruments that generate US source dividend or interest income.

Although adopted in March 2010, FATCA is not fully implemented. After issuing successive Notices regarding positions the Treasury intends to take in future FATCA Regulations, and after seeking comments on such proposed positions, the Treasury issued Proposed Regulations on February 8, 2012. Numerous comment letters were submitted

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on the provisions set forth in the Proposed Regulations. The current status is that the IRS intends to issue final FATCA Regulations later in 2012.

After that date, the IRS would enter into FATCA reporting agreements with FFIs. Thereafter, the 30% FATCA withholding on payments of interest, dividends and other fixed income to FFIs that have not entered into a reporting agreement with the IRS would apply commencing January 1, 2014. FATCA withholding on proceeds of disposition of instruments that generate US source interest and dividend income would commence on January 1, 2015.

FATCA raises important conflicts of law issues. European Union law and the laws of various EU member states would prohibit FFIs within the EU from disclosing the information required to be reported under FATCA. In addition, legal questions regarding the disclosure of information required to be reported under FATCA have also been raised in various other non- EU jurisdictions. FFIs subject to privacy and data protection laws are faced with a dilemma: either suffer the 30% FATCA withholding tax on withholdable payments or avoid US investments that generate withholdable payments.

Many FFIs, finance industry organizations and representatives of various countries have noted the serious conflict between the requirements of FATCA and the prohibitions on information sharing contained in non-US law. Seemingly in recognition of this conflict, simultaneously with the promulgation of the Proposed Regulations under FATCA, the Treasury issued a Joint Statement (the "February 2012 Joint Statement") with the governments of France, Germany, Italy, Spain and the United Kingdom in which the nations stated an intent to explore separate bilateral agreements that would address the FATCA requirements for FFIs resident in each non-US country that is a party to such an agreement with the US.

Pursuant to the February 2012 Joint Statement, the bilateral agreements would provide that the non-US governments would amend their domestic law to require FFIs within their jurisdiction to provide to the non-US government information that FATCA would require FFIs to provide to the IRS. The non-US governments would then forward information with respect to US account holders to the IRS. In exchange for this agreement by the non-US governments, the US would agree to provide "reciprocal" information with respect to accounts maintained by residents of the non-US jurisdictions maintained in the US.

On June 21, 2012, the Treasury also issued a Joint Statement with each of Japan and Switzerland. The Japanese Joint Statement provides that the Japanese competent authority would agree to direct and enable financial institutions in Japan to register with the IRS and comply with official Japanese guidance that is consistent with reporting under FATCA, with the Japanese competent authority exchanging information with respect to US account holders to the IRS. The Swiss Joint Statement provides that Switzerland would agree to enter into a bilateral agreement with the US whereby Switzerland would direct all Swiss financial institutions, not otherwise exempt or deemed compliant, to enter into a reporting agreement directly with the IRS.

Switzerland would agree to grant an exception under Swiss law to permit such financial institutions to report information with respect to US account holders to the IRS. The Treasury has indicated an interest in entering into similar bilateral agreements with other nations as well. On July 26, 2012, the Treasury released a Model Intergovernmental Agreement for implementing FATCA. There are two versions of the model agreement – a reciprocal version and a nonreciprocal version. Both versions establish a framework for reporting by FFIs of certain financial account information to their respective tax authorities, followed by the automatic exchange of such information under existing bilateral tax treaties or tax information exchange agreements. The reciprocal version of the model also provides for the US to exchange information currently collected on accounts held in US financial institutions by residents of partner countries, and includes a policy commitment to pursue regulations and support legislation that would provide for equivalent levels of exchange by the US.

This version of the model agreement is expected to be available only to jurisdictions with whom the US has in effect an income tax treaty or tax information exchange agreement and with respect to whom the Treasury and IRS have determined that the recipient government has in place robust protections and practices to ensure that the information remains confidential and that it is used solely for tax purposes. The Treasury and the IRS will make this determination on a case by case basis. On the other hand, the nonreciprocal version of the model does not provide for the US to exchange account information nor does it provide for a policy commitment to pursue equivalent levels of exchange by the US. Note that the February 2012 Joint Statement and Japanese Joint Statement each expressly contemplates an exchange of information by the US.

FFIs in countries that enter into such a bilateral agreement with the Treasury would be treated as deemed compliant FFIs and would not be required to enter into any agreement with the IRS to report or withhold with respect to FATCA.

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Much remains to be done under FATCA, including the negotiation of bilateral agreements with various nations. Although the Treasury has issued a Model Intergovernmental Agreement, it will undoubtedly require some time to negotiate and implement the various bilateral agreements under FATCA with other nations. It is unclear if all bilateral agreements will be in place in time to avoid the application of FATCA withholding. FFIs in nations that have privacy laws or data protection laws that would prohibit compliance with FATCA may be compelled to dispose of US securities if the FATCA withholding deadline takes effect prior to the date the US enters into a bilateral agreement with the nation in which such FFIs are resident.

John Lillis *is involved in a broad range of transactions regarding tax issues. He structures and analyzes the tax issues in investment funds formation, and investment and operating joint ventures. In addition Mr. Lillis structures and negotiates asset and stock acquisitions by investment funds and other clients.*

Mr. Lillis' work on investment fund formation and joint ventures typically involves cross-border structuring to achieve tax efficiencies from a US and non-US tax perspective. He has worked with both US and non-US sponsors in establishing equity and other investment funds. In these transactions, Mr. Lillis is often responsible for examining and coordinating advice on the domestic US and non-US tax issues, and developing the most advantageous fund structures to minimize the tax burdens on investors.

Mr. Lillis also structures and negotiates asset and stock acquisitions. Mr. Lillis works with clients to determine historic tax issues and the tax treatment of the acquired entities. In addition, Mr. Lillis handles tax-free reorganizations and counsels clients to ensure that the chosen structures achieve tax-free reorganization treatment.