Clients&FriendsMemo

U.S. Treasury Department Releases Model FATCA Intergovernmental Agreements

August 10, 2012

I. Introduction

On July 26, the U.S. Treasury Department released two model intergovernmental agreements that will provide residents of signatory countries with an alternative withholding and reporting regime to that imposed under the "Foreign Account Tax Compliance Act" ("**FATCA**") provisions contained in sections 1471 through 1474 of the Internal Revenue Code.[1] One model is "reciprocal"—that is, each country exchanges information with the other;[2] the other is "nonreciprocal"—that is, only the signatory country provides information. Simultaneously with the release of the model agreements, France, Germany, Italy, Spain, the United Kingdom, and the United States issued a joint statement endorsing the model agreements. Over forty other countries have been reported to be interested in entering into similar agreements with the United States, including Australia, Brazil, Canada, the Cayman Islands, Ireland, Luxembourg, the Netherlands, New Zealand, Japan, and Russia.

The intergovernmental approach to FATCA is intended in part to mitigate local-law barriers to FATCA implementation, such as bank secrecy laws that prohibit foreign financial institutions from reporting information about their debt, equity, and other "financial account" holders to the IRS.

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[1] All references to section numbers are to the Internal Revenue Code of 1986, as amended, or to the proposed Treasury regulations promulgated thereunder.

In February, the IRS released proposed regulations under FATCA. We discussed these regulations in a previous Clients & Friends Memo, which is available at http://www.cadwalader.com/assets/client_friend/021712ApplicationProposedFATCARegulations.pdf.

[2] Under the reciprocal agreement, the United States agrees to provide the signatory country with the information it currently collects on depository accounts and non-depository financial accounts held by individuals or entities resident in the signatory country, and commits to pursue regulations and support legislation that would require U.S. taxpayers to provide to the United States, and the United States to provide to the signatory country, "equivalent" levels of information as the signatory country agrees to provide under the agreement.

The model agreements generally retain the effective dates and basic information reporting requirements adopted under the proposed FATCA regulations issued in February.[3] However, the model agreements contain six significant differences from the proposed regulations:

- First, under the model agreements, financial institutions resident in a signatory country and branches of financial institutions that are located in the signatory country are permitted to report information to their country rather than the IRS; their country would, in turn, remit the information to the IRS;
- Second, certain entities, such as passive "home offices" and family trusts, are excluded from the definition of "foreign financial institution" and therefore need not report information about their financial account holders to their signatory country. However, unless the proposed regulations are amended, these entities will still have to enter into a FATCA agreement with the U.S. Treasury Department. In addition, under the model agreements, certain instruments, such as "tracking" stock and similar instruments that reference the value of U.S. assets, are not treated as "financial accounts" and therefore are not subject to reporting.
- Third, the model agreements replace the requirement that foreign financial institutions report any 10% U.S. owners of non-publicly traded passive nonfinancial foreign entities with a requirement that they report U.S. persons who "control" the nonfinancial foreign entities.
- Fourth, the model agreements do not require signatory country financial institutions to withhold on gross proceeds payments or "passthru" payments to (and terminate the accounts of) "recalcitrant" account holders that fail to provide the requisite information to the financial institutions, although the agreements contemplate that penalties will be imposed on foreign financial institutions that fail to collect and remit the required information.
- Fifth, the model agreements permit signatory country financial institutions to comply with FATCA even if their affiliates or branches outside of the signatory country are prohibited by local law from complying.
- Finally, the model agreements provide that the amount and characterization of payments made with respect to an account that is subject to reporting under FATCA are determined under the laws of the signatory country, instead of under U.S. tax law,

[3] Like the proposed regulations, the model agreements require reporting on a phased-in basis with respect to information collected from 2013 onward. However, the first information reporting deadline under the model agreements is September 30, 2015, which is one year later than the first reporting deadline under the proposed regulations.

In addition, the model agreements provide optional alternative account diligence procedures that permit foreign financial institutions to rely heavily on "self-certification" instead of IRS forms signed under penalties of perjury.

as under the proposed regulations. Moreover, interpretational issues are generally resolved under the laws of the country applying the agreement, which often will be the signatory country. These choice of law issues could present arbitrage possibilities.

Part II of this memorandum discusses in greater detail the model intergovernmental agreements and the differences between the model agreements and the proposed regulations.

