

Taking control of FATCA

Building effective internal controls
and processes to promote compliance
and certification

June 2013

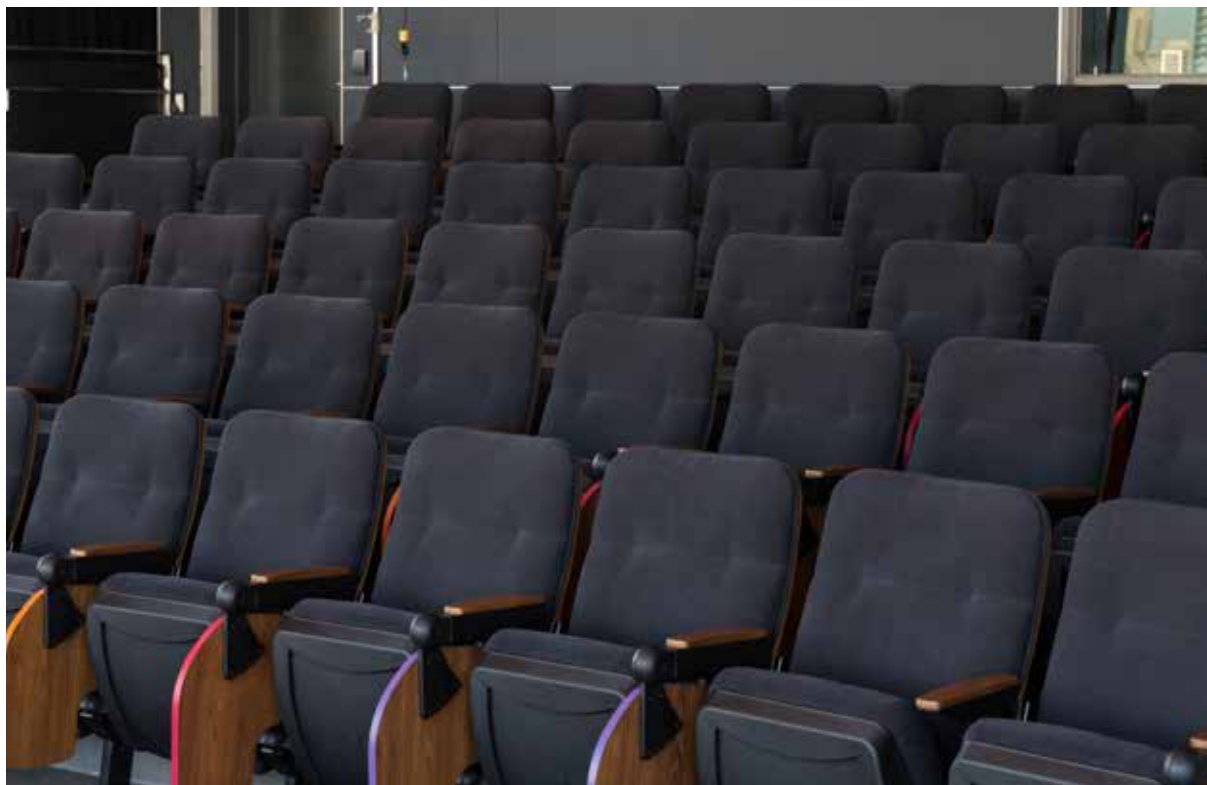


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Introduction



In January 2013, the Foreign Account Tax Compliance Act (“FATCA”) final regulations were issued, which provide an internal control certification requirement for the responsible officer (“RO”).

FATCA was enacted with the primary goal of providing the Internal Revenue Service (“IRS”) with an increased ability to detect US tax evaders concealing their assets directly in foreign accounts or indirectly through offshore entities. It aims to accomplish this goal by requiring US and non-US entities to comply with a new set of tax information reporting and withholding rules as well as investor due diligence and documentation requirements. The consequences of non-compliance include being subject to or liable for a 30% withholding tax on income from US sources 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 highlight the need for entities impacted by FATCA to develop and maintain:

- Sufficient controls around the areas directly impacted by FATCA, such as customer on-boarding, account maintenance, withholding, reporting, and the technology and operational areas that support these processes;

- Adequate infrastructure to enable ongoing compliance with FATCA’s requirements, both within and potentially outside the enterprise; and
- A FATCA compliance program sufficient to make periodic certifications to the IRS or demonstrate compliance in an IRS examination, as needed.

