

# ***US Inbound Newsalert***

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## *FATCA implications for non- financial services corporations*

"FATCA" is the acronym for the Foreign Account Tax Compliance Act and was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act on March 18, 2010 (P.L. 111-147). Many multinational corporations (MNCs) whose primary business activities are outside of the traditional financial services industry mistakenly believe FATCA will not impact them. However, FATCA may impact all MNCs in at least one of the following three ways: 1) additional documentation may need to be collected from certain non-US parties related to payments made as part of the Treasury and Accounts Payable function; 2) entities within the MNC's worldwide group may, in fact, meet the definition of a "foreign financial institution" or "non-financial foreign entity" and may be required to take affirmative steps to be compliant under FATCA; and 3) MNCs will need to verify whether their foreign banking or other financial relationships that they have within their global organization are with foreign financial institutions that are FATCA compliant.

This newsalert provides a brief overview of FATCA, debunks the common misconception that FATCA only affects entities in the financial services industry, and provides insight into key points that MNCs should start undertaking to comply with FATCA.

### ***What is FATCA?***

FATCA is the US government's response to a concern that certain US persons were using foreign accounts to hide income offshore either by directly owning these accounts or indirectly controlling non-US entities which held the accounts.



FATCA creates a new tax information reporting and withholding regime for certain payments made to certain foreign entities. Additionally, FATCA creates an information reporting mechanism that may require foreign entities to disclose financial accounts held by high net worth US persons. The information reporting is designed to increase income tax compliance by US persons.

Under the proposed regulations issued on February 8, 2012, any US company or its subsidiary (including a controlled foreign corporation of a US shareholder) that pays, or a non-US company that receives or pays, a "withholdable payment" is a withholding agent and may be impacted by FATCA in a number of unanticipated ways. A withholdable payment is defined as US source interest, dividends, royalties (and similar income often referred to as fixed or determinable annual or periodic (FDAP)) and gross proceeds from the sale of an asset that could produce US source interest or dividends.

Although the primary focus of FATCA is to require non-US banks, custodians, investment vehicles, and insurance companies (referred to as foreign financial institutions) to identify US account holders and report account balances (among other information) to the Internal Revenue Service (IRS), FATCA also requires withholding agents (US and non-US entities) to provide certain information to the IRS. Specifically, withholding agents may need to identify foreign financial institutions and certain non-financial foreign entities (NFFE) (including when these NFFEs have substantial US ownership). If the NFFE fails to provide the proper certification or if a foreign financial institution is not compliant, the withholding agent is required to withhold tax at 30 percent on the withholdable payments.

## *Common Misconception: FATCA only affects the financial services industry. NOT TRUE.*

Although much of the burden of FATCA will be felt by entities within the financial services industry, most MNCs will also be affected by FATCA in one way or another.

### **FACT 1: Almost any MNC making payments of US source income will feel the impact of FATCA.**

MNCs, and their subsidiaries, wherever located, that make withholdable payments to non-US persons are withholding agents under FATCA. As a withholding agent, the MNC may be required to obtain certain documentation regarding the payee's ("the recipient's") status, report these payments to the IRS and the recipient, and in certain cases, withhold 30 percent from these payments and remit the withholding to the IRS.

### **Impact on the Treasury Function**

FATCA generally will impact the Treasury department of a MNC because it is responsible for maintaining the MNC's worldwide cash management. In general, with respect to Treasury operations in the US, payments made by the US Treasury center may be treated as US source withholdable payments. If so, FATCA withholding and reporting may be required. Withholding may be avoided with proper FATCA-specific documentation identifying the recipient (foreign financial institutions and NFFEs) as FATCA compliant.

If third-party foreign financial institutions are used by the Treasury department to assist with worldwide cash management, MNCs should examine these legal relationships to assess (1) whether the relationship causes the foreign financial

institution to have to comply with FATCA; and (2) if so, whether each foreign financial institution will be compliant under FATCA. This is important in order to determine whether the MNC (or its subsidiaries) might be required to withhold on payments under FATCA.

