The FATCA Challenge Facing Caribbean Banks

Paul W. Eldridge
Managing Director, Tax
PwC Bermuda

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Executive Summary

FATCA is an acronym for the Foreign Account Tax Compliance Act ("FATCA"), which was enacted into law on March 18, 2010 as part of the Hiring Incentive to Restore Employment ("HIRE") Act. FATCA seeks to identify US taxpayers who have accounts in foreign financial institutions ("FFI") or ownership interests in non-financial foreign entities ("NFFE") and will enforce information reporting through the threat of a withholding tax.

When fully phased in, FATCA will require withholding agents to withhold a 30 percent tax on US sourced income (e.g., interest, dividends, rents, royalties, annuities, etc.) on payment to FFIs or NFFEs. More onerously, a 30 percent withholding will eventually be levied on gross proceeds (not net profit) from the sale of assets that generate US sourced interest or dividends. Withholding can be avoided if an FFI enters into a binding agreement with the IRS by July 1, 2013 and agree to information disclosures, documentation and other due diligence compliance activities. NFFEs avoid withholding by either certifying to the US Internal Revenue Service ("IRS") that it has no US shareholders or disclosing information about its "substantial" (more than 10%) US owners.

An FFI is defined by FATCA as broadly as you can imagine, sweeping in commercial banks, broker dealers, trust companies, investment funds, and life insurance companies as well as many other entities (see page 5).

As the discussion starting on page 9 indicates, FATCA requires an FFI to primarily perform four tasks:

1. Identify new US customers;
2. Examine existing customer information for indicia of US status;
3. Annual reporting on US accounts; and
4. Foreign passthru withholding on payments to recalcitrant account holders and non-participating FFIs

These four obligations must be performed between 2013 and 2017 according to a phased in timeline established by the IRS (see page 11). The timely completion of these four obligations must be certified by an officer of the FFI. While the regulations will be finalized in 2012, Caribbean banks and other financial institutions should now begin to assess how FATCA will impact their organizations in order to meet the phased in deadlines beginning July 1, 2013.

The "foreign passthru payment" mechanism is an anti-abuse rule designed to prevent an FFI becoming a "blocker" for a non-participating FFI or US person trying to avoid US taxes by making indirect investments in US assets. As we discuss on page 13, the foreign passthru payment mechanics are a major unresolved issue for banks and other FFIs. The IRS has essentially "kicked the can down the road" by deferring withholding on foreign passthru payments to January 1, 2017 at the earliest. Starting on page 14, we highlight the many process and technology considerations financial institutions may face in complying with FATCA.

We outline in our report some of the implications of FATCA for Caribbean banks starting on page 16. These specific challenges include:

1. Local country law (such as privacy, secrecy, and regulatory laws) may conflict with FATCA regulations that could hinder timely compliance;

2. Possible loss of capital and business flight to other jurisdictions as result of participating FFIs not wanting to conduct business with a non-compliant FFI either by choice or due to conflicting local laws;
3. The impact of the proposed alternative to FATCA compliance as currently proposed to be implemented by country to country information exchanges. The United States and five European countries (Ireland and others have joined as well) have issued a joint statement to create an inter-governmental information reporting exchange between nations, which may be a precursor of a long term general adoption of a worldwide exchange of taxpayer information between countries.;
4. Common technology challenges endemic to FATCA. The FATCA fallout for an organization may affect many of their enterprise operations and technologies in order to comply. In addition, many commercial banks in the Caribbean have significant paper records for their account holders and it may be costly challenging to conduct reviews of those files.;
5. The proposed FATCA regulations contain several categories of deemed compliance status, which potentially applies to banks and which if applicable can ease the FATCA compliance burden.

FATCA is here to stay. The US Internal Revenue Service has issued three notices and almost 400 pages of proposed regulations to date. It has essentially reaffirmed its timetable for full implementation. Although the IRS will continue to listen carefully to financial institutions' concerns and may make small changes in the law to aid compliance, there will likely not be major modifications and certainly no repeal. Indeed, the joint statement between the United States and the five European countries is most likely the opening move in creating a central worldwide clearing house for the exchange of taxpayer information between nations.

THIS DOCUMENT WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, FOR THE PURPOSE OF AVOIDING TAX PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER

A. Summary of the provisions of FATCA Regulations

What is FATCA?

"Each year, the United States loses an estimated $100 billion in tax revenues due to offshore tax abuses." – US Senate permanent Subcommittee on Investigations Staff Report on Dividend Tax Abuse, 11 September 2008.

FATCA is an acronym for the Foreign Account Tax Compliance Act ("FATCA") provisions enacted as part of the Hiring Incentive to Restore Employment ("HIRE") Act On March 18, 2010 (P.L. 111- 147). FATCA creates a new information reporting, documentation and withholding regime in the new "Chapter 4" of the Internal Revenue Code. FATCA is intended to increase transparency for the Internal Revenue Service with respect to US persons that may be investing and earning income through non-US financial institutions and other foreign entities (and not reporting this earned income on their US tax returns.) While the primary goal of FATCA is to gain information about US persons, FATCA imposes a withholding tax where the desired documentation and reporting requirements are not met.

What are the withholding requirements under FATCA?

In general, a withholding agent is required to withhold 30% on a "withholdable" payment made to a "foreign financial institution" (FFI) or to a "non-financial foreign entity" (NFFE), unless the FFI or NFFE satisfy certain requirements. In addition, an FFI must withhold 30% on any "foreign passthru payments" it makes to a recalcitrant account holder, as well as any foreign passthru payment it makes to another FFI unless that FFI also meets certain requirements. Under the proposed regulations FATCA withholding will begin on U.S. source interest, dividends, royalties and other passive income on January 1, 2014 and on all other withholdable payments on January 1, 2015. Withholding on foreign passthru payments will begin no earlier than January1, 2017.

A withholding agent is any US or non-US person (including an individual, corporation, partnership, trust, association, or any other entity) that has control, receipt, custody, disposal, or payment of any withholdable payment.

What is a withholdable payment?

In the simplest of terms, a withholdable payment is a payment of either: US source income that is fixed or determinable, annual, or periodical (FDAP) income; or gross proceeds from the sale or other disposition (including redemption) of property that can produce US source interest or dividend income. FDAP income includes interest, dividends, rents, royalties, premiums, and annuities.

