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THE UK APPROACH TO FATCA DISCLOSURE LIABILITIES AND CLIENT CONFIDENTIALITY

Introduction

When I was first asked by Michael to talk on this subject I hoped he was asking me to address you not on "FATCA" but about "FAT CATS", a term frequently applied by the popular press in this country to apparently smug, selfish and greedy lawyers exploiting their positions for their own personal gain at the cost of others, often named and shamed by the media for earning far too much money for advising and defending those who do not deserve it. At least a talk about FAT CATS might get more laughs.

Alas, no. It is I am told the UK's approach to "FATCA" disclosure liabilities and client confidentiality that you are interested in.

When you think about it, the criticism of FAT CAT lawyers is no different to the fashionable governmental and media criticism, certainly in this country, levelled at those said to pay too little tax, and the complex mechanisms by which they avoid or evade it, with high profile celebrities and global corporations resident in the UK being publicly named and shamed almost daily for enjoying the fruits of their offshore tax-free millions. Tax-shaming is the new game in town.

This is the realpolitik underpinning FATCA, which I am in fact asked to talk to you about. As one legal commentator has put it, FATCA was this summer's top acronym thanks to the wide-sweeping US rules that came into force on 1st July 2014. It may not

be on everyone's lips, but it has certainly caused a stir in legal and accountancy circles.

The provisions of FATCA or to give it its proper title, the Foreign Account Tax Compliance Act, are contained within the Hiring Incentives to Restore Employment Act 2010 ("**HIRE**") in which it was originally enacted.

For those unfamiliar with it, the provisions are US legislation aimed at reducing perceived tax evasion by US citizens and residents through the use of offshore accounts. The legislative intent is to ensure there is no gap in the US Government's ability to determine the ownership of US assets in foreign accounts.

FATCA impacts significantly on the systems and operations of both US and non-US companies. Generally, all foreign financial institutions ("**FFIs**") are required to enter into disclosure compliance agreements with the US Treasury Department, which means reporting on accounts held by specified US persons. FFIs include banks, asset managers, trust companies as well as certain insurers.

To ensure compliance, FATCA cunningly introduced a 30% withholding tax on US source payments to non-compliant institutions. This means that unless the FFI is based in a jurisdiction that has entered into an intergovernmental agreement ("**IGA**") with the US, non-compliance may lead to the local tax authority or the US Internal Revenue Service ("**IRS**") directly taking measures against the FFI. And it does so by ensuring that all US-sourced payments that the FFI receives on behalf of itself or its clients – for instance dividends and interest paid by US corporations or gross sale proceeds from the sale of relevant US assets – will be subject to the 30% withholding tax.

The provisions require a number of steps to be taken in advance to ensure compliance. In order to avoid its local tax authority or indeed the IRS taking measures against it, each FFI is obliged to enter into an agreement with the IRS.

If the FFI is based in an IGA country, it must make arrangements with its local tax authority to comply with the regulations. These include the FFI identifying its US

clients and correctly reporting them to the IRS, capturing additional documentation on new customers when setting up accounts, and reporting annually to the IRS on assets and transactions that have taken place.

Unless the FFI is within an IGA jurisdiction, the FFI must also have systems in place to withhold the 30% tax on clients refusing to supply the requisite information and documentation.

The challenges to FFIs, especially those that are global, include ascertaining whether or not pre-existing client accounts are to be treated as US accounts. It requires electronic data searches for personal accounts over $50,000 in value, and for non-personal accounts over $250,000 in value, assuming they are not already designated US accounts, and for those over $1 million in value, a paper search of the FFI's records is an additional requirement.

While the existence of an IGA may offer a crumb of comfort, each IGA is inevitably jurisdiction-specific meaning the FFI may not be able to adopt the same approach in each jurisdiction in which it is based.

The UK Approach

The talk I have been asked to give is directed at the UK approach to FATCA. I can do no more than provide a broad-brush overview of what are on any showing complex arrangements.

Unsurprisingly, the UK tax authorities have taken to its invasive provisions with a fair degree of enthusiasm. The culture sits well with the modern, increased media focus and attention on high profile tax dodgers, and satisfies those, who believe in times of swingeing governmental budgetary cuts and austerity, that everyone should pay their fair share of tax, especially where they have assets hidden offshore.

On 8th February 2012, HM Treasury (the UK's economic and finance ministry) issued a "Joint Statement regarding an intergovernmental approach to improving international tax compliance and implementing FATCA". The US, France, Germany, Italy, Spain and the UK were parties to the joint statement. It identifies the UK's early

approach to FATCA compliance.

The joint statement endorsed the participating countries' support for "the underlying goals of FATCA" but acknowledged the difficulty for FFIs in those countries of compliance due to local legal impediments, which, it added, an intergovernmental approach would address in order to simplify practical implementation, and reduce FFI costs.

