Commercial Insights

Risk Management

FATCA for AML Made Easy?
By Alan S. Abel, CPA/CFF, CFE

Most of what has been written about the *Foreign Account Tax Compliance Act* (FATCA) has been directed at its primary target—foreign financial institutions (FFIs). The IRS' main objective via FATCA is to target potentially unreported earnings by high-net-worth U.S. citizens and taxpayers who may have unreported income flowing through offshore accounts.[1]

FATCA's prevailing FFI focus has led many U.S. financial institutions that do not have a large percentage of foreign-based U.S. taxpayers to believe—at times mistakenly—that they have no FATCA obligations, compliance risks, or consequences.

However, U.S. financial institutions without obvious FATCA implications should take action sooner rather than later to mitigate potentially unfavorable consequences from noncompliance. At a minimum, institutions should take the following steps:

1. **Expand the organization's concept of Know Your Customer (KYC) to reflect FATCA, as well as anti-money-laundering (AML) and fraud concepts.** The AML and fraud concepts of KYC require institutions to know their customers well enough to reasonably believe that customers are not engaging in money laundering, fraud, or related financial crime. FATCA's interpretation of KYC is that a financial institution should know its customers well enough to reasonably believe that its customers are not dodging paying taxes or receiving payments on behalf of someone who is.

   Getting to FATCA KYC comfort means having sufficient, competent evidential matter that will withstand the scrutiny of an IRS audit. Without more customer due diligence, the presumption that the organization has very few U.S. customers living abroad might not prove to be accurate.

2. **Update and augment the institution's KYC due diligence for existing customers.** Increasing customer due diligence (CDD) and enhanced due diligence (EDD) means reviewing existing W-8 and W-9 forms and potentially requesting updated forms. (As of this writing, the revised forms W-8 [W-8BEN-E and W-8IMY] are still in draft.) It is also advisable to audit customer files to determine whether new documentation is needed when the revised forms become available.

   If any of FATCA's specific seven U.S. indicia[2] are present, an institution likely will need to obtain sufficient documentation from those customers to determine if they are properly classified and treated. That includes revised IRS forms, copies of foreign passports, and written explanations.. If any customer claims to be a foreigner and not a U.S. taxpayer and there are indicia of U.S. status present, the institution should obtain and document sufficient evidence to cure those indicia.

3. **Revise the institution's onboarding process to include additional KYC due diligence procedures for new customers.** Augmenting KYC due diligence procedures (CDD and EDD) to an institution's onboarding process likely will have an impact on the customer experience—and, unfortunately, not a favorable one. Requiring more information upfront from customers will seem burdensome and unnecessary to some customers. Management might need additional training for handling customer inquiries and complaints.
   In addition, if a customer seems reluctant to provide additional requested information, a Suspicious Activity Report (SAR) might be appropriate. Because employees—rather than automated systems—will be the primary source of internal suspicious referrals, employees will need to be properly trained to identify and report potentially suspicious behavior.

4. **Expand the institution's AML risk assessment processes.** Institutions should evaluate how FATCA will affect their AML risk assessment processes—both their enterprise AML risk assessment (geographies, customers, and perhaps certain products) and their customer risk assessment models and processes for individuals and entities.

For geographic risk, FATCA compliance risk management may recommend adding a new element to the organization's risk model—an element of tax transparency with the United States. The IRS has entered into FATCA model agreements[3] with several foreign governments and hopes to have more than 50 such agreements in place by the end of this year. Model 1 agreements (or intergovernmental agreements – IGAs) are made with countries that already have tax information exchange treaties in place with the United States. Model 1 IGA parties may arguably present lower risk than Model 2 IGA parties, which are countries that have U.S. tax treaties but not signed IGAs, and non-IGA countries. In fact, some FFIs in non-IGA countries are starting to terminate their relationships with U.S. customers to avoid FATCA obligations and more U.S. extraterritorial jurisdiction.

5. **Designate a FATCA-responsible officer.** Although only FFIs technically are required to designate FATCA-responsible officers, many FATCA-driven requirements or compliance safeguards will simply fall through the cracks at organizations that fail to designate a person or group to oversee FATCA-related compliance.

6. **Expand and wrap suitable governance around the organization's new FATCA compliance program.** Sound risk management requires identifying and managing all aspects of compliance risk, and the prospect of new exposures—significant civil and criminal penalties and fines for failure to comply with new IRS regulations—falls squarely in that domain. While the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Securities Exchange Commission are not FATCA implementing agencies, they all require sound risk management practices.

Accordingly, boards should act now to designate and articulate FATCA compliance oversight before regulators knock at the door. Boards need to ask themselves what their FATCA compliance risks and exposures are today and what they are doing about their institution's risk exposures to make sure they are headed toward effective FATCA compliance risk management.

7. **Take a fresh look at the institution's typologies, red flags of unusual and suspicious activity, and monitoring rules.** As mentioned previously, the primary source of FATCA-related SARs will be the internal referrals from savvy employees. However, there might be FATCA-prompted transactional activities, such as, transactions that might be indicators of taxpayer recalcitrance, that could be readily monitored with some scenario modeling and tuning.

FATCA Is Not Just a Tax Rule

While the FATCA requirements seemingly reside within the tax department's realm, in almost any financial institution covered by the *Bank Secrecy Act*, AML owns and operates the infrastructure (the organization, people, processes, technology, data, and competencies) to best comply and protect the organization from financial crime and from compliance breakdowns. AML understands what is usual and reasonable and what is unusual, suspicious, and SAR reportable. U.S. financial institutions should determine their risks and institute the policies and procedures needed to detect and address such risks now, before it's too late.

Alan Abel is director and global AML practice leader with Crowe Horwath LLP in the Fort Lauderdale, Fla., office. He can be reached at 954.492.4411 or alan.abel@crowehorwath.com.

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[1] It was the United Bank of Switzerland (UBS) matter that lit the FATCA fuse. In 2009, UBS avoided prosecution (DOJ Deferred Prosecution Agreement) by agreeing to identify 4,500 customers who were allegedly evading U.S. taxes and pay a $780 million fine.

[2] U.S. Department of the Treasury, 26 CFR Parts 1 and 301, TD 9610, p. 291-296.

[3] http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx