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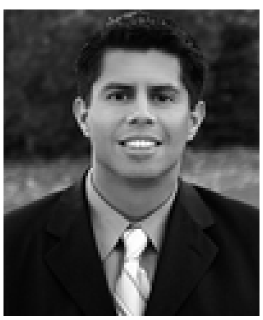
U.S. and European Laws Set to Clash–*Again*: New Tax Law Requires Foreign Banks to Share Unprecedented Details About Customers Overseas



BY HARRY A. VALETK

For years, multi-national companies have grappled with the legal concerns Sarbanes-Oxley Act whistleblower hotlines raised across Europe. More recently, the European Parliament has criticized the collection and sharing of passenger name records with the United States. Now, new federal tax reporting requirements may re-ignite irreconcilable conflicts between U.S. and European law.

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Beginning in 2013, the Foreign Account Tax Compliance Act ("FATCA"),[1] will require "foreign financial institutions" to share unprecedented amounts of customer information with U.S. tax authorities. This law attempts to identify U.S. taxpayers with financial accounts offshore, and enforce reporting of those accounts through withholding provisions. But what happens when data privacy laws of other countries restrict transferring information about individuals to the United States?

[1] FATCA refers to the Foreign Account Tax Compliance Act of 2009. FATCA was not originally enacted, but its reporting and withholding provisions became law on March 18, 2010 as part of the Hiring Incentives to Restore Employment Act.

FATCA is primarily a tax law meant to thwart various efforts to evade U.S. tax liability by holding income-producing assets at foreign financial institutions. To establish a binding legal relationship, it requires foreign financial institutions to enter into an agreement with the Treasury Department. That agreement will, in turn, require these foreign entities to share name, address, taxpayer identification numbers, and certain other information belonging to any direct or indirect U.S. account holder abroad with the Internal Revenue Service (''IRS'').

Foreign entities refusing to enter into this FATCA-required agreement with the Treasury Department face 30 percent withholding on certain U.S.-source income and the gross proceeds from the sale or disposition of property that produces U.S.-source income.

Foreign Financial Institutions

FATCA defines ''foreign financial institution''[2] as any foreign entity that accepts deposits in the ordinary course of business, holds financial assets for the account of others, or is engaged primarily in the business of investing, reinvesting, or trading in securities. This broad definition—together with the multi-national nature of financial services firms—captures banks, credit unions, broker-dealers, entities acting as custodians for employee benefit plans, and, in some cases, even foreign hedge funds and insurance companies.

This past August, the IRS issued Notice 2010-60 to offer preliminary guidance and public comment on key FATCA definitions. This guidance excluded the following entities from the definition of ''financial institutions'':

- Holding companies that are not investment funds and that hold only subsidiaries that are not financial institutions.
- Start-up companies that intend to start non-financial institution businesses. This exclusion expires after 24 months from the entity's organization.
- Non-financial entities that are liquidating or in the process of reorganizing under bankruptcy.
- Hedging or financing entities that service only a non-financial ''expanded affiliated group''[3] that does not include financial institutions.
- Insurance companies that issue insurance or reinsurance contracts without cash value, such as most property and casualty insurance companies, and life insurance companies that issue only term life contracts.
- Retirement plans that:
  1. Qualify as retirement plans under the law of the country in which established;
  2. Are sponsored by a foreign employer; and
  3. Do not allow U.S. participants or beneficiaries other than, generally, employees that work for the foreign employer in the retirement plan's established country.

Indicia of Potential U.S. Ownership

Once a foreign financial institution has entered into an agreement with the Treasury Department, it will have 12 months to search its own electronic databases of preexisting individual accounts for ''indicia'' of U.S. ownership. Indicia of potential U.S. ownership include:

- Identification of any account holder as a U.S. resident or citizen;
- A U.S. address associated with a holder of the account;
- U.S. place of birth for a holder of the account;
- U.S. ''in care of'' address, a ''hold mail'' address, or a P.O. box address that is the sole address on file with respect to the account holder;
- Power of attorney or signatory authority granted to a person with a U.S. address; or
- Standing instructions to transfer funds to an account maintained in the United States or directions received from a U.S. address.

Once an account is identified as containing indicia of potential U.S. status, foreign financial institutions must follow up with the account holder to request proof that the account is actually a U.S. account. Examples of appropriate supporting documents cited in the IRS Notice 2010-60 include Form W-9 and Form W-8BEN.

If the account holder provides adequate proof that he or she is not a U.S. person, the foreign financial institution need not take further action. But if the account holder verifies being a U.S. person, or fails to adequately respond to the financial institution's inquiry within a reasonable time, then the foreign financial institution must report specific account holder information to the IRS.

