WHITE PAPER

Impact of FATCA on Client Onboarding

Achieve FATCA compliance with effective, result-oriented IT and operational changes

Abstract

In March 2010, the Foreign Account Tax Compliance Act (FATCA) was enacted as part of the Hiring Incentive to Restore Employment (HIRE) Act. It mandates financial institutions to employ enhanced KYC procedures to report US individuals and legal entities evading US tax liabilities using non-US financial entities or accounts.

This research paper is intended to provide a snapshot on FATCA compliance, illustrate the IT solution framework and suggest the IT and operational changes required to manage FATCA compliance.

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Understanding FATCA

The Foreign Account Tax Compliance Act (FATCA) aims to provide the Internal Revenue Service (IRS) of the US with an increased ability to detect US tax evaders concealing their assets in foreign accounts and investments. It serves as an extension to the existing anti money laundering (AML) and KYC compliance requirements with the specific aim to curtail tax evasion for US individuals or legal entities that have financial exposure outside the United States.

What are the triggers that forced the IRS to introduce FATCA?

Before FATCA, the Qualified Intermediary (QI) program was instituted by the IRS, which required participating foreign financial institutions (FFIs) to maintain account holders status, report foreign income and withhold taxes. The QI program was deemed ineffective due to poor participation of FFIs and ineffective self-reporting of foreign assets.

According to estimates by the Permanent Committee on Investigations, the US Treasury was losing approximately US$100 billion annually to offshore tax non-compliance. In addition, IRS discovered that many participating intermediaries (FFIs) were fraudulently concealing information about their American account holders. For example, in 2009, UBS, a leading Swiss bank, had to settle just such a case with the IRS by paying US$780 million in penalties.

Instituting FATCA

- Introduced in October 2009 by Senator Max Baucus and Representative Charles Rangel. After multiple rounds of discussions and deliberations, signed into law by US President Barack Obama on March 18, 2010

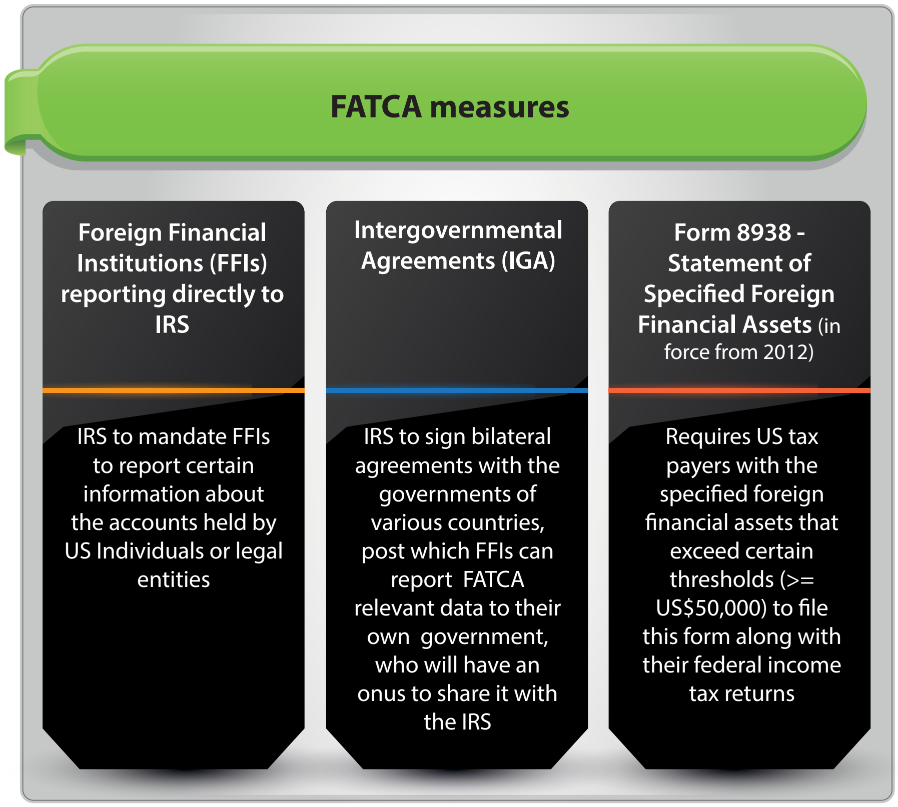

Figure 1: Component measures of FATCA

- Within10 years from the date of enforcement, FATCA is expected to generate additional revenue of US$8.7 billion to the US Treasury
- However, a cost of US$40 billion per year is anticipated to scale up the infrastructure to support the international tax evasion legislation
- As on June 2013, the US has signed the IGA with 8 countries – UK, Denmark, Mexico, Ireland, Switzerland, Norway, Spain and Germany. Typically, this requires FFIs to report foreign income of US domiciled account holders to the local government and, as per IGA, the respective government would in turn report it to the IRS.
- Generally, all non-US financial institutional entities, such as banks, brokers, intermediaries, insurance companies, hedge funds, wealth management practices and private equity funds, are considered FFIs.
- FFIs need to report the name, address, taxpayer id. number (TIN), account number, account balance, gross dividends and other income deposited in the foreign account holder.

