THE SAGA CONTINUES

By Anthony Quinn

Since the proposed FATCA regulations were issued on 8 February 2012, there have been quite a few people burning the midnight oil to digest and understand the draft regulations so that a formal response could be submitted to the US Treasury by the 30 April 2012 deadline.

The next stage in the process was a public hearing scheduled for 15 May in Washington to provide a platform for industry groups and others to have their voice heard. To ensure that the voice of industry is still ringing in the ears of the bureaucrats and politicians in Washington long after the day-long hearing, many industry groups have appointed the services of political lobbyists who understand the dynamics of law making on Capitol Hill in order to attempt to influence the outcome before final law is passed.

Earlier statements from US Treasury indicated that final FATCA legislation would be passed in the 'northern summer 2012' (June-September). However, given the number of outstanding and unworkable issues put on the table in the last round of submissions, whether this deadline will be met is anyone's guess (personally, I suspect not).

Across the many submissions that US Treasury received, there were a large number of issues – as would be expected with many countries, industries and legal standards represented.

This article will discuss the key sticking points and outstanding issues with the proposed regulations and provide suggestions regarding the actions that Foreign Financial Institutions (FFIs), should take to prepare, given the uncertainty during the deliberation period.

The key issues can be broken down into the following themes:

- Reliance on existing AML/KYC standards;
- Thresholds, due diligence and verification;
- Entities deemed compliant or posing low tax-evasion risks;
- Limited branches and FFI affiliates in different countries;
- Inter-government agreement (IGA) for information reporting; and
- Timing and transition.

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Reliance on existing AML/KYC standards

In the preamble to the proposed regulations, US Treasury indicated it was introducing 'burden reducing' measures in respect to identification of new and customer accounts, whereby FFIs could rely on existing anti-money laundering/know your customer (AML/KYC) procedures. While this intention to reduce the operational burden placed on FFIs is supported unanimously, there are a number of inconsistencies between US AML laws and those that exist in Australia (and many other countries) which would result in the proposed regulations having the opposite outcome to that intended.

Under US laws, reporting entities are required to reidentify all clients either on expiry of the identification document or every three years (whichever is sooner) which is not the case in Australia or many other comparable AML regimes around the

world. Industry argued that organisations simply do not capture expiry dates in their systems to facilitate this process and that reidentification would have a significant impact on clients, likely resulting in an increase in the number of clients that fail to respond to requests for reidentification.

In addition, FATCA proposes that identification be performed on an account-by-account basis (meaning that each time a client applies to open a new account identification would be required) whereas in Australia reliance can be placed on existing KYC information if the client has already been onboarded. The submissions argued that introducing this new standard would create an additional burden on clients being subject to identification every time they apply for a new product.

Another major difference is the threshold used to identify ultimate beneficial owners (or substantial US owners as it is referred to under FATCA), which for FATCA proposes a far lower threshold of >=10 percent, than the current AML standard of 25 percent. Under this scenario, FFIs would either have to lower the threshold to the lowest common denominator or run two separate thresholds based on the circumstance – which could be confusing to operations staff and prone to error. Industry has argued that FFIs be allowed to rely on the local AML laws (which could ultimately change, should pressure be applied by the Financial Action Task Force (FATF) to local governments to lower the threshold).

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Finally, the proposed regulations require FFIs to retain a copy of identification documents. However, industry has argued that there are many circumstances where FFIs do not actually retain a copy themselves but have access to them through third parties conducting due diligence on their behalf (where the FFI is operating under Australian law) or where the person conducting the identification simply sights an original document and transcribes key information.

It was argued that unless the above inconsistencies were addressed the result would be a major disruption to business and a significant time and cost burden in changing existing standards to come in line with US law.

This uncertainty creates a significant issue for industry. If final regulations are not issued until October 2012 and the FATCA commencement date remains unchanged at 1 July 2013, without the granting of these concessions, FFIs will have less than nine months to implement. Given that most organisations required the full 18-24 months to implement the Customer Identification Program (CIP) when AML/CTF was introduced, a successful outcome is unlikely.

Thresholds, due diligence and verification

FATCA has different de minimus thresholds under which pre-existing accounts can be classified as non-US accounts, which for individual account holders is USD<$50,000 and for entities is USD<$250,000. Industry submitted that there is no valid reason for the difference in thresholds and explained that the disparity might actually encourage account holders to structure their accounts as entities (to fly under the threshold) but stopped short of suggesting that the individual threshold be raised to the same level as entities.

Entities deemed compliant or posing low tax evasion risks

In the proposed regulations, the US Treasury announced additional entities that could be considered "Deemed Compliant FFIs" (DCFFIs) on the basis that certain entities pose low risk of tax evasion (including organisations such as foreign governments, central banks, international organisations and certain retirement funds).

Unfortunately, after reading the criteria for certain retirement funds to qualify for the DCFFI status, it seems that most regulated superannuation entities in Australia will not meet all of the qualifying criteria and therefore will not be deemed compliant. As this is a significant issue for Australian business,

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industry has demonstrated the highly regulated nature of the superannuation business and requested a broader definition in the final version such that this exemption can apply to Australian superannuation funds without undermining the objectives of FATCA.

