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United States and G5 Countries Release Model Intergovernmental Agreement Addressing Tax Evasion Measures Under FATCA

I. INTRODUCTION.

On July 26, 2012, the U.S. Treasury Department released a model intergovernmental agreement ("Model IGA"), developed cooperatively with France, Germany, Italy, Spain and the United Kingdom (the "G5 countries"), that lays out for the first time a detailed framework for intergovernmental cooperation to reduce tax evasion by U.S. taxpayers, under the U.S. "Foreign Account Tax Compliance" ("FATCA") rules, and by partner country taxpayers.[1] For financial institutions operating in a jurisdiction covered by an agreement, the Model IGA should eliminate or substantially reduce concerns about conflicts between FATCA and local bank secrecy, data protection and privacy laws, and also will ease their FATCA compliance burdens. U.S. financial institutions, on the other hand, face the prospect of increased tax compliance burdens as a result of the United States' commitment to seek additional information about their account holders to provide to the partner country. The implications of the Model IGA for financial institutions in other countries are less clear, as it is uncertain whether the rules set forth in the Model IGA will be adopted into U.S. law or will be available only to partner country financial institutions. Finally, for multinational financial institutions, the Model IGA is likely to result in different rules in different jurisdictions, rendering compliance with FATCA more complex.

The Model IGA establishes a framework for bilateral negotiations between the United States and the G5 countries and is expected to serve as the basis for similar agreements with other countries. Under this Model IGA, partner country financial institutions will report information about U.S. account holders to their own government instead of to the U.S. Internal Revenue Service (the "IRS"), and the partner government in turn agrees to transfer the information on an automatic basis to the IRS. A second model IGA (which is being negotiated with Japan and Switzerland) is expected to be released later this year, under which partner country financial institutions will report information about

[1] The model agreement is available at http://www.treasury.gov/press-center/press-releases/Pages/tg1653.aspx. The model agreement was released in two versions, a reciprocal and non-reciprocal version. The non-reciprocal version will be used when the United States is only receiving tax information from FATCA partner countries. The reciprocal version will be used when the United States both gives information about accounts at U.S. institutions and receives information from partner countries.

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U.S. account holders directly to the IRS. It is generally believed that several dozen other countries have expressed interest in entering into one of these IGAs with the United States.

FATCA generally requires a "foreign financial institution" ("FFI") such as a bank, custodian, fund or other investment vehicle, and certain insurance companies, to enter into an agreement with the IRS under which it agrees to (i) identify and report to the IRS information with respect to certain U.S. persons that directly or indirectly hold depository and custodial accounts at the FFI and equity and debt of the FFI, (ii) withhold on "passthru" payments[2] made to account holders that do not comply with FATCA, provide required information or permit the FFI to report information to the IRS ("recalcitrant" account holders), and (iii) in some cases, close accounts if the account holder does not permit the FFI to report information to the IRS. An FFI that does not enter into such an agreement, or otherwise qualify as compliant or exempt (a "nonparticipating FFI"), is subject to a 30% U.S. withholding tax on "withholdable payments" such as U.S.-source dividends, interest and gross proceeds, that it receives for its own account or for the account of customers. This regime is intended to force non-U.S. financial intermediaries and U.S.-owned foreign entities to identify and report on U.S. account holders and investors. The IRS has proposed regulations to implement FATCA that are expected to be finalized later this year.[3]

II. <u>SUMMARY OF THE KEY POINTS OF THE AGREEMENT</u>.

A. <u>Conflict of Laws and Related Issues</u>

One of the principal concerns that has been raised regarding the adoption of FATCA is that the reporting of customer information by an FFI to the IRS may be inconsistent with the laws of a number of jurisdictions, including those relating to data protection, bank secrecy and privacy law, those relating to FATCA's mandate to close accounts under certain circumstances, and FATCA's requirement to withhold tax on *foreign* source payments to account holders and investors. Concerns also have been expressed about the unilateral and extraterritorial nature of FATCA.

