Ironing out the kinks

Douglas S Stransky and Geoffrey Wynne examine the impact of the Foreign Account Tax Compliance Act (FATCA) and the confusion arising in its implementation

Almost six years after its enactment and two years since many of its provisions took effect, the Foreign Account Tax Compliance Act (FATCA), and the network it has spawned of intergovernmental agreements between the US and other countries, has made it much more difficult for people to maintain bank accounts around the world.

The US Internal Revenue Service (IRS) says more than 100 countries have signed agreements under FATCA to provide information from financial firms in their jurisdictions regarding accounts held by US taxpayers. Ultimately the IRS believes that such international cooperation will help it recover some of the more than US$1trn it claims is held in offshore accounts and not disclosed to the IRS.

But for professionals in the trade finance business, FATCA's impact is still undetermined. While it does not appear to be the nightmare many critics predicted, it clearly has been a burden on foreign financial institutions (FFIs). Often they struggle to identify the proper parties to contact when attempting to comply with the disclosure law and what paperwork to ask those parties to complete.

Potential trade disruptor

Trade finance transactions include import/export letters of credit (LCs), trade acceptances, documentary bankers' acceptances, and open account payments resulting in payments to a party other than an FFI, either directly or through an FFI. The fear prior to the 1 July 2014 implementation date was that FATCA could unintentionally disrupt global

"The cost and other unintended consequences that were concerns prior to the enactment of FATCA still remain"

trade by imposing reporting requirements on such transactions, even though they are unlikely ways for people to hide offshore assets.

As we commented in our article published before theimplementation date in May 2014, 'Why FATCA implementation could be bad for trade, let alone privacy', FATCA could have an unintentional but potentially disruptive impact on global trade. Generally, these are not high-margin transactions. If the burden of FATCA compliance requirements is added to other regulatory burdens, it is less likely that major market banks will be willing to continue in the trade finance business. That would leave trading partners with fewer places to finance their operations and a likely hike in fees by those who remain in the market."[1]

Fortunately, FATCA's impact has not been as severe as anticipated.[2]

But the confusion it is causing banks is real and the consequences still to be seen. A frequent problem has been incorporating FATCA provisions into credit agreements, particularly when renewing such agreements. Typically parties use the prior agreement as a template. Now they are required to add in FATCA terms when they are not familiar with those provisions because they have not used them in the past.

But the greater confusion for foreign banks is in identifying people whom they think might have a connection to the US. FATCA includes a withholding tax provision. Foreign banks that invest in the US and earn US source income face a 30% withholding of income if they fail to provide required information.

But consider the sort of complexity FFIs are up against when trying to cooperate. If two foreign parties are involved in some form of trade finance, FATCA would not affect them unless they were investing in the US. However, in the world of trade finance, both parties could be located outside of the US yet conduct business on a secondary market with someone in the US. That could generate US source income and fall under FATCA rules.

To ensure that they are compliant and not risking a withholding tax under FATCA, foreign banks are often asking US parties for documentation they do not have or that the banks are not sure they even need. Perhaps the bank is asking for information from a foreign company that is owned by another foreign company that is owned by a US company. Should the bank request documentation for the foreign company or documentation about the US owner?

In many cases the parties involved in the transaction know that the banks are asking them to complete paperwork that is improper and have told the banks as much. However, typical of the confusion that currently exists, banks have insisted upon the documents they believe are correct to minimise their risk of non-compliance. Accordingly, they report to the IRS that they are in compliance when in reality they are not.

Who should take the risk?

Adding to the muddle is the fact that foreign banks are not in agreement with the IRS that they should bear the compliance risk in a transaction. In the US loan market there is agreement that the risk should be placed with the lender because the lender can control compliance. But in other countries, especially the UK, there is less agreement on who takes the risk.

The Loan Market Association (LMA) establishes loan practices in Europe, the Middle East and Africa. It has provided wording for 'borrower risk' and 'lender risk' for banks, but has not made a choice or created a market standard. Without guidance from LMA it has become even more difficult in trade finance to deal with something as sweeping as FATCA. Ultimately it will come down to the commercial bargaining power of the borrowers and the lenders to determine who will accept that risk responsibility.

The cost and other unintended consequences that were concerns prior to the enactment of FATCA still remain. More than 77,000 foreign firms have signed on to FATCA, many of whom say the high price of tracking down US accounts is an unnecessary burden. For example, HM Revenue & Customs (HMRC) estimates the cost for UK business over the first five years to be £1.1-£2bn, with an annual cost of £50-£90m thereafter. HMRC estimates that its own project costs for FATCA implementation are approximately £5m, with ongoing annual costs of £1.4m from 2016.

