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FATCA & Intergovernmental Agreements

Automatic exchange of information on taxes on the rise

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The Foreign Account Tax Compliance ("FATCA") provisions of the U.S. Internal Revenue Code comprise an important broadening of the international reach of the U.S. tax system. This law is aimed at countering tax evasion by U.S. citizens and residents who receive earnings from assets held offshore. FATCA was enacted by the U.S. Congress in March 2010, and is subject to a multi-year implementation timeline. On February 8, 2012, the U.S. Treasury Department ("Treasury") and the U.S. Internal Revenue Service ("IRS") issued lengthy Proposed Regulations which provide a detailed explanation of the FATCA requirements.

A central feature of FATCA is the requirement that U.S. withholding agents (such as banks) deduct a 30% withholding tax from certain types of income derived from U.S. sources ("withholdable payments") by foreign financial institutions ("FFIs"). This tax is designed to encourage non-U.S. financial institutions to enter into an information-sharing agreement by creating a dis-incentive for noncompliance. By entering into such an agreement, an FFI will be able to receive income from U.S. sources free and clear of FATCA withholding. On the other hand, FFIs that choose not to enter into such information-sharing agreements will be subject to the tax.

FATCA also requires a separate 30% withholding tax to be imposed on with-holdable payments made to certain non-financial foreign entities ("NFFEs"). This withholding tax can generally be avoided by the NFFE in question if it provides information regarding its beneficial owners. It is important to note that direct and indirect holdings will have to be reviewed for this purpose.

Additionally, FFIs that enter into the agreements (known as "participating FFIs" or "PFFIs") will themselves be obliged to deduct withholding tax from with-holdable payments to NPFFIs in the same manner as U.S. withholding agents. Due diligence and payee identification procedures under FATCA are complex and vary depending on whether a "new" account as opposed to a "pre-existing" account is being reviewed by the PFFI, and whether the account holder in question is an individual or an entity, among other factors.

Currently a growing number of Intergovernmental Agreements (IGAs) between the United States and partner countries are being negotiated to overcome the conflict of laws issues raised by the application of FATCA as well as to simplify implementation and reduce compliance costs. The IGA framework alters the choices faced by both governments and FFIs when facing the FATCA regime in a number of ways. For example, it provides for the possibility of reciprocal and automatic information exchange between different tax administrators. It may render financial institutions generally accountable to their home government. Therefore the emerging IGAs framework can be seen as part of a larger system to implement automatic exchange of information on taxpayers. But the compliance costs of the FATCA regime to multinational PFFIs will be very significant even after taking into account the IGA framework.

FATCA & Intergovernmental Agreements (IGAs): International embedding of U.S. tax rules on the rise

In recent months, a number of countries have reached agreements with the U.S. government regarding the Foreign Account Tax Compliance Act ("FATCA"). The first of these "intergovernmental agreements" ("IGAs") was signed by the governments of the United States and the United Kingdom ("U.S.-U.K. IGA") on September 12, 2012. Other governments which have signed IGAs to date include Denmark, Mexico, Ireland, and Norway. Furthermore, the U.S. Department of the Treasury ("Treasury") issued a press release on November 8, 2012 indicating that the total number of governments with which it is engaged in discussions regarding potential IGAs is approximately fifty.

These developments represent a turning point in the evolution of the FATCA regime. The multiplication of the IGA approach clearly indicates that FATCA is developing from a unilateral U.S. rule to an international framework for the detection of tax avoiders.

The IGA concept was originally conceived as a means to overcome the conflict of laws issues raised by the application of FATCA, as well as to simplify implementation and reduce compliance costs. By now this approach is – at least from a U.S. point of view – becoming the preferred international model for the *reciprocal* exchange of tax information relating to individual taxpayers who are engaged in tax avoidance activities. With regard to the exchange of information on tax purposes there exist a number of cooperations between countries. Within the European Union the Savings Taxation Directive is a similar and multilateral example of the exchange of information for tax purposes.

The origins of FATCA

The FATCA provisions were enacted in March 2010 by the U.S. Congress as part of the HIRE ("Hiring Incentives to Restore Employment") Act. Although FATCA was only one element of a larger legislative package, it has major importance on its own. The FATCA provisions are aimed at countering tax evasion by U.S. citizens and residents who receive earnings from assets held outside the U.S., and as such constitute an important broadening of the international reach of the U.S. tax system.