- The Model IGA addresses the first concern in several ways. First, it allows FFIs in the partner country to report information about U.S. account holders to their own government instead of to the IRS. The partner government in turn agrees to transfer the information on an automatic basis to the IRS. FFIs in the partner

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2 "Passthru" payments include not only U.S.-source FDAP income and gross proceeds from the disposition of property producing U.S.-source interest or dividends, but also may include certain foreign-source payments that are "attributable to" such amounts ("foreign passthru payments").

3 See Cleary Gottlieb Alert Memo "Treasury and the IRS Release Proposed Regulations under FATCA and a Joint Statement with Other Countries Regarding an Intergovernmental Approach to FATCA Implementation," available at http://www.cgsh.com/treasury_and_the_irs_release_proposed_regulations_under_fatca/. The proposed regulations are available at http://www.irs.gov/pub/newsroom/reg-121647-10.pdf.

country would be deemed to be in compliance with FATCA, unless specifically identified by the IRS as non-compliant, and therefore would not be subject to FATCA withholding tax on payments they receive. Partner jurisdiction FFIs would not be required to close accounts, and would be required to withhold tax on foreign source payments to account holders and investors only under circumstances suggesting tax abuse, as described further below.

- The Model IGA addresses the second concern through the use of existing procedures under a treaty or tax information exchange agreement ("TIEA"). For example, the IRS agrees to seek any supplementary information with respect to recalcitrant account holders from the partner government under a treaty or TIEA. In addition, negotiations between Treaty Competent Authorities will be used to develop detailed procedures for exchanges of information, and to resolve concerns about financial institutions in significant non-compliance with their obligations.

- The reliance on existing treaties and TIEAs to implement the Model IGA suggests that countries that do not have such agreements with the United States, like Brazil, will not be able to enter into a Model IGA. Government officials have stated, however, that they intend to extend similar opportunities for cooperation to non-treaty/TIEA countries. Further development of model IGAs thus would appear to be necessary.

B. Coordination with AML/KYC Rules

Another major concern raised by many commentators about FATCA is that the burdens and costs for a financial institution to build an entirely new compliance system are very high, and may outweigh the benefits to the U.S. fisc. The Model IGA addresses this concern to some extent by more closely tailoring the diligence requirements that FFIs must satisfy to the parallel anti-money laundering/know your customer ("AML/KYC") rules that many financial institutions are already subject to. As a result, the Model IGA appears to have somewhat less onerous diligence rules than what has been proposed in IRS regulations.

- **Definition of "Financial Institution**." FATCA is applicable only to certain "financial institutions," which makes the scope of the term critical to FATCA's reach. As noted above, the term "financial institution" under FATCA generally refers to banks, custodians, investment vehicles and certain insurance companies. The Model IGA does not use the FATCA definitions. Instead it defines the term "financial institution" by reference to similar terms used in the Financial Action

Task Force Recommendations of February 2012 (the "FATF Recommendations").[4]

The most notable difference is with respect to investment entities. The Model IGA definition is both broader and narrower than the comparable FATCA statutory definition: (i) it includes entities that conduct certain investment activity "on behalf of a customer," which may include portfolio managers and pure advisers (e.g., stock brokers and fund investment advisers), which generally are not treated as FFIs under FATCA; and (ii) it does not clearly exclude entities that invest in asset classes not covered by FATCA, such as real estate. It is not clear that this expansion of the investment entity definition was intended, or what its practical implications are. Conversely and quite significantly, the definition also appears to exclude investment vehicles that are not run as a business or managed by an entity engaged in an investment management business, such as family trusts or entities with a static portfolio. These entities presumably are treated instead as "passive NFFEs," as commentators have recommended.