This withholding obligation is particularly onerous for two reasons. First, since it is levied on "gross" proceeds, the obligation is not limited to profits from the sale of a U. S. security but could also apply to further reduce your recoverable basis in an investment on which you had already suffered a loss. Second, capital gains on US source income are not currently taxed or withheld upon under US tax law when the recipient is a non-resident alien or a foreign corporation. A foreign passthru payment is any other payment made by an FFI to the extent that such payment is attributable to a withholdable payment.

What is not a withholdable payment?

There are seven items that are not to be withholdable payments. They include:

1. Payment where the withholding agent lacks controls, custody or knowledge of a payment;
2. Certain short-term obligations (any obligation payable no more than 183 days from its issue date.)
3. Income effectively connected to a US business
4. Ordinary course of business payments;
5. Gross proceeds from sale of excluded property;
6. Sale of fractional shares; and
7. Certain accrued interest.

B. Entities affected by FATCA

What foreign organizations are subject to FATCA's new information reporting and withholding requirements?

FATCA requires withholding agents to withhold a 30% tax on US source FDAP income and gross proceeds of investments generating US source dividends and interest to foreign financial institutions ("FFI") and certain non-financial foreign entities ("NFFE"). As one can see in Table 1, the definition of an FFI is very broad and is expected to encompass a number of entities generally not considered to be financial institutions.

- Foreign Financial Institution (FFI) – any foreign entity that is not specifically excepted that:

Activity:	Examples:	
1. **Accepts deposits in the ordinary course of a banking or similar business (Type 1); or**	▪ Commercial banks ▪ Savings and Loan Associations	▪ Credit unions ▪ Co-operative banking institutions
2. **As a substantial portion of its business, holds financial assets for the account of others (Type 2); or**	▪ Broker Dealers ▪ Clearing Organizations ▪ Trust Companies	▪ Custodial banks ▪ Custodian of Employee Benefit Plan
3. **Is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities, or any interest in such assets (including derivatives such as forwards, futures or options) (Type 3); or**	▪ Mutual Funds ▪ Funds of Funds ▪ ETF ▪ Hedge Funds ▪ Private Equity Funds ▪ Venture Capital Funds	▪ Commodity Pools ▪ Managed Funds ▪ Collective Investment Vehicles ▪ Sovereign Wealth Funds
4. **Is an insurance company (or holding company of an insurance company) obligated to make payments with respect to cash value insurance contracts and annuity contracts (Type 4).**	▪ Life Insurance, Reinsurance companies/products	
An NFFE is any foreign entity which is not an FFI		

Table 1. Definition of foreign financial institutions

How can an FFI avoid 30% foreign withholding?

An FFI can avoid the 30% FATCA withholding tax by signing a legally binding agreement with the US Internal Revenue Service ("IRS") by June 30, 2013. NFFE‟s can avoid the 30% FATCA withholding tax by either certifying to the IRS that they have no US owners or identify any "substantial" (more than 10%) US owners. An FFI that enters into an FFI agreement with the IRS is referred to as a participating foreign financial institution ("PFFI"). An FFI that does not enter into an agreement with the IRS is referred to as a non-participating foreign financial institution (NPFFI). A NPFFI is subject to a 30% FATCA withholding tax as described above.

An FFI Agreement is an agreement between the IRS and a FFI. Although the IRS has not yet made a model version of the agreement available (although a draft model agreement has been promised for release by the IRS in sometime in 2012); it is expected that the provisions of the agreement will require an FFI to perform the following functions:

- Obtain information on account holders that is necessary to determine if accounts are US accounts;
- Comply with any required due diligence and verification procedures with regard to new and existing accounts;
- Report information on US accounts and recalcitrant accounts;
- Deduct and withhold a 30% tax on " foreign passthru payments" paid to account holders who do not provide the required information ("recalcitrant account holders"), or a "NPFFI" (an FFI that does not enter into an FFI agreement);
- Comply with IRS information requests; and
- Attempt to obtain from US accounts a waiver of applicable bank secrecy, privacy or other information disclosure limitations, and close the accounts if a waiver is not obtained within a reasonable period of time.

Are any foreign entities exempt from FATCA withholding on their income?

Yes, certain foreign entities are exempt because the IRS believes they pose a low risk of tax evasion. The proposed regulations provide that a withholding agent does not need to perform FATCA withholding on payments if the beneficial owner is:

- Any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one or more of the foregoing;
- Any international organization or any wholly owned agency or instrumentality thereof;
- Any foreign central bank of issue;
- Certain foreign retirement plans;
- Governments of U.S. possessions;
-

- Any FFI which primarily engages in investing, reinvesting or trading securities and other financial interests that are wholly owned by one of the previously mentioned exempt beneficial owners; and
- Any other class of persons identified by the IRS or US Department of the Treasury (US Treasury) as posing a low risk of tax evasion.

Are any other foreign entities expected to be excluded from being FFIs?

Yes. The proposed regulations from the IRS and US Treasury indicate the following entities will not be FFIs, and will instead be treated as NFFEs". The US Treasury and IRS intend to exempt payments beneficially owned by these entities from FATCA withholding:

- Certain holding companies – limited to entities whose primary purpose is to act as a holding company for a subsidiary or group of subsidiaries that primarily engage in a trade or business other than that of a "financial institution."
- Start-up companies – applies to certain entities that invest capital into assets with the intent to operate a business other than that of a "financial institution," but is not yet operating the business. This exclusion only applies to the first 24 months after the entity's organization. After such time, a foreign entity will no longer qualify for this particular exclusion.
- Liquidation or bankruptcy – non-financial entities that are liquidating or emerging from reorganization or bankruptcy. This exception only applies if the entity was not a financial institution before the beginning of the reorganization or liquidation process.
- Hedging or financing centres of a non-financial group – an entity that primarily engages in financing and hedging transactions with or for members of its expanded affiliated group that are not FFIs and that does not provide such services to non-affiliates, may only be excluded from the definition of a financial institution if the expanded affiliated group is primarily engaged in a non-financial institution business.
- A foreign entity that is described in section 501(c)(3) of the U.S. Internal Revenue Code;
- Certain tax favoured retirement and savings accounts also savings accounts held by certain pension or retirement plans; and
- Certain insurance companies – entities whose business consists solely of issuing insurance or reinsurance contracts without an investment or cash value (term life, health, property, casualty, etc.)

Are all NFFEs subject to FATCA withholding?

