FATCA – a compliance phantom takes shape

Experts claim that a bank's spending on FATCA (Foreign Account Tax Compliance Act) might amount up to 40 percent of its change budget allocated to modernization of processes and IT infrastructure. Moreover, FATCA represents a trend towards an increasingly complex network of international regulations pushed by the U.S., EU, OEDC and also driven by Asian state authorities. For financial institutions FATCA is therefore a real challenge concerning cost, time and sustainability: Since regulations commit growth and innovation resources to obligatory expenditure that most of the time doesn't yield any ROI, achieving compliance under FATCA will presumably be subject to strict cost-savings – but without compromising on the goal. In addition, banks will run out of time if they don't get started now, the ongoing legal uncertainty notwithstanding. Inasmuch as FATCA is regarded as a model for the international exchange of fiscal data, the implementation has to be sustained and ideally serve as blueprint for further regulations.

FATCA – From labour-market initiative to a "compliance phantom"

When starting in 2010, FATCA didn't first and foremost aim at fostering tax justice neither at strengthening the revenue side of the U.S. With the identification of U.S. account holders and gains deposited in foreign banks the new regulations targeted the off-shoring of jobs: liable to tax "de jure" but de facto often hidden from the IRS the earnings form investments in foreign working places were alleged to be way too lucrative. FATCA was created to stop this. Embedded in a comprehensive labour-market initiative the new fiscal legislation didn't make much noise in the U.S. – in contrast, it nearly immediately caused a stir in Europe. The concerns of financial institutions were fueled by the fuzziness around FATCA with only one fact being sure: FATCA had to be implemented with short lead time and severe penalties for non-compliance. The legal basis stayed sketchy. Lacking a detailed implementation roadmap as well as a definition of the requirements and how to put them into practice banks felt like maneuvering in the dark. Now, the "Model Agreement" (*Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA*) published in the end of July delineates an intergovernmental solution. Negotiated between the U.S. and five European "heavy weights" (Germany, France, GB, Italy and Spain) the "Model Agreement" brings considerable relief to banks but not yet full planning reliability.

FATCA "Model Agreement": Things get easier, not easy

There are two versions of the "Model Agreement". The preference is clearly on the part of the government-to-government solution with reciprocal data sharing. According to this model, banks transfer the due data and reportings to their national (tax) authorities. The alternative is still a direct contract between a foreign bank and the IRS – similar to the existing QI agreements. While promoting the intergovernmental data sharing among her traditional partners the U.S. will fall back on direct contracts with banks if there are doubts as to a country's legal, administrative and technological maturity.

Certainly, the intergovernmental draft treaty makes things easier for banks in several ways:

- **Legal certainty:** When exchanging data with national authorities financial institutions can use trusted and secure communication channels which are more accepted by customers, especially with regard to privacy protection. Now, the state acts as data custodian and guarantees the fulfillment of obligations such as “legal remedies of the data subject”, „defining and granting fixed processes to delete data and to prevent unprotected transmissions”, “granting data integrity” and “compliance with the principle of proportionality”. In the case of direct agreements with the IRS banks could be liable for “privacy infringements” – especially when acting sandwiched between national/European data protection legislation und the demands of the U.S. Treasury Department.
- **Relaxation of the schedule:** The model agreement defines a reliable, slightly relaxed road map to achieve FATCA compliance. The first reporting of name, address, TIN, account number (or functional equivalent) and balance (including reportable values as Insurances and other financial assets) of U.S. customers is now postponed to September 30, 2015. However, the first year under review is no later than 2013. Complex transaction won’t be put under review until 2015 and 2016. The relevant reports will be a due in the following years (2016/2017).
- **Reduced obligations:** Initially, FATCA imposed three tasks on cooperating banks: Identification of U.S. account holders, annual reports and application of the 30 per cent withholding tax on U.S. source income flowing to non-compliant banks or recalcitrant customers. Now, banks still have to complete the first two tasks. The withholding responsibility on behalf of the IRS is cancelled. Instead, banks just have to report on transactions to nonparticipating financial institutions.
- **More partnership, less penalty**: Daunted by what was widely regarded as a massive threat posture of the U.S. Treasury Department some banks were alleged to preemptively close U.S. accounts. With the “Model Agreement” Washington signalizes cooperative banks and financial service providers more commitment to the give-and-take principle. In case of significant non-compliance jeopardizing a bank’s “Reporting Status” a maximum “grace period” of 18 months is given to national authorities and banks to fix the problem. During this period the FATCA status remains untouched on the presumption of the bank’s willingness to cooperate.
- **Compromising on objective FATCA impediments**: Financial institutions with branches in foreign countries that are prevented by national jurisdiction from implementing FATCA abroad are still regarded compliant if they fulfill the obligations of the “Model Agreement”.