Although the provisions of FATCA became law in March 2010, the statute provided only the basic framework for FATCA’s requirements. Much of the details about implementation were left to the discretion of the US Department of Treasury (“Treasury”) and the IRS. After issuing preliminary guidance, the IRS and Treasury issued the final regulations (“Final Regulations”) on January 17, 2013. In addition, Treasury continues to work with a number of foreign jurisdictions around the globe on completing Intergovernmental Agreements (“IGAs”) designed to improve international tax compliance and enable the implementation of the FATCA provisions. The IGAs may change how FATCA compliance activities are performed in certain jurisdictions (such as complying with local law concepts versus the US regulations) and companies should monitor these changes.

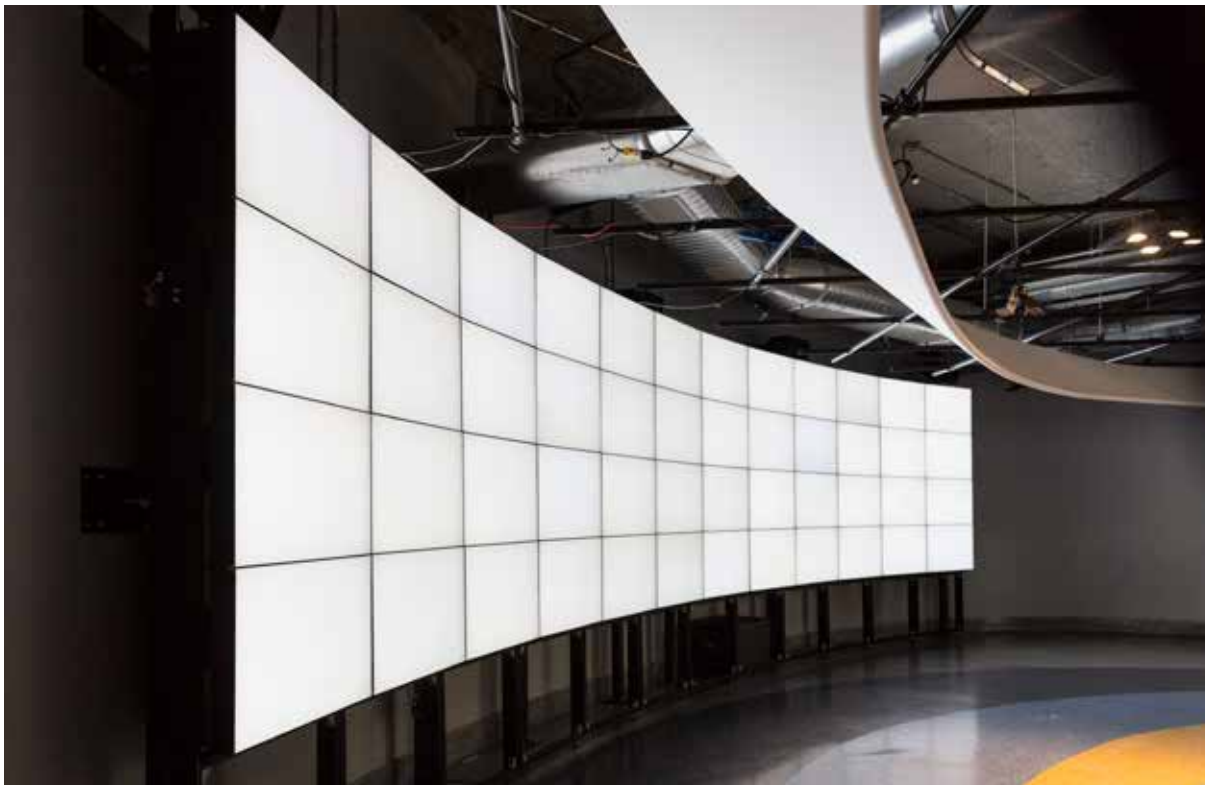
The requirements of FATCA, and to varying degrees the IGAs, broadly include:¹

- **Enhanced due diligence on account holders and investors** – Financial institutions must employ prescriptive due diligence procedures on their account holders, investors and other persons and obtain additional documentation as required.
- **Tax reporting** – Financial institutions will be required to report more transactions and financial account relationships to either the IRS or their local government.
- **Tax withholding** – Financial institutions will need to withhold US tax from a variety of payments that are made to recalcitrant account holders and non-participating foreign financial institutions (“NPFFIs”).²
- **Governance** – FATCA requires many foreign financial institutions (“FFIs”) to enter into an agreement with the IRS (“FFI Agreement”). The final regulations also require many FFIs to appoint an RO who, on behalf of an FFI is required to provide certifications to the IRS about the FFI’s compliance with FATCA.