FATCA withholding is not required on a payment to an NFFE if the payment is beneficially owned by:

- Any corporation whose stock is regularly traded on an established securities market;

- Any corporation that is a member of the same expanded affiliated group as a corporation whose stock is regularly traded on an established securities market;
- Any entity organized under the laws of a US possession and wholly owned by one or more bona fide residents of the possession;
- Any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of one or more of them;
- Any international organization or wholly owned agency or instrumentality of an international organization;
- Any foreign central bank of issue;
- Active entities defined as those with less than: 1) 50% passive income or 2) assets less than 50% of which produce passive income. Payments to so called withholding partnerships and withholding trusts –those entities that have a separate agreement to withhold with the IRS; and
- Any other class of persons identified by the IRS or US Treasury as posing a low risk of tax evasion.

C. Implications of FATCA for banks and other foreign financial institutions

What will FATCA require FFIs to do?

FATCA will require an FFI to perform four obligations. Table 2 summarizes these obligations. The "responsible officer" (e.g., Chief Compliance Officer) will have to certify to the IRS that these steps have been accomplished by the dates the IRS has established (under penalty of perjury). Table 3 summarizes the initial verifications of FATCA compliance required of a responsible officer. Table 4 summarizes the certifications of FATCA compliance the FFI's responsible officer will periodically have to make to the IRS.

One area in which the proposed regulations provide significant relief is in the due diligence that must be performed on pre-existing accounts. In addition to providing *de minimis* account exemption options for individuals (account balances not exceeding US $50,000 (except for cash value life insurance or annuities where the value cannot exceed US $250,000) and business entities (account balances not exceeding US $250,000) from due diligence procedures. The proposed regulations only require electronic reviews for individual accounts up to US $1 million. Only if the pre-existing account is over US $1 million (a "high value" account) will both electronic and non-electronic files generally have to be reviewed (and relationship managers interviewed). Also very significant is the greater reliance for business entity account due diligence that can be placed on existing "KYC/AML" due diligence requirements and information and other existing account information already held by the financial institution.

1 Identify New Customers	2 Identify Existing Customers	3 Reporting	4 Withholding
Need to enhance existing KYC/AML processes and underlying supporting technology to gather documentation to identify whether a customer is a US person or non US person and to review for US indicia	Need to search records on existing customers for indicia of US ownership. For individuals: 1. US citizenship or resident status (e.g., green card) 2. US birthplace 3. US residence or correspondence address (including a US PO Box) 4. Standing instructions to transfer funds to a US account 5. 'Care of' or 'hold mail' address as sole address 6. Power of Attorney with a US address 7. US telephone number For individual accounts of $50,000 USD or below can be excluded from due diligence procedures, For accounts below $1 million USD, an electronic search is sufficient. For accounts of above $1 million USD, all ('high value') account files must be examined. If US indicia is present or discovered when interviewing relationship managers, documentation must be requested to prove US or non-US status. For entities, accounts above $250,000 USD are subject to due diligence procedures.	Annual reporting requirements on all US persons who are not exempted and aggregate reporting on recalcitrant account holders and accounts held by non-participating FFIs	Requirement to withhold on payments made to 'recalcitrant' accounts (for example, US persons who do not provide documentation) and on foreign banks and other institutions who do not enter into FFI Agreements or are not a deemed compliant FFI or otherwise exempt from FATCA

Table 2. Four main obligations on FFIs

Table 3 lists the verification and compliance required of a "responsible officer".

Certification Required of a "Responsible Officer"
1. Within one year of the effective date of the FFI agreement, the responsible is required to certify to the IRS that to the best of responsible officer knowledge, from August 6, 2011 until the date of certification, no formal or informal practices or procedures were in place to assist account holders in the avoidance of FATCA;
2. Within one year of the effective date of the FFI agreement, the responsible officer is required to certify to the IRS that the participating FFI has completed the review of all high value accounts; and
3. Within two years of the effective date of the FFI agreement, the responsible officer is required to certify to the IRS that the participating FFI has completed the review o all other pre-existing accounts.

Table 3. Verification of Compliance

In addition to the initial certifications of the responsible officer, Table 4 lists the four continuing verification of compliance responsibilities.

The Responsible Officer of the participating FFI will also need to periodically certify to the IRS:
1. Conducted periodic reviews of the FFI's compliance with due diligence, withholding and reporting obligations under the FFI agreement.
2. The Responsible Officer may be required to provide certain factual information and to disclose material failures with respect to the participating FFI's compliance with any of the requirements of the FFI agreement.
3. Verification of compliance through a third-party audit is not required of FFIs.
4. The IRS may choose to perform an audit of the FFI in instance of suspected trends of compliance failures.

Table 4. Continuing Verification of Compliance

What is the timetable for FATCA implementation?

The deadlines for finishing the four obligations an FFI must perform under FATCA, and when withholding obligations begin are listed in Table 5. The phased implementation starts in 2013 and ends in 2017. The key dates and milestones for implementation and the dates when 30% FATCA withholding would begin are:

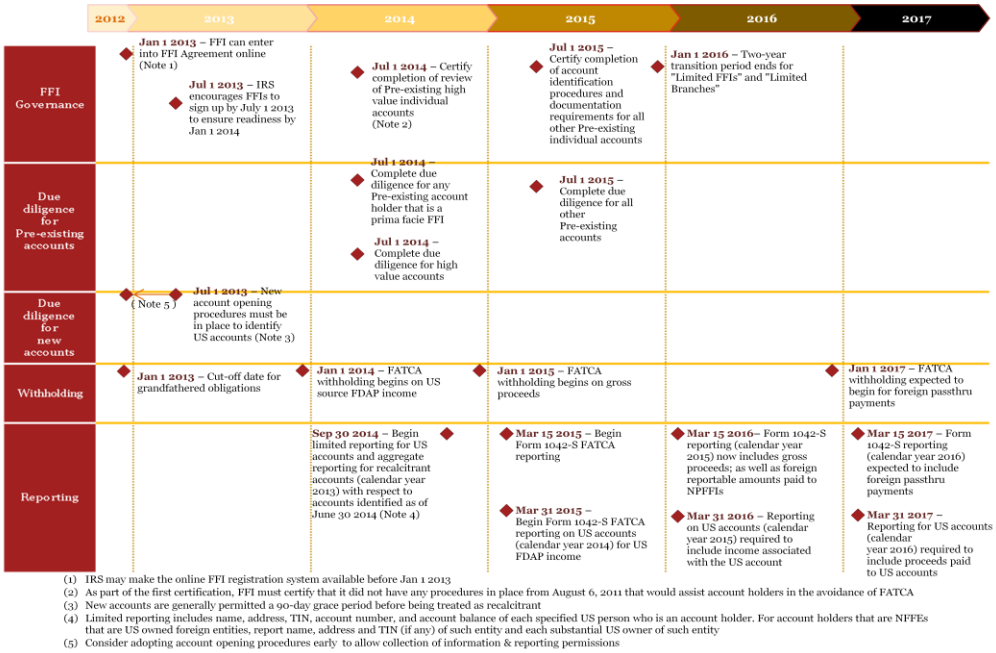

Table 5. FATCA Timeline – For FFIs (for agreements effective 7/1/2013)

What is a grandfathered obligation?