Even though the „Model Agreement“ lowers the requirements and provides a true chance to implement FATCA the implementation is still challenging. Just an example: Banks have to single out non-U.S. entities with one or more controlling persons specified as U.S. citizens. Yet, it still remains unclear how the term of “US citizens in control” has to be interpreted especially when defining criteria for the bank’s digital record search. The scanty reference to the “Recommendations of the Financial Action Task Force” doesn’t really help. Another issue is the great number of indicia specifying U.S. citizens as such according to FATCA. These numerous indicia make the record search quite complex. This is especially true of accounts with a balance or value that exceeds $1,000,000. Here, the “Model Agreement” stipulates enhanced in-depth paper review procedures. Especially medium-sized private banks with many wealthy clients will have to make significant personnel and organizational efforts to detect U.S. persons.

Taking action on the basis of the „Model Agreement“ – a wise thing to do?

The current version of the “Model Agreement” leaves much room for interpretation and its binding effect is inferior to e.g. a Letter of Intent. Details are not fixed and subject to future negotiations. A finalized, valid and legally incontestable version of the agreement is lacking and practical arrangements are still to be defined. A deadline for intergovernmental contract conclusions isn’t announced. Yet, not only the “when” is doubtful: emphasizing the principle of reciprocity the “Model Agreement” stipulates a “Quid pro Quo” in data sharing, which might emerge as the major stumbling block for FATCA. According to this, U.S. financial institutions resp. U.S. authorities are equally committed to providing Berlin, London or Paris with information about potential tax evaders. A push-back from U.S. institutions on the FATCA reciprocity agreement could at least delay bilateral negotiations.

Influential media as Wall Street Journal have staunchly criticized FATCA as it is – on the grounds that U.S. investors would be refused by foreign companies for fear of a data drain to the U.S. enabling the IRS, other authorities and even competitors (when data is leaked to them) to get hold on business secrets like financial figures or capitalization. Now, the “Quid pro Quo” is likely to heat up resistance, not least because the financial sector recently had to put up with the issuance of the final deposit interest reporting regulations targeting a bank’s business relationship to nonresident aliens. The „Quid pro Quo“ could namely intensify the fear of capital flight from the U.S. Moreover, as compared to European financial institutions U.S. banks have significantly less lead-time to get ready for FATCA. It’s not unlikely that initiatives to alleviate burdens or defer implementation dates might be started.

Moreover, the question whether the U.S. Senate’s approval of each bilateral agreement is required and whether it will be given is hard to answer at this stage. It’s also debatable whether the European governments will insist on reciprocity and make it a “conditio sine qua non” for their FATCA participation. The impact of the upcoming United States presidential election and the many elections for state legislatures on FATCA is also difficult to assess.

What shall a bank do right now?

Despite those many imponderables banks have virtually no choice: the time to get ready for implementing their individual FATCA solutions is now – even under the condition of regulations that are neither fixed in detail nor stipulated in a legally binding form. Yet, postponing the implementation to the moment, when those intergovernmental agreements are enacted is no viable option. Awaiting the issue could create massive pressure of time – and pushing things through will considerably increase cost, quality and project risks.
The fact, that FATCA is particularly a defiance to banking IT, is raising the question, how to prepare the ground for an IT solution that is neither “over-compliant” nor failing the test – and all this with setting aside as little of the change budget as possible.

Starting with the most difficult and urgent task

According to the „Model Agreement“ financial institutions have the option to outsource their FATCA reporting, while, as things stand now, the punitive 30 percent withholding tax has been cancelled. This makes the identification of relevant U.S. accounts the presumably most complex and pressing mission. Here, a bank should take action with priority and especially so since the record review is a FATCA core requirement that is most likely to be enacted and to become really operative. The risk to develop a solution that turns out to be expendable should be considered by far lower than the risk to await the final issuance of FATCA and to miss the deadlines then.