The use of definitions similar to those applicable for AML/KYC rules generally is a welcome development. However, they create interpretive questions about FATCA compliance that as a practical matter presumably will be addressed by partner country regulators. As a result, it is possible that the same definition will be given different meanings in different countries. If that were the case, FATCA compliance could become more difficult for financial institutions outside the partner country, particularly with respect to the threshold question of what partner country entities constitute FFIs.

- **Rules Applicable to Account Holders that are Non-U.S. Entities**. Under the proposed FATCA regulations, a very limited class of foreign entities ("passive non-financial foreign entities," or "passive NFFEs") that have an account with an FFI are required to provide information about U.S. direct and indirect owners with a 10 percent stake in the entity, and certain investment entity FFIs (owner-documented FFIs) are required to provide information about direct and indirect owners of *any* interest in the entity. The Model IGA, by contrast, requires reporting only with respect to *controlling* persons that are U.S. individuals, in the case of a legal entity, or certain specified parties with control over a trust.[5]

[4] The FATF is an independent inter-governmental body that develops and promotes policies to protect the global financial system. According to the FATF, its Recommendations on International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation are recognized as the global standard. *See* www.fatf-gafi.org. The Model IGA states that its definition of investment entity is to be interpreted in a manner consistent with the definition of investment entity forth in the FATF Recommendations (on page 115).

[5] There can be more than one controlling person depending on the ownership structure of the entity. The FATF Recommendations generally suggest a 25% ownership threshold for a legal entity. FATF Recommendations, pages 60-61.

Identifying only controlling persons aligns the agreement with the approach taken by the FATF Recommendations, which are again expressly referred to in the Model IGA. This change is particularly meaningful when combined with the Model IGA's treatment of many non-commercial FFIs (such as family investment vehicles) as passive NFFEs rather than as FFIs.

- **Limited Requirement to Update Diligence**. Unlike the diligence rules in the proposed regulations, the Model IGA does not require an FFI to repeat diligence on an account except under very limited circumstances.[6] This change also aligns the agreement's procedures more closely with those of the AML/KYC rules.

C. Implications for Multinational Financial Institutions

An important consideration for international banks and other multinational financial institutions is whether the details of FATCA compliance are consistent from jurisdiction to jurisdiction, in order to minimize compliance costs and permit centralization of oversight functions. They also have expressed concerns over the potential that it will not be possible, or not economically rational, for some affiliates to comply with FATCA. The Model IGA is helpful with respect to the latter but not the former.

- **Branches (and Foreign Subsidiaries) Subject to Varying Rules**. The Model IGA contemplates that a partner government will be responsible for FATCA compliance for all FFIs doing business in that jurisdiction. Branches of partner-jurisdiction FFIs located outside the partner jurisdiction are specifically excluded, and locally resident branches of non-partner jurisdiction FFIs are specifically included. This focus on where the entity is doing business may cause an increase in compliance cost for some multinational institutions because they will need to comply with different sets of rules if they have branches or subsidiaries operating in partner countries that have entered into different IGAs or that interpret the provisions of a particular IGA differently than another partner jurisdiction.

- **The IGA "Umbrella" for Financial Institutions.** The Model IGA provides that all FFIs in any country that has entered into an IGA will be treated as participating FFIs, except for any FFI that is on an IRS list as a result of significant non-compliance. A partner jurisdiction FFI that is a qualified intermediary that has elected to assume primary withholding responsibility under chapter 3 will need to withhold on U.S.-source withholdable payments made to any nonparticipating FFI, while other partner jurisdiction FFIs will need to

[6] The agreement does, however, require further inquiry with respect to certain high-value accounts (*i.e.* those with a value greater than $1,000,000) assigned to relationship managers when the relationship manager acquires actual knowledge that the account holder is a specified U.S. person.

provide information to the immediate payor of such payments information to enable that payor to withhold the required tax. A partner jurisdiction FFI will not be required to withhold on payments to recalcitrant account holders or to close those accounts if the IRS receives the information regarding those accounts pursuant to the IGA.