Limited branches and FFI affiliates in different countries

FFIs welcomed the introduction of the concept of limited branches and FFI affiliates, which was designed to allow an FFI to enter into an agreement despite certain branches/affiliates being unable to comply due to ongoing domestic law issues. However, concerns remain that the FFI Agreement could be at risk of termination if by the end of the sunset clause on 31 December 2015 these branches are unable to fully comply. Industry has argued that two years is insufficient time to influence domestic lawmakers and regulators, and have requested that this be extended for a further two years.

Inter-Government Agreement (IGA) for information reporting

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Nonetheless, industry is concerned regarding the time that the IGAs would take to agree, with a likely outcome that they remain 'in-flight' at the time of FATCA commencement, forcing FFIs to build and implement tax reporting solutions directly and indirectly simultaneously, which would lead to throw-away work. Industry have argued that once a memorandum of understanding has been reached that FFIs can operate on the basis that the IGA will be signed at some point so that they can design solutions accordingly to minimise implementation cost.

The IGA aside, this does not solve the many issues associated with providing the Inland Revenue Service (IRS) with the required gross proceed information, which poses a significant issue for wealth management business in particular due to the multi-layered way in which managed investment schemes operate. Furthermore, there is no current standard for tax reporting data requirements between tax authorities, meaning that significant effort will need to be expended to come to a commonly used set of data attributes (which may or may not exist) within the FFIs or domestic tax authorities existing systems.

Timing and transition

Generally, most FFIs have an issue with the commencement date of FATCA, which for United States Financial Institutions (USFIs) is 1 January 2013, which could be around three months from the date that final regulations are passed. For FFIs, the commencement date of 1 July 2013 is also not seen as achievable if the AML inconsistencies remain unchanged, since this would require significant changes to customer on-boarding collateral, systems and procedures to be implemented within less than 12 months.

Industry also requested that the commencement dates for FATCA for USFIs and FFIs be aligned (to no earlier than 1 July 2013) as well as calling for an extension on other dates, for example lengthening the sunset clause for limited FFI branches.

Summary

The US Treasury received over 100 lobbying submissions from industry associations and other organisations from around the world in the previous round of guidance; it is not inconceivable that it will receive many more this time round, with other associations now having woken up to FATCA (although others clearly have their heads in the sand!).

Whether US Treasury is able to read and digest the avalanche of submissions (most of which are 50 pages plus), consider alternative propositions and amend the final regulations such that they are largely workable by September remains to be seen, but the midnight oil for the next few months at least will be burning on Capitol Hill once again.

So what can you do now?

One thing that is almost certain is that FATCA is not going away. The core components of FATCA have already been defined. The main focus now is on driving an outcome that satisfies the ambitions of the US Government in reducing tax evasion, while seeking pragmatic concessions to reduce the impact on financial institutions around the world in having to align current domestic practices with those of the United States.

The uncertainty presents a dilemma for FFIs, particularly in relation to customer identification, which is on the critical path. Given the 18-24 month lead time for AML KYC changes, FFIs have to make a decision whether to start enriching existing client collateral, systems and processes to FATCA

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KYC standards to meet the commencement deadlines or whether to hold fire until further clarification is provided, potentially exposing FFIs to the risk that implementation will not be achieved on time, potentially jeopardising their FFI status.

Given the considerable disruption, the costs involved and the economic situation, many boards – will quite rightly – be reluctant to undertake a major overhaul of the customer onboarding processes until the situation becomes clearer.

There are actions that FFIs can start now, to prepare for FATCA, such as conducting analysis to understand the legal entity framework that exists under the corporate umbrella globally. This in itself can present some challenges to understand the nature of all legal entities and whether it falls under the definition of a 'Financial Institution' and if so, whether it meets the qualifying criteria as a 'deemed compliant FFI', which is a prerequisite step in signing the FFI Agreement and registering the legal entities to receive the all-important FFI-EIN[1].

FFIs should also start to develop an understanding of the products and services that they offer (globally), to determine which fall under the definition of a 'financial account', as well as, identifying the 'financial accounts' that generate U.S. FDAP income[2] so that the business processes that support withholding and reporting currently can be better understood.

It is also a worthwhile exercise for FFIs to conduct a 'dry-run' of the pre-existing US account discovery analysis. Not only will this highlight the number of potential US accounts and high-value accounts that require additional actions to be taken, but it should highlight the potential scope of withholding and reporting on 'US' and 'recalcitrant' account holders so that they can get a feel for the conceptual solution based on the scale of the issue.

This exercise in itself will yield valuable lessons as FFIs will learn the complexities associated with extracting client data from multiple sources, excluding accounts that fall outside scope, aggregating account balances (where it is possible to do so), segmenting clients into the FATCA categories and identifying the various scenarios for flagging FATCA account status at various stages in the process.

Finally, FFIs can start looking at the FATCA risk and compliance framework and decide how this sits alongside existing functions, for example, the role of the money laundering reporting officer and determine whether the FATCA responsibilities will be added to this function or whether it will be managed separately.

While the above is by no means an exhaustive list, there is greater degree of certainty around these aspects of the FATCA regulations and it will serve FFIs well to start thinking more closely about this prior to further guidance being available on customer identification, which has the potential (should the lobbying efforts be unsuccessful) l to require major changes comparable to the AML Customer Identification Program, which as anyone that has been involved in implementing is a painful undertaking. ■

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[1] FFI – EIN means the Foreign Financial Institution Employer Identification Number.
[2] DAP means Fixed and Determinable Annual or Periodical income.