A technologically careful FATCA implementation

At present, FATCA requirements are ranked as top of a bank's to-do list. Financial Institutions are right to focus on this but the FATCA awareness shouldn't make blind to adequately asses the number und importance of U.S. clients for most of the banks e.g. in Germany. They should weight the new regulations according to the real effects and make sure that implementation efforts don't exceed the true impact which is less e.g. as compared to the withholding tax "Abgeltungsteuer". A technologically "conservative" approach to FATCA is therefore recommendable. Due to necessary plausibility checks in onboarding processes and when updating customer data, enhancements in the bank's customer data system are indispensable. Nevertheless, the operations of classifying existing clients and the gathering of data for the reporting should not interfere with core business processes. Implementing FATCA in the "heart" of the banking IT wouldn't only overemphasize the relevance of the comparatively small number of reportable U.S. accounts with a Cash Value greater than $50,000. In fact, this approach could considerably increase project cost and risk when implementing the new compliance routines. The more these routines are separated from the core banking system the faster and easier it will be to modify and adapt all review procedures to preliminarily regulations until the uncertainties relating to FATCA are removed.

Benefit from available resources and sustainable innovation

Banks that already use "data pooling" will benefit from this when implementing FATCA. Information integration and consolidation of data from many distributed sources facilitate the required identification of U.S. clients. To achieve this, data from relevant sources (e.g. core banking and third-party systems) is extracted, transformed and loaded into the data pool. The advantage of this concept is the (virtually) complete visibility of homogenous records. Moreover, "data pooling" allows data in operations to be separated from data needed for the FATCA reporting.

If FATCA motivates a bank to launch a data pool for the first time sustainability – beyond the mere compliance purpose – is crucial: the data pool should be designed for long-term, strategic and productive use, especially with regard to the optimization of business models (e.g. with Business Intelligence, BI).

Best Practice

Banks and their IT providers don't have to break new ground when dealing with compliance – this is also true for international regulations (e.g. EU Savings Tax Directive) as well as for regulations (e.g. the withholding tax “Abgeltungsteuer“) over which state authorities struggled until last narrowing down the time frame between the passing of the bill and the deadline for compliance. Moreover, banks have much experience with the identification of clients in conformity with the Know Your Customer (KYC) principle as it is stipulated in the GwG (Geldwäschegesetz) Money Laundering Act. Other financial institutions have already acquired valuable experience with U.S. fiscal authorities when applying for QI (Qualified Intermediary) status or renewing existing QI agreements. Provided that a bank succeeds in reusing existing corporate knowledge and manages to reactivate routines from past implementation projects they can regard FATCA quite calmly.

Conclusions

Even without knowing what the final act will look like financial institutions should now pave the way for their FATCA implementation. With regard to “moving targets” it’s advisable to start with the most urgent task that is very likely to stay compulsory – the identification of U.S. clients according to the FATCA definitions. While the reporting can be standardized and delegated to third-party specialists, the identification of relevant accounts demands an individual solution because banks widely differ in their IT landscapes. The solution should be outlined in a way that it remains open to potential FATCA amendments. Moreover, the solution should leave operations unaffected, charge the modernization budget as little as possible and – ideally – offer added value beyond FATCA.
Modularity, open interfaces and consolidated data repository grant additional flexibility in the FATCA implementation. Platform independence and standard software broaden the choice of qualified tools (e.g. for the reports) and using “best practice“ knowledge reduces costs as well as risks in development and implementation. In anticipation of stricter regulations to come sustainability and expandability should be considered from the very beginning. Notwithstanding the necessary attention on FATCA, a sound sense of proportion is advisable here: with this in mind core banking processes shouldn’t be subject to far reaching interventions.

However, banks may take FATCA as an opportunity and think about modernizing their IT infrastructure – using e.g. consolidated records not only to ensure FATCA compliance but also to drive future business on a valid information base.

„FATCA is a challenge – its implementation should set the course for future compliance solutions.”

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