¹ These provisions are being phased in over a number of years beginning in 2014.

² A recalcitrant account holder is an account holder of a participating foreign financial institution (“PFFI”) who does not provide adequate documentation or information within a prescribed timeframe.

Focus on certification



FATCA’s tax information reporting, withholding and investor due diligence requirements are imposed on financial institutions both in the US and abroad.

While FATCA’s requirements apply broadly to both FFIs and US withholding agents (“USWAs”), certain FFIs are required to register with the IRS and enter into FFI Agreements. These FFIs will need to make certain certifications to the IRS regarding compliance with the FFI Agreement. To make certain that FFIs who enter into Agreements with the IRS are in compliance, the IRS will require such participating FFIs (“PFFIs”) to appoint an RO who will make these certifications. 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 entity to US tax withholding under FATCA. As such, an internal sub-certification program should be implemented to facilitate this process. For USWAs that do not need to certify, an internal sub-certification program should be considered, as an industry leading practice, to enable consistent compliance with FATCA across the organization.

In addition to core FATCA certification requirements, IGAs must also be considered. Although a requirement for compliance certification is not explicitly included in the model IGAs, global organizations that operate in both FATCA and IGA jurisdictions should consider a global compliance program. In IGA jurisdictions, evidence of a control framework may need to be provided to local regulators if the entity is questioned regarding its compliance or is trying to remediate instances of non-compliance.

Certifications required under the final regulations

Although the IRS has not yet published a draft of the FFI Agreement, the Final Regulations outline the following series of “one-time” certifications regarding PFFI compliance.

Type of certification	Frequency	When is certification required?
Completion of due diligence and documentation requirements on pre-existing accounts	One-time	60 days after the 2nd anniversary of the FFI Agreement
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

In addition to the one-time certifications shown above, the RO must also periodically certify to maintaining effective internal controls to the IRS, specifically stating:

1. The RO (or its designee) has **established a compliance program** that is in effect **as of the date of the FFI Agreement**, and that the compliance program has been subject to a review of its effectiveness.
2. There were no material failures during the certification period, or, if there were material failures, appropriate actions were taken to remediate such failures and to prevent such failures from reoccurring; and
3. With respect to any failure to withhold, deposit, or report to the extent required under the FFI agreement, the FFI has corrected such failure by paying taxes due (including interest and penalties) and filing the appropriate return (or amended return).

Considering that the certification period begins with the effective date of the FFI Agreement, there are about 6 months left to design and implement a FATCA controls framework to comply with the periodic certification requirements.

The role of the responsible officer and the need for effective controls

FATCA's rules are far reaching and complex, affecting many legal entities, lines of business, and various functions, all of which must be analyzed and potentially modified to achieve compliance. In a large organization, data sources and business processes can vary across products and geographies, only adding to the complexity.

The Final Regulations do not dictate who in the organization should fill the role of the RO, so PFFIs must make their own determination of who is best qualified for the job. Although

FATCA is essentially a tax regulation, its impact goes well beyond the traditional role of corporate tax, as it significantly impacts client onboarding and maintenance, and transaction processing such as tax withholding and calendar year-end reporting. As such, the RO may not necessarily be someone within the tax department. However, the person chosen should have sufficient authority in the organization to enable compliance across a wide variety of functions, and have a broad view of the entity's operations to effectively monitor compliance. Considering that the RO certifies compliance, he or she has a vested interest in the development and implementation of FATCA compliance policies and procedures.

