

# ***FATCA***

## A perspective on service providers

February 2014



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## Introduction

The Foreign Account Tax Compliance Act (FATCA), enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, was designed to provide the Internal Revenue Service (IRS) better capability to identify US tax evaders who are concealing their assets directly in foreign accounts, or indirectly, through offshore companies. FATCA requires companies to comply with new tax information reporting and withholding requirements as well as investor due diligence and documentation requirements. FATCA's requirements apply broadly to foreign financial institutions (FFI), non-financial foreign entities (NFFE), as well as US withholding agents (USWA).

Certain FFIs are required to register with the IRS and enter into FFI Agreements. The consequences of noncompliance include being subject to, or liable for, a 30 percent withholding tax on income from US sources (FATCA withholding) and eventually on the gross proceeds from the sale of securities that could produce US-sourced interest and dividends.

The purpose of this paper is to explore how FATCA's requirements may impact the relationship between companies and their service providers, and to discuss how service providers can work with their clients to understand their FATCA related needs and prepare to provide information to enable their clients to certify FATCA compliance.

Service providers need to be aware of FATCA requirements and understand the relationship to the services they offer to their clients. Changes to services offered, contract terms, liability provisions and/or internal controls reporting requirements are all possible effects of the FATCA regulation. Service providers must be knowledgeable about the challenges their clients are facing associated with FATCA and be prepared to respond to their clients' changing needs as a result of the regulation.

*FATCA was enacted with a primary goal of providing the IRS with an increased ability to detect US tax evaders.*

## Requirement for controls

Embedded within the FATCA regulation are compliance requirements that include certifications to be made to the IRS by an appointed “responsible officer” of participating FFIs (PFFIs) (see Figure 1). While the initial certifications are at a point in time and non-recurring, the responsible officer certification that the PFFI maintained effective internal controls related to FATCA compliance is required periodically, and covers the effectiveness of internal controls over the certification period.

Failing to make the required certifications could constitute a default under the FFI Agreement, which may result in the IRS terminating the FFI Agreement and subjecting the companies to FATCA withholding. PFFIs must design and implement a FATCA controls framework to comply with the periodic certification requirements by June 30, 2014.

FATCA compliance will be an ongoing and potentially challenging responsibility for many PFFIs. Companies that have begun to consider certifications

and controls as part of their FATCA compliance programs have identified that some of the processes, and thereby the controls relating to FATCA compliance, are performed by service providers. As companies analyze the regulatory requirements and inventory their processes and controls, they identify areas where they expect to rely on internal controls at their service providers to support the PFFI responsible officer certification responsibilities.

*FATCA compliance will be an ongoing and potentially challenging responsibility for PFFIs.*

*The following table outlines the certifications required for PFFI compliance.*

| Figure 1  |           |  |                          |
|---|-----------|--|--------------------------|
| Type of certification   | Frequency | When is certification required?  | IRS Regulation Reference |
| Completion of due diligence and documentation requirements on pre-existing accounts   | One-time  | 60 days after the 2nd anniversary of the FFI Agreement                                       | §1.1471-4(c)(7)          |
| No formal or informal practices or procedures in place from August 6, 2011 through the date of such certification to assist account holders in the avoidance of Chapter 4 | One-time  | 60 days after the 2nd anniversary of the FFI Agreement                                       | §1.1471-4(c)(7)          |
| Certification on the effectiveness of internal controls over FATCA compliance covering a three-year period  | Recurring | 6 months after the 3rd full calendar years following the effective date of the FFI Agreement | §1.1471-4(f)(3)          |

## Impact on service providers

Many of the companies affected by the requirements of FATCA rely on service providers — including fund administrators, custodians, prime brokers, transfer agents, and law firms — to assume responsibility, or provide support, for some internal controls related to areas impacted by FATCA's requirements.

Service providers perform a range of important services that may directly or indirectly relate

to the areas where internal controls are required to support a PFFI's continued compliance with FATCA. Many service providers have even evaluated the requirements of FATCA and identified additional services that can help meet their clients' operational needs. Responsible officers will need to find effective ways to support their certification requirements related to effective internal controls, with adequate information from their service

providers related to outsourced services. These requirements may drive client demand for assurance over internal controls at service providers to support the PFFI's compliance and certification requirements for FATCA.

Understanding how to address this demand is critical. While some oversight has always existed and most service providers have third-party reporting in place over internal controls over financial

reporting, their clients may now begin to also demand third-party reporting over internal controls for FATCA related services (such as onboarding) in order to support the responsible officer certification of compliance with FATCA to the IRS. As soon as possible, service providers and their clients should begin identifying internal control responsibilities related to services provided and expectations related to supporting the responsible officer certification by the PFFI.

*The table below identifies examples of service providers that are likely providing services related to areas affected by FATCA.*

Figure 2

| FATCA regulation area |                             |                                |                    |             |           |
|-----------------------|-----------------------------|--------------------------------|--------------------|-------------|-----------|
| Service provider      | Legal entity classification | Registration and certification | Account assessment | Withholding | Reporting |
| Fund administrators   | ✓                           | ✓                              | ✓                  | ✓           | ✓         |
| Custodians            | ✓                           |                                |                    | ✓           | ✓         |
| Prime brokers         | ✓                           |                                |                    | ✓           | ✓         |
| Transfer agents       | ✓                           |                                |                    | ✓           | ✓         |
| Law firms             | ✓                           |                                |                    |             | ✓         |
| IT general controls   |                             |                                |                    |             |           |



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## Meeting client needs

Service providers currently use a variety of independent audit reports to demonstrate the design and operating effectiveness of internal controls to their clients. However, these reports typically focus on internal controls over financial reporting and will likely not address the controls necessary to support responsible officers in demonstrating FATCA compliance. In order to support their clients certification of compliance to the IRS, service providers will need to pursue reporting on internal controls related to the services that align to the FATCA requirements.

An independent attestation report on internal controls related to these service areas can help service providers efficiently and effectively provide the assurance their clients need to certify compliance. Service providers could use this report to demonstrate the effectiveness of internal controls in place related to the services offered to responsible officers of their clients.

The service provider could provide this report to clients who outsource all or part of their business processes that are impacted by FATCA.

*FATCA reports differ from SOC 1 reports in that they report on controls related to operations and compliance.*

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## Conclusion

As companies continue to develop plans to achieve FATCA compliance, many are relying on existing service providers to support the internal control requirements of the regulation. Consequently, there is an increasing need for transparency and trust that internal controls are in place at service providers and are aligned to regulatory requirements such as FATCA. This dynamic changes the relationship between service providers and their clients. Companies needing to comply with FATCA, and their responsible officers who need to certify compliance, will look to their service providers to demonstrate effective controls in support of the company's regulatory requirements. Service providers will need to explore their service obligations and reporting options to meet their clients changing needs. Independent reports designed to

provide assurance on the design and operational effectiveness of operational and compliance controls can efficiently and effectively help service providers to meet this new demand, providing necessary information to meet the needs of companies and their responsible officers. In our view, service providers should engage in discussions with their clients to determine the expectations associated with FATCA compliance and reporting required from the service provider to meet their clients' needs.



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