Financial Services - Indonesia

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Ready, set, FATCA:

How the new rules will affect insurers, and why early action July 2011 is the best policy

Introduction

In March of 2010, the Foreign Account Tax Compliance Act (FACTA) provisions became law with the enactment of the Hiring Incentives to Restore Employment (HIRE) Act. FACTA imposes additional US information reporting requirements on financial institutions, as it requires financial institutions(FI) to employ enhanced due diligen procedures to identify US persons using either non-US financial accounts or non-US entities to evade US taxes. Although substantial portions of the law are left to be written as regulations, the statutory definitions are very broad and not only classify insurance companies as financial institutions, but many types of insurance contracts as financial accounts. Failure by a non-US financial institution (referred to as foreign financial institution (FFI) in the law) to comply with FATCA's requirements will subject the institution to a 30% withholding tax on any "withholdable payment" made to its proprietary account. In turn, any US financial institution that fails to obtain the proper documentation and withhold from an account holder on a "withholdable payment" to a non-US entity will be subject to a failure to withhold penalty of 30% on any such payment.

The definition of a "withholdable payment" under the statute is broad and includes not only interest, dividends, rents, and other US source passive income, but also the gross proceeds on the sale or disposition of property that could produce US source interest or dividend income. For example, a non compliant FFI receiving gross proceeds of $1 million on the sale of a US Treasury bond from the FFI's proprietary trading account (even if held for a just day) could be subject to a $300,000 withholding tax. In addition, at the transaction level, all companies (both US and foreign) will need to review payments to non-US entities to determine if the payment is subject to FATCA and whether the payee has provided the appropriate FATCA documentation or it will be liable for the 30% withholding tax on that payment and any associated interest and penalties.

As such, based on current guidance, FATCA will generally require:

- Non-US insurance companies (FFIs) to identify their US policyholders and report payments made to them to US tax authorities on a number of different products as part of their agreement with the IRS to be FATCA compliant;
- Non-financial foreign entities (NFFEs) to either provide the identity of any substantial US owners or certify that there are none;
- US insurance companies to enhance their current analysis of certain entity policyholders for either FATCA compliance (in the case of an FFI)or US ownership (in the case of an NFFE); and
- All companies,US and non US, will be required to do an analysis of any foreign company before they make a payment to determine if the payee is required to comply in some form with the FATCA rules and that it has in fact done so, or withhold tax on that payment.

Beginning January 1, 2013, insurance companies will need to have in place a process to review all information recieved from policyholders for indicators that the policyholder may be a US person.

The provisions of FATCA are generally effective for payments made after December 31, 2012, so the time available for insurance companies to enhance their due diligence procedures to be able to request, collect, review and store the additional account holder information required under FATCA is short.

Impact on insurance companies

To avoid FATCA withholding, all non-US insurance companies will be required to enter into an FFI agreement with the IRS, and obtain an identification number to certify they entered into a FATCA agreement with the IRS. An entity that enters into a FATCA agreement will need to implement a preseribed process to identify individual policyholders who are US citizens or residents, and in the case of an FFI that is a policyholder, verify FATCA compliance. For payments made to non financial foreign entities (NFFEs), the insurance company will need to obtain the name, address, and TIN of each US owner or certification from the NFFE that there are no such US owners.

US insurance companies are already subject to a number of US information reporting requirements on payments (e.g., Forms 1099-R, 1099-Misc, etc.) and have been feeling the pressure of the IRS stepping up its enforcement in this area.

CCO or equivalent must certify FATCA compliance

As part of the FATCA certification process, the responsible officer (the CCO or equivalent) must certify that between May 9, 2011 and the effective date of the FFI agreement FFI management personnel did not engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging, or assisting account holders with respect to strategies for avoiding identification of their accounts as US accounts.