In February 2012, Treasury and the U.S. Internal Revenue Service ("IRS") issued comprehensive proposed regulations[1] to implement FATCA ("Proposed Regulations"). In conjunction with the publication of these regulations, Treasury also released a statement with the governments of the U.K., Germany, France, Italy, and Spain, declaring their joint intention to develop an intergovernmental approach to implementing FATCA.

The FATCA law and the Proposed Regulations together provide the IRS with a sophisticated tool to obtain personal and account information on U.S. persons who may be investing and earning income through foreign financial institutions, whether through offshore accounts maintained by such institutions or investment in their stock or debt, whether direct or indirect. In other words, the core problem addressed by FATCA is the problem of asymmetric information between individual tax payers and tax authorities.

It is important to note, in connection with FATCA, that the U.S. imposes tax on its citizens and residents on a worldwide basis. Many other governments apply an alternative regime which taxes income only to the extent it is obtained

[1] In this study we refer to the proposed regulations. However, we expect the final version of the

Important FATCA terms 1

- Withholding agent
- Withholdable payment
- Passthru payment
- U.S. account
- U.S. person
- FFI – Foreign financial institution
- NFFE – Non-financial foreign entity
- PFFI – Participating foreign financial institution
- NPFFI – Non-participating foreign financial institution
- NPFFE – Non-participating foreign financial entity
- IGA – Intergovernmental agreement

within that state's jurisdiction. The former approach is often referred to as the "residence" principle, whereas the latter is the "source" principle.[2] Economically speaking, i.e. from an efficiency aspect, preference should be given to capital-export-neutral cross-border taxation, because in that case equal treatment of domestic and foreign income, and therefore production efficiency, is guaranteed.[3] This goal, in turn, requires enforcement of the residence principle and the taxation of worldwide income to the extent practicable. As a result, tax authorities need information on the income of residents which is earned abroad.

It is important to note, however, that governments which impose tax solely on a residence basis have experienced tax evasion by the use of offshore accounts, and thus also have concerns regarding asymmetric information. As a result, the FATCA regime is relevant to them as well.

How FATCA works – due diligence, reporting and withholding

The Proposed Regulations describe a complex regime which includes a large number of technical terms and concepts. In general these terms and concepts are interpreted in a manner generally designed to achieve the widest-ranging effect possible (see boxes on the left).

What kind of information does a financial institution need to submit and what information has the client to reveal? 2

- *Personal information* (name, address, tax identification number), includes also information on all substantial U.S. owners (>10% ownership) of an NFFE
- *Account information* (account number, account balance or value, gross receipts and gross withdrawals or payments from the account)
- *Additional information* (upon request of the IRS)

See IRC SEC. 1471 (c)

A central feature of FATCA is the requirement that U.S. withholding agents deduct a 30% withholding tax from certain types of income ("withholdable payments") paid to foreign financial institutions ("FFIs") that are not compliant with FATCA. The term "withholding agent" generally means any entity that has the control, receipt, custody, disposal, or payment of income derived from the U.S. As a result, U.S. financial institutions making payments of U.S.-source dividends or interest across borders are considered withholding agents for this purpose. The withholding tax is designed to encourage the FFIs deriving U.S.-source income to enter into information-sharing agreements ("FFI agreements") with the IRS by creating a disincentive for noncompliance. By entering into such an agreement, an FFI will be able to receive income from U.S. sources free and clear of FATCA withholding. FFIs which choose not to enter into information-sharing agreements (called "non-participating FFIs" or "NPFFIs") will be subject to the tax.

What are the obligations for a non-U.S. bank (and in general an FFI) under FATCA? 3

In general: sign a contract with the IRS and fulfil obligations, such as:

- Obtain information on account holders which is necessary to identify US accounts
- Comply with any required due diligence/verification procedures
- Report information on U.S. accounts
- Deduct and withhold a 30% withholding tax on certain payments ("passthru payments" to account holders and payments to another FFI where neither supplies required information)
- Comply with (additional) IRS information requests
- Attempt to obtain from U.S. accounts a waiver of (national) applicable bank secrecy or other information disclosure limitations (e.g. data protection) – if this fails within a reasonable time close the US account

FATCA also imposes another 30% withholding tax to be imposed on withholdable payments made to certain non-financial foreign entities ("NFFEs"). The term NFFE generally refers to any legal entity resident outside the U.S. whose business activities cannot be characterized as "financial" in nature. This withholding tax can be avoided by the NFFE if it provides information regarding its beneficial owners to the withholding agent. Specifically, the NFFE must state whether any of its owners whose interests exceed a specified threshold (generally 10%) are U.S. persons. If any are, the NFFE must provide their identities and other relevant information. It is important to note that both direct and indirect holdings must be reviewed for this purpose.

