# Maintaining momentum in the compliance quest

Changing deadlines, reporting and classification challenges, and the impact of intergovernmental agreements are the major concerns being raised in relation to the Foreign Account Tax Compliance Act. A panel of industry experts, convened by *Operational Risk & Regulation* and sponsored by Fenergo, detail how institutions are, and should be, responding

**Can you provide an overview of the Foreign Account Tax Compliance Act (Fatca), and outline the current landscape and key issues that institutions are facing?**

**Yvonne Kunihira-Davidson, Burt, Staples & Maner:** The Fatca provisions were actually signed into law on March 18, 2010, with an original effective date of January 1, 2013. Recently, that effective date was realigned to January 1, 2014 for most institutions. Where we are now is that proposed Fatca regulations were issued in February 2012. The original intention was that these regulations were to be issued at the end of last year and the final regulations were to be issued in the summer. We now understand that the Treasury Department and the Internal Revenue Service (IRS) have revised the timeline to say final regulations will be issued by the end of 2012, but most people in the industry believe they will be issued in the first quarter of 2013. Around the same time that the proposed regulations were released, there was also an announcement about intergovernmental agreements (IGAs) – the first being between the UK, France, Italy, Germany and Spain (Model I IGA) – which are designed to help foreign financial institutions (FFIs) comply with the extraterritorial effects of Fatca.

**And, to clarify, the agreement you are referring to was to pursue a model. All of those countries are yet to sign up to an IGA, except for the UK.**

**Yvonne Kunihira-Davidson:** Yes, since that first announcement of an intent to enter into an agreement with those first five, which is the Model I agreement, there has been a further announcement of the Model II agreement[1], which is for countries like Switzerland and Japan. So financial institutions and foreign governments need to decide if they are in a country that could become a Fatca partner and which model suits them. To date, only the UK has signed an IGA based on Model I. Some of the other countries within the first five are also well advanced, but there are still many open issues.

1 The US released the Model II agreement on November 15, 2012, after this webinar took place.

> **The Panel**
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> **Amy Harkins**, Senior Vice-President and Managing Director, BNY Mellon
> **Dan Murphy**, Chief Operating Officer, Fenergo
> **Yvonne Kunihira-Davidson**, Director, Burt, Staples & Maner LLP

**What are the issues you are facing in the context of both Fatca and the introduction of IGAs?**

**Amy Harkins, BNY Mellon:** The biggest concerns around Fatca would be in three buckets. One would be around the IRS – the continual changing of regulations and when it releases information to the public. That is really complicating the implemention of Fatca.

Number two is account classification, or what some people call entity classification – how we work with clients to classify their accounts appropriately, both for pre-existing accounts and new accounts.

And the third challenge we have is around the IGAs. Our concern is that each of these IGAs may be different, so that would be a further classification for our client accounts. What IGA would they fall under for reporting purposes?

**Dan Murphy, Fenergo:** That is very similar to what we are seeing in our own installed customer base. If you take the components of a robust Fatca solution, what you are looking at is the data-mining exercise that needs to be done to identify both new clients and existing clients to help you identify US indicia.

Having identified those US indicia, it is then a matter of making the correct classification as to whether they are Fatca-compliant or do not have any Fatca liabilities at all.

Once you make that classification, it is then important to engage with

Dan Murphy

your existing clients to ensure they are on board with the classification that you have made. And that is where we have seen the introduction of a self-service portal to help clients and financial institutions grapple with the challenge of managing a paper solution in some sort of automated digital manner. You should make this process as streamlined as possible and minimise the number of interactions you have with your end-client. There are also the withholding and reporting elements that need to be catered for as part of the overall solution.

**What are the challenges involved in the classification of existing clients and new clients?**

**Harkins:** From an existing client perspective, we have further *de minimis* rules that have come into effect that we need to look at. We have to understand what those *de minimis* rules are and how they impact our documentation collection. When we look at accounts, we are probably not looking at account balances, and some of the *de minimis* rules that Fatca is putting in place require that information.

