Model I Intergovernmental Agreement Released as Alternative to FATCA Regime

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On July 26, 2012, the U.S. Treasury Department released two versions of the Model I Intergovernmental Agreement (Model IGA) to implement the information reporting and withholding tax provisions of the Foreign Account Tax Compliance Act (FATCA), together with a joint message with France, Germany, Italy, Spain, and the United Kingdom endorsing the agreement.[1]

The following discussion provides some of the notable (and, in certain cases, welcome) distinctions between the Model IGAs and the requirements under the proposed regulations.

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[1]The release included a Model IGA “With Reciprocity” and “Without Reciprocity.” While it was first anticipated that the “Without Reciprocity” would be the alternative approach for countries without an income tax treaty or Tax Information Exchange Agreement (TIEA) currently in place, the Model IGAs made clear that this is not the case. Both Model IGAs require that the country entering into the agreement first have an income tax treaty or a TIEA in place. The distinction between the two Model IGAs appears to be a requirement that, before a country can enter into an IGA “With Reciprocity,” Treasury and the IRS must confirm it is a country that would utilize the information provided by the United States appropriately and for tax purposes only. Because the statements released with respect to the Model II IGA (Switzerland and Japan) also contemplate the possibility of direct reporting to the IRS with an exchange of information “upon request,” it is possible that the same requirement (treaty or TIEA) will be required. If true, this will, undoubtedly, be a disappointment to the many countries that do not have a tax treaty and TIEA with the United States.

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Modification of definition of financial institutions

Pursuant to the proposed regulations, the broad definition of a "financial institution" includes any entity that is primarily engaged in the business of investing, reinvesting, or trading in securities, commodities, partnership interests, etc. For this purpose, an entity is primarily engaged in such activities if its gross income attributable to such activities equals or exceeds 50% during the relevant testing period.

Given this definition, foreign funds, collective investment vehicles, and passive investment corporations are considered foreign financial institutions (FFIs) and not passive nonfinancial foreign entities (NFFEs). This distinction is significant in terms of compliance requirements.

A passive NFFE must provide: (1) a certification that it has no substantial U.S. owners (more than 10% direct or indirect ownership); or (2) the name, address, and taxpayer identification number (TIN) of each such owner.

An FFI, on the other hand, must enter into a formal agreement with the IRS and agree, among other things, to identify and report its U.S. accounts or meet one of the deemed compliant or other excepted categories.

Generally, a passive corporation can meet the requirements of a deemed-compliant owner documented FFI (ODFFI) if its withholding agent agrees to treat it as an ODFFI and it discloses information (and documentation)

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relating to all of its underlying owners.

Pursuant to the Model IGA, the definition of this category of FFI has changed significantly. Specifically, in lieu of the regulation definition outlined above, a Partner Country Financial Institution (FI) includes an "Investment Entity," which means "any entity that conducts as a business (or is managed by an entity that conducts as a business)" trading, portfolio management, or investing, administering, or managing funds "for or on behalf of a customer."

Given this new definition, it appears that fund managers, as well as the funds they manage, are considered FIs.[2] A passive investment corporation, however, is not. This is because it does not engage in any of the activities listed above for customers, nor is it generally managed by an entity that does.

Under the Model IGA, a Partner Country FI that has a Passive NFFE account holder must obtain a self-certification from the entity establishing its status, determine whether it has any Controlling Persons and, if so, determine whether there is a Controlling Person that is a U.S. citizen or resident. For this purpose, the Model IGA defines a Controlling Person as the one that exercises control over the entity. It further provides that the term must be interpreted in a manner consistent with the *Recommendations of the Financial Action Task Force*.

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[2] ***KPMG observation***: Given the plain language, an FI designation for a self-managed SICAV is not as clear. There is, however, what appears to be a catch-all provision that states the definition of an Investment Entity "shall be interpreted in a manner consistent with similar language set for in the definition of 'financial institution' in the Financial Action Task Force (FATF) Recommendations." While that definition is unclear as set forth in the 2012 FATCA Recommendations, reports from prior years, as well as other published FATF documents, seem to indicate that such a vehicle would be included within the definition of a financial institution regardless of whether it was managed by a third party or was self managed.