FFIs that choose to enter into the information-sharing agreement ("participating FFIs" or "PFFIs") will be obligated to conduct due diligence of their customer

[2] The procedures to implement the principles are the credit method and the exemption method. For more details see Zipfel, Frank (2007), One Europe, one tax?, p. 7. Recently the question whether exemption or credit method should be preferred has been intensively discussed in academic debate and in real world tax policy but it currently remains unclear whether the new arguments are sufficient to establish superiority so convincingly that abolishing the domestic taxation of foreign-source dividends is justified. See for more details Becker, Johannes; Fuest, Clemens (2010), The Taxation of Foreign Profits – The old view, the new view and a pragmatic view, WP 11/4 Oxford University Centre for Business Taxation.

[3] See Homburg, Stefan (2007), p. 271ff. and p. 307f. and Homburg (1999), Competition and Co-ordination in International Capital Income Taxation, in: Finanzarchiv 56, 1-17.

accounts in accordance with specific standards and procedures set out by Treasury and IRS in the Proposed Regulations. The scope of review includes both accounts held by U.S. persons and accounts held by non-U.S. entities which may, in turn, be owned by U.S. persons.

These due diligence and payee identification procedures are complex. The specific requirements vary depending on whether a "new" account as opposed to a "pre-existing" account is being reviewed by the PFFI, and whether the account holder in question is an individual or an entity, among other factors. For example, regarding accounts held by individuals, these procedures will in many cases require a review of account documentation for specific "indicia" that, when present, increase the likelihood that the account holder is a U.S. person. When such indicia are found, the PFFI will be required to make further inquiries. Another example of a specific due diligence procedure, applicable in the context of pre-existing accounts, is the "relationship manager inquiry." For certain such accounts, it may be necessary for the PFFI to identify the relationship manager assigned to the account and determine whether he or she has "actual knowledge" that the account holder is a U.S. person. If so, an inquiry must be made of the account holder to definitively establish such status.

To the extent that a PFFI discovers that an account is owned by a U.S. person, it will be required to report detailed information regarding the account to the IRS, including identification of the holder of the account and the income and assets recorded therein. This reporting will generally be required on an annual basis.

PFFIs will also be required under their agreement to deduct U.S. withholding tax from withholdable payments made to NPFFIs. As a result, FFIs that choose to participate will assume new responsibilities as withholding agents acting on behalf of the U.S. government, as well as the aforementioned responsibilities regarding due diligence of accounts and reporting of U.S. account holders. Finally, PFFIs will also be required to impose withholding tax on payments made to accounts of holders who refuse to cooperate with information requests or to waive foreign privacy law restrictions on the reporting of their information to the IRS ("recalcitrant account holders").

As an example of how these withholding taxes will affect business operations, we can examine their impact on a hypothetical payment of a dividend derived from a U.S. equity investment to the account of a non-U.S. investor. If the account is maintained by the investor at a non-U.S. bank, the relevant U.S. withholding agent making the payment (often a U.S. bank or broker dealer) must determine whether or not the non-U.S. bank signed an agreement with the IRS. In the case of an FFI that has not done so, the U.S. withholding agent must withhold tax at 30%. On the other hand, if the non-U.S. bank does participate, it will be exempt from the tax. As a consequence of its status, however, the participating FFI may be required to review the account in question according to due diligence standards set by Treasury and the IRS. To the extent this procedure reveals the existence of a U.S. owner or investor, the participating FFI will be required to report information as described above. To the extent the account holder does not cooperate with the due diligence as required, the participating FFI will have its own withholding responsibility with respect to the U.S. dividend.