II. Modifications to FATCA under the Model Intergovernmental Agreements

A. "Home offices" and family trusts not treated as foreign financial institutions; financial accounts do not include "tracking" stock or similar instruments absent a tax-avoidance purpose

"Home offices" and family trusts not treated as foreign financial institutions. Under the proposed FATCA regulations, "foreign financial institutions" generally must enter into a FATCA agreement with the U.S. Treasury Department to report information about all U.S. holders of their equity, debt and other financial accounts. Foreign hedge funds, "home offices," and family trusts generally are treated as foreign financial institutions under the proposed regulations.

Under the model agreements, an investment entity is treated as a foreign financial institution that must report information to the signatory country about all U.S. holders of its equity, debt, and other financial accounts only if the investment entity conducts investment management activities as a business for or on behalf of a customer, or is managed by an entity that conducts investment management activities for or on behalf of a customer. Most hedge funds will be treated as foreign financial institutions under this definition because they are managed by an investment manager that conducts investment management activities for customers, such as hedge funds. However, many "home offices" and family trusts do not conduct investment management activities for or on behalf of customers, and are not managed by a person that conducts investment management activities for or on behalf of customers. Therefore, these entities generally are not foreign financial institutions under the model intergovernmental agreements.[4] Instead, these entities are classified as "nonfinancial foreign entities."

Under the model agreements, passive nonfinancial foreign entities (such as home offices and family trusts) are not required to report information directly to their signatory countries. Instead, if a passive nonfinancial foreign entity is not publicly traded and holds a financial account in a signatory country financial institution, the financial institution must report information to the signatory country

[4] An investment entity may still be a foreign financial institution if it is (i) a bank or other "depository institution," (ii) a broker or other "custodial institution," or (iii) an insurance company.

about the U.S. persons who exercise "control" over the nonfinancial foreign entity, which the signatory country will, in turn, report to the IRS.

However, because home offices and family trusts are treated as foreign financial institutions under the proposed regulations, these entities still would be required to enter into a FATCA agreement with the U.S. Treasury Department to report information about all U.S. holders of their equity, debt and other financial accounts. We suspect that the drafters of the model intergovernmental agreements intended to exempt these entities from having to enter into a FATCA agreement, and we are hopeful that final regulations will clarify that entities that qualify as nonfinancial foreign entities under a model agreement will be treated as nonfinancial foreign entities for all purposes of FATCA.

Financial accounts do not include "tracking" stock or similar instruments absent a tax-avoidance purpose. Under the proposed regulations, if the value of any non-publicly traded equity or debt issued by a foreign depository or custodial institution is directly or indirectly determined primarily by reference to assets that give rise to U.S.-source income, it is treated as a "financial account" and the institution is required to collect and report FATCA information. So, for example, under the proposed regulations, if a non-U.S. investment bank issues non-publicly traded notes that provide for contingent interest based on the value of the S&P 500, those notes are treated as financial accounts subject to FATCA reporting.

The model intergovernmental agreements narrow this class of financial accounts that are subject to FATCA reporting by providing that non-publicly traded equity or debt issued by a foreign depository or custodial institution is treated as a financial account under FATCA only if the applicable class of equity or debt is established with a purpose of avoiding FATCA reporting.

Moreover, under the model agreements, the characterization of an instrument generally is determined under local law. If a note is treated as a "forward contract," "swap," or other derivative under local law (and not equity or debt), it would not be subject to information reporting under FATCA, even if it were established with a purpose of avoiding FATCA reporting.

B. Replacement of the "10% U.S. owner" test with a "control" test

Under the proposed regulations, a foreign financial institution is required to report information about any U.S. persons who own more than 10% of the voting power or value of any non-publicly traded passive nonfinancial foreign entity (such as a foreign real estate investment trust or royalty trust) that owns a financial account in the foreign financial institution. In addition, under the proposed regulations, a nonfinancial foreign entity that does not disclose its "10% U.S. owners" to its counterparties or does not certify that it has no 10% U.S. owners will be subject to FATCA withholding.