A grandfathered obligation is an obligation that is outstanding on January 1, 2013. Income payments and gross proceeds from the sale or other disposition of a grandfathered obligation are exempt from FATCA withholding. Preliminary guidance indicates that a grandfathered obligation is defined as any legal agreement that produces or could produce withholdable payments or foreign passthru payments , but does not include any instruments that is treated as equity for US tax purposes, or any legal agreement that lacks a definitive expiration date or term (for example, savings deposits, demand deposits, and other similar accounts are not grandfathered obligations because they lack a definitive term). In addition, a legal agreement that produces withholdable payments does not include brokerage, custodial and similar agreements to hold financial assets for the account of others and to make and receive payment of income and other amounts with respect to such assets. Additionally, a master agreement that only sets forth general and standard terms that are meant to apply to a series of agreements are not "obligations," standing alone. To be an obligation, there will need to be an agreement between at least two parties incorporating the standard terms on under which money will be loaned and which have a fixed maturity date when the loan must be repaid. A life insurance policy payable upon a stated age or death can also be a grandfathered obligation. Finally, any material modifications (which is determined based on the relevant facts and circumstances) to a grandfathered obligation will cause it to lose its grandfathered status.

Due diligence must still be performed on financial accounts under a grandfathered obligation. Also, grandfathered obligation status only impacts FATCA withholding obligations. Financial institutions will still have to report information on US account holders.

FATCA – how the basic system works

Table 6 summarizes the way the FATCA tax information, withholding, documentation and account information sharing system should work when fully phased in.

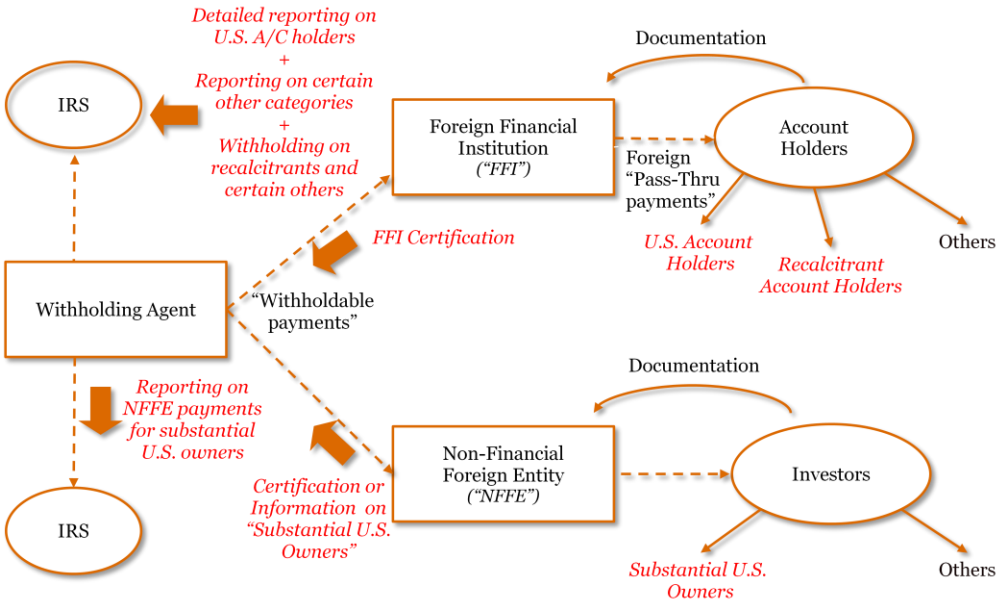

Table 6. FATCA – Overview of FATCA's Operational Document Flow

In Step 1, the FFI asks for and receives either Form W-8 BEN (indicating non-US status) or W-9 indicating US status. If the documentation is not obtained to establish the account is not a US account, the FFI will be required to report the account as "recalcitrant" account and withhold FATCA tax on US source payments to the account and ultimately to close the account if the required documentation is not received in a reasonable amount of time. In Step 2, for US account holders, the participating FFI must report certain information to the IRS with respect to US accounts it maintains. The extent to which reporting is required is also staggered, with simplified reporting on calendar year 2013 balances due on September 30, 2014 and full FATCA reporting beginning in 2017 . Among the items of information which must be reported are:

- The name, address and US tax identification number (TIN) of each account holder that is a US person or;
- In the case of any account holder that is a US owned foreign entity, the name, address and TIN of each substantial US owner of such entity;
- The account number;
- The year-end account balance or value; and
- Gross proceeds and income from the account.

In addition to the information on US accounts, a participating FFI must report to the IRS annually:

- The number and aggregate value of financial account held by recalcitrant account holders;

- The number and aggregate value of financial accounts held by related or unrelated NPFFIs; and
- The number and aggregate value of financial accounts held by recalcitrant account holders that have US indicia.

For NFFE's, in order to avoid 30% FATCA withholding an NFFE must provide the withholding agent with either:

- A certification that the NFFE does not have any substantial US owners (i.e., owners with a more than 10% interest); or
- The name, address, and US Taxpayer Identification Number (TIN) of each substantial US owner

Where the NFFE provides information in regard to substantial US owners, the withholding agent must report that information to the IRS.

Step 3 involves withholding on "foreign passthru payments."

Foreign Passthru payment mechanism is a major unresolved issue for banks and other FFIs

Under FATCA, even if an FFI does not hold any direct US source investments it will still have to enter into an FFI agreement with the IRS in order to avoid FATCA withholding. This is because a non-participating FFI that does not hold any direct US investments may still be subject to FATCA withholding if it receives a "foreign passthru payment." As mentioned earlier, the foreign passthru payment rule is an anti-abuse rule designed to prevent a participating FFI acting as a blocker for a non-participating FFI or otherwise for a US person trying to avoid US tax by making indirect investments in US assets.

- A foreign passthru payment is defined as any withholdable payment or other payment to the extent attributable to a withholdable payment.
- Participating FFIs are required to deduct and withhold 30% of any foreign passthru payment made to a recalcitrant account holder or non-participating FFI.
- Notice 2011-34 introduced a mandatory allocation formula to determine the portion of payments deemed to be a foreign passthru payment.
- The FATCA foreign passthru payment requirements represent one of the most complex elements of FATCA.

