

Uncertainty looms over resources required for FATCA compliance, say lawyers. Dec 06 2011 Ajay Shamdasani

With just over a year before the U.S. Foreign Account Tax Compliance Act (FATCA) is set to come into effect, many foreign financial institutions are still unclear on its ramifications and what they will have to do to prepare. In all likelihood, compliance with FATCA is expected to require coordination across several departments within institutions, according to lawyers.

FATCA, which is expected to take effect from January 1, 2013, is aimed at making it more difficult for U.S. citizens to hide taxable income through financial institutions in foreign jurisdictions. Under current proposals, FATCA will impose on foreign financial institutions stringent reporting obligations to the U.S. Internal Revenue Service (IRS). The act covers a wide range of entities — brokers, custodians, funds, insurance and reinsurance companies, trusts, trust companies and all other investment vehicles fall within its regulatory ambit. It is also expected to impose a punitive "withholding tax" on institutions seen not to be in compliance.

Compliance with the act will likely require participation from numerous departments within financial institutions, said Alan Granwell, a partner with law firm DLA Piper in Washington, D.C. "An institution will need to involve its legal, tax, risk assessment and compliance, IT, and audit and verification departments, and account relation managers," he said.

Granwell explained that which department ultimately took the lead depended on a firm's particular organisational structure. "Clearly, dealing with FATCA is a multi-disciplinary undertaking," he said, warning that some funds or other types of investment entities may not have the full range of skills in-house to deal with FATCA and should seek external help.

According to Karl Egbert, a partner with law firm Dechert in Hong Kong, the legal component of FATCA compliance would be substantial because financial institutions would need to build an entirely new compliance structure. He said that FATCA's provisions require legal interpretations, contracts will need to be analysed, and cooperation agreements will have to be in place with the IRS by January 1, 2013.

"At this initial stage, it makes sense to have the legal team involved," he said. "I suspect that once these structures are put into place, compliance teams may take over again: FATCA compliance will run parallel to many functions that compliance teams already run."

Egbert said that similar patterns were probable in Asia and that smaller institutions would likely seek the expertise of outside consultants. Nevertheless, he stated that in-house counsel would still do much of the preliminary analysis and compliance officers would finalise operational issues.

The information technology (IT) function would also have to be heavily involved in ensuring FATCA compliance, added Joan Arnold, a partner with law firm Pepper Hamilton in Philadelphia. She said that compliance with the legislation was more of an IT than a legal matter. "This is really a systems- driven issue and the key question for IT is: can you get the information [on overseas U.S. taxpayers]? The legal question is: can you disclose the information?"



Implementation regulations for the act are expected to be issued on or before December 31, 2011. They will be subject to a notice and comment process for stakeholders, with finalised rules expected during the summer of 2012.

Ongoing compliance

Dechert's Egbert said that FATCA would be a serious burden for internal lawyers and compliance officers at banking and financial institutions in Asia. "FATCA doesn't just focus on the obvious 'hiding places' — even if an institution has no ties with the U.S., it will still be subject to FATCA's due diligence requirements," he said.

"Compliance with FATCA involves coordinating highly technical work of various service providers and internal functions — for some, it can be a full-time job in its own right. FATCA's due diligence provisions require financial institutions to comb through their investor records using certain specified criteria that might indicate a U.S. owner," Egbert said.

Such criteria are technical and specific to FATCA, he added. For example, the definition of a U.S. person under FATCA differs from common definitions. "Even after implementation, FATCA will continue to present challenges — counterparties, investors and service providers may all need to be screened for FATCA compliance on an ongoing basis," Egbert warned.

Penalties for non-compliant financial institutions are expected to include a 30 percent withholding tax on U.S.-sourced income, plus possible penalties and interest for non-collection of taxes from institutional customers. Arnold said that the IRS was very committed to full transparency. "The economic consequences are very serious and will impact any investment with a U.S. connection and that will affect their investment decisions."

Although some foreign financial institutions could simply disgorge all U.S. proprietary investments and American account holders to avoid regulatory burdens, Robert Wood, founding partner of San Francisco law firm Wood LLP, said that complete withdrawal from the U.S. market was impractical. "Given the widely held nature of U.S. stocks, that seems likely to motivate many institutions to comply," he said.

Additionally, wilful non-compliance could invite criminal sanctions. U.S. felony charges may apply if foreign financial institutions aid or abet U.S. account holders to evade American taxes. Another consequence of non-compliance is lost business. According to Marnin Michaels, a partner with law firm Baker & McKenzie in Zurich: "If you cannot have counterparties to effect your transactions, you cannot be in business."

FATCA-compliant institutions may simply decide not to transact with non-compliant institutions, effectively isolating the latter. The IRS could even mandate this separation, said Dechert's Egbert.

"Some institutions are asking how the IRS will enforce FATCA — I ask them: 'Can you live without Citibank as a counterparty? Can you live without any major financial institution as a trading partner?' Because that's the world we're looking at. Compliant institutions won't want to jeopardise their own compliance status," he said.

2013 deadline beckons

For institutions to be FATCA-compliant, they will need to conclude cooperation agreements with the IRS by January 1, 2013, indicating that they have protocols and



procedures to identify and report overseas U.S. accounts, and withhold necessary taxes for the U.S. government. "This leaves no margin for error," Egbert said. "To the extent possible, financial institutions should try to do as much work in advance as possible — a 'wait and hope' strategy may leave a financial institution on the wrong side of the compliance deadline."

Likewise, according to Michaels, the process of addressing issues with FATCA now must start. "If it does not, compliance will be impossible and this puts banks at a competitive disadvantage," he warned.

The IRS has previously issued three notices on implementation issues and approaches. DLA Piper's Granwell pointed out that there would continue to be regulatory uncertainty in certain areas because FATCA affected financial transactions and financial institutions worldwide. "These proposed regulations would not be all-inclusive," he said.

Granwell added that the IRS was "actively seeking and considering stakeholder comments, but because of the diversity and complexity of the areas to be regulated, it is likely that there will be areas requiring additional revision and clarification".

FATCA compliance would likely be an industry in itself, Wood LLP's Robert Wood stressed. Furthermore, Pepper Hamilton's Arnold said that while most firms have just created temporary, FATCA-specific compliance teams, some large banks and investment funds have created dedicated FATCA teams. "For many of them, it's a permanent move," she said.

Arnold concluded that the practicalities of enforcement were still unclear: "No one has ever exported their tax law to another country before."