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Initial impressions of the FATCA proposed regulations and implication for Swiss Financial Institutions

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Proposed regulations as guidance (REG-121647-10)

The Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-121647-10) as guidance concerning information reporting by foreign financial institutions for U.S. accounts, and withholding on certain payments made to foreign financial institutions and other foreign entities under the Foreign Account Tax Compliance Act (FATCA).

The following discussion provides an overview of initial impressions of certain provisions in the 389-page proposed regulations under FATCA.

The proposed regulations are scheduled to be published in the Federal Register on Wednesday, February 15, 2012.

Government-to-government reporting
The FATCA rules introduce information reporting requirements for foreign financial institutions (FFIs) for certain accounts. These rules have raised a number of issues for FFIs established in certain countries (including France, Germany, Italy, Spain and the United Kingdom) – for example, that FFIs established in these countries may not be able to comply with the reporting, withholding, and account closure requirements because of legal restrictions.

The FATCA proposed regulations introduce a new concept of government-to-government reporting. As noted in a related U.S. Treasury Department release* an intergovernmental approach to FATCA implementation would address the legal impediments to compliance, simplify practical implementation, and reduce FFI costs. The United States would reciprocate by collecting and exchanging information on accounts held in U.S. financial institution by residents of these countries. Thus, the United States and France, Germany, Italy, Spain and the United Kingdom have agreed to "explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchanged…"

**Joint Statement from the United States, France, Germany, Italy, Spain and the United Kingdom Regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA (February 8, 2012)*

Other guidance included in today's proposed regulations
Since FATCA's enactment in March 2010, the IRS issued several rounds of guidance (namely Notice 2010-60, Notice 2011-34 and Notice 2011-53). According to the preamble, today's proposed regulations incorporate the guidance contained in these IRS notices, but also provide guidance on topics that were not addressed in the FATCA-related notices, including:

- An expanded scope of "grandfathered obligations"
- Transitional rules for affiliates with legal prohibition on compliance
- Additional categories of deemed-compliance FFIs
- Modification of due diligence procedures for the identification of accounts
- Guidance on procedures required to verify compliance
- Refinement of the definition of financial account
- Extension of the transition period for the scope of information reporting and withholding on passthru payments

Expanded scope of grandfathered obligations
Pursuant to the statute, a withholding agent would not be required to impose FATCA's penal withholding on any payments, including the gross proceeds from any disposition, related to an obligation that was outstanding on March 18, 2012.

The proposed regulations extend this relief by excluding, from the definition of withholdable or passthru payment, any payment made under an obligation outstanding on January 1, 2013. For purposes of this relief, the definition of an obligation set forth in earlier guidance remains substantially the same.

Transition rules for affiliates with legal prohibitions on compliance
Earlier guidance had indicated that each FFI member within an expanded affiliated group must be either a participating FFI (PFFI) or a deemed-compliant FFI (DCFFI).

In the proposed regulations, Treasury and the IRS recognize that this is not possible for certain FFIs organized in jurisdictions with laws that prevent an FFI to fully comply with the withholding and reporting requirements of FATCA. To that end, the rules adopt a two-year transition period, until January 1, 2016, for FFIs in such jurisdictions to become compliant with the initial rule. In the interim period, such FFIs must, among other requirements, agree to perform the account identification procedures to identify U.S. accounts.

It is important to note that these FFIs will be subject to the penal withholding on withholdable payments during this time.

Additional categories of deemed-compliant FFIs
In preliminary guidance, Treasury and the IRS described certain entities that it believed could be treated as deemed compliant (meaning they would not have to enter into a formal "FFI Agreement"). However, the listed requirements to ascertain such status were so restrictive that few, if any, entities could actually take advantage of this status.

In the proposed regulations, Treasury and the IRS have now expanded the categories of entities that would be considered deemed compliant as well as loosened some of the requirements that were previously set forth. In addition, under the proposed rules, several types of entities that fall within the deemed compliant category will no longer be required to adhere to the formal registration process and, instead, will be permitted to self-certify this status. These modifications could be very useful to many potential DCFFIs (e.g., certain group retirement plans).

Modification of due diligence procedures for the identification of accounts
The proposed regulations have completely eliminated the heightened scrutiny for accounts that previously fell within the broad definition of "private banking." Instead, the heightened scrutiny is based solely on a $1 million dollar threshold.

Significantly, the requisite paper search for U.S. indicia for these accounts has also been scaled back to include only more recent account data (as opposed to a search of every paper document on file).

In addition, the de minimus threshold has been increased to $250,000 for entity accounts, as well as for the cash value of insurance policies.

Finally, the proposed rules extend the reliance on existing AML and KYC procedures for pre-existing account identification. Tax professionals believe that these modifications would be welcomed and demonstrate that Treasury and the IRS are listening to the voice of industry.