Timeline

Below are the important FATCA milestones

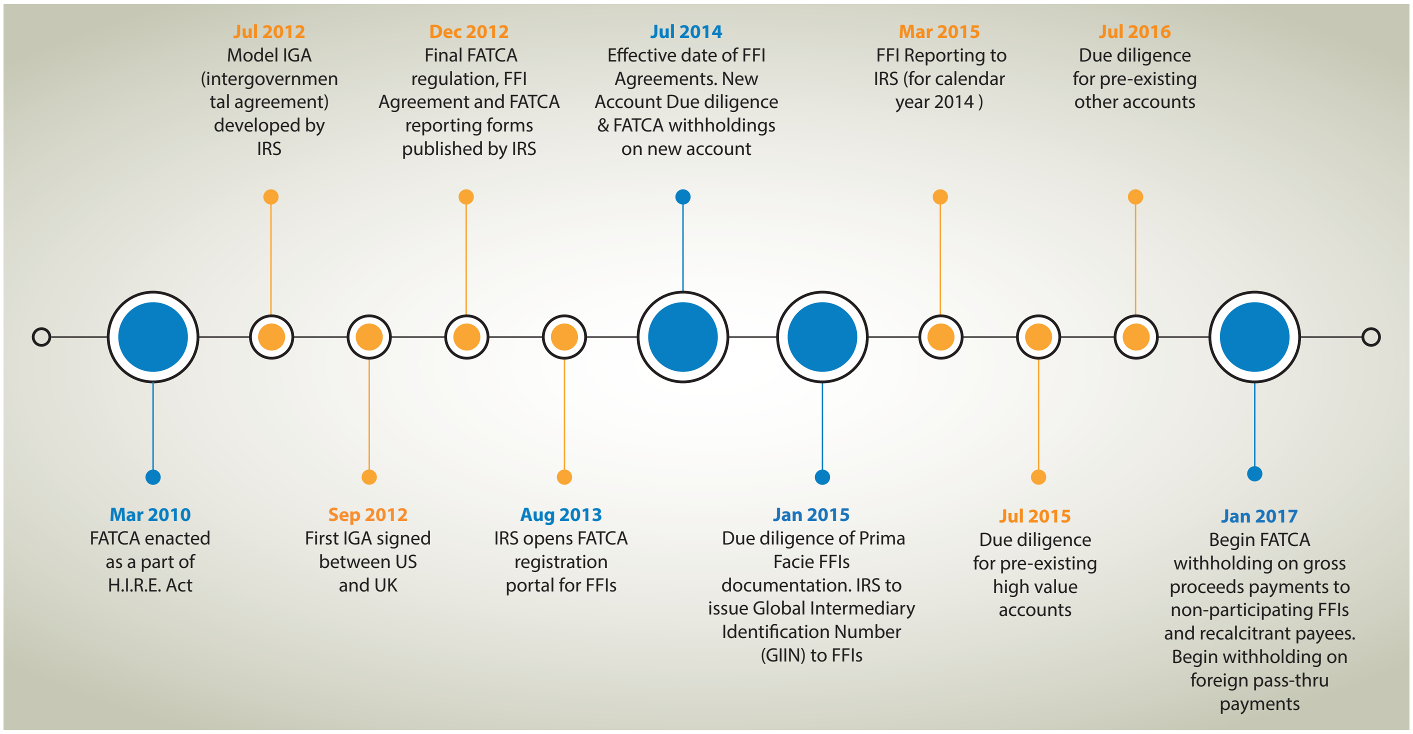

Figure 2: Important FATCA timelines

Costs of non-compliance

As per IRS guidelines, non-compliance in reporting certain FATCA sensitive information by FFIs can cost up to 30 percent withholding of tax on the US sourced interest and dividend income of FFIs. In turn, if an account holder does not share sufficient information with the participating FFI (as per FATCA, they are referred to as a "recalcitrant") then FATCA empowers the FFI to withhold 30 percent tax on their foreign income. FFIs are also empowered to close the account, if the need so arises.

With FATCA, the IRS is leaving no stone unturned when it comes to ensuring compliance from its taxpayers on foreign income and assets. By placing the onus on financial institutions in addition to individual taxpayers, the IRS is making sure it gets information from all possible sources.

In accordance, FFIs need to align their KYC program with the FATCA compliance in addition to existing KYC and AML norms.

