

## Offshore No More

### Editorial

Financial authorities certainly set their sights high last year, which translates into a major operational overhaul for this year. With a proliferation of rules issued by different countries and for different types of investors, new regulations have led to the necessity for new controls, processes, organizational structures and market infrastructures.

While this means securing transactions and processes, it also ushers in a new era of controlling undeclared transactions. Although the US has had this issue on the radar screen for decades, the government has now decided to take definitive action by imposing stringent controls on undeclared foreign accounts. **The new FATCA legislation** won't go into effect until January 2013, yet considering its significant operational implications, 2013 seems right around the corner.

In this month's article, we analyze the act's key requirements and highlight the changes that financial organizations must effectuate.

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## >> FATCA: A New Regime of Tax Governance

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The Foreign Account Tax Compliance Act (FATCA), officially signed into law by the US President on March 18, 2010 has undoubtedly called for some major changes in the financial sector's reporting regime. Alongside banks, the circle of affected parties accounts for close to 100,000 institutions worldwide. These include broker-dealers, investment companies, stock exchanges and clearing houses. For a US person, the enactment of a new "anti-tax haven" law implies a more transparent assessment of global assets as well as a comprehensive reporting of all financial possessions. For global financial institutions, it introduces sizable operational challenges, process and procedural changes, and a possible monitoring of transactional activity, all under the looming pressure of a January 1, 2013 deadline.

### The FATCA Ruling

#### Objectives

With an estimated \$345 billion in tax revenues lost annually from current offshore tax exploitation, the US government is eradicating the use of concealed and undeclared accounts held abroad by US corporations and individuals. The FATCA ruling's imposition ensures that there will be no deficiency in the ability of the US government to determine the ownership of US assets in foreign accounts. FATCA defines a foreign financial institution ("FFI") as a foreign entity that in its ordinary course of business accepts deposits or holds financial assets for others, or has the primary business activity of investing in and trading of financial assets or commodities. With limited exemptions by way of the above noted treasury regulations, foreign banks, broker-dealers, foreign hedge funds, private equity funds, private investment funds, pension funds, insurance companies, foreign trust companies and foreign trusts are all included in the FFI definition. FATCA therefore introduces an additional layer of regulation to the Qualified Intermediary Program.

#### The Rule

The legislation calls FFIs to identify accounts owned by or in the beneficial interest of a United States taxpayer and report them to the Internal Revenue Service, otherwise they will suffer a 30% withholding tax on any US originated payments. The identification of affected accounts sounds simple, but will likely require coordination and structured organization across multiple business lines worldwide. By 2013, this withholding tax will also be applicable to all interest dividends and sales returns. In addition, FATCA implies that certain products previously exempt from withholding tax, such as total return swaps or securities lending, will now be subject to such taxation as well.

The FFI's identification of such clients becomes considerably more laborious as the burden of proof is reversed: in order that the withholding tax not be imposed on a financial intermediary, it must prove that it is a "compliant FFI" and has no US clients. In essence, it is not only the taxpayer's responsibility but rather the onus is on the intermediary to identify these accounts.

FFIs are also facing the difficult task of identifying US persons who directly or indirectly control more than 10% of a foreign company, which includes those individuals linked to complex structures such as foundations or trusts. It is important to note, however, that despite the anecdotal severity of this ruling, there is a clause exempting all US persons who hold less than a total of \$50,000 in an FFI or in its affiliated companies from paying taxes.

With a broad scope to cover, the act cannot be implemented within the current structure and state of financial corporations' processes and systems. Hence an overhaul for compliance and risk intelligence, coupled with enhanced systems requirements, is necessary to create a new operating paradigm. Additionally on a more macro level, it is important throughout the mapping process to decode the risks and specific effects to which the new legal provisions will need to adhere.

#### The Process Flow

Accordingly, FATCA is compelling financial institutions, both domestic and abroad, to conduct proactive system diagnostics that include the identification of one or more of the following:

- > FFIs that receive "withholdable payments" depository or custodial accounts belonging to certain US persons, which are maintained by the financial institution
- > Any debt or equity interest in the financial institution held by a specified US person or US owned foreign entity.

In asserting the complexity of the work that needs to be addressed, and in order to implement the proper framework to support all institutions that face the FATCA challenge, four critical steps have been identified for the converging process:

#### Agreement

To properly comply with these new reporting requirements, an FFI will have to enter into a special agreement with the IRS during 2012. Under this agreement a “participating” FFI will be obligated to disclose if the withholding tax is not to be imposed on financial intermediaries, at which time the financial intermediary must prove that it has no non-US clients.

#### Documentation

Obtainment of waivers: foreign financial institutions must obtain a waiver from each US account holder, such that they could report the required customer data to the US tax authority. If a customer refuses the waiver request, the act requires that the financial institution close the corresponding account or abstain from entering into a new business relationship.

#### Withholding

The annual reporting generally occurs in electronic form, requiring major adjustments to the internal systems of banks and financial services providers.

#### Reporting

Penalization of uncooperative persons or entities is a strong incentive for financial services providers to enter into the agreement with the IRS and to report the assets of US persons. The US government is acting on the assumption that all financial intermediaries will sign the agreement with the IRS. The withholding tax deduction does not represent an alternative to compliance with the disclosure obligations; if a client does not adhere to the new information regulations, the FFI is to terminate the business relationship with that client.

### Operational Challenges

#### Defining the Framework

Although regulations have not been formally finalized, financial organizations will need to make modifications to existing systems,

control frameworks, processes and procedures in view of the new operating model. The act will require the following adjustments:

- > New overall roadmap of systems and processes: understanding the basic requirements, assessing strategic options, and incorporating the effect on derivative payments and securities lending.
- > Evaluation of effects of new procedures and systems: this implies waiver handling, identifying clients (individuals and entities), distinguishing their status as direct or indirect accountholders, and form processing.
- > Adaptation of processes: recreating policies and procedures, mapping and implementing the withholding mechanism, identifying counterparties and IRS notification system.
- > Adoption of contract forms: general agreement processing and exception processing for credit derivatives and securities lending.
- > Formulation of withholding and reporting: financial withholding for non-compliant FFIs and recalcitrant account holders, and direct reporting to the IRS for US accounts.
- > Introduction of audit and internal controls: complete due diligence work.
- > Establishment of post implementation: client and account stock review, and confirming validity of process and systems.

#### Solutions - Making Strategic Decisions

Due to the demanding time frame, it is vital to proceed promptly with a comprehensive roadmap. An initial overarching strategy needs to be in place followed by an adjustment of processes and systems given the anticipation of pending clarifications of the act's requirements. After a strategic assessment, some FFIs should review their US client policy (including closing their US accounts and/or limiting their offerings to non-US products) in order to minimize the impact of FATCA's implementation and enable qualification for the deemed-compliant FFI status.

OTC Conseil has had the opportunity to advise high profile institutions in Europe on the program management for the FATCA initiative. In assisting our clients with their process and technology gaps, we have developed best practices in this domain. We are eager to pass on our wealth of expertise by informing our clients of the latest and most comprehensive frameworks in response to the FATCA ruling. As always, we are committed to risk intelligence and can securely guide clients through precarious regulatory landscapes. Please contact us for questions and inquiries ●