Further, it is unclear why the Model IGA includes the third party fund manager, itself, within the definition of an FI. Generally, the fund manager is not in the chain of payment and does not have investors. In addition, the "financial account" that the fund manager must identify is anyone holding an "equity interest." Interestingly, that definition does not include the shareholder of a corporation. Given that, there would never be anything to report. The same would seem to hold true for a fund that is in corporate form. Pursuant to the proposed regulation classifications, most fund managers would be considered active NFFEs and, as such, excluded from these rules. Instead, under the regulations, it is generally the funds that they manage that will be treated as FFIs and faced with the requirement to enter into the FFI Agreement with the IRS.

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While the term “Controlling Persons” is not specifically used in that report, it does provide that “[a] controlling ownership interest depends on the ownership structure of the company. It may be based on a threshold, e.g., any person owning more than a certain percentage of the company (e.g. 25%).”

Given this, the Model IGA appears to require the FI to identify those owners that hold a 25% interest and then determine whether those persons are U.S. citizens or residents. For a preexisting account, the identification may be based on information collected under AML and KYC procedures for accounts with a balance that does not exceed $1 million and a self-certification from the account holder or the Controlling Person(s) for accounts with a balance in excess of $1 million.

For a new account, the FI must identify whether there are any Controlling Persons (as determined pursuant to AML and KYC procedures) and must determine whether such Controlling Persons are U.S. citizens or residents based on self-certifications.

KPMG observation

Excluding the passive investment corporations from the FFI category, and aligning the ownership thresholds for Passive NFFEs to those generally required for AML and KYC purposes, are positive moves. However, the account identification requirements for these accounts (obtaining a self-certification from the entity that it is a passive NFFE, determining whether there is a Controlling Person based on the AML and KYC documentation, and determining whether any Controlling Person is a U.S. citizen or resident based on another self certification) continue to place a significant burden on the Partner FI. Notwithstanding that, after carrying out the requisite procedures, the Partner FI essentially relies on self-certifications from the entity and its Controlling Person(s).

Given that many U.S. persons hiding income offshore sign their tax returns and certify, under penalties of perjury, that the income reported is accurate (when, in fact, it is understated), it is unlikely that a self-certification from such persons to their bank would be reliable. Thus, the value of the information obtained from the due diligence requirements set forth in the Model IGA will be diluted (i.e., it is not likely to include the accounts held or controlled by the U.S. tax evaders the legislation was enacted to target).

It is important to point out that the vast majority of this account base has no U.S. ownership and no investments or other ties associating them to the

U.S. Requesting self-certifications for U.S. tax purposes over this broad account base is onerous from the perspective of the Partner FI and intrusive from the perspective of the Controlling Person(s). For those entities that are U.S. owned, relying on AML and KYC documentation for the Controlling Persons, accompanied by a due diligence requirement to look for, and follow-up on, U.S. indicia associated with the account would seem to provide a better means of U.S. account identification and would be less burdensome to the Partner FI. (Again, the likelihood of a U.S. tax evader representing he/she is U.S. on a certification in a bank opening statement is improbable.)

It is important to note that the modifications of this category of FFI are likely a precursor to the rules in the final regulations. Several commentators had argued that, by pulling the passive investment corporations and family trusts into the third category of FFIs, Treasury and the IRS had essentially written section 1472 out of the Code. In support of a corresponding regulation change, it is not practicable to have a particular entity treated as an FFI in one country and as a passive NFFE in another. Such disparate treatment would overcomplicate an already complex regime.

Significant reliance on self-certifications

As noted above, the rules in the Model IGA seem to have departed from the reliance on more concrete evidence (e.g., documentary evidence obtained under AML and KYC procedures or third-party sources) and, instead, rely heavily on self-certifications.

This is particularly true for the account identification requirements for new accounts held by individuals. For these accounts, notwithstanding the fact that the Partner FI may have a copy of the account holder's non-U.S. passport and further noted that there are no U.S. indicia associated with the account, it must nevertheless obtain a self-certification "to determine whether the account holder is a resident of the United States for tax purposes."