In short, the FATCA regime gives rise to a "chain of liability" as a result of which withholding is required at any point at which a non-participating FFI or recalcitrant account holder arises in the payment scheme, taking into account, for example, indirect participations and intermediary investment vehicles.

The withholding imposed by FATCA is broad in scope and will come into effect in stages. Initially, withholding will apply only to payments of interest, dividends, rents, royalties, and other income that is considered fixed determinable annual or periodical ("FDAP") income from U.S. sources under U.S. tax principles.

Interest and dividends paid by U.S. corporations are a common example of U.S.-source FDAP. In the second stage, withholding will also apply to gross proceeds from the sale of instruments that produce dividends and interest from U.S. sources.

In addition to these two types of payments (known as “withholdable payments”), FATCA will ultimately also impose a withholding tax on “foreign passthru payments”, which are generally understood to be payments indirectly related to U.S. sources. However, the full scope of the foreign passthru payment rule is not known because the Treasury has not yet issued a formal definition, and has also stated that no withholding on “foreign passthru payments” will be required until January 1, 2017, at the earliest. It is important to note that the definition of withholdable payments contained in the Proposed Regulations does exclude certain payments made in the ordinary course of business.

The FATCA withholding rules supplement, rather than replace, the existing non-resident withholding system imposed by U.S. law. In fact, a significant component of the Proposed Regulations is devoted to coordination of the two regimes.

The timing of FATCA

FATCA is subject to a multi-year implementation schedule. For FFIs which decide to be compliant, the first relevant step will be to enter into agreements with the IRS to be a participating foreign financial institution. These registrations will generally take place during 2013, and the IRS has stated that as long as an FFI enters into an agreement prior to December 31, 2013, the agreement will have an effective date of January 1, 2014.

According to the most recent guidance issued by the IRS, a PFFI will be required to implement the FATCA due diligence requirements applicable to “new” client accounts by the later of January 1, 2014 or the effective date of its agreement with the IRS. Any accounts opened prior to that time will be considered “pre-existing” accounts subject to their own due diligence procedures.

The rules require completion of due diligence of pre-existing accounts within specific deadlines depending on the type of account. First, PFFIs will have six months from the effective date of their FFI agreements (for example, June 30, 2014 in the case of an FFI agreement that is effective January 1, 2014) to complete due diligence of so-called “prima facie” FFI accounts. For pre-existing entity accounts which do not fall into the “prima facie” category, PFFIs will have until the later of December 31, 2015 or two years after the effective date of its FFI agreement to complete due diligence. The term “prima facie” FFI refers to non-U.S. entities which can be identified on a preliminary basis as financial institutions utilizing information which may be readily available in the records of the PFFI, including designation as either a “qualified” or “non-qualified” intermediary (“QI” or “NQI”) under U.S. tax rules and/or the availability of certain standardized industry codes indicating that the entity is a financial institution.

Similar deadlines apply to due diligence of pre-existing individual accounts. If they are “high-value accounts”, the PFFI is required to complete due diligence by the later of December 31, 2014 or one year after the effective date of its FFI agreement. For accounts held by individuals which are not “high value”, the relevant deadline requires completion of due diligence by the later of December 31, 2015 or two years after the effective date of its FFI agreement. The term “high-value account” generally refers to a pre-existing individual account that has a balance or value in excess of USD 1 m at the end of the calendar year preceding the effective date of the FFI agreement.

The IRS has stated that once a particular account has been documented as a U.S. account, the PFFI must begin withholding or reporting with respect to that account even though the relevant deadline for completing the identification and documentation of pre-existing accounts as described above may not have arrived. In terms of reporting, the IRS has stated that the PFFIs will be required to file information reports regarding U.S. accounts with respect to the 2013 and 2014 calendar years by March 31, 2015.

Origin of the IGA framework

The U.S. Congress recognized that the reporting requirement contained in FATCA would conflict with data protection statutes in many countries. Furthermore, other local laws may also prohibit participating FFIs from blocking, transferring or closing accounts in accordance with FATCA requirements.

The February 2012 joint statement indicated that the IGA process was intended to overcome such conflicts of law by providing for an international framework for the exchange of information which would supersede local law constraints. This goal would require the foreign government in question to enact legislation, if necessary, to ensure that FFIs under its jurisdiction are able to conduct due diligence and report relevant information either to their home government or directly to the IRS.