In some cases, the Treasury department's derivatives, swaps and other hedging arrangements will be affected. These types of transactions frequently involve non-US counterparties that are banks (either directly or through assignment through a multi-branch or multi-party ISDA agreement) and, in some cases, the payments made are treated as being US source payments. If an MNC or its subsidiary makes US source payments to a foreign financial institution that is not in compliance with FATCA, the entity may need to withhold tax at 30-percent.

Although the FATCA rules do not change the normal sourcing rules applicable to derivatives and foreign currency transactions, these products may create US source payments in unexpected places (such as collateral arrangements, up-front payments and transactions with respect to US equities). Although there are grandfathering rules that may limit the impact of FATCA (i.e., payments with respect to certain obligations outstanding on January 1, 2013, as well as gross proceeds from the disposition of these obligations, are generally exempt from FATCA withholding), these rules are of limited application and many foreign financial institutions are already beginning to request changes to their ISDA agreements to address FATCA. MNCs should make sure they are comfortable with the FATCA specific ISDA language and alter processes to ensure future arrangements are compliant with FATCA.

### **Impact to Accounts Payable and other Departments**

The proposed regulations indicate that payments made in the ordinary course of a trade or business are not subject to withholding under FATCA. Consequently, the majority of payments that are made in an Accounts Payable function should not be affected by FATCA. However, one-time payments (such as litigation settlements, large acquisitions and similar transactions) raise questions about whether such transactions are in the "ordinary course of business." Similarly, payments that are defined as "financial services payments" do not enjoy this exception. Moreover, the proposed regulations do not provide a functional definition of what types of payments constitute "financial services payments." It will be important for Accounts Payable departments to identify the FATCA relevant payments and ensure procedures are in place to capture payments not in the ordinary course of business.

### **Documentation Changes**

While these requirements are similar to existing withholding and reporting requirements for payments of US source FDAP to non-US persons, the documentation that MNCs will be receiving from recipients (e.g., Forms W-8 and Forms W-9) is going to be enhanced to accommodate FATCA. There will be new tax certifications and new recipient statuses. In addition, the withholding regime will become more complex as the current withholding regime is transitioned to meet the new requirements. Reporting functions will have to be enhanced to capture and report any additional data required by FATCA. As a result, Treasury and Accounts Payable departments that process tax documentation, determine withholding, and ensure proper reporting will be required to adapt to these changes.

As part of determining if FATCA withholding applies, a number of MNCs are using this effort to also review current information reporting and withholding processes performed by Accounts Payable, and other departments to ensure compliance with other withholding payments. Withholding agents that make US source FDAP

payments to non-US persons may currently be required to report the payments to the IRS and withhold 30 percent generally. Compliance reviews related to US source FDAP payments made to non-US persons are occurring because these issues are required to be reviewed during an IRS examination. Consequently, preparation for FATCA presents a good opportunity to ensure compliance with current information reporting and withholding regimes.

**What should MNCs do?** *Given the impact of these changes and the fact that FATCA withholding will begin for certain recipients on January 1, 2014, it is not too early for MNCs to begin revising information reporting and withholding policies and procedures, developing new checklists for validating recipient certifications, and planning for training the personnel involved in the withholding and reporting process.*

**FACT 2: A number of MNCs have foreign financial institutions within their organization and, therefore, will be subject to the more onerous aspects of FATCA.**

MNCs are surprised to learn that affiliated entities could meet the definition of a foreign financial institution as the definition generally includes (in part) any entity that is primarily engaged in investing in securities. Although MNC holding companies and non-US hedging or treasury centers of a MNC group may be excluded, these exclusions may not cover offshore investment Treasury centers that invest in securities other than in hedging transactions. As an example, a Treasury center may invest in third party securities as part of its cash management functions. If this investment activity rises to the level of being the entity's primary activity, it might not be exempted.

In order to enjoy the low cost of funding provided by depository accounts, a number of MNCs have recently created "deposit taking institutions" for third party customers and their employees outside the US where the regulatory laws are favorable. Similarly, some entities similar to credit unions provide employees with a vehicle to both invest funds at an attractive rate of return and borrow funds cheaply. More commonly, MNCs often establish special purpose securitization vehicles as an efficient way to float debt. Each of these types of entities may be a foreign financial institution under FATCA and will need to become compliant with FATCA.