All of this, of course, assumes that financial entities overseas have inter-connected systems and searchable databases on-hand that are capable of cross-referencing against these specific fields. In fact, most entities don't.

Cross-Border Data Transfers Overseas

That summarizes FATCA in general. But our question here is international. And transferring foreign-based information about individuals to the United States raises potential foreign sovereignty conflicts.

In Europe, for example, all member states have adopted national data protection laws under the European Union's Data Protection Directive.[4] For FATCA purposes, the key compliance challenge lies with the EU Directive's provisions limiting the transmission of personal information about European-based subjects outside Europe's data zone. Under the Directive's chapter IV, article 25, personal data generally cannot leave Europe unless the transmission goes to a country that ''ensures an adequate level of protection.'' And, so far, the European Union considers the current sectorial approach to data privacy in the United States to fall short of its ''adequacy'' standards.

Several alternatives exist to get around this EU adequacy requirement. Those alternatives include Safe Harbor, binding corporate rules, and binding model contractual clauses. The Directive also allows companies to transmit personal data outside of the European

[2] Pub. L. 111-147 (H.R. 2847), section 1471 (d)(4)-(5).

[3] An ''expanded affiliated group'' is, generally, one or more chains of non-corporate entities owned (by value) by at least 50 percent of the members of a group of entities. It also includes taxable C corporations that are connected through stock ownership with a common parent that owns at least 50 percent (by vote and value) of the stock of at least one of the group members, and where at least 50 percent (by vote and value) of the stock of the other members is owned by any of the other members.

[4] EU Dir. 95/46/EC.

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Economic Area if the data subject has freely given consent unambiguously to the proposed transfer. European data authorities pay close attention to the voluntariness of consents, and take the position that consents must specifically list the categories of data and the purposes for the processing outside the European Union. Data subjects also have the right to revoke consent. In some countries—like France and Spain—data protection authorities may require final say, even after the data subject has consented.

A growing group of countries in North America, Latin America, and Asia outside the EU have similar data privacy requirements. Those requirements include restrictions on moving personal information across borders.

To this, FATCA simply tells foreign financial institutions, if local data privacy law restricts the transfer of personal information to the United States, get individual consent or close the account.

> In any case in which any foreign law would (but for a waiver described in clause (i)) prevent the reporting of any information referred to in this subsection or subsection (c) with respect to any United States account maintained by such institution –
>
> > (i) to attempt to obtain a valid and effective waiver of such law from each holder of such account, and
> >
> > (ii) if a waiver described in clause (i) is not obtained from each such holder within a reasonable period of time, to close such account.[6]

This all-or-nothing statutory approach, however, could call into question the voluntary nature of the account holder's consent. In some cases, unilaterally closing an account or canceling a whole life insurance policy may contradict commercial contracts between the parties, and even violate local law governing the sale of financial products and services.

Conclusion

All told, much remains unclear about FATCA's complicated foreign account reporting and withholding regime. In its current form, FATCA raises a host of questions and possibilities about how financial institutions are expected to build the necessary internal systems to comply, while simultaneously reconciling conflicting data privacy laws in Europe, Asia, Latin America, and perhaps other places.

Given the jurisdictional bouts we saw during the Sarbanes-Oxley whistleblower hotlines, we can expect to see similar disputes among regulators over FATCA. In the meantime, the clock is ticking for foreign financial institutions potentially impacted by this new law to craft an appropriate compliance strategy and influence the Treasury Department's final regulations.

Here are a few suggestions for multi-national financial services firms to consider as they engage internal and external support partners.

Ask the right people the right questions. Talk to your tax team to understand how FATCA will directly impact your company. Then find out if the laws applicable to your business even allow you to unilaterally close accounts or policies belonging to individuals who refuse to consent to a cross-border data transfer.

Assess the compliance risk. Prepare a detailed assessment of functional areas and systems impacted, and analyze your company processes to estimate what it will take to comply with FATCA's reporting requirements.

Estimate the potential costs to comply, and the consequences of not complying by 2013. Many affected firms seem startled at the potential scope of this new law, and few have a clear strategy on dealing with the conflicting laws applicable to their business.

Engage in legislative and industry outreach. Work with your government relations team or industry association to voice the implementation challenges potentially facing your multi-national company beyond just the tax implications. Open comment period for the IRS Notice 2010-60, however, ended Nov. 1.

[6] Pub. L. 111-147 (H.R. 2847), section 1471 (b)(1)(F).