While organizations are currently focused on the process and technology changes necessary to become FATCA compliant by the impending deadlines, they must not lose sight that FATCA compliance will be an ongoing,

***FATCA checkpoint:
If your organization has multiple FFIs located around the world, how will you ensure that each FFI is in compliance?***

and complicated responsibility. Organizations should take a step back from their current implementation focused activities and consider whether it is more efficient and effective to establish the appropriate compliance framework now, or revisit these requirements later. USWAs, FFIs and large multinational organizations that have begun to consider compliance certifications and controls as part of their FATCA programs have started to realize that existing controls related to tax information reporting are often inadequate or non-existent. Designing and implementing

the controls framework now has the added benefit of evaluating new business models that are being adjusted to meet regulatory requirements to potentially head off control issues before they present challenges in 2014, post-implementation.

Although an FFI's requirement to establish a robust controls framework to comply with FATCA is relatively new, the concept of a controls framework is not new to the IRS or information reporting audits. The IRS Internal Revenue Manual notes that, "Evaluation of the written procedures (or

lack thereof) may provide the examiner with an indicator of the overall reliability of the US entity's existing withholding tax functions such as withholding and reporting for non-resident aliens. This assessment may assist in determining the extent of additional audit procedures, such as the review of account files statements and withholding certificates". As such, having a robust controls framework is important and a potentially overlooked factor for US entities as well.

Key action items for the responsible officer

While the requirement for an RO is one individual per FFI, some organizations have already determined that a support structure, consisting of multiple functional competencies, is critical. Under this model, organizations have begun plans to establish an RO at the top of the organization

to provide guidance and oversight to various functional areas. The benefit of such a structure is to ensure that FATCA certifications and the supporting sub-certifications are performed at the appropriate levels throughout the enterprise.

Regardless of the structure, a single RO in a smaller organization or the “Responsible Office” in larger ones may have the following responsibilities:

- Ensure that sub-certifying officers are in place across each relevant key process/jurisdiction, etc., and that they have the appropriate authority to execute their responsibilities.*
- Communicate FATCA policies and procedures across the organization.*
- Development and maintenance of effective internal controls to ensure compliance with the regulations.*
- Ensure that FATCA-related compliance training on policies and procedures is conducted regularly for all impacted parties.*
- Leverage internal audit, compliance, risk management, or external parties to self-test compliance in each relevant territory/area.*
- Periodically review that the appropriate procedures have been performed across the organization, for all impacted legal entities. If key functions (e.g., account setup, reporting, income payment processing, tax withholding, etc.) have been outsourced to a third party service provider, develop/execute a program to ensure the provider is FATCA compliant with respect to the financial institution’s accounts/processes.*
- Review all sub-certifications and follow up on any issues identified. Certify to the IRS in a timely manner and disclose any material failures. Ensure that schedules are in place to monitor required certifications to the IRS.*

Building a FATCA controls framework



When building an effective controls framework, organizations must begin with a detailed understanding of what is required under FATCA regulations.

A FATCA controls framework should be designed around business processes that have as their foundation, regulatory and business requirements. These business processes span many FATCA-impacted areas, such as the creation, purchase, sale and liquidation of legal entities (e.g., identifying USWAs or FFIs), client account due diligence, transaction processing, tax withholding, reporting, and certification/governance. The controls framework should specify objectives aimed at mitigating risks of non-compliance, and also provide “industry leading practice” controls for organizations to follow. Within the framework, organizations should not only document controls, but assess if there are any gaps (e.g., no control to meet a particular objective or inconsistent controls across territories, etc.). For example, the table below provides a limited excerpt of how this may take shape.

Example FATCA controls framework (excerpt)				
Area	FATCA summary requirement	Risk	Control objective	Sample key control
Legal entity monitoring	The creation, purchase, liquidation and sale of non-US entities should be monitored for their FATCA classification.	A new legal entity that should be classified as an FFI is not identified and registered with the IRS resulting in non-compliance.	Controls provide reasonable assurance that changes in the enterprise’s legal entity structure are appropriately identified and approved by appropriate personnel.	The approval of new entities includes a determination of their FATCA classification and required next steps (e.g., FFI registration) are taken.