On July 26, 2012 the U.S. Treasury provided its first detailed guidance regarding the IGA process as well as drafts of the first model agreements to serve as a basis for negotiation. These agreements were developed by Treasury in the course of discussions with France, Germany, Italy, Spain, and the U.K.

Treasury has proposed two different types of IGAs, Model I and Model II. Under Model I, FFIs located in the signatory country ("partner jurisdiction") would report information regarding U.S. accounts to their local government rather than directly to the U.S. government as originally contemplated under the FATCA statute. The Model II agreement, on the other hand, would facilitate reporting directly to the U.S. government. In the event that a foreign government enters into a Model II IGA, every FFI organized under the laws of that country would be required to sign an FFI agreement with the U.S. It is expected that the U.S.-Japan and U.S.-Switzerland IGAs, among others, will follow the Model II approach. Treasury released a draft of the Model II agreement on November 16, 2012.

Treasury classifies Model I agreements further into reciprocal and non-reciprocal versions. The former allows for mutual exchange of information between the U.S. and the partner government, whereas the latter only permits information to flow from the partner government to the U.S. government. The exchange of information would occur in accordance with existing tax treaties or tax information exchange agreements between the U.S. and the partner jurisdiction in question. The U.S.-U.K. IGA follows the Model I reciprocal approach. The non-reciprocal version may be appropriate in case Treasury and IRS have not determined that the partner jurisdiction in question has adequate legal safeguards in place to ensure that any information provided by the U.S. government is used properly, i.e., for purposes of tax administration only.

Under both the Model I and Model II approaches, FFIs which qualify under their home country IGAs and report accordingly are treated as compliant and alleviated of the FATCA withholding which would otherwise apply to them, just as if they had become PFFIs under the Proposed Regulations.

How IGAs change the playing field

The IGA framework alters the choices faced by both governments and FFIs when facing the FATCA regime in a number of ways.

First, the possibility of reciprocal information exchanges may be of interest to governments facing their own tax evasion issues. These governments now have an opportunity to obtain information about their own citizens who may be using U.S. financial institutions to hide assets. The U.S.-U.K. IGA illustrates this point by providing that U.S. financial institutions will be required to report information on certain U.K. accounts to the IRS.

Second, the Model I IGA will render financial institutions more accountable to their home governments for compliance. Under the U.S.-U.K. IGA, for example, U.K. financial institutions will be required to register with the IRS but will be alleviated of entering into a formal FFI agreement as required under the Proposed Regulations. Furthermore, both governments are obligated to report instances of significant non-compliance to its counterpart and are also required to apply its domestic law to address the non-compliance.[4]

It is important to note that, in the case of financial institutions operating in branch form, it is the location of the branch rather than the location of the head office that determines whether an IGA is available with respect to the branch's operations. For example, the Spanish branch of a U.K. resident bank would report to the Spanish government under the U.S.-Spain IGA rather than to the U.K. government under the U.S.-U.K. IGA.

Third, the IGAs remove the uncertainty as to whether an FFI and its branches and affiliates can be FATCA compliant without violating local laws. It is important to note that the Proposed Regulations include a transitional rule which allows an FFI to participate even if it has branches and affiliates which are prohibited from doing so, but only for a limited period after which the entire group would cease to qualify. The IGAs overcome a critical obstacle to full implementation of the FATCA regime by superseding the proposed regulation and by permitting compliant FFIs to maintain and operate noncompliant branches and affiliates on a permanent basis, subject to applicable restrictions.

Impact of IGA on scope of FATCA

As compared to the requirements found in the Proposed Regulations, the IGA framework also modifies the obligations of compliant FFIs relating to due diligence, reporting, and withholding. In many instances, the IGA requirements may go some way to alleviate these burdens.