Further, the Model IGA provides that "for this purpose, a U.S. citizen is considered to be resident in the United States for tax purposes, even if the account holder is also a tax resident of another country." Thus, this rule seems to require that the Partner FI ask for residency and citizenship information and, more importantly, ask whether the person has dual citizenship (one being U.S.). The rule further provides that the Partner FI must confirm the "reasonableness" of the self-certification based on the

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information it obtains under AML and KYC. It does not, however, provide details regarding how this determination is to be made, nor does it provide information regarding what a Partner FI is to do if it cannot confirm such reasonableness. Given the subjective nature of this determination, compliance with the requirement is likely to vary significantly from Partner FI to Partner FI.

KPMG observation

Although the intent was likely the opposite, the burden placed on Partner FIs under this requirement is astonishing. They will now be required to obtain self-certifications regarding an account holder's tax status for U.S. tax purposes for each one of the hundreds of millions of accounts that will be opened around the globe over the years to come—the vast majority of which will be opened by non-U.S. persons with no ties to the U.S.

Further, as mentioned above, a U.S. citizen or resident that readily certifies to the accuracy of false information on his/her U.S. tax return, under penalties of perjury, is not likely to hesitate when making a less than truthful certification on a bank opening statement. This, again, calls into question the value of the information that will be obtained under this new requirement. Relying on the AML and KYC documentation, coupled with a due diligence requirement to look for, and follow-up on, any U.S. indicia associated with the account (as detailed in the proposed regulations) is a less onerous method of account identification and likely to conclude better results.

It is noteworthy that Article 6 of the Model IGA commits the two countries to work with other partners, including the OECD and the EU, on adapting the terms of the agreement to a "common model" for automatic information exchange, which is to include standardized due diligence requirements.

Following the Model IGA requirements, the requisite self-certifications to cover all countries and their tax systems (citizenship, residency, or other) may result in a very lengthy account opening document.

While a uniform approach is reasonable, and the only approach that would be feasible if other countries adopt similar FATCA-type legislation, the purpose of the concerted effort is unclear when the foundation of the system is self representation.

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Modification to account identification timeline

The Model IGA contains a very welcomed modification to the account identification timeline. Specifically, it provides that a Partner FI may treat any account opened in 2013 as a pre-existing account, which means a delay in the requirement for on-boarding new accounts until January 1, 2014. This eliminates a significant amount of pressure that had been placed on the FIs under the proposed regulations to determine that their internal system enhancements and internal and external training were completed by June 30, 2013—a time requirement that would have undoubtedly been missed due to the lack of final guidance.

KPMG observation

It is anticipated that Treasury and the IRS will include the same modification in the final regulations for all withholding agents. If so, this would also be an enormous relief for U.S. withholding agents, who are currently facing the looming January 1, 2013 date for new account on-boarding. In addition, such relief would be beneficial because: (1) many U.S. withholding agents have FFIs within their groups and need to implement centralized processes; and (2) nonwithholding and owner-documented FFIs will be transmitting documentation and/or withholding instructions relating to their account holders to their upstream U.S. withholding agents. Thus, having both sides (U.S. withholding agents and FFIs) on the same timeline will greatly simplify the process.

Elimination of certain reporting requirements

Pursuant to the proposed regulations, withholding agents (both U.S. withholding agents and FFIs) are required to report not only certain U.S. persons but, also, payments to properly documented foreign payees. This latter reporting requirement is a Form 1042-S reporting requirement (sometimes by pool, depending on payee), as opposed to the Form 1099 requirement for the U.S. person reporting.

The Model IGA eliminates the need for the Form 1042-S requirement to report payments to properly documented foreign payees and limits reporting to:

- Financial accounts held by: (1) one or more Specified U.S. Persons; or (2) a non-U.S. entity (Passive NFFE) with one or more Controlling Persons that is a Specified U.S. Person; and

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- Payments made in 2015 and 2016 to each Nonparticipating FFI (NPFFI)

It is significant to note that the first U.S. account reporting (for calendar years 2013 and 2014) is not required to be exchanged until September 30, 2015.