Example FATCA controls framework (excerpt)

Area	FATCA summary requirement	Risk	Control objective	Sample key control
Client account assessment	Review information collected with respect to an individual account holder claiming to be non-US for US indicia.	Certification of compliance is incorrect as a review for potential US indicia was not completed.	Controls provide reasonable assurance that non-US accounts are adequately reviewed for US indicia.	<p>Evidence of review of a non-US account was performed and completed by the appropriate personnel.</p> <p>Periodically, an exception report highlighting accounts without required approval is produced and reviewed for follow up by authorized personnel.</p>
Certification procedures	The RO must make periodic certifications with regards to ongoing compliance and effective controls.	Sub-certifications do not cover all business functions impacted by FATCA, or areas of the organization are not included in the FATCA compliance program.	Controls provide reasonable assurance that the certification process includes all relevant business functions impacted by FATCA.	<p>All functional areas of FATCA impacted legal entities have been identified and included in the compliance program.</p> <p>The sub-certification structure is reconciled to the list of all functional areas to ensure all key business functions have been properly included.</p>

Developing a certification framework



In addition to a controls framework, a certification framework should also be established to ensure that every relevant part of the organization is represented in the certification process.

The RO or Responsible Office of an FFI should consider appointing sub-certifying officers across each of the relevant businesses or functions and assign them the responsibility of certifying compliance for their respective areas.

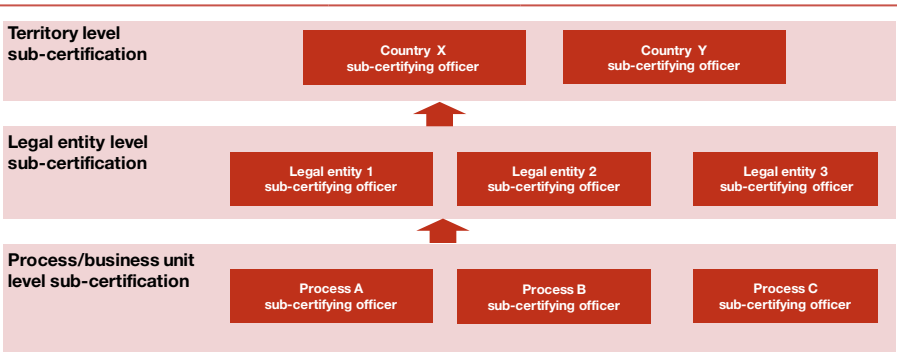
Because of the complexity of ensuring compliance, financial institutions may need to view their operations from several perspectives to determine who the most appropriate sub-certifying officers should be. The framework will vary from one financial institution to the next depending on the structure of the organization. For example, in organizations with a regional focus, the head of each region might be assigned the role of sub-certifying officer. In other organizations, this role might be

filled by business unit leaders. Depending on the size and complexity of the organization, there may be several additional sub-certifying officers below these levels – for instance, functional heads, or individuals assigned to legal entities. There must be enough sub-certifying officers assigned to ensure that all parts of the organization which are affected by FATCA are in compliance with its requirements. These officers must have the requisite expertise so that the RO has the confidence that all sub-certifications are performed timely and accurately. For USWAs, the development of a sub-certification structure is a leading practice to ensure that FATCA compliance continues to be achieved. A sample certification framework is illustrated below.

FATCA checkpoint:

- *Have you developed a sub-certification process to enable disparate reporting units to provide assurance to the RO?*
- *Are all sub-certifying officers well qualified for the position?*

Sample responsible officer governance structure



Considerations for third party providers

Financial institutions frequently use third party service providers to perform functions that fall under the scope of FATCA (e.g., an administrator that provides services to an investment company). The RO must include such service provider relationships into its enterprise FATCA compliance program. This may include the oversight

of third parties and the review of relevant documentation that gives the RO comfort that controls are in place at third parties to ensure compliance. This changes the relationship between PFFI's and their service providers who will have to work more closely together to allow the RO to make the necessary certifications.

Conclusion



Most organizations implementing FATCA are currently focused on addressing core requirements around due diligence, withholding and reporting. However, leading organizations are beginning to simultaneously address governance, compliance and controls frameworks. Early “lessons learned” from such governance activities indicate that the level of complexity to implement controls will be significant, the controls and sub-certification framework will likely be multi-dimensional (e.g., by function, business unit, and geography) and the FFI Agreement certifications by the RO will require significant coordination and communication across the enterprise. In our view, institutions should focus on designing a compliance and controls framework concurrent with the core FATCA implementation effort.

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