Proposed Solution Framework

Below is the illustration of the client onboarding and KYC framework that encompasses FATCA parameters along with the respective onboarding and KYC inputs. It depicts a suggested high level technology solution framework, which may need to be aligned with the internal systems landscape of the financial institution.

Capture data

Ability to capture the following data elements in the client onboarding and enhanced KYC system:

a) **Client data** – Capture primitive client data, such as legal name, addresses, entity role, identifiers, industry classification, etc.

b) **Business relationship data** – Legal entity or individual establishes business relationship(s) with the FFIs by identifying the target product(s) at the desired geographic location. While onboarding a client, the system needs to capture:

- i) Business relationship data includes:
  - (1) Business unit or line of business (who is sponsoring and adopting respective client)
  - (2) Adoption location (where client intends to do a business)
  - (3) Adoption entity (representative FFI entity in that geography)
  - (4) Products (all the products in which a client intends to do business with the FFI. For example, equities or foreign exchange cash)
  - (5) Systems (system platform required for executing the transaction)
- ii) Respective client regulators and exchanges info
- iii) Credit and legal relevant attributes
- iv) Information about sub accounts and underlying principals, if applicable

c) **Enhanced KYC inputs**

i) Customer due diligence (global and local) - capture basic client information along with additional norms (if any) based on country-specific regulations.

ii) Anti-money laundering check - Capture data attributes specific to the anti-money laundering guidelines applicable based on the respective regulations at the client adoption location

d) **FATCA attributes - Key FATCA attributes to be captured as a part of client onboarding are:**

- i) Legal entity
  - (1) Domicile/registered address
  - (2) US Tax identification number
  - (3) Nature of business
  - (4) Shareholding pattern
  - (5) Average monthly investments
  - (6) CUSIP number
- ii) Individual
  - (1) Primary citizenship/place of birth
  - (2) Residential address
  - (3) Average monthly balance
  - (4) Power of attorney on US account
  - (5) Standing instructions (if any)
  - (6) Beneficiary information

Workflows and interfacing systems

Collaborative workflows and close integration with the function-specific interfacing systems is required to effectively analyze and translate captured data into useful information for downstream applications

a) Create/update client information (workflow A)

- i) To capture and validate client related basic information
- ii) Manage change in circumstances for the on-boarded client

b) Collect and maintain business relationship information (workflow B)

- i) To capture and analyze business relationship data
- ii) Facilitate exchange of data with the function-specific interfacing systems

c) Perform KYC and periodic reviews based on the risk rating (workflow C)

   i) To collect KYC inputs and ensure periodic reviews to authenticate correctness of data

   ii) Assess KYC collected data using specialized risk engine to arrive at the risk rating of the client

d) Workflow to facilitate FATCA checks

   i) Gather FATCA-specific inputs and documentation

   ii) Perform requisite checks – legal team, taxation team, etc.

   iii) Facilitate generation of FATCA compliance reports as per IRS/IGA

Reference database

A centralized client database is required to facilitate the single source of data for upstream data processing by various workflows as well as for consumption by downstream applications. Data is constantly analyzed at various stages of the workflow and having single reference database is of paramount importance to FFIs for accuracy of the information and overall integrity.

Downstream applications

Various downstream systems (platforms) and applications can leverage the data collected, analyzed and stored in the reference database.

Post successful client onboarding and KYC, the data can be consumed by:

a) Systems (platforms) identified as a part of business relationships

b) Reporting applications to generate requisite forms and compliance reports for FATCA, in addition to any other customary reports