As originally envisioned, participating FFIs would potentially have to include all balance sheet assets and transactions in total asset calculations. This is because of IRS concerns that derivative and other synthetic products are being used to avoid these rules. FFIs were also to use a single currency in calculation of the total assets. Calculations under the original proposal certainly would have required major internal process and technological enhancements to current capabilities.

Additional problems with the foreign passthru payment concept as originally conceived are:

1. The formula for determining the foreign passthru payment may result in a passthru payment being disproportionate to the underlying withholdable payments. Indeed, a foreign passthru payment withholding could have been due

even if there is no "withholdable payment" because no US source income has been distributed.

2. There is currently no clear limitation on the scope of the concept of the foreign passthru payment (e.g. what type of payment).
3. Payments (i.e. dividends, redemption payments, interest, and principal repayment) that are associated with financial accounts (e.g. debts and equity issued by an FFI) could be treated as foreign passthru payments

The proposed regulations issued on February 8, 2012 have not provided additional guidance on foreign passthru payments and have deferred any withholding on them until 1/1/2017 at the earliest. In a real sense the IRS has gone "back to the drawing board," and will fashion a new foreign passthru withholding process. The US Internal Revenue Service appears to have responded to many business comments complaining about the costs, administrative complexity and legal impediments related to calculating and withholding on foreign passthru payments. Until 2017, FFI must report annually to the IRS the aggregate amount of certain payments made to each non-participating FFI. US Internal Revenue Service may eventually adopt safe harbours for FFIs that elect not to calculate a foreign passthru payments percentage. In any case, FFIs need to watch closely forthcoming IRS proposals involving foreign passthru payments as the potential compliance costs associated with them are high.

Process and technology considerations

Although these FATCA regulations are only proposed, they appear to provide sufficient guidance for banks to determine what products are in scope, the process and system changes which will need to be made, and also to enable banks to develop a communication plan with customers and distribution networks in order to address compliance within the looming effective dates of these rules.

Understanding your bank's current state

An organization will need to understand the impact FATCA will have in order to make informed decisions on how they plan to approach compliance and update their processes and systems. A critical initial step is identifying what information gaps exist within your organization and assessing their impact. So acting sooner than later cannot be emphasized enough. After mobilizing a project team, an organization should analyze their legal entities to properly classify them according to FATCA definitions. This is important because each classification has different requirements, with the FFI having the most rigorous requirements. In addition, organizations should analyze their customers and accounts to determine US individuals and entities.

The *de minimis* thresholds in the proposed regulations have been increased to lighten the burden of due diligence performed on the existing financial accounts of financial institutions. For example as mentioned, "high value accounts" above $1 million are only financial accounts required to conduct electronic and non-electronic searches for determining US indicia. A common concern is not in identifying the customers that are already reporting their US status but those that should be and have not. Also, an organization should assess their products to determine which are in scope as some new exceptions were created in the proposed regulations. While the proposed regulations provide options that may reduce the bank's efforts, a bank should conduct an analysis to clearly understand their full exposure.

A bank can then use their "gap" analysis between their current state and their target state regulatory and business requirements to define their future state operating models and technical architectures. Strategic decisions should be made to direct how

an organization may conduct business going forward. For example, will a centralized "know your client" process and system be more cost effective than separate processes and systems for a multi-jurisdictional organization?

Some organizations are using this regulation as an opportunity to streamline their organization.

Operational change is inevitable due to FATCA

While the proposed FATCA regulations are tax regulations, the largest challenge for banks and other financial institutions may be the process and system changes that may be needed to comply with FATCA. A bank's policies and procedures should be evaluated to determine points of change. For example, the current FFI's "know your client" processes are likely not to capture all US indicia and documentation essential to maintaining compliant FATCA status. IT system and infrastructure is another area that may fall short. For example, a major European bank estimated that implementing FATCA concepts into existing IT infrastructure could cost €10 to €20 million for only two of their largest subsidiaries, particularly as their current IT infrastructure did not identify US assets. Once an organization understands what system gaps may exist, the challenge will be to update them by the required deadlines. The US IRS and Treasury did lighten the burden to try and promote an alignment with existing "know your client" and AML processes, but system changes may still be needed. The estimates for lead times for system changes could range from 12 to 24 months, which will create a challenge to meet the compliance deadlines. One area that may cause the most IT changes could be withholding for customers and foreign passthru payments. Most organizations do not have systems that perform these functions and may have to implement new capabilities.

Impact on a bank's ancillary business and third parties

Another concern for banks is how this will affect their ancillary business activities and their current relationships with third parties. An organization's legal agreements with customers, investors, and businesses may need to be evaluated to incorporate new requirements. A concern to consider is how local privacy laws and regulations will affect those agreements. How can a bank rely on a third party such as counter parties, distributors, transfer agents, etc.? What third parties will the bank need to certify as part of complying with the FATCA regulations? How does an organization treat entities where they have a minority interest or rely on others to conduct asset management investments? While it may not be the responsibility of the FFI to comply, they may be required to suffer a withholding if those third parties or entities are not compliant. So a bank should begin dialogues with third parties they conduct business with to understand their plans and evaluate potential risks of withholding penalties.

D. Implications of FATCA for Caribbean banks

Overview of the Caribbean Banking sector

The Caribbean domestic banking sector is comprised of two distinct groups of entities, namely:

- The branch or subsidiary operations of global financial institutions.
- Indigenous banks, which were established in individual countries to provide services tailored to their citizens. Many of these institutions have expanded over time, primarily through an aggressive approach to the introduction of new products and services and the adoption of a less risk averse strategy, to become leading players in the sector.

In addition, many Caribbean countries have enacted legislation to support the development of international financial services, as part of an overall strategy to transition to a services-based economy. This has contributed to social and economic development of those countries to varying degrees, and in some cases, is the mainstay of the local economy. Specifically, the following should be noted:

- The Cayman Islands is now one of the largest banking centres globally, with assets estimated at US $1.7 trillion.
- Bermuda is regarded as a global centre of excellence for reinsurance. The offshore sector contributes nearly 50% of GDP, and is responsible for 30% of employment on that island.
- A recent study of the international financial services sector in Barbados has indicated that this sector contributed an average of 60% of corporate taxes between 2008 and 2010. Further, it was estimated that for each tax dollar paid, the sector had an additional $3 spend in the local economy.