Smaller FFIs are also feeling the financial strain. In late 2014, Thomson Reuters conducted a survey of approximately 300 financial institutions about FATCA reporting. About

Please see www.tfreview.com/node/13409 for the full version of this summary table detailing reporting dates and requirements for financial institutions and sponsoring entities

Key FATCA Implementation Dates (2015 and beyond)	
2015	Reporting (by financial institutions) 2015 – reporting begins
2016	Registration (by financial institutions) Reporting (by financial institutions)
2017	Registration (by financial institutions) Reporting (by financial institutions)
2018	Reporting (by financial institutions)
2019	Withholding (by withholding agents) Reporting (by financial institutions)
After 2019 or TBD	Withholding (by withholding agents) Reporting (by financial institutions)

55% said they expected to exceed their original budget estimates for FATCA costs. About 27% said their cost would range between US$100,000 and US$1m in 2015, up from 16% who expected the expense to be in that range earlier in 2014. The revised forecasts suggest that financial institutions are gaining a greater appreciation of the FATCA cost.

Delays in implementation

The good news is that the Treasury Department and the IRS are aware of the confusion and willing to make allowances for it. Federal officials announced in 2015 that they would extend the period of time when certain transitional rules will apply. Some of these provisions include:

- Extending the start date of gross proceeds withholding for sales or other dispositions occurring after 31 December 2018 (this change extends the Form 8966, FATCA Report deadline to March 31, 2020);
- Extending the start date of withholding on foreign passthru payments to the later of 1 January 2019 or the date of publication of final US regulations defining the term 'foreign passthru payment';
- Extending the use of limited branches and limited foreign financial institutions (limited FFIs) to be eligible to participate in an intergovernmental agreement to 31 December 2016; and
- Extending the deadline for a sponsoring entity to register its sponsored entities and re-document such entities with withholding agents to 1 January 2017.

Additionally, to reduce compliance burdens on withholding agents that hold collateral as a secured party, the Treasury Department and the IRS intend to amend regulations for grandfathered obligations with respect to collateral.

Impact on expats

FATCA has also been a burden for the roughly seven million Americans who live overseas. Critics in the US have argued that FATCA does not distinguish between US citizens living abroad for family and work-related reasons and US citizens who are residents of the United States and are hiding money in foreign accounts.

In many cases American expatriates have been unable to open new accounts with foreign banks or have had their accounts closed, so the bank can avoid the expense of complying with FATCA. These consequences have also hit many US companies operating overseas. Other Americans have incurred the expense of revising their paperwork with the IRS, even though they may not owe a tax because they have already paid in another country and receive a credit against taxes in the US.

Perhaps not coincidentally an increasing number of Americans are renouncing their US citizenship. Between January and March 2015, a record 1,336 Americans relinquished their US citizenship, according to a quarterly report by the IRS. The previous record was 1,130 in the second quarter of 2013. A record total of 4,279 Americans renounced their citizenship in 2015. Before FATCA the number was a few hundred per year.

The heavy-handed approach by the US, including the 30% withholding for non-compliance, has created a level of resentment towards the US by FFIs and their governments. But several non-US countries have since decided to support a similar effort called the Common Reporting Standard. More than 90 nations have signed on to the CRS, which will enable countries to exchange tax data digitally by 2018 and reduce offshore tax evasion among their citizens.

In the meantime, several dozen countries that have signed FATCA agreements or are expected to sign, are eligible to receive information from the IRS regarding their taxpayers' US accounts. That data will not be released, however, until the IRS investigates the security of tax information in each country. Among the approved countries to date are the UK, Mexico, Sweden and Brazil, according to the IRS. Ironically the US has established itself as one of the world's most financially secretive nations. According to the Tax Justice Network, a UK-based advocacy group, the US ranked number three in the recent Financial Secrecy Index 2015. Only Switzerland and Hong Kong were ranked as larger tax havens than the US.

The future

Eventually the questions surrounding FATCA compliance will be answered and the confusion will clear up. Even the IRS does not expect that to be soon, considering its extended deadlines. When the reporting kinks are finally ironed out, we may learn if the money the FFIs are spending to comply, the delays in trade finance the paperwork has caused and the funds the US recovered from offshore accounts made FATCA worth the trouble.

In the meantime trade finance transactions will continue to 'muddle through' using whatever FATCA language seems appropriate (or not!).

Douglas S Stransky is a US international tax partner and head of the international tax practice for the law firm of Sullivan & Worcester in the firm's Boston office.

Geoffrey Wynne is head of the Trade & Export Finance Group for Sullivan & Worcester and head of the firm's London office

"An increasing number of Americans are renouncing their US citizenship"

References

1. www.tfreview.com/node/10407
2. See www.tfreview.com/node/13409 for implementation date table