

# White Paper

## Intergovernmental Agreements Under FATCA: Comparing the Two Models

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On January 17, 2013, the US Internal Revenue Service (IRS) released final Treasury regulations (the Regulations) under sections 1471 through 1474 of the US Internal Revenue Code of 1986, as amended, commonly referred to as the Foreign Account Tax Compliance Act (FATCA). What became apparent in the Regulations, and was foreshadowed in announcements leading up to the release of the Regulations, is that the IRS and the US Department of the Treasury (Treasury) intend to rely heavily on intergovernmental agreements (each, an IGA) between the United States and foreign countries (each, a FATCA Partner) to implement FATCA. Treasury has entered into several IGAs and announced that it is in talks with over 50 foreign countries regarding entering into an IGA. This discussion highlights the main differences between the two forms of IGAs that Treasury has released (referred to as the Model 1 IGA and Model 2 IGA) and some considerations governments may be taking into account when deciding between implementing a Model 1 IGA or Model 2 IGA.

### FATCA Background

FATCA was signed into law on March 18, 2010. Its purpose is to uncover US persons who may be evading US taxes by investing through foreign financial institutions or other foreign entities. To accomplish this goal, FATCA creates a new information reporting and withholding regime, in addition to existing US information reporting and withholding rules. Although the FATCA legislation is generally effective beginning January 1, 2013, the Regulations phase in the implementation of FATCA over the next several years.

FATCA generally requires certain withholding agents, which includes both US and foreign persons, to withhold 30 percent on certain payments made to any (i) foreign financial institution (FFI), if the FFI does not enter into an agreement with the IRS (FFI Agreement) to report information about its US accounts to the IRS, and (ii) nonfinancial foreign entity (NFFE), if the NFFE (or its beneficial owner, as applicable) does not provide to the withholding agent information about its substantial US owners (generally a US person that owns directly or indirectly more than 10 percent of the NFFE). Foreign governments, international organizations, foreign central banks of issue and other entities identified by the IRS as posing a low risk of tax evasion are exempt from withholding under FATCA.

## IGA Background

In conjunction with the release of the proposed FATCA regulations on February 8, 2012, Treasury issued a statement reporting that it was working with five European countries to develop an intergovernmental framework to implement FATCA. This framework is designed to “address . . . legal impediments to compliance, simplify practical implementation, and reduce FFI costs.” The framework described in the statement developed into what is now known as the Model 1 IGA.

Under a Model 1 IGA, FFIs will not enter into FFI Agreements with the IRS (although, like FFIs subject to a Model 2 IGA, they will need to register with the IRS) but instead will provide required information to the relevant FATCA Partner. Two versions of the Model 1 IGA were released by Treasury in draft form on July 26, 2012: a reciprocal version and nonreciprocal version. In general, the reciprocal version requires an exchange of information between the IRS and the FATCA Partner with respect to information about account holders in each country’s financial institutions that are residents of the other country. The nonreciprocal version requires reporting only by the FATCA Partner to the IRS. Under a Model 1 IGA, FFIs are generally required to report certain information (Reportable Information) about accounts held by US persons or by foreign entities controlled by US persons, including the US taxpayer identification numbers of such persons, and payments made to nonparticipating FFIs (*i.e.*, FFIs that have not entered into an FFI Agreement or are not otherwise deemed to comply with FATCA).

The Model 2 IGA was issued by Treasury in draft form on November 14, 2012. Under the Model 2 IGA, the FATCA Partner will direct and enable each FFI to register and “comply with the requirements of an FFI Agreement, including with respect to due diligence, reporting, and withholding.” Pursuant to the Regulations, such requirements will also include having a responsible officer of each FFI periodically certify to the IRS about the adequacy of the FFI’s FATCA compliance program. Unlike under a Model 1 IGA where an FFI will report Reportable Information to the FATCA Partner, under a Model 2 IGA an FFI will report that information directly to the IRS.

Both the Model 1 IGA and Model 2 IGA include Annex II, which is a list of financial institutions and products that are generally exempt from FATCA reporting because they represent a low risk of tax evasion for US persons. One of the biggest challenges in negotiating an IGA will be what entities and products appear on Annex II.