The FATCA Challenge

Addressing FATCA compliance will create additional challenges for a sector that is currently under strain. The global financial crisis has prompted a suite of regulatory reforms to improve financial stability; the most significant being the Basel III Capital Accord and Dodd Frank. While considered vital to reduce the risk of bank failures, the requirements imposed by these reforms have the potential to change the landscape of banking. Ultimately, only the fittest will survive.

The prolonged global recession has led to reduced activity in key economic sectors which, in turn, has resulted in increased unemployment and under-employment. Delinquency rates on credit portfolios in domestic banks have increased, prompting many institutions to change their credit strategies and adopt more robust risk management practices, either through voluntary actions and in order to comply with more rigorous regulatory oversight. Personal and corporate customers too have adopted a more conservative approach, and have been reluctant to undertake any venture that would involve any significant credit exposure. As a result of these factors, the demand for credit, the life blood of commercial banking entities, has been significantly reduced. In the face of declining profitability, many banks have taken

steps to review their operations with a view to implementing sustainable cost reduction.

The offshore sector has also had to address a number of challenges within the last 20 years, from OECD "blacklisting" to the requirement to enter into Tax Information Exchange agreements.

Domestic or international Caribbean banks have overcome past challenges, however, FATCA compliance is likely to be a more costly and complex matter to address than any previously encountered.

The following sections summarise the key challenges that are expected to be encountered by Caribbean banks as they navigate the minefield of activities leading to FATCA compliance.

Local country law may prohibit financial institutions from complying with FATCA

Disclosure of confidential information

Many countries (e.g. Brazil and Peru) have forcefully made the case that their local laws would prohibit their financial institutions from complying with FATCA as currently written. Bank secrecy and information confidentiality law are often cited for the proposition that FFIs could not disclose their client information without violating several local country laws. The proposition has also been advanced that local laws will often render even what appears to be a voluntary waiver of a bank secrecy or confidentiality law as null and void as the result of implicit coercion.

It should be noted that even where specific laws do not prohibit disclosure of client information, many banks provide services under contracts, which require specific authorisation from customers prior to disclosing confidential information to third parties unless certain pre-determined circumstances apply, e.g., by court order, or a request made under a Mutual Legal Assistance Treaty.

Withholding and remittance of taxes

In addition, it should be noted that the tax laws of many countries do not include provisions to allow a financial institution to withhold and remit any foreign taxes. In addition, many countries do not allow taxes to be assessed on a basis of indirect allocations as is proposed for foreign passthru payments under FATCA. This raises the question as to whether, in such circumstances, banks may be able to charge any tax withheld to the relevant customer, or will be forced to set off these amounts against their own profits.

Termination of customer relationships

Many local laws do not allow accounts of recalcitrant account holders to be closed involuntarily, or may require lengthy procedures to do so. In the interim, the FFI will still be responsible for executing its withholding obligations.

These could be major issues for banks in the Caribbean region. To the extent local law does not allow you to comply with FATCA, you will face many additional costs of doing business in addition to the ones already identified to get into FATCA compliance. For example, if a bank withholds and remits tax to the IRS in a country where local law does not permit it, the bank may have to absorb these additional costs as a part of doing business and may not be able to pass the costs to account holders. Additionally, if account holder information is disclosed in situations in which local law prohibits disclosure, a financial institution may be exposed to

possible law suits, with significant legal expenses and judgement costs and other penalties. Further, the possibility of actions by local financial systems regulators cannot be discounted.

Because of these potential local law issues, (even though the FATCA statute requires that every member of an FFI's expanded affiliated group also must be a participating FFI or none of them can be) the proposed FATCA regulations allow a two year transition period until January 1, 2016, during which time a participating FFI may have affiliates or branches in countries where local law prohibits aspects of FATCA reporting and compliance. During this two-year period the affiliate or branch in the restrictive jurisdiction must perform the required due diligence to identify US accounts, report U.S. accounts to the IRS, perform FATCA withholding on payments to recalcitrant accounts, maintain records, and are prohibited from opening new US accounts or NPFFI accounts. The affiliate or branch in the restrictive jurisdiction must also identify itself to withholding agents as a non-participating FFI. After January 1, 2016, if the affiliate of branch in the restrictive jurisdiction cannot fully comply with FATCA, none of the FFIs in the expanded affiliated group will continue to be able to continue being participating FFIs. The inescapable conclusion if this happens is FFI groups will sell or close affiliates or branches in countries with local law barriers to complying with FATCA.

Possible loss of capital and business flight

In addition to having custodial, depository and equity or debt interest accounts, financial institutions engage in transactions with many counterparties. If a bank is obligated to make a payment to a non-participating FFI counterparty, that payment could be subject to FATCA withholding. Withholding is also applicable to payments to recalcitrant accountholders.

Withholding can be a nightmare for financial institutions. First withholding does not apply to all US sourced income: some income types are specifically exempted, while certain assets, e.g., those covered by the 'grandfather obligation' provisions are excluded. Secondly, significant challenges may arise in determining the income that should be allocated to a specific customer subject to withholding. For example, whereas in a wealth management scenario, discrete investment portfolios may be held for customers, this is not the case in a retail banking environment. In the latter, funds that are invested may arise from the pooled resources of all depositors. Significant and costly systems development will therefore be necessary to enable the income allocation process that will be vital in supporting withholding.

In such circumstances, a FATCA compliant institution may opt to exit a business relationship with a non-participating FFI, particularly if the expenses associated with enabling its systems to support withholding, on-going operational costs, and administrative burden of withholding are assessed to be in excess of the revenues or other benefits to be gained. An FFI may also opt to take a similar position with respect to known US accounts and recalcitrant accounts.

Since the regulations have been issued, there has been heightened awareness as to the impact of FATCA on the financial sector. Customers too, are becoming aware of the potential impact on their earnings if their bank is unable or unwilling to achieve FATCA compliance. Consequently, it is possible that customers may elect to maintain deposit accounts with banks who they perceive will be FATCA compliant. This may place some institutions at a disadvantage, particularly if customers believe that those entities may not be able to allocate the level of resources to the required FATCA compliance project.

Lastly, there has been speculation that in jurisdictions that have local laws conflicting with FATCA regulations, detailed in the previous section above, financial institutions

and investors may begin to move financial assets to jurisdictions that are known not to have local law issues. This would enable easier compliance with FATCA and could happen before the country to country prototype mentioned in following section below is finalized.