The model agreements replace the "10% U.S. owner" test with a "control" test that requires signatory country financial institutions to report any U.S. persons who control the nonfinancial foreign entity. "Control" for this purpose is determined by reference to the "Financial Action Task Force Recommendations" for developing international standards on combating money laundering and the financing of terrorism and proliferation. Trusts and similar legal arrangements are treated as controlled by their settlors, trustees, protectors, beneficiaries, and any other natural persons exercising control over the arrangements. Control for other entities is based on the "facts and circumstances." A foreign financial institution may rely on information it collects and maintains pursuant to applicable "anti-money-laundering" and "know-your-client" ("AML/KYC") standards to determine whether a foreign entity has controlling U.S. owners.[5]

The standard under the intergovernmental agreements appears to exclude a U.S. person who owns more than 10% of the economic interest in a foreign entity but does not have voting rights, but could conceivably include a U.S. person who owns less than 10% of the entity's voting power.

However, because nonfinancial foreign entities still must report their 10% U.S. owners (instead of their controlling U.S. owners) to their counterparties under the proposed regulations, these entities could be required to disclose their U.S. owners based on different tests depending on the status of their counterparty. For example, a non-publicly traded foreign real estate investment trust or royalty trust that owns a financial account in a signatory country financial institution may be required to determine its controlling U.S. owners so that the signatory country financial institution can comply with its reporting requirements, but also may be required to disclose its 10% U.S. owners to a U.S. borrower so that the borrower is not required to withhold under FATCA on interest payments to the trust. This result does not appear to have been intended by the drafters of the model intergovernmental agreements, and we are hopeful that the final regulations will adopt the control test of the model agreements so that non-publicly traded passive nonfinancial foreign entities can determine their reportable U.S. owners based on a single test for all purposes of FATCA.

C. Elimination of certain withholding and account termination requirements

Account termination; passthru payment withholding. The proposed regulations contemplate that foreign financial institutions will be required to terminate the accounts of "recalcitrant" account holders that do not provide the information required to be collected under FATCA. In addition, the proposed regulations contemplate that, beginning on or after January 1, 2017, foreign financial institutions will be required to withhold 30% on any "passthru" payments that are attributable to U.S. assets made to recalcitrant account holders or to noncompliant foreign financial institutions.[6]

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[5] The Financial Action Task Force Recommendations also provide that 25% ownership may constitute control.

[6] The proposed regulations do not define passthru payments.

The model intergovernmental agreements do not require account termination or passthru payment withholding.[7] However, the model agreements contemplate local-law penalties for signatory country financial institutions that fail to comply with the information reporting requirements under the model agreements. In addition, under the model agreements, a signatory country financial institution will be deemed noncompliant by the IRS and subject to FATCA withholding after 18 months of "significant" noncompliance.[8]

Gross proceeds withholding. Under the proposed regulations, beginning in 2015, all withholding agents, including foreign persons, will be required to withhold 30% from the gross purchase price they pay for any assets that give rise to U.S.-source income if the seller does not establish its compliance with FATCA. By contrast, the model intergovernmental agreements do not require signatory country financial institutions to withhold on gross proceeds.[9] This exemption may encourage noncompliant individuals and entities to hold and sell assets through signatory country financial institutions to avoid the gross proceeds withholding.

D. Modified "limited branch" and "limited affiliate" rules

Under the proposed regulations, a foreign financial institution generally cannot comply with FATCA if any of its branches or affiliates does not comply. Limited exceptions apply before 2016 if a branch or affiliate is prohibited under local law from complying with FATCA.

The model intergovernmental agreements provide that a signatory country financial institution may comply with FATCA even if its branches or affiliates outside of the signatory country cannot comply, as long as (i) the signatory country financial institution treats the branch or affiliate as a separate entity that is a noncompliant foreign financial institution, (ii) the branch or affiliate complies with FATCA to the extent permitted under applicable law, (iii) the branch or affiliate does not solicit U.S. accounts held by persons that are not resident in the jurisdiction in which the branch or affiliate is located, or accounts held by noncompliant foreign financial institutions that are not established in the jurisdiction where the branch or affiliate is located, and (iv) the branch or affiliate is not used to circumvent FATCA or the model intergovernmental agreement.

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If you have any questions about this memorandum, please contact Shlomo Boehm, Mark Howe, David S. Miller, Daniel Mulcahy, Jason Schwartz, or any other member of our Tax Department.

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7 The model agreements provide that the United States and the signatory country will cooperate to develop an "alternative approach" to passthru payment withholding.

8 The IRS will publish a list identifying any noncompliant signatory country financial institutions.

9 The model agreements provide that the United States and the signatory country will cooperate to develop an "alternative approach" to gross proceeds withholding.