From an institutional perspective, there is further documentation we will need to look at to validate some of the classifications. When we did client onboarding in the past we may not have had to know the client legal contract, but we will with Fatca. We may have needed the information before from a know-your-client (KYC) perspective, but not from an account-opening perspective or a reporting perspective. So tax and KYC have to be more in line than they are today.

And there is also the problem of making sure clients understand whether or not they are a non-financial foreign entity (NFFE) or a non-financial institution (NFI), and how that changes the requirements. Explaining that to some clients has been very cumbersome, so we have a lot of client education around this.

**We are hearing a lot about problems with the W-8 and W-9 tax forms. Can you tell us about them?**

**Kunihira-Davidson:** It is written into the proposed legislation that the forms W-8/W-9 are the gold standard. When you are dealing with the US, if you have US accounts, you need to use Form W-9. If you are in a non-IGA country and are dealing with non-US account holders, Form W-8 is something you want to look at – or a substitute self-certification form that helps you to gather the same information. The challenge is that the draft Form W-8 series that were released over the summer – for example, the one for entities (Form W8-BENE) – are six pages long. People can't even get the current one-page Form W-8 correct, so how are they going to get the six-page ones right? And, when you look at Form W-8IMY, which is for intermediary institutions, it used to be two pages and now it is several pages long. So you see the need for future-proofing the Fatca investment – you want to be able to automate information as much as possible to reduce the errors that will occur. We hope the W-8 forms will be finalised by the end of this year, but there is going to be a sunset period. And some people are saying that, since there is this sunset period, they are going to use the existing Form W-8 series for their existing clients and transition to the new forms once that six-month sunset period expires.

**Murphy**: This is going to be a regular classification and the review is going to have to be repeated time and time again, so the process will work its way through. If an organisation makes a decision to use the new W-8 forms rather than the old forms for the onboarding of new clients, in six months to a year from now, all clients will be using the new forms.

**What are the different challenges for countries with an IGA and those without an IGA?**

**Kunihira-Davidson:** The purpose of an IGA is to help financial institutions overcome the hurdle of having to do withholding on accounts that refuse to complete information – having to report information in breach of local data privacy laws. When you look at the challenge of existing customers, it is easier if you are in an IGA country because the IGA allows for greater reliance on existing anti-money laundering (AML) and KYC procedures in your home country – you can deem a client to be compliant without having to ask them. Whereas if you are not in an IGA country, you have to look at what the US proposed regulations say and they are much stricter, for example, in terms of FFIs.

While the challenge is a little less if you are in an IGA country, the challenge around the classification of NFFEs is still great. In an IGA country, you can classify an NFFE as being an active NFFE on the basis of publicly available information, but there is still quite a bit of heavy lifting. And how much risk do you want to obtain as an organisation? So people might decide that, even though the IGA permits them to rely on that relevant agreement, they will actually go for the higher standard in the US proposed regulations.

**Harkins:** We also have concerns over what the IRS is going to do. We could have the tax authorities giving guidance in one direction, but we may have different corporate policies and procedures to comply with, which could be refined. We have a very broad base of clients we have to keep happy at the same time as meeting our internal control requirements to maintain our status. From my perspective, I have a US withholding status requirement, so I'm held to a different standard than that of a similar competitor that is not a US withholding agent.

And many individuals and institutions may not be properly educated on what is supposed to be in each of those boxes on the W-8 or W-9 forms, so we do a lot of client education and internal education on that. Even for a

Amy Harkins

simple field like capacity, we have a tremendous amount of debate about who can sign a form in the right capacity on behalf of a client. So it just further complicates an already difficult workflow, and it has probably quadrupled the level of complication of the process.

Another issue I have with IGAs is that they further complicate the number of fields we need to maintain depending on the client that we are servicing. And then they may comply with reporting but not with withholding, but we will still have to keep the information around withholding.

**What are the differences between new and exisitng clients? What do institutions need to be thinking about and what documentation do they need?**

**Kunihira-Davidson:** You assume the organisation has gone through the exercise of determining which of their products are impacted by Fatca, what types of accounts they have, what falls within a financial account and, if they are in an IGA country, whether they have a product set and, therefore, a business group that is effectively outside the scope of Fatca because it is exempt under Annex II.