Elimination of withholding requirement for gross proceeds

The proposed regulations provide that a withholdable payment includes U.S. source fixed or determinable annual or periodical income (FDAP) as well as the proceeds from the sale or other dispositions of assets that generate U.S. source interest or dividends.

Passthru payments, on the other hand, include a withholdable payment plus a foreign passthru payment (currently, an undefined term). Pursuant to the proposed regulations, the requirements to impose withholding are phased in. Specifically, the withholding on FDAP begins on January 1, 2014, followed by the requirement to impose withholding on gross proceeds beginning January 1, 2015.

For Participating FFIs (PFFIs), the proposed regulations provide that withholding on foreign passthru payments would begin January 1, 2017, at the earliest. It is significant to note that the requirement for a PFFI to impose withholding on non-U.S. source income under FATCA has been the most contentious issue to date.

As expected, the Model IGA limits the withholding requirements to payments made to NPFFIs—in non-partner countries and to recalcitrant account holders when the requisite reporting is not provided to the Competent Authority.

The Model IGA eliminates the requirement to impose withholding on proceeds or foreign passthru payments at this time. The agreement does require, however, that both parties commit to work together, and with other partners, "to develop a practical and effective alternative approach to achieve the policy objective of foreign passthru payment and gross proceeds withholding that minimizes burden." Interestingly, the Model IGA does not state when the Partner FI must begin withholding on FDAP payments.

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KPMG observation

The elimination of the requirement to impose withholding on gross proceeds is a substantial departure from the statute and, in many instances, results in the same amount of withholding as the rules in place today (e.g., a non-U.S. partnership that refuses to disclose its partners is subjected to 30% withholding on U.S. source FDAP, yet receives gross proceeds free of withholding, which is an accepted outcome for some U.S. tax evaders). It is significant to note that this problem was a primary impetus to the enactment of FATCA.

Also, it is impractical for a U.S. withholding agent to adopt and implement policies and procedures to accommodate counterparties that operate under the regulations and IGAs.[3] It is further impractical for global institutions to adopt and implement policies and procedures for different FATCA requirements, depending on where they are operating (i.e., Model IGA procedures in partner countries and regulation procedures in non-partner countries).

Further, different withholding requirements in different countries would be contrary to Treasury's goal of not pushing U.S. tax evaders into different investments or countries as a result of these rules. Given that, it will be interesting to see if this, too, is a precursor of what the final regulations will contain.

Modification to the limited FFI rule

The limited FFI concept was adopted to help certain FFIs within expanded affiliated groups. The proposed regulations provide that all FFIs within an expanded affiliated group must either be a PFFI, deemed compliant FFI (DCFFI), or otherwise exempted from the rules.

[3] This statement presumes that a U.S. withholding agent would impose withholding as set forth in the IGA for a particular country and not pursuant to the regulations. (The presumption is made because it would not make sense if the rules required a Partner FI that is not a withholding QI to pass up withholding instructions to its U.S. withholding agent who, under the regulations would impose withholding on FDAP as well as certain gross proceeds while the Partner FI that is a withholding QI and, thus, withholds under FATCA itself, would do so only on the FDAP).

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Understanding that certain FFIs operate in jurisdictions that prohibit disclosures of account holder information, closing of recalcitrant accounts, etc., Treasury and the IRS devised a transition rule for "limited FFIs" and "limited branches."

Specifically, the limited FFI rule would apply where an FFI within an expanded affiliated group is legally prohibited from either:

(1) reporting **and** closing or transferring an account; or
(2) withholding **and** blocking, closing, or transferring an account.[4]

Pursuant to the proposed regulations, if an FFI in such a jurisdiction qualifies as a limited FFI, the IRS will permit the other FFIs within its expanded affiliated group to become PFFI and/or DCFFIs.

As currently drafted, the limited FFI within the group must agree to the account identification requirements as set forth in the FFI Agreement. Further, it must agree to not open any new U.S. or NPFFI accounts. Significantly, the rules provide that the limited FFI would be treated as a NPFFI for purposes of the penal withholding on reportable payments. Pursuant to the proposed regulations, the limited FFI relief is transitional and ends on December 31, 2015.