For example, the U.S.-U.K. IGA clarifies in Annex II which types of FFIs are eligible for reduced FATCA responsibilities because they are considered to be at low risk of involvement in tax evasion ("deemed compliant" FFIs). For example, this group specifically includes U.K. governmental organizations, the Bank of England and its subsidiaries, the U.K. offices of specified international organizations such as the IMF, and certain retirement funds established in the U.K. Also included in the classes of organizations receiving beneficial treatment are non-profit organizations and financial institutions determined to be limited to a local client base. This latter category includes credit unions, investment trust companies, and venture capital trusts, as well as mutual, building, friendly and

[4] For example, Art. 4(1) of the U.S.-U.K. IGA provides that each "Reporting United Kingdom Financial Institution" shall be treated as compliant with FATCA and therefore not subject to FATCA withholding so long as it complies with the requirements found in Art. 2 and 3 as well as Art. 1(a-e). Furthermore, Art 5(2) requires each government to report to the other instances of significant non-compliance, in which case the non-compliant institution will eventually be treated as an NPFFI.

industrial and provident societies. Each of these so-called “deemed compliant” FFIs is defined and recognized under current U.K. laws and regulations. The definition of FFI under the U.S.-U.K. IGA also excludes entities engaged in investment activities so long as they are not required to apply the U.K. Anti Money Laundering (AML) regulations, so that most family trusts are excluded so long as they are not professionally managed.

Thus the process of negotiating IGAs will allow other governments to identify and obtain exemptions for specific types of low-risk businesses which may otherwise have had ambiguous status under the Proposed Regulations.

The IGAs also include significant changes to the withholding responsibilities applicable to FFIs. Among these changes is a narrowing of the definition of “withholdable payment” to exclude gross proceeds. Furthermore, IGAs contain a specific provision alleviating FFIs of responsibility for withholding on payments to recalcitrant accounts and replacing it with a requirement to report such accounts on an individual basis. Finally, in the case of FFIs, the IGAs further limit withholding to situations in which the FFI is also a qualified intermediary which has elected primary withholding responsibility under U.S. tax law. FFIs which do not have this special “QI” status are required to provide information “upstream” to the immediate payor of the U.S.-source income to an NPFFI in lieu of withholding themselves.

Assessment of economic impact

The adverse effects of the FATCA law can be identified in three broad categories:

i. potential impact on portfolio investment decisions

ii. potential competitive distortions between FFIs and US-based financial intermediaries, and

iii. the administrative costs which will be incurred by compliant FFIs.

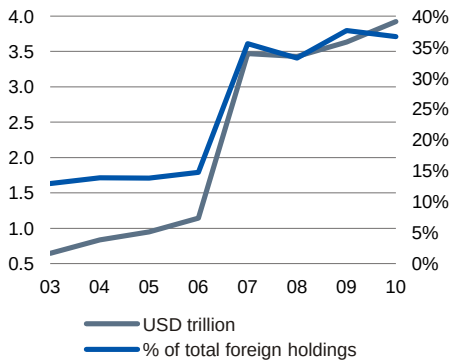
With respect to (i), not much will change for tax honest paying investors. The emergence of a multilateral rather than unilateral regime of automatic information exchange reduces the likelihood that investors will be dissuaded from investing in the U.S. due to FATCA withholding. The IGA framework itself generally requires compliance by all FFIs organized under the laws of the partner jurisdiction. As a result, the global population of FFIs who have the option of noncompliance will diminish with each new executed IGA. Furthermore, as noted above, the IGA framework will reduce the situations in which U.S. withholding taxes will be applicable to withholdable payments by eliminating withholding on gross proceeds and on all such payments made to recalcitrant account holders. These developments will reduce the incentives to avoid investing in U.S. capital markets due to the possibility of FATCA withholding or of facing a conflict of laws.

With respect to (ii), the IGA approach will help to equalize the burdens imposed on U.S. financial institutions in comparison with their non-U.S. peers. The rapid development of the IGA framework highlights the fact that the U.S. is not the only jurisdiction which is concerned about tax avoidance. To the extent that the Model I reciprocal IGA becomes the dominant arrangement, U.S. financial institutions will be compelled to complete due diligence and reporting as well. These reciprocal obligations will reduce the potential for competitive distortions.