Potential loss of correspondent banking and other relationships

FATCA will result in increased operational costs along all parts of the value chain, and service providers will seek to minimise such increases particularly where it is not possible to recover them from customers. Experience has shown that correspondent banks have terminated relationships solely on the basis that the income generated does not merit the cost and effort required to maintain that relationship. It is possible that some banks may be unable to maintain existing correspondent banking relationships. Further, it should be noted that significant difficulties may be encountered in concluding new correspondent banking relationships, particularly in light of the enhanced due diligence requirements and regulatory standards that are now applicable. Undoubtedly, the loss of a correspondent banking relationship will adversely impact a bank's capability to provide certain services. In turn, this may also trigger the loss of key customers who will require these services to support their business operations.

Proposed intergovernmental information reporting – FATCA partners

Joint statements were issued from the United States, France, Germany, Italy, Spain and the United Kingdom regarding intergovernmental approach to improving international tax compliance and implementing FATCA.

In large part because of considerations raised in the last section on local country law conflicts with FATCA, the US Treasury and the IRS announced on February 8, 2012, the United States and five major European countries (since joined by Ireland and other countries) were exploring a "country to country" framework to implement a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchanges of information based on existing bilateral tax treaties. The stated goals of the proposed intergovernmental partnership were to avoid legal impediments to compliance, simplify practical implementation and reduce compliance costs.

Although still to be negotiated in final form, the Joint Statement outlined how a hypothetical country to country exchange system might work. First, the FFIs in a particular country would collect the information required by FATCA and its tax authorities and transfer the information to the United States on an automatic basis.

In return, the IRS would not require the FFI to enter into a separate legal agreement with the IRS to directly report taxpayer information to the IRS, and eliminate FATCA withholding on payments to the FFI. This would be done by identifying all FFIs in the particular country as participating FFIs or deemed compliant FFIs. The United States would also agree to reciprocity by collecting and reporting on an automatic basis to the other country's tax authority's information on US accounts of residents of the other country.

The hypothetical agreement also goes on to posit that such a bilateral country information exchange would not require FFIs in the partner country to:

1. Terminate the account of the recalcitrant account holder;

2. Impose foreign passthru payment withholding on payments to recalcitrant account holders; and
3. Impose foreign passthru payment withholding on payments to FFIs within the partner country or in any other country with a similar agreement with the US>.

The Caribbean Association of Banks should watch this "different path to FATCA compliance" closely to see what the terms of the actual framework agreement turn out to be when finalized. It is likely other countries will be encouraged to negotiate similar agreements with the IRS, particularly when there are local law prohibitions against FATCA compliance as mentioned in the prior section. This will not be a "no brainer" decision as the alternative could be more costly for financial institutions and governments to implement than a direct agreement with the IRS.

Included below are links to the Treasury press release and the joint statement.

Link to release:

http://www.treasury.gov/press-center/press-releases/Pages/tg1412.aspx

Link to statement:

http://www.treasury.gov/press-center/pressreleases/Documents/020712%20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf

Common technology challenges endemic to FATCA

Organizations are beginning to realize the enterprise wide challenges FATCA has introduced and the process and technology needs they may require. The following are some areas with which banks and other organizations are experiencing challenges:

1. **Technology and operations governance**. FATCA requirements may inevitably drive an organization to need increased governance over their data, processes and systems to ensure compliance with FATCA. The regulations affect many parts of an organization and may need greater communications and transparency to manage. As the regulations continue to change, technology will need to adapt to meet those needs. So an organization should consider how changing requirements will be monitored and implemented in their systems. Operational governance will be needed as well. For example, how a legal entity is created should be tightly controlled to ensure new entities that are created or changed can be analyzed for FATCA implications.
2. **Reliance on AML/KYC**. While the proposed regulations suggest alignment with an organization's AML/KYC processes and systems, they may be challenged to do so. Some organizations have decentralized KYC processes by jurisdiction and business lines. As a result, strategic decisions will need to be made to change existing systems and processes to incorporate new FATCA requirements or go to a centralized model to maintain customer data. Each has implications as to how the business will operate. In addition, organizations may not have a robust process to leverage AML for FATCA purposes.
3. **Aggregation of account holder balances and information**. Organizations may not have the ability to aggregate data across systems and jurisdictions. In some cases, privacy and secrecy laws prevent aggregation, while in others; the

systems do not exchange data or an organization may not want to allow it to occur for business reasons. So being able to leverage *de minimis* thresholds in analysing the account holders will be a challenge particularly because an organization may think an account holder would fall under some of the thresholds, but in fact if aggregated could take them above those thresholds. So banks should consider how their customer data is managed and maintained across business lines, jurisdictions and systems.

4. **Analysis and remediation of pre-existing accounts**. Many commercial banks in the Caribbean have significant paper records for their account holders. The due diligence over electronic vs. paper records will be a challenge for many requiring manual resources to overcome. An organization in the Caribbean had stated for one jurisdiction, it estimated it would take 10 to 15 resources approximately two years to review their paper documentation to assess existing account holders. Another consideration would be to leverage technology solutions to assist in this effort.

A summary of the potential systems and technology impacts of FATCA compliance is set out in Appendix A.

Practical Challenges

Project Governance and Management

The FATCA compliance project will probably be the most complex individual initiative that has been undertaken for most banks. Further, there are strict timelines, with no indication that these will be relaxed. In such circumstances, strong project governance and robust project management is mandatory.

Many institutions have encountered difficulties in managing large and complex projects, resulting in cost overruns, missed deadlines, and in some cases failure to achieve anticipated benefits.

A strong governance structure for FATCA must:

- Represent relevant view-points. In particular, the project team must incorporate all lines of business and regional structures where appropriate. The team must also include representatives from Operations; Tax, Legal and Compliance; Technology; Customer Service; Public Relations; and Finance.
- Leverage existing initiatives
- Drive consistency
- Coordinate common solutions
- Provide support and quality assurance
- Provide baseline requirements and guidance
- Share relevant knowledge and expertise

The project will also involve significant change for the institution. As such a comprehensive change management programme will be necessary to create a shared understanding of the potential solutions, help stakeholders come to agreement on the most viable solution, promote acceptance and buy-in to decisions, and help facilitate the incorporation of new ways of working into the sustained attitudes and behaviors of employees.

Due Diligence

As noted above, FATCA requires participating FFIs to perform certain due diligence procedures and maintain specific information to support reporting. While it is expected that FFIs will modify their account opening processes to collect this data, it will also be necessary to request and maintain such information from pre-existing customers where this is not already maintained.

In our experience, retroactive requests for information have always been a sensitive issue, particularly where there is a longstanding relationship with a customer. Further, any customer who refuses to comply with the request will be deemed recalcitrant, and the FFI will be obligated to undertake withholding. Ultimately, this may lead to closing of customer accounts.