## The Model 1 IGA and Model 2 IGA Compared

### Due Diligence

#### Model 1 IGA

Annex I of the Model 1 IGA sets forth due diligence requirements for FFIs to determine whether their accounts and payments are Reportable Information. As an alternative to the requirements of Annex I, the FATCA Partner is permitted to allow its FFIs to apply the more onerous due diligence requirements of the Regulations.

#### Model 2 IGA

Like the Model 1 IGA, Annex I of the Model 2 IGA sets forth due diligence requirements for FFIs to determine whether their accounts and payments are Reportable Information. As an alternative to the requirements of Annex I, FFIs may

apply the more onerous due diligence requirements of the Regulations. However, if an FFI chooses to apply the due diligence requirements of the Regulations, it must continue to apply them rather than the requirements of Annex I, unless there is a material modification to the Regulations. In addition, FFIs must comply with the requirements of an FFI Agreement, including due diligence, unless the Model 2 IGA provides otherwise.

### **Considerations**

*FFI Impact:* The due diligence requirements of the Model 1 IGA and Model 2 IGA are materially the same. However, as noted above, FFIs subject to a Model 1 IGA will only be subject to the requirements of the Model 1 IGA, whereas FFIs subject to a Model 2 IGA will generally also be subject to the requirements of an FFI Agreement. Therefore, FFIs may prefer to be subject to a Model 1 IGA.

## **Information Reporting**

### **Model 1 IGA**

Under a Model 1 IGA, FFIs will report Reportable Information to the FATCA Partner, which in turn will report that information to the IRS. There will be information reporting flowing the other way under the reciprocal version of a Model 1 IGA.

### **Model 2 IGA**

Under a Model 2 IGA, FFIs will report Reportable Information directly to the IRS. However, an FFI must seek the consent of the account holder or nonparticipating FFI to disclose the Reportable Information to the IRS. For all such persons that fail to provide their consent (each, a Nonconsenting Person), the FFI is required to report aggregate account information. The IRS can then make a group request about such Nonconsenting Persons from the FATCA Partner under an income tax treaty or tax information exchange agreement. An FFI generally will be prohibited from opening a new account or entering into a new obligation with a Nonconsenting Person.

### **Considerations**

*Government Impact:* A Model 1 IGA FATCA Partner will be required to report annually to the IRS Reportable Information provided by its FFIs. In order to implement the collection of FATCA information in its own jurisdiction, a FATCA Partner may need to adopt internal laws or regulations and enforce them. This may present an insurmountable administrative burden for a FATCA Partner to enter into a Model 1 IGA if it does not want to invest in the necessary resources for gathering such information from its FFIs and forwarding the information to the IRS. Even in light of this administrative burden, a FATCA Partner may still opt to enter into the reciprocal version of a Model 1 IGA if it wishes to obtain information from US financial institutions to determine whether its tax laws are being evaded by its own residents investing through such institutions.

Although a FATCA Partner's obligation to participate in the reporting mechanism is far less under a Model 2 IGA, there is still some administrative burden placed on a Model 2 IGA FATCA Partner. Should the IRS seek additional information about Nonconsenting Persons, the FATCA Partner will be obligated to obtain that information from its FFIs and forward it to the IRS.

## Withholding

### Model 1 IGA

FFIs subject to a Model 1 IGA generally will not be subject to withholding under FATCA on payments they receive or on payments they make to account holders, provided they comply with the requirements of the Model 1 IGA. Even if an FFI subject to a Model 1 IGA fails to meet its requirements under the IGA, withholding under FATCA will not be imposed on payments to it unless the IRS has included the FFI on the nonparticipating financial institutions list (see below under *Enforcement*).

However, an FFI subject to a Model 1 IGA that has assumed responsibility for regular withholding under US tax law (*i.e.*, by virtue of being a withholding qualified intermediary, withholding foreign partnership or withholding foreign trust) is required to apply withholding under FATCA on payments of US source fixed or determinable annual or periodic (FDAP) income (*e.g.*, US source interest or dividends) made to a nonparticipating FFI. If the FFI has not assumed such withholding responsibility, it is required to disclose certain information to the payor of US source FDAP income it is receiving on behalf of a nonparticipating FFI so that the payor may apply the FATCA withholding.