When you look for existing accounts for products that are in scope, there is a difference between whether you are dealing with existing entity accounts or whether you are seeing individual accounts. Both the proposed regulations and IGAs have thresholds for existing accounts that can be applied – the lower value threshold of $50,000 on certain individual accounts, $250,000 on certain entity accounts, and the higher value accounts of $1 million.

The good news is that, when you are dealing with existing customers, the first thing to do is an electronic review. If you find indicia of US status, then you need to obtain the appropriate documentation – and both the regulations and the IGAs are quite clear in terms of what documentation you need. The second challenge when you are dealing with entity accounts is classifying them. And, if you are in an IGA country, you have more scope to classify certain financial institutions and active NFFEs in your country or in another partner country. If you cannot classify an entity as an active NFFE based on good data you hold or in the public domain, you will need to ask the entity to certify what it is, and also obtain such certifications from passive NFFEs. If you find US indicia when you are dealing with individuals, you need to respond to that.

When dealing with all new customers – and new accounts for existing customers – both the IGA and US regulations are prescriptive as to what information should be obtained so as to classify them accordingly.

**Our first poll question asked what your main pain point is in relation to Fatca regulation? According to the listeners, reporting was the main pain point with 30.7% of the vote, but in second place was the classification of existing clients with 23%. Can you explain these results?**

**Kunihira-Davidson:** Classification is a complete pain because you have buckets for existing clients. When you are dealing with an entity account, you have to determine whether it is an FFI or an NFFE. If it is an FFI, what type of FFI is it? We have different types of categorisation such as broad ones like deemed-compliant FFI, partner FFI or owned IGA-country FFI. But, even with the deemed-compliant FFIs, you have further subcategories based on certifications that firms will make to you. It is very complex, so this is where having the W-8 form for entities helps because it narrows down and solidifies those different classifications.

**What do you think institutions should be doing to reduce the impact of Fatca on their operations?**

**Kunihira-Davidson:** For existing customers, institutions should be looking to see whether they can use existing data – depending on how good their data quality is – to classify some of the low-hanging fruit such as an FFI in the same jurisdiction or in an IGA country, or active NFFEs if you have sufficient data to do that.

When you are looking at new customers, it is important to think about getting this information as a matter of course during the onboarding process. It is much easier to catch the client the first time around as opposed to having to chase them after the fact.

**Murphy**: There are a couple of technical developments institutions should make. The first is the data-mining exercise and US indicia. Once that has been done, some clients can be automatically excluded. Some of the income from pension funds, for example, is actually carved out as part of the legislation.

Once you have done some level of automation, you are just down to the client repositories you have on board that will already have strong US indicia. It is neccessary to have an efficient workflow and an efficient engagement with those clients.

You need to build out a solution within your organisation that not only caters for the Fatca classifications, but other classifications that are coming down the line as well. If you look at the UK Tax Deduction Scheme for interest legislation, it requires similar classifications to Fatca – and Mifid has to be accommodated as well. Having a single solution that can do all of that for new and existing clients should help an organisation drive down costs and streamline the entire process.

**Kunihira-Davidson:** For new customers, many people think it is a matter of adding an extra form, an extra question or a couple of questions on the account opening form, but it is more than that. Even if you are in an IGA country, what you need to be capturing from January 2014 is very specific. And, by and large, you are looking at self-certification forms from large parts of your new customer base, and then doing the remediation if you find US indicia on your existing customer base.