Finally, with respect to (iii), it is important to recognize that the administrative costs of the FATCA regime to multinational PFFIs will be very significant even after taking into account the efficiencies produced by the IGA framework. FATCA requires the development of processes and systems related to account

European holdings of U.S. securities 4

In %, USD tr



Source: US Treasury

Holdings of US Securities 5

2010, USD bn	Total foreign	EU	DE
Equity	2,814	1,308	57
ST Debt	958	359	8
LT Debt	6,921	2,256	130
Total	10,691	3,922	195
% of total foreign	–	36.7	1.8

Source: US Treasury

US FDI in the euro area 6

2010, EUR bn

Direct investment	922.9
% of total FDI in the euro area	24.8%
of which:	
Equity/reinvested earnings	702.5
Other capital	220.4

Source: ECB

identification, reporting, and withholding which are truly global in scope. It is still unclear at this point whether the revenue benefit to the U.S. and its partner jurisdictions from the combined FATCA/IGA regime will outweigh the aggregate global compliance costs of banks, brokerages, funds, insurance companies, and the various other entities classified as FFIs. In assessing the revenue benefit, Treasury's estimate of approximately USD 1 bn in additional tax revenue earned annually through FATCA will ultimately be supplemented by the tax revenue gathered by partner jurisdictions through international cooperation under IGAs.

The aggregate compliance costs have proven to be very difficult to estimate. This is especially true of large banks and other multinational FFIs, which must confront the fact that FATCA participation entails an assumption of responsibilities related to due diligence, reporting, and withholding by almost every business line and legal entity. In the case of a major bank or broker dealer, it can be expected that millions of financial accounts will be affected. The institution's IT infrastructure and business processes will need to be upgraded on a global basis to achieve full compliance with the complex standards contained in the Proposed Regulations and IGAs. Employees across a variety of functions – compliance, legal, front office, among others – will need practical training to ensure an adequate understanding of the rules they will be charged with following. Finally, the fact that the standards themselves continue to evolve as IGAs are negotiated and the Treasury and IRS develop final guidance also adds to the uncertainty around the ultimate cost.

To give an idea of the relevant scope, it is useful to have a closer look at the number of actors/institutions and the possible volume or size of cross-border activities which could be affected by the evolving regime. The financial integration between the United States and Europe alone is very complex. Significant capital transfers occur in nearly every segment of the economy and in both directions.

In order to have an approximate overview of the transactions between the United States and Europe, the following section includes data published by Treasury and the ECB. In addition, as an example of a bilateral relationship between two advanced economies, a brief overview of the financial connections between the United States and Germany will also be given, utilizing information obtained from the Bundesbank.

Regarding the U.S.[5], 19.3% of the total outstanding U.S. long-term debt and equities were foreign-held as of June 2010. European investors alone accounted for more than one-third (36.7%) of this amount. This means that around 7.1% of total outstanding U.S. long-term debt and equity were held by European investors. Some 39% of the USD 3.9 tr in European holdings had been invested in long-term debt issued by corporations (thereby counting for 61.3% of all foreign holdings in this section). Another 33.4% had been invested in U.S. equities (46.5% by the same measure). German investments added up to 1.8% of all foreign holdings of U.S. securities in 2010 (i.e. roughly 5% of all European holdings). German financial actors invested primarily in long-term debt (66.4% of German holdings) and equities (29.3% by the same measure) as well.

When considering the financial connections between the United States and Europe, another important metric is the stock of direct investments. Direct investments flows can be found in the financial account of the balance of payments. Their classification comprises all investors (individuals, private or public enterprises, trusts, estates, etc.) that are deemed to have an influence on the management. According to the "Balance of Payments Manual" issued by the IMF (which is the basis for U.S. and European statistics), the influence on

[5] The figures are from a special report of the U.S. Treasury Department: Department of the Treasury (2011), Report on Foreign Portfolio Holding of U.S. Securities (as of June 30, 2010), 2011.

management has to consist of more than 10% of the ordinary shares (or voting power) in order to be registered with the national statistics. Regarding the euro area, the stock of direct investments from the United States into the euro area totalled EUR 922.9 bn in 2010 (24.8% of total FDI into the euro area).

Turning now to the specific example of U.S.-German economic relationships, it is worth noting that German investors held a significant share of their FDI[6] in the U.S. Specifically, total direct investments were EUR 161 bn by 2010 (16% of all the German capital destined to investments in other countries). Total annual revenues amounted to EUR 326 bn (16% of all revenues obtained by foreign enterprises with a significant German participation). The direct investments of the whole euro area in the U.S. totalled EUR 899.7 bn in 2010.