### Model 2 IGA

FFIs subject to a Model 2 IGA, like FFIs subject to a Model 1 IGA, generally will not be subject to withholding under FATCA on payments they receive or on payments they make to account holders, provided they comply with the requirements of the Model 2 IGA. However, if the FATCA Partner fails to respond within six months to a group request from the IRS for information about a Nonconsenting Person that is an account holder, then until the FATCA Partner supplies such information the FFI generally will be required to withhold under FATCA when paying such account (i) US source FDAP income, (ii) gross proceeds from the disposition of property of a type that can produce US source dividends or interest or (iii) foreign passthru payments. Even if an FFI subject to a Model 2 IGA fails to meet its requirements under the IGA, withholding under FATCA will not be imposed on payments to it unless the IRS has included the FFI on the nonparticipating financial institutions list (see below under *Enforcement*).

In addition, FFIs subject to a Model 2 IGA will be required to withhold under FATCA when paying a nonparticipating FFI (i) US source FDAP income, (ii) gross proceeds from the disposition of property of a type that can produce US source dividends or interest or (iii) foreign passthru payments. The definition of foreign passthru payment has been reserved in the Regulations, and withholding on gross proceeds will begin on January 1, 2017 and on foreign passthru payments no earlier than January 1, 2017. However, the Model 2 IGA provides that Treasury and the FATCA Partner will work together to develop an alternative approach that minimizes the burden to achieve the policy objectives of withholding on gross proceeds and foreign passthru payments.

### Considerations

*Government/FFI Impact:* Under the Model 1 IGA, there is more certainty that FATCA withholding generally will not apply to payments made by FFIs because the continued exemption from FATCA withholding with respect to such payments does not depend on the FATCA Partner supplying information about Nonconsenting Persons within six months in certain circumstances. Furthermore, FFIs have less withholding responsibility under a Model 1 IGA than a Model 2 IGA. An FFI subject to a Model 1 IGA is required to withhold only US source FDAP income, and only

when it is a withholding qualified intermediary, withholding foreign partnership or withholding foreign trust. An FFI subject to a Model 2 IGA is potentially liable to withhold on (i) US source FDAP income, (ii) gross proceeds from the disposition of property of a type that can produce US source dividends or interest and (iii) foreign passthru payments. Such considerations may weigh in favor of implementing a Model 1 IGA rather than a Model 2 IGA.

## **Enforcement**

### **Model 1 IGA**

A FATCA Partner is required to apply its own domestic law (including penalties) to any FFI that the IRS determines is significantly noncompliant with its obligations under a Model 1 IGA. If the noncompliance is not remedied within 18 months, the IRS may revoke the FFI's compliant status and place the FFI on a nonparticipating financial institutions list, and therefore subject payments received by the FFI to withholding under FATCA.

### **Model 2 IGA**

The IRS will notify the FATCA Partner if an FFI is significantly noncompliant with the requirements of the FFI Agreement. If the noncompliance is not remedied within 12 months, the IRS may revoke the FFI's compliant status and place the FFI on a nonparticipating financial institutions list, and therefore subject payments received by the FFI to withholding under FATCA.

### **Considerations**

*Government/FFI Impact:* Under the Model 1 IGA, enforcement is to be carried out by the FATCA Partner in the first instance. Under the Model 2 IGA, the FATCA Partner does not serve an enforcement role. Accordingly, FFIs may prefer the Model 1 IGA because they would interact with their own tax authorities at the beginning stages of an enforcement action. A FATCA Partner may also prefer a Model 1 IGA because it offers greater transparency and control regarding FATCA compliance by its FFIs. However, being in charge of enforcement would likely necessitate more administrative and budgetary resources.

## **Conclusion**

As discussed above, the two IGA models differ significantly in their approaches to FATCA implementation. Choosing between the two will require a potential FATCA Partner to consider its own priorities along with the benefits and burdens of each model.

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