**Our second poll question asked what level of complexity IGAs will add to the Fatca solutions of institutions with operations in multiple regions? 36% said there would be minor variances across regions; 43% said countries with IGAs in place might have different reporting requirements; and 21% said each government's interpretation and enactments of IGAs may differ substantially, resulting in complex solutions per region. What do institutions face from a reporting perspective?**
**Kunihira-Davidson:** From a data perspective, it is actually the same whether or not you are under an IGA. All the IGA means is instead of a UK bank, for example, having to report this information directly to the IRS, it will report it to Her Majesty's Revenue and Customs, which will then automatically exchange it with the IRS. So the amounts that have to be reported will be exactly the same, but the format will be different. If you are not in an IGA country or if you are in a Model II IGA, it would entail direct IRS reporting using amended versions of the existing 1099 and 1042 tax forms. We don't know what those amendments will look like because we haven't seen any draft reporting forms under Fatca.

**Harkins:** Operationally, we have the mechanisms in place to do that. From an IGA perspective, not knowing how we are going to collect and report that information – whether we have to report that information or the government body needs to report it, or whether there is going to be some sort of matching between the IGA governing body and us, as BNY Mellon's withholding agent – is where we have concerns.

**Murphy**: There is a bit of analysis paralysis taking place. Clients are worried that, if they make an investment or decision that takes them down one route, it might make them inflexible as the legislation evolves. So what we have tried to do for our clients is construct something that allows them to be flexible about the reporting, whether from a technology point of view or from a physical point of view. They can have something in place that allows them to generate a 1099 if it is required for an IRS report, or whatever the equivalent requirement is in a country that is covered by an IGA. But some clients are a little hesitant about moving down one particular path until the final pieces of the legislation are confirmed.

**Our third poll question asked whether you envisage Fatca implementation to be more or less challenging for IGA countries than non-IGA countries? We had 14% respond that it would be more challenging; 62% that it would be less challenging; and 24% felt the challenge would be the same. What are your views on that?**
**Kunihira-Davidson:** It will be challenging. I can understand where the more challenging perspective may come from because, if there are in excess of 40 countries negotiating and in discussion with the IRS, you could eventually have 40 versions of an IGA. But, when you look at the UK agreement, the model agreement is basically unchanged. It will be unchanged, that is the IRS position.

There are two clauses or parts that can change based on the Most Favoured Nations Clause in Article 7: Annex I, which is around the due-diligence rules; and Article 4, which is the application of the IGA to local FFIs. Model 1 IGA country regulators are expected to provide guidance as to how the IGA will be implemented in practice, using their discretion to ensure that the procedures are implantable within the spirit of the IGA obligations they have signed up to. So it could be less challenging to the extent that banking and other industry bodies are able to lobby the local ministry of finance or the tax authority for a rational, practical interpretation of what Annex I requires. But, to the extent that they end up having to effectively do more than they would be required to do under local AML rules, apart from the self-certification side, then certainly it would be more of a challenge.

Yvonne Kunihira-Davidson

**The final poll question asked what the change in deadline has done to Fatca projects within your institutions? Of the listeners, 77% said their projects were going ahead as planned; 14% said their budgets had been reallocated elsewhere and the projects were on hold; and 9% said the budgets were still allocated but the projects were on hold.**
**Harkins:** I made the recommendation not to put the Fatca project on hold because they are very aggressive timelines even if we do get delayed by six months or one year. I would be very cautious of situations where you lose your budgets and they get allocated elsewhere because all organisations need the extra time to be prepared for Fatca. The Treasury and the IRS are delaying the onboarding requirements, but not the reporting and withholding requirements, and you will have to do it all at the same time.

**Kunihira-Davidson:** This is partly linked to the level of senior management buy-in into Fatca, and into the impact of Fatca. There are some people who believe Fatca is going to go away and they are just kidding themselves.People still need to press ahead. You have more time to think more tactically and strategically about how you deal with new account due diligence, but taking your foot off the pedal is not the answer.

**Murphy:** I would be concerned that those organisations were always planning to do something that was less than sophisticated, such as a spreadsheet type exercise, which ultimately is like a red rag to a regulator. It is more or less a declaration that you are not doing the job correctly or interpreting the legislation correctly.

**Harkins:** People think the IGAs will allow them to get out of compliance, but the IGAs are just a different mechanism for compliance.

**This article provides only a flavour of what was discussed during the webinar. To hear the entire proceedings, visit www.risk.net/2224257**