- **Relaxation of the "All or None" Rule**. The proposed FATCA regulations generally provide that an FFI can be a participating FFI only if all of its affiliates and branches also are in compliance with FATCA. There is a limited two-year transition period during which an affiliate or branch that is prevented by local law from complying with FATCA can be out of compliance under certain conditions without impairing the ability of other FFIs in the group to be in compliance.

  The Model IGA contains a permanent exception enabling a partner jurisdiction FFI to be in compliance so long as the non-compliant affiliate or branch (i) is treated as a nonparticipating FFI, (ii) identifies its U.S. accounts and reports them to the extent permitted under local law, (iii) does not specifically solicit U.S. accounts held by persons that are not resident in its jurisdiction (or accounts held by nonparticipating FFIs that are not established in its jurisdiction), and (iv) is not used by the other members of the group to circumvent FATCA.

D. Somewhat Reduced Diligence and Reporting Burdens.

While the Model IGA diligence and reporting rules generally track those of the proposed FATCA regulations, several parts of the Model IGA provide for less burdensome diligence requirements than the proposed regulations.[7] It is unclear whether these are intended to incentivize jurisdictions to enter into an agreement with the United States or whether the final FATCA regulations will also impose these reduced burdens. Similar to the proposed regulations, the diligence requirements under the agreement are phased in over time, are based on the account's size and characteristics, and depend on whether an account is a "preexisting account."

- **Basic Due Diligence Requirements Track the Proposed Regulations.** The Model IGA contains, in Annex I, the due diligence obligations for identifying and reporting on U.S. reportable accounts and on payments to certain nonparticipating FFIs. To a great extent, the requirements set forth in Annex I track the requirements in the proposed regulations, although they are presented in a more succinct and less technical manner, and take into account other changes to

[7] The Model IGA allows, with the partner country's consent, a reporting financial institution to choose between its diligence requirements or those set forth under the FATCA regulations, meaning that the agreement's diligence requirements in practice will likely be no more onerous than those provided in the regulations.

the scope of FATCA described above (for example, with respect to reliance on AML/KYC documentation and self-certification regarding controlling persons of non-U.S. entities). Financial institutions that had hoped that their due diligence burdens would be substantially relaxed under an IGA are likely to be disappointed.

- **Preexisting Account Cut-off Changed and Diligence Periods Pushed Back**. Both the proposed regulations and the Model IGA provide less onerous diligence requirements for "preexisting accounts." The cut-off date for determining whether an account is preexisting under the proposed regulations depends on the effective date of the relevant FFI agreement (generally July 1, 2013), which may not match well with compliance systems. The Model IGA pushes the cut-off date for a preexisting account back to December 31, 2013, which generally represents a postponement of six months and provides a "clean" start date of January 1, 2014 for treating an account as a new account.

- **No Responsible Officer Certification**. The proposed regulations require a responsible officer to certify to the IRS that certain diligence procedures have been carried out and that policies and procedures are in place to prevent avoidance of FATCA compliance. This requirement is dropped in the Model IGA, presumably because it is expected that local regulators will police compliance.

- **Modified Reporting Deadline**. The Model IGA requires a partner jurisdiction to provide the information that it receives from FFIs about their U.S. account holders and investors for a particular year to the IRS by September of the following year. The Model IGA does not specify when FFIs must provide that information to their regulators. The in-country deadline may therefore be later than the March deadline for reporting information to the IRS that is in the proposed regulations. The in-country deadline may vary from country to country.

  For the 2013 taxable year, the Model IGA provides that information from FFIs must be provided by the partner country to the IRS by September 2015, which may mean that FFIs will not be required to report this information to their local tax authorities until some time earlier in 2015. By comparison, the analogous provision of the proposed regulations requires that FFIs report information with respect to 2013 no later than September 30, 2014.

E. Enhanced Certainty and Clarity.

The Model IGA uses a number of techniques to increase the administrability and certainty of the FATCA regime. A key approach is the use of annexes or published lists to provide country-specific information.