Recognizing that there may be jurisdictions where local law impediments will never permit an FFI operating therein to achieve full FATCA compliance, the Model IGA permits a FATCA Partner's Related Entity[5] to effectively operate as a limited FFI indefinitely as long as:

- The limited FFI: (1) identifies itself as an NPFFI; (2) identifies its U.S. accounts and reports, when permitted; and (3) does not specifically solicit U.S. accounts that are held by nonresidents or

[4] While the proposed regulations do not currently read the same, the description of FFIs eligible for limited FFI status has been taken from both the explanation in the Preamble as well as informal conversations with drafters of the regulations. It is anticipated that the final rules will be corrected to reflect this language.

[5] An entity is a "related entity" of another entity if either entity controls the other entity, or the two entities are under common control. For this purpose, "control" includes direct or indirect ownership of more than 50% of the vote ***or*** value in the entity. Interestingly, the statute provides that an entity is within an expanded affiliated group if it is controlled (more than 50% by vote ***and*** value) by the same parent. Notwithstanding that difference, the Model IGA also provides that "the FATCA partner may treat an entity as not a related entity of another entity" if the two entities are not members of the same affiliated expanded group as defined in the statute.

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NPFFIs that are not established in the country where the limited FFI is operating; and

- The FATCA Partner FI does not use the limited FFI in its group to circumvent its obligations under the relevant rules.

KPMG observation

When another entity in the expanded affiliated group cannot comply with the FATCA rules because of local law impediments, the Model IGA provides that the FATCA FI will not lose its compliant status as long as the stated requirements (outlined above) are satisfied. It does not, however, provide the same relief for other compliant entities in the group that may be operating in Non-Partner Countries. Without a corresponding regulation change, such entities would presumably be treated as NPFFIs after December 31, 2015.

Additional carve outs for retirement plans

The Model IGA contains an anticipated provision relating to additional carve outs for certain retirement plans. While the proposed regulations do contain carve outs for some retirement plans and accounts, the requirements were not sufficiently broad to encompass many plans when the risk of tax evasion is minimal.

The Model IGA contemplates that Annex 2 (Annex 1 contains the due diligence and reporting obligations) to the agreement will contain the list of entities, plans, and products that will be excluded.

KPMG observation

It is, again, important to note that consistency among jurisdictions as it relates to products and plans is imperative for the success of the FATCA regime.

For example, retirement plans that are identical—other than the fact that one is organized in a Partner Country and the other is not—must be treated the same under these rules (i.e., the Partner Country plan cannot be excluded from FATCA under the Partner Country IGA and the Non-Partner Country plan considered an FFI solely because the country in which it is organized did not enter into an IGA).

Further, a product cannot be excluded in one country and not another. A global institution must have a standardized methodology for achieving FATCA compliance. If this is not possible due to varying applications of the rules to the same type of entity or product, the regime will, undoubtedly, fail.

Reciprocity—Potential for future requirements for U.S. withholding agents

Pursuant to the Model IGA (With Reciprocity), the United States will exchange certain information with its FATCA Partner Country. Specifically, it will exchange information relating to U.S. bank deposit interest in excess of $10 paid annually to individuals resident in the partner country as well as information relating to other payments made to residents of the Partner Country that are subject to reporting under current reporting requirements. The United States further commits to the exchange of TINs associated with that reporting beginning in 2017 (and when the country does not issue its residents TINs, the residents' date of birth).

More significantly, the Model IGA provides that the United States acknowledges that it must obtain like information to automatically exchange and, to that end, commits "to further improve transparency and enhance [relationships] by pursuing the adoption of regulations and advocating and supporting relevant legislation to achieve such equivalent levels of reciprocal automatic exchange."

KPMG observation

Given current proposed legislation, this commitment could result in the requirement for a U.S. withholding agent to look through a corporation to identify, and report on, underlying shareholders.

Documents

- U.S. Treasury Press Release
- Reciprocal Version of the IGA
- Nonreciprocal Version of the IGA

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