King & Spalding

Client Alert

Tax Practice Group

July 6, 2012

Third FATCA Compliance Model Announced
Inter-Governmental Agreements

The U.S. Department of the Treasury (Treasury) issued joint statements with the governments of Japan and Switzerland on June 21, 2012 outlining a new framework for foreign financial institutions (FFIs) in those countries to comply with the Foreign Account Tax Compliance Act (FATCA). This new framework is in addition to that introduced in the February 2012 joint statement released by the United States and five European governments. Other countries seeking to reduce some of FATCA's burdens or impracticalities now have a choice between the February approach (Model I) and the newly announced approach (Model II).

FATCA does not require foreign governments to enter into either type of agreement described above, and the inter-governmental approach is not open to all countries. However, the Treasury has indicated that it is open to adopting either approach with countries willing to cooperate to achieve FATCA's goals. The Treasury also has indicated that a country does not need to have an existing income tax treaty with the United States in order to enter into an inter-governmental FATCA agreement.

Countries have a strong incentive to pursue the inter-governmental approach. Entering into an inter-governmental FATCA agreement under either model will: 1) avoid withholding on passthru payments made by FFIs in that jurisdiction, 2) identify certain types of FFIs in that jurisdiction as "deemed compliant" with FATCA, and 3) provide some local law relief relating to some obligations imposed by FATCA. We expect FFIs to urge their governments to explore FATCA agreements with the United States.

Please see our Client Alert of March 5, 2012 **here** for a more detailed discussion of FATCA generally and the Model I approach. An electronic version of the joint statements for Japan and Switzerland are available on the Treasury website here: **Japan** and **Switzerland**.

Background

FATCA was enacted in March 2010 with the goal of reducing evasion of U.S. federal income tax on income in foreign accounts held by U.S. taxpayers. FATCA's approach is to require FFIs to determine which of their direct or indirect account holders are U.S. taxpayers and to report such information to the U.S. government. In some cases accounts of "recalcitrant" account

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holders must be closed to further this goal. Because the United States could not unilaterally impose this obligation on foreign institutions in relation to non-U.S. accounts, a new and expansive 30% gross basis withholding tax, which would be waived for FATCA compliant FFIs, was introduced to incentivize FFI compliance.

It is important to note that the definition of an FFI extends well beyond the commonly understood concept of a financial institution. The FATCA definition includes any non-U.S. entity that is a bank, broker-dealer, custodian, or trust company, or is engaged (or holds itself out as being engaged) primarily in the business of investment or trading in securities, commodities, or partnership interests. This latter category, as a general matter, can include private equity and hedge funds.

Model II

Model II establishes structures of direct reporting by FFIs to the IRS, supplemented by information provided by the foreign governments upon request by the United States. Therefore, Model II is a hybrid approach between a straight FFI agreement and Model I's intergovernmental approach. It also simplifies FATCA's implementation. Under Model II, all FFIs in a country would identify themselves to the IRS and either be exempted or agree to share information about U.S. account holders. In exchange, all such FFIs would be exempt from the 30 percent FATCA withholding tax. Also, identification of recalcitrant account holders would occur on an aggregate basis under existing treaty obligations rather than on an FFI-by-FFI basis. We expect that if a foreign country entered into a Model II agreement and did not have an income tax treaty with the United States that an exchange of information agreement would be part of the package.

It is believed that the agreements with Japan and Switzerland will increase legal certainty for affected FFIs and reduce implementation costs. Model II is intended to address foreign legal impediments to FATCA implementation while still providing some reduction in the administrative burdens imposed by FATCA.

Japanese Framework

Under the framework outlined in the joint statement with Japan, the Japanese authorities would agree to:

> (1) direct and enable financial institutions in Japan, not otherwise exempt or deemed compliant, to register with the IRS and confirm their intention to comply with official guidance issued by Japanese authorities that is consistent with the obligations of participating FFIs under FATCA; and
>
> (2) provide additional information on an aggregate basis about U.S. accounts identified as recalcitrant.

The U.S. authorities would agree to:

> (1) eliminate the obligation of each FFI in Japan to enter into a separate comprehensive FFI agreement directly with the IRS, provided that each FFI is registered with the IRS or is excepted from registration pursuant to the framework or IRS guidance;
>
> (2) identify specific categories of Japanese financial institutions or entities that would be treated as deemed compliant or exempt due to presenting a low risk of tax evasion;

(3) eliminate U.S. withholding under FATCA on payments to financial institutions in Japan that have registered or entered into an FFI agreement with the IRS and conduct due diligence and reporting in a manner consistent with FATCA requirements or are treated as deemed compliant or exempt pursuant to the framework; and

(4) provide certain other measures to reduce burdens and simplify the implementation of FATCA.

Additionally, financial institutions in Japan that comply with their obligations would not be required to:

(1) terminate the account of a recalcitrant account holder; or

(2) impose withholding on passthru payments to recalcitrant account holders, to FFIs organized in Japan that have registered or entered into an FFI agreement with the IRS, or are otherwise exempt or deemed compliant, or to FFIs in another jurisdiction with which the United States has in effect an agreement for an intergovernmental approach to FATCA implementation or to otherwise facilitate FATCA implementation.

Swiss Framework

Under the framework outlined in the joint statement with Switzerland, the Swiss authorities would agree to:

(1) direct all Swiss financial institutions, not otherwise exempt or deemed compliant, to conclude an FFI agreement with the IRS;

(2) enable Swiss financial institutions to comply with the obligations prescribed by the FATCA rules and set forth in such FFI agreements by granting an exception from Article 271 of the Swiss Criminal Code; and

(3) provide additional information on an aggregate basis about U.S. accounts identified as recalcitrant.

The U.S. authorities would agree to:

(1) identify specific categories of Swiss FFIs or schemes that would be treated as deemed compliant or exempt;

(2) eliminate U.S. withholding under FATCA on payments to Swiss financial institutions; and

(3) provide certain other measures to reduce burdens and simplify the implementation of FATCA.

Additionally, financial institutions in Switzerland that comply with their obligations would not be required to:

(1) terminate the account of a recalcitrant account holder; or

(2) impose withholding on passthru payments to recalcitrant account holders, to other FFIs organized in Switzerland, or to FFIs in another jurisdiction with which the United States has in effect an agreement for an intergovernmental approach or for intergovernmental cooperation to facilitate FATCA implementation.

Implications

It is worth noting that the Model II approach is not uniform. Under the Japanese framework, non-exempt Japanese FFIs would register with the IRS and confirm their intention to comply with Japanese guidance. Under the Swiss framework, non-exempt Swiss FFIs would enter into FFI agreements with the IRS. The joint statements described above are also not final agreements. Rather, they announce an intent to negotiate and create an agreement along the foregoing lines.

Treasury expects to release a model agreement for Model I shortly. According to the Treasury no additional alternative models are expected.

One critical element raised by both Model I and Model II is how foreign governments implement their side of the agreement. Will the implementing rules in the local legislation be broadly similar across jurisdictions signing up to either model? More importantly, will compliance and enforcement of the rules be broadly similar?

FATCA reporting is likely to evolve but not disappear as many FFIs hope. The joint statement with Japan noted that the parties would be willing to work with other FATCA partners and the OECD in the medium term to develop a common model for automatic exchange of information and diligence standards.