c) Tax advisory system to compute FATCA tax status and applicable withholdings

d) Other relevant FFI-specific downstream applications

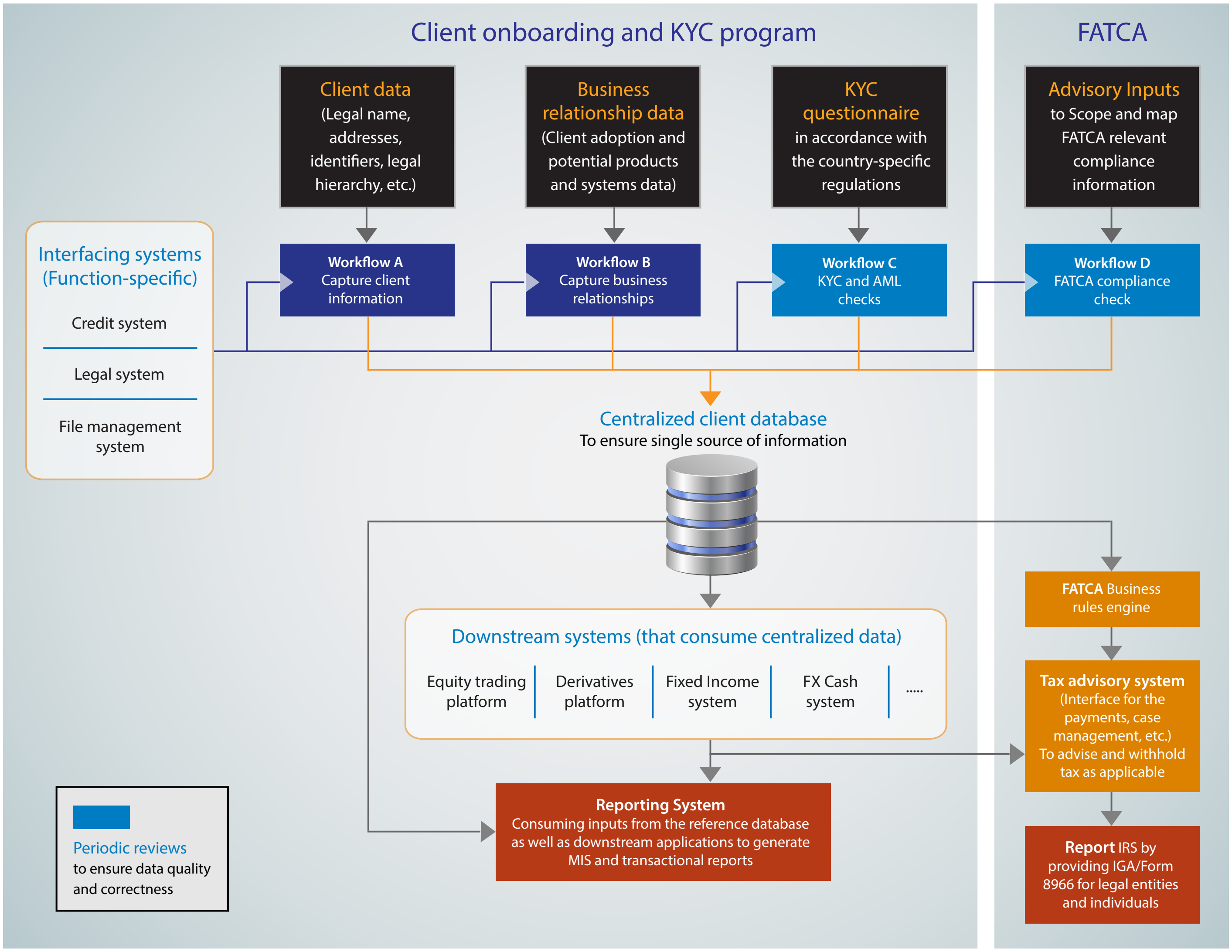

Figure 3: Proposed FATCA solution framework

How does an FFI achieve FATCA compliance?

1) Step 1: Organizational assessment

FFIs need to assess the impact of FATCA on their client onboarding programs, both from IT and operational change management perspective.

Typically, it involves assessing the existing client onboarding landscape across the line of business/business units and evaluating various systems involved in facilitating the workflow and data storage.

a) Assess the business unit structure and its linkage to legal entities or individuals

b) Understand account creation and business booking process for various products

c) Evaluate existing reporting and tax withholding procedure

d) Assess various on-boarding systems used across different lines of business

e) Understand KYC and AML policies and procedures

f) Assess database model and system workflows for onboarding and KYC

2) Step 2: Identify gaps to be addressed in order to achieve FATCA compliance

Post the assessment of the existing IT and operational processes, FFIs need to identify the gaps to be addressed in their client on-boarding and KYC programs. Below are the representative areas:

a) Identify operational gaps

- i) Classify existing accounts into FATCA categories – US, non-US or recalcitrant
- ii) Gaps in operational plan to monitor accounts and enable withholding mechanism
- iii) Gaps in the reporting process to comply with IRS requirements
- iv) Functional realignment and team restructuring

b) Identify technology gaps

- i) Handling of existing client data to capture additional information
- ii) Impact on database model and whether any data migration required

3) Step 3: Implementation roadmap

The suggested implementation roadmap is as follows:

a) Define FATCA target operating model considering identified operational and technology gaps

b) Evaluate dependencies of various work streams to optimize execution

c) Align overall change management program with FATCA deadlines to gradually transition into a FATCA-compliant organization

d) Execute considering the impact on people, technology, data and process

e) Establish governance model by operational realignment

Conclusion

The scope of FATCA is enormous, the 30% withholding tax is punitive and the time left to prepare for the compliance is short. Consequently, FFIs need to quickly and effectively put in place the necessary technological and operational aspects required to achieve FATCA compliance at the earliest.

About the author

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Saurabh is a business process management (BPM) professional with 9 years of consulting experience in the banking and financial services sector. He has performed business analyses, process modeling and IT advisory roles across USA, Singapore and India. His areas of professional interest includes business process reengineering, consulting on the effective usage of social media in the business process, analyzing the impact of regulatory changes on the IT solutions and the operational & IT change management.

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