FATCA regulations define certain indicia of potential US persons, which may create certain challenges for Caribbean financial institutions. It is a known fact that many Caribbean nationals maintain dual citizenship, hold "green cards", or exhibit other characteristics that would result in them displaying these indicia, and hence falling within the definition of a US person. In such circumstances, FFIs will be required to collect certain information that will prove whether these customers are US persons or not, and if they are therefore exempted from the reporting requirements.

Enhancements to Core Systems

FATCA compliance may require significant enhancements to core banking systems, particularly to support account holder data maintenance and reporting requirements. The ability to complete these modifications will be dependent on whether the software developer is able to allocate the necessary resources to these projects.

We note that among domestic banks, there are four main core banking systems in use, which also have significant installed customer bases outside of the region, and which will also be impacted by FATCA. As a result, we expect that effecting the necessary modifications will be a priority for the developers of these systems. However, it must be noted that some of these core systems have been customized to meet the specific needs of individual banks and/or interfaces have been developed to provide data interchange with other applications in use by these entities. The need to address these specific modifications required in these circumstances may increase the cost and complexity of the software enhancements and also impact on the ability to complete the modifications within the FATCA timelines.

Are there any FFIs that can qualify for a reduced FATCA compliance burden?

The proposed regulations describe three categories of 'deemed compliant' FFIs. They include: 1) registered deemed compliant FFIs, 2) certified deemed compliant FFIs, and 3) owner-documented FFIs. If an FFI can fit itself within the definitions of one of the various financial entities describe in one of the three categories of deemed compliant FFIs, the FFI will avoid having to enter into an FFI agreement with the IRS and will not be subject to FATCA withholding. The following are descriptions of the various entities within each deemed compliant FFI category:

1. Registered Deemed Compliant FFI: these types of FFIs must register with the IRS and certify their continuing compliance with the requirements of their particular type of deemed compliant status every three years.

- Local FFI – a bank, securities broker /dealer, financial planner or investment advisor that is regulated in its (FATF compliant) country of organization or operation and limits its activities entirely to that country. This category has eight separate requirements, including policies and procedures which will limit severely US person accounts.
- Non-reporting members of affiliated groups;
- Qualified collective investment vehicles; and
- Restricted funds.

2. Certified Deemed Compliant FFI: (must properly certify their status to a withholding agent)
   - Non-registering Local Bank – an FFI that is relatively small and operates in only one country with no more than $175 million USD in assets on its balance sheet (an expanded affiliated group if applicable could have no more than $500 million USD in assets on its balance sheet);
   - Retirement funds;
   - Non-profit organizations; and
   - Low-value Accounts – a bank or custodian all of which accounts are $50,000 USD or less and which has a value of no more than $50 million USD on its balance sheet.
3. Owner-documented FFI: This category is limited to FFIs that are engaged primarily in investing, reinvesting, or trading in securities or other financial interests. This category could apply to personal or family trusts or other investment vehicles. To qualify, the FFI must not maintain a financial account for any FFI that has not signed an FFI agreement or issued debt in excess of $50,000 (unless the debt is regularly traded on an established securities market). The owner documented FFI must provide to a US financial institution or FFI (that has signed an FFI agreement with the IRS) in their capacity at a withholding agent on a yearly basis, information about the beneficial owners of the FFI aimed at identifying US persons and sending their information to the IRS.

Conclusions

The financial services sector, more than any other component, is inextricably linked to the economy in which it operates. With profitability under pressure for the last three years due to the global recession, and recovery slow and uncertain, FATCA presents banks with yet another challenge.

Achieving FATCA compliance is not an option: in many cases, the organisation's survival will depend on it. Non-compliance with FATCA, or the perception that a bank will not be FATCA compliant, may lead to business flight and termination of key relationships, including correspondent banking. Attaining this objective will not be easy, and may be further complicated if local laws relating to data privacy and third party tax collection are in conflict with FATCA obligations. Indeed, many banks could face civil and criminal liability for breach of existing legislation, as well as loss of goodwill and customer loyalty.

At a minimum, the project will involve significant changes to existing processes and banking application systems, changes to customer acceptance procedures (including retroactive collection of documentation), and on-going reporting on accounts held by US persons. Where there are recalcitrant accounts, banks may also need to incur significant costs in developing complex withholding engines.

Time is of essence. There is no room for indecision or complacency.

E. Final word

FATCA is here to stay. The US Internal Revenue Service has issued three notices and almost 400 pages of proposed regulations to date. It has essentially reaffirmed its timetable for full implementation. Although the IRS will continue to listen carefully to financial institutions concerns and will make small changes in the law to aid compliance, there will likely not be major modifications and certainly no repeal. Indeed, the joint statement between the United States and the five European countries is most likely the opening move in creating a central worldwide clearing house for the exchange of taxpayer information between nations.

Link to Department of Treasury and IRS regulations

The proposed rules released February 8, 2012 are available at:

http://www.ofr.gov/OFRUpload/OFRData/2012-02979_PI.pdf

Appendix A - Process and IT systems implications

FATCA Capabilities	Action Steps	IT Systems	Business Processes
Classifying the FACTA status of new clients	Introduce system functionality to identify whether an entity account is US, FFI, deemed compliant FFI, or NFFE (including subcategories)	√	
	Enhance On-boarding procedure to request, collect and electronically store US indicia documents from individuals and entities		√
	Implement system functionality to record and store additional data attributes	√	
Existing client remediation and on-going client maintenance	Develop a process to review individual or entity client account information for potential US indicia		√
	Ensure system functionality exists to electronically search for US indicia information that is collected and stored	√	
Maintenance of client FATCA status and related supporting documentation	Develop a process to review updated information and FATCA categorisation		√
	Introduce system functionality to alert staff when changes are made to key attributes of customer data that are indicative of US status	√	√
	Introduce system functionality to identify if an account is recalcitrant	√	√
	Develop a process to initiate and monitor requests for FATCA required documentation with links to Remediation Management tool	√	√
	Enhance document repository as well as audit trail functionality as it relates to monitoring reviews of FATCA documentary evidence (e.g., what was reviewed, when, and by who)	√	
	Introduce a process to request tax documentation for changes to entity ownership information	√	√
Reporting of Account Holdings for Impacted Clients by legal entity	Develop a reporting process to perform account-level reporting for US accounts based on FATCA reporting requirements	√	√
	Develop a reporting process for US owners of NFFEs, non-participating FFIs, and recalcitrant NFFEs based on FATCA reporting requirements	√	√

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