- For example, all FFIs in a partner country are treated as compliant with FATCA, unless the IRS specifies in a published list that a particular FFI is non-compliant.
- In addition, the IRS may exclude particular accounts, products or arrangements from the definition of the term "financial account" in an annex to an IGA.
- A third important case is that all partner-country retirement plans identified in an annex are treated as deemed compliant or exempt, alleviating the difficulty that the IRS has had in defining retirement plans in a manner that covers the wide range of arrangements used around the world.

The use of published lists and annexes also provides flexibility to update critical aspects of the regime in a timely manner.

F. Possible Additional Reporting by U.S. Financial Institutions.

The "reciprocal" version of the Model IGA requires the United States to provide information to the partner country of the type that U.S. financial institutions currently report to the IRS.[8] The information currently collected by the IRS from U.S. financial institutions with respect to their foreign account holders generally is much less intrusive than the information that FATCA requires FFIs to provide.

The U.S. government acknowledges in the Model IGA "the need to achieve equivalent levels of reciprocal automatic information exchange" with partner countries. The Model IGA states that the U.S. government is committed to pursue regulations or legislation to obtain equivalent information. In view of the fact that the principal step that the IRS has taken to date to that end – requiring U.S. banks to report to the IRS interest on bank deposits paid to non-U.S. persons – has been controversial, and is the subject of an effort by some members of Congress to roll it back, we expect that future steps will take place primarily through regulation.

[8] Government officials have stressed that the IRS will provide tax information to a partner country only pursuant to a treaty or TIEA, and even then only if the IRS is confident that the information will be used solely for legitimate tax enforcement purposes. Where both conditions are not satisfied, the United States presumably will enter into the non-reciprocal version of the Model IGA.

G. Withholding on Foreign Source Payments ("Foreign Passthru Payments").

FATCA requires FFIs to withhold U.S. tax on certain foreign source payments made to account holders who do not cooperate with an FFI's attempts to comply with FATCA's diligence and reporting rules, and to FFIs that do not comply with FATCA. The principal purpose of this rule is to prevent nonparticipating FFIs from becoming havens for U.S. tax evaders. The foreign passthru payment withholding requirement has been very controversial, however, as a matter of administrability, international relations and conflict of laws issues, and the proposed regulations deferred implementation of those rules to at least 2017.

- The Model IGA generally commits the United States and G5 countries to develop an alternative approach to achieve the policies of these rules, suggesting that it is unlikely that foreign passthru payment withholding will ever be required of partner jurisdiction FFIs.

- The Model IGA also further limits the potential for such withholding (as well as FATCA's due diligence requirements) to apply to debt or equity of banks. Under the proposed regulations, withholding and due diligence regarding the ownership of such interests is required only if the value of the debt or equity instrument is linked to U.S. assets. The Model IGA adds a purpose test, so that even in that case no withholding is required unless the class of interests was established with a purpose of avoiding FATCA reporting. While ostensibly helpful, this purpose requirement in fact introduces uncertainty as to when such withholding and due diligence will be required.

H. Effect on Deadlines for FATCA Implementation

In order to implement the Model IGA, each partner country must sign an actual IGA and then adopt domestic rules necessary to implement it. FFIs operating in those partner countries then will need to adapt (if they have centralized FATCA compliance measures in place) or create the systems necessary to comply with those rules. It is difficult to believe that these steps can be completed by the deadlines contemplated in the proposed FATCA regulations or the Model IGA. Moreover, as noted above there is a second model IGA still to be released, and there are many countries interested in entering into IGAs. Notwithstanding the fact that government officials have continued to say that they intend to adhere to the ambitious deadlines they have set for issuing final FATCA regulations later this year, it seems likely that whatever final rules are adopted this year will further defer the implementation of some of FATCA's requirements.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our U.S. partners and counsel listed under Tax under the "Practices" section of our website at http://www.clearygottlieb.com.

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