German FDI in the US 7

2010

FDI (EUR bn)	161
% to total direct investment	16%
Number of enterprises	4,148
% to total	13%
Total annual revenues (EUR bn)	326
% to total	16%

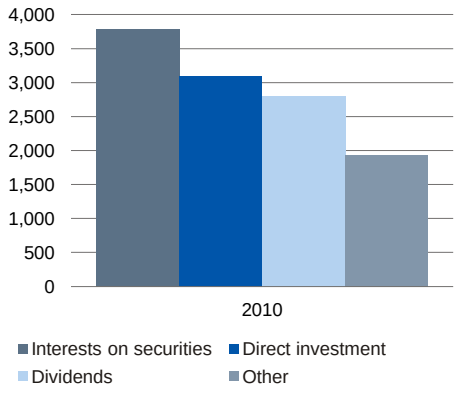
Source: Bundesbank

All figures mentioned in the preceding paragraphs comprise stocks of capital already invested in the U.S., or in foreign countries by U.S. sources. Another metric which is indicative of the scope of activity impacted by enhanced international information exchange and withholding requirements is the volume of capital flows. The monitoring of cross border payments will have a significant impact on the administrative costs of financial institutions. It is also important to note that data on capital transactions is generally more difficult to obtain than data on stock investments. Even when it is available, the impact of netting effects in the current account computation (as part of the balance of payments) renders an accurate estimate of capital transactions more difficult.

One important example of these capital flows is capital aimed at new direct investments. These flows contain all the transfers of capital being invested in new direct investments abroad and therefore they give an outline of the variation in the stock of direct investments. In 2009 net capital flows between Germany and the United States totalled an outflow of EUR 1.7 bn from Germany. In 2010 this figure increased to a net outflow of EUR 5.4 bn. Additionally, it has to be taken into account that direct investments are only a fraction of all the new investments being carried out by financial actors in the economy every year. Other forms of new investments recorded in the balance of payments include payments destined for acquisitions of securities which, in the transatlantic space, actually outweigh FDI flows by far. These investments constituted a net outflow of EUR 17.5 bn from Germany to the United States in 2010 (net investments in U.S. bonds were the main contributor to this outflow, with a share of 75.6%).

US income in Germany 8

In EUR m, 2010



Source: Bundesbank

Another important financial connection between the two countries is the payment of income abroad, which can also be found in the balance of payments (in the current account). Due to the significant stock of U.S. investments in Germany, and given the amount of new capital being invested every year, a large outflow of income to the U.S. is recorded in the annual statistics of the Bundesbank. The largest share of outflows was recorded in interest payments for U.S.-held German securities (EUR 3.8 bn). Also earnings on direct investments (EUR 3.1 bn) and payments of dividends (EUR 2.8 bn) had a significant share in income transfers.

Considering the whole euro area, the importance of capital from the U.S. is even stronger. As has been shown before, investors from the United States hold about 25% of the stock of direct investments in the euro area. This figure is, in part, reflected in the impressive amount of income that is transferred to the United States. The EUR 118.8 bn of income outflows from the euro area to the U.S. accounted for 25.5% of total income outflows.

[6] Special Data from the Bundesbank: Bundesbank (2012). Bestandserhebung über Direktinvestitionen, April 2012. The report is published annually (the latest containing data for 2010) and contains the stock of foreign direct investments, classifying investments by country of origin.

The foregoing figures have been presented merely for illustrative purposes, in order to provide an indication of the scope of activity affected by FATCA. Since they are limited to European transactions, they in fact understate breadth of application. An FFI operating internationally rather than just regionally will of course be required to implement the relevant standards on a global level.

International cooperation in the field of taxation

There are well established precedents for international cooperation between countries on tax matters. The international system of tax treaties is a long-standing example. Other examples include: the EU Savings Taxation Directive[7], the Directive for mutual assistance for the recovery of claims relating to taxes, duties and other measures[8], the Directive on administrative cooperation in the field of taxation[9] in the EU, as well as various agreements and initiatives on OECD or G20 level. All those initiatives can be seen as part of a larger system of measures enabling countries to enforce their right to charge taxes beyond their national borders. The EU and OECD approaches are driven by the idea of implementing an automatic exchange of information on taxes between countries. The enactment of FATCA by the U.S. Congress and the subsequent emergence of the IGA regime represent another step in that direction.

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[7] Council Directive 2003/48/EG and COM(2008)727.
[8] Council Directive 2010/24/EU.
[9] Council Directive 2011/16/EU.

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