FATCA now requires US insurance companies to also enhance their due diligence process to determine whether the FFIs and NFFEs who own policies are FATCA compliant or withhold 30% on certain payments under these policies. In addition, US insurance companies also need to review the types of payments made to non-US counterparties and whether the counterparty is FATCA compliant; otherwise the US insurance company becomes liable for the withholding tax.

Domestic insurers should not be lulled into thinking that the "Foreign" in FATCA relieves them of compliance responsibilities.

With the combination of cross-border withholding being a top three priority audit issue and these requirements under FATCA. many US insurance and non-insurance companies are finding that their existing compliance efforts may be insufficient.

Insurance entities and products subject to FATCA

Unfortunately, while the guidance issued to date clearly includes insurance companies in its broad grasp, there is not complete clarity about which entities and products are within the scope of FATCA. What is clear is that insurance companies, foreign and domestic, will need to reevaluate the types of information collected from clients to determine whether the policy holder or counterparty is compliant.

Fortunately, the statute grants the Secretary of the Treasury regulatory authority to exclude or include insurance companies and certain products based on the probability of being used for US tax evasion. The IRS has already announced its intentions to exclude certain insurance companies, such as those that solely issue property and casualty insurance from FATCA and potentially narrow the focus of FATCA to insurance products with just a cash value (investment) component, such as whole and variable life and annuity products.

Products in scope*

Most likely out of scope	Probably out of scope	In scope or most likely in scope
• Term Life • Reinsurance • Property and casualty insurance • Group benefits without cash value	• Group retirement and pension • Group benefit plans without cash value	• Annuity products with cash value • Life products with cash value • Mutual funds (separate accounts and retail) • Group benefits with cash value • Regulated banking operations (thrifts, bank holding companies) • Investment management operations (managers of general and separate account funds)

* Based on interpretation of currently available guidance.

Challenges for insurance companies

Current FATCA guidance is not easily applied to insurance companies because the initial guidance has focused on banks, banking products and to a lesser extent, the asset management industry. The insurance industry is different from banking and asset management. For this reason, the Internal Revenue Code and Treasury Regulations separate corporate insurance taxation rules from both the general corporate and banking rules.

Although substantial portions of FATCA are left to be written as regulations, the IRS has only issued some directional guidance to affected organizations to begin implementing the systems and processes required to comply fully with the new withholding, documentation and reporting requirements.

While the guidance to date is clearly directed at the banking sector, it is of limited use for insurers. There is still a need for greater clarity regarding the application of FATCA to the insurance industry especially given that it will take 12-18 months for companies to create the process, systems and procedures necessary to comply. Since the initial guidance has primarily focused on banking the insurance industry will be challenged to adapt quickly and move forward with implementation as more guidance becomes available.

More IRS guidance needed

The IRS has issued three rounds of guidance related to FATCA, but insurance companies require more definitive guidance to answer outstanding questions such as:

- Will any type of policy issued before the effective date be grandfathered?
- How to comply with FATCA in light of country-specific privacy laws?
- Will there be a “de minimis” rule (cash value or premium paid) for insurance contracts?
- How will FATCA apply to companies and products in “run-off”?
- Which types of group contracts can be excluded?
- How to properly identify complex insurance products for compliance?
- How to manage the legal and practical difficulties with respect to withholding on passthru payments?
- Will the due diligence process require evaluating information from low risk products (i.e. property and casualty)?
- Will there be a “good faith” effort relief from penalties?

Classifying accounts

Payments on products within the scope of FATCA will require insurance companies to investigate all payments to non-US entities in order to determine if the payee falls into one of many categories created by FATCA. These classifications include, among others:

- Documented US person
- Participating FFI
- Deemed compliant FFI
- Non-participating FFI
- Exempt FFI
- Compliant NFFE (substantial US owners)
- Exempt NFFE (no substantial US owners)
- Recalcitrant

For payments to non-US entities who do not comply, insurance companies will have to withhold a 30% tax from all withholdable payments. Not only must the new FATCA classifications be captured; the categories also must flow throughout business and operational processes, technology and systems. In addition, the classifications must be monitored and updated on a regular basis in order to maintain FATCA compliance.