**Stealth Foreign Financial Institutions**

Under FATCA, a foreign financial institution could include an entity that is not technically an affiliate of the MNC but closely tied to it. These "stealth foreign financial institutions" include offshore leasing or financing companies or factoring entities, captive insurance companies, and foreign retirement plans that do not meet the limited exclusions in the FATCA regulations. Additionally, many MNCs have non-US charitable foundations and organizations. These non-US foundations and other non-US charitable organizations that are not tax exempt under section 501(c) of the Internal Revenue Code may be treated as foreign financial institutions under FATCA.

**Observation:** *The definition of a foreign financial institution is very broad and may encompass entities that are not typically considered as financial institutions, such as companies engaged in third-party industrial leasing and financing companies engaged in the factoring of receivables. In addition, while there are exceptions for investment vehicles that are thought of as posing a low risk of tax evasion, such as retirement plans and tax exempt entities, criteria for these exceptions have been circumscribed to*

*assure they are limited to low risk vehicles; consequently, some entities will not be excluded from FATCA.*

### **Unexpected NFFEs**

FATCA generally provides an exception for NFFEs whose stock is regularly traded on one or more established securities markets. This NFFE exception for public companies is good news because excepted NFFEs do not have to determine whether they have substantial US owners (generally US persons that own greater than a 10-percent interest in the entity).

This exception also applies to any related entity of a publicly traded company that is not a financial institution if the public company owns greater than a 50-percent interest in the related entity. However, an entity in which a public company has a 50-percent or less ownership interest is not eligible for this public company exception and, therefore, will not be treated as an excepted NFFE. Other unexpected NFFEs could include certain non-US foundations or charitable institutions that do not have tax exempt status under section 501(c) of the Internal Revenue Code. These unexpected NFFEs will have to determine whether they have any substantial US owners and provide additional documentation to withholding agents to avoid the 30-percent withholding tax.

***What should MNCs do? MNCs should inventory non-US joint ventures and other related entities (1) to determine ownership overlap; and (2) where relevant, to identify potential non-exempt foreign financial institutions and NFFEs and, with respect to those identified, take steps to make these entities FATCA-compliant.***

### **FACT 3: MNCs using foreign financial institutions for cash management, custody and credit services may be affected by FATCA because of these relationships.**

FATCA encourages a foreign financial institution to become a participating foreign financial institution (or a deemed compliant foreign financial institution) by imposing a significant cost -- 30-percent withholding tax -- on all US source withholdable payments received by a non-compliant foreign financial institution. This withholding tax applies to payments that a foreign financial institution receives on its own behalf, as well as payments a foreign financial institution receives on behalf of account and interest holders. If an MNC has "accounts" (including cash pooling arrangements, custody relationships and similar arrangements) with foreign financial institutions, the MNC must determine whether the foreign financial institution itself is FATCA compliant or risk facing 30 percent withholding on payments the MNC receives through the foreign financial institution. Common transactions that can be impacted by FATCA include cash sweep arrangements (both physical, zero-balance and notional) and Treasury investments held by a foreign custodian.

***What should MNCs do? For most MNCs, avoiding the FATCA withholding requirements means scrutinizing existing and future cash management and banking relationships to ensure that those relationships only are with entities that are FATCA-compliant. Financial relationships maintained by non-US subsidiaries (or non-US branches) located in countries where compliance with FATCA conflicts with local law may prove to be a significant challenge for many MNCs. MNCs may also be required to update account information and provide additional documentation to***

*foreign financial institutions where they have existing cash management, banking, and credit relationships.*

## *Effective Dates*

Information reporting under FATCA begins with certain data collected in 2013. The withholding provisions of FATCA apply to withholdable payments made on or after January 1, 2014 (withholding on gross proceeds is delayed an additional year to 2015). However, due to the complexity of account (recipient) verification and due diligence requirements, many entities (both financial and industrial) have taken steps to assess the impact of FATCA to their operations and are taking steps to minimize its impact.

## *Conclusion*

FATCA is one of the most comprehensive and complex information reporting regimes in the world. During the next few months, we would expect comment letters from institutions, industries, and other foreign governments. Treasury and IRS still expect to issue the final regulations before the end of this year. MNCs will find that FATCA has an unexpected impact on their organization; therefore, early assessment and planning is critical to minimizing risks and administrative burdens.

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