Guidance on procedures required to verify compliance
Another welcomed provision for FFIs is found in the rules relating to verification of compliance with the FFI Agreement. Unlike the qualified intermediary (QI) regime that requires QIs to hire an external auditor twice in every six year agreement term to conduct a compliance review, the proposed regulations provide that FFI Agreement verification would be accomplished through internal reviews and certifications.

In addition, the proposed rules provide that any FFI that adheres to the requirements set forth in the FFI Agreement will not be strictly liable when it fails to identify a U.S. account.

Refinement of the definition of financial account
The proposed regulations refine the statutory definition of a "financial account" – depository account, custodial account, or debt or equity interest in an FFI, other than those that are regularly traded – by focusing on the traditional meaning of these accounts and excluding certain retirement savings accounts and other tax favored non-retirement savings accounts. In addition, as indicated in preliminary guidance, the definition of a financial account also includes an insurance contact with a cash value.

Extension of the transition period for the scope of information reporting and withholding on passthru payments
Finally, the proposed regulations provide additional transition relief related to reporting and withholding.

Notice 2011-53 provided that the first reporting requirement under FACTA would take place in 2014 (for U.S. accounts maintained in 2013). In addition, it provided that the requisite withholding on any passthru payments, that is not a withholdable payment, made by a PFFI to a recalcitrant account holder or NPFFI would take place no earlier than January 1, 2015.

For reporting, the proposed rules phase in the information that is required to be reported over a period of years. In 2014 and 2015 (for accounts maintained in 2013 and 2014), the information will be limited to name, address, TIN, account number, and account balance information. The following year, any income paid to the account must also be reported. Finally, in 2017, all of the above information, as well as gross proceeds paid to the account, would also be required.

This phased-in approach with respect to the reporting requirements was in direct response to commentators that had voiced concerns regarding necessary system changes for the reporting of income and proceeds.

To date, the requirement for an FFI to impose withholding on passthru payments has been one of the most debated and contentious areas of the new regime. Given the complexity and legal questions surrounding this requirement, Treasury and the IRS have decided to further delay the issue by providing that this withholding would not be required on any foreign passthru payments (the portion of a passthru payment that is not a withholdable payment) before January 1, 2017.

KPMG comment – Impact on Swiss Financial Institutions

Overall the draft regulations provide a relief in terms of implementation / costs for financial institution, which do not deal with HNWI and UHNWI. The introduced thresholds and the increased reliance on electronic search and KYC-procedures are the main driver for that. However the devil is in the details. Account balances do change over time and the documentation requires rigorous monitoring to ensure compliance, correct and complete reporting. For the Swiss Financial Institutions the impact can be summarized as follows:

Impact on banks
The FATCA draft regulation will definitely provide relief for certain universal/retail banks, which typically do not deal with HNWI or UHNWI for the following reasons:

- The definition of a private banking account has been dropped and no distinction to other accounts is made anymore;
- In addition to that the threshold for additional due diligence around account holders has been increased from USD 500,000 to USD 1 million. Accounts with a balance that exceeds $1,000,000 are subject to review of electronic and non-electronic files for U.S. indicia, including an inquiry of the actual knowledge of any relationship manager associated with the account;
- To minimize burden, review of non-electronic files is limited to the current customer files and certain other documents, and is required only to the extent that the electronically searchable files do not contain sufficient information about the account holder. For entity accounts below USD 250,000;
- The IRS emphasises however that the applied KYC-procedures need to ensure that US Persons also below that threshold need to be identified for new accounts and reported if the value exceeds USD 50'000 for individuals and USD 250,000 for entities respectively.

Overall by reducing the requirements around the paper file review, dropping the private banking account definitions as well as the increase of the respective threshold to USD 1 million will significantly reduce the implementation work on the existing customer base. Nevertheless the importance of an electronic search and confidence level to be achieved by this (i.e. identifying the US persons) has increased.

Impact on life insurance
There is a major relief to be expected for life insurance companies to the for pre-existing accounts for the so called cash value insurance policies or annuity contracts below a threshold of USD 250,000. For those accounts no specific due diligence procedures are required. For accounts between USD 250,000 and USD 1 million only a review on electronic searchable data is required. No further search of records or contact with the account holder is required unless U.S. indicia are found through the electronic search. It has to be noted though that a minimum of data points need to be included in the electronic search.

The newly introduced threshold and reliance on electronic research is certainly a relieve for the Swiss domestic business.

Impact on collective investments vehicles
Collective investments vehicles that are regulated in Switzerland need to ensure that they only work with PFFI in order to benefit from a deemed-compliant status, which has to be certifies every three years (self certification). Furthermore distributors of those funds (PFFI's, registered deemed-compliant FFIs or restricted distributors) need to put agreements in place that prohibit sales of debt and equity interests of the funds to US persons, NPFFI and passive NFFE's with one or more substantial US owners.

As we indicated in the past Swiss funds will achieve the deemed-compliant status. However the distribution chain may potentially need significant changes if the distributions is not done via PFFIs.

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