Enterprise-wide impact

As opposed to banking or brokerage, insurance is generally a "low touch" business - meaning insurers frequently do not have contact with their policyholders except at the initial purchase of the product and then when a payment is made related to the product. Bankers and brokers frequently make payments throughout the year (interest, dividend etc.) and consequently have several times within a year to communicate with their customers. Therefore, FATCA poses specific challenges to the insurance industry. Often the only contact an insurer has with a policyholder is when a policy is purchased or when there are policy changes and transactions during the lifetime of the policy. Companies may need to change how and how often they interact with their policyholders. Opening new accounts may require more documentation, and companies may have to follow up with customers to ensure that all required forms (e.g., W-8 forms) are kept up-to-date. In addition, information captured for on-boarding, AML/KYC, tax withholding and reporting, and credit risk information, as well as any other information captured for any regulatory purpose will need to reviewed for indicia of US status or for inconsistencies. This is an area for which the insurance industry continues to seek more guidance, as achieving compliance in this area would require some fundamental administrative changes to processes.

FATCA will have far-reaching implications and present significant challenges for many insurance companies. The new regulations will require changes to front, middle and back office technology and operations as well as analysis and integration of disparate areas.

Because FATCA impacts processes and systems throughout the organization and requires new information collection and reporting systems and procedures, addressing it will require a multidisciplinary effort. FATCA is not just a tax initiative but a regulatory requirement. To achieve and maintain compliance with the new regulation, insurance companies will have to develop multidisciplinary support teams that include not only tax specialists but specialists from service and operations, information technology (IT), and compliance.

Classifying accounts

Despite the fact that regulations have yet to be issued, insurance companies should begin planning their FATCA compliance efforts today. The window of time available to prepare for these rules is relatively narrow, and implementation will require a substantial amount of work, especially for large multi-national insurance companies. For such large organizations, it could take two months or more justto identify and mobilize a multidisciplinary global program team that can focus on the multiple impact points across the enterprise. In addition, FATCA may require significant resources and budgets throughout 2012, and thus should be considered in the budgeting cycles for the last half of 2011.

By taking steps today to address FATCA, insurance companies can gain a better sense of the time, staffing and budget required to achieve and maintain compliance. Starting too late will leave less time to carry out essential prioritization of operational changes. IT enhancements and compliance-related activities.

A three-step approach to compliance

FATCA compliance activities can be divided broadly into three steps:

1) Current state analysis; 2) Future state and roadmap development; and 3) Implementation. Insurance companies can take significant action to complete the first two steps before any regulations are published, and even take-small steps toward implementation.

Each compliance activity should be viewed through six dimensions-factors that could be affected by FATCA: people, process, technology, governance, standards and data. Many financial institutions focus too narrowly on one or two of these six dimensions and minimize the others. For instance, an insurance company might focus on data requirements and building new technology to address FATCA but fail to adequately address the governance processes that are essential to achieving and maintaining compliance. All six dimensions must be kept in mind as the organization proceeds through the threestep compliance process.

In addition, an organization should consider which of the following eight functions should be involved at each step in the compliance process: operations, tax operations, technology, legal, compliance (AML/KYC), on-boarding, new product development, and distribution. FATCA will impact each ofthese functions in some way. A thorough, multidisciplinary approach that considers the six dimensions and eight functions at every step ofthe way will help to ensure that no detail is overlooked which could jeopardize future compliance.

To prepare for FATCA compliance even before final IRS guidance is issued, insurance companies can complete a current state analysis, begin developing a future state vision and roadmap, and start implementing some improvements to systems, processes and procedures to comply with the new regulations.

Step 1: Current state analysis

The first step in achieving FATCA compliance is to assess the current state of the organization and determine what current processes and technology can be le-ve-rage-d and which must be modified in order to be compliant. Among other activities, this step requires insurance companies to carry out the following activities;

- *Entity analysis*: Review the company's exiting organizational structure existing and entity data to identify potential US FIs, FFIs, and NFFEs.
- *Product analysis*: Identify and review the company's portfolio of policies that may be subject to FATCA
- *Business Unit analysis*: Review the documentation collection and management process for onboarding, tax withholding, and AMLjKYC to see where indicia of US ownership or entity compliance can be found. Each business unit needs to also be assigned to the appropriate legal entities.
- *Customer account analysis*: Establish the number-of us and non-US accounts/policyholders by legal entity. Identify the information collected from policy holders and gaps to remediate.
- *Review of client agreements and service level* agreements to determine FATCA data and process responsibilities.

In conducting these activities, the organization should consider the implications for people, process, technology, governance, standards and data and determine which of the eight functional areas will be affected and thus should be involved. Given the enormity of the tasks highlighted above, many organizations have conducted pilots to evaluate the impact of FATCA on a particular business unit or geography to understand particular issues prior to evaluating all business units or geographic areas affected.

Step 2: Future state and roadmap development

The next step is to develop a target operating model-a view of the future state of the organization under FATCA-and create a preliminary implementation roadmap. Key activities during this step include;

- Defining target state regulatory, business, and functional requirements;
- Defining future state operating models and technical architectures;
- Conducting a gap analysis (current vs. desired future state);
- Creating a plan to rernediate existing accounts and develop new "business as usual" processes;
- Prioritizing roadmap and implementation plan by business unit; and
- Developing a business rase and funding request.

As with the current state analysis, for each activity in Step 2, the organization should consider the implications for people, process, technology, governance, standards and data as well as the eight functional areas that could be impacted by FATCA.

Step 3: Implementation

Until final FATCA regulations are issued, organizations will not be able to execute fully on the implementation roadmap. That said, the IRS has issued enough guidance at this point to enable insurance companies to identify gaps between the current and future states and implement many needed improvements to systems, processes and procedures to comply with the new regulations, such as gathering required customer data and ensuring communications across systems that will be affected by FATCA. In addition, firms can begin to educate customers and affected business units about the new data collection and reporting requirements. Doing so now will help to avoid potential problems later, when FATCA goes into effect.

How PwC can help

PwC can assist insurance companies in evaluating the impact of FATCA on their organizations and in planning and executing the steps required to achieve compliance. To meet our clients' needs in this area, we have established a global network of financial services industry FATCA specialists located in key capital markets throughout the world. These professionals are part of our Global Information Reporting (GIR) practice, which brings together tax specialists and advisory professionals worldwide who combine expertise in the intricacies of tax law with deep knowledge of local jurisdictions, rules and regulations as well as clients' local operations.

During the past several months, we have been working with financial institutions in banking, insurance and asset management. Our teams have been working with clients to conduct current state assessments and gap assessments. We also helped to establish training programs and global FATCA program management offices (PMO), that provide the tax and regulatory expertise needed, to get organized around FATCA's requirements.

PwC's global coordination and experience can result in a more efficient process that saves both time and money to implement the required changes.

Conclusion

The US government continues to solicit input from stakeholders about FATCA. Proposed regulations are not expected until the latter half of 2011, and it could be almost a year or more before final regulations are issued.

The scope of FATCAis enormous, the 30% withholding tax is punitive, and the time left to prepare for compliance is short-call of which reinforces the importance of taking action now. Many financial services firms have begun to do so: of 685 firms responding to a PwC survey in March 2011, more than half (55%)were planning to perform a current state assessment over the next few months, and 17% had completed one already. Of the latter group, 85% believe their FATCA compliance effort will be significant.

By planning the work needed for compliance, and completing as many preliminary steps as possible today, insurance companies can minimize the disruption to their business operations as the FATCA deadline approaches.

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