Encouragingly, the joint statement added, that because the policy objective of FATCA was to achieve reporting, and not to collect withholding tax, the US was open to adopting an intergovernmental approach to implement FATCA and improve international tax compliance.

How was this to be achieved? Quite simply by adopting reciprocal arrangements for FFIs in the US so that the US expressed its willingness to collect and exchange on an automatic basis information on accounts held in US financial institutions by residents of France, Germany, Italy, Spain and the UK.

As the joint statement went on to boast, "The approach under discussion … would enhance compliance and facilitate enforcement to the benefit of all parties." Everyone would be happy, apart perhaps from FFIs having the burden of compliance. So a common approach was to be explored which might keep compliance costs down and lead to common reporting and due diligence standards.

The joint statement set out a possible framework for intergovernmental approach. Let me read it:

1. The US and a partner country (FATCA partner) would enter into an agreement pursuant to which, subject to certain terms and conditions, the FATCA partner would agree to:

    a. Pursue the necessary implementing legislation to require FFIs in its jurisdiction to collect and report to the authorities of the FATCA partner the required information;

b. Enable FFIs established in the FATCA partner (other than FFIs that are excepted pursuant to the agreement or in US guidance) to apply the necessary diligence to identify US accounts; and

c. Transfer to the US, on an automatic basis, the information reported by the FFIs.

2. In consideration of the foregoing, the US would agree to:

   a. Eliminate the obligation of each FFI established in the FATCA partner to enter into a separate comprehensive FFI agreement directly with the IRS, provided that each FFI is registered with the IRS or is excepted from registration pursuant to the agreement or IRS guidance;

   b. Allow FFIs established in the FATCA partner to comply with their reporting obligations under FATCA by reporting information to the FATCA partner rather than reporting it directly to the IRS;

   c. Eliminate US withholding under FATCA on payments to FFIs established in the FATCA partner (i.e., by identifying all FFIs in the FATCA partner as participating FFIs or deemed-compliant FFIs, as appropriate);

   d. Identify in the agreement specific categories of FFIs established in the FATCA partner that would be treated, consistent with IRS guidelines, as deemed compliant or presenting a low risk of tax evasion;

   e. Commit to reciprocity with respect to collecting and reporting on an automatic basis to the authorities of the FATCA partner information on the US accounts of residents of the FATCA

partner.

3. In addition, as a result of the agreement with the FATCA partner … FFIs established in the FATCA partner would not be required to:

    a. Terminate the account of a recalcitrant account holder;

    b. Impose passthru payment withholding on payments to recalcitrant account holders;

    c. Impose passthru payment withholding on payments to other FFIs organized in the FATCA treaty partner or in another jurisdiction with which the US has a FATCA implementation agreement.

4. The United States, France, Germany, Italy, Spain and the United Kingdom would:

    a. Commit to develop a practical and effective alternative approach to achieve the policy objectives of passthru payment withholding that minimizes burden.

    b. Commit to working with other FATCA partners, the OECD, and where appropriate the EU, on adapting FATCA in the medium term to a common model for automatic exchange of information, including the development of reporting and due diligence standards.

On 12th September 2012 the UK and the US signed a Treaty to implement FATCA in the UK (known as "The UK-US Agreement to Improve International Tax Compliance and to Implement FATCA").

Small wonder that the UK was one of the first to sign up to FATCA when many of the corporations over recent years publicly outed in this country for paying far too

little tax in the UK are global US companies: giants such as Google, Amazon, Starbucks.

The IGA was designed to remove some of the implementation problems faced by UK financial institutions, such as the legal impediment to compliance without breaching data protection restrictions.

Because UK data protection law precluded financial institutions from complying with FATCA, the UK agreed to introduce legislation enabling UK financial institutions to provide the data required by the US without breaching those data protection restrictions. This is achieved by requiring UK financial institutions to provide HMRC (or Her Majesty's Revenue & Customs to give the UK's tax authority its full title) with the required information. HMRC then forwards that information to the US IRS.

As a result, the US agreed to remove UK institutions from the US legislation and it agreed a simpler and far less onerous approach to compliance by the financial institutions, and the US also agreed to provide the UK with reciprocal data in respect of UK persons with UK accounts.

According to an HMRC information document, the measures address two main policy objectives: (1) to enhance HMRC's compliance activities (stemming from the additional data); and (2) to assist UK financial institutions by addressing the legal issues preventing them from complying with the US legislation as well as reducing their compliance costs. Addressing the legal issues and providing a mechanism for UK financial institutions to supply the US with information it requires for its tax compliance purposes removes the threat of a 30% withholding tax, which would have had a significant negative impact on UK business - potentially leading to reduced lending and increased costs to customers.

The UK primary legislation bringing into effect the implementation of the UK-US Treaty was contained within section 222 of Finance Act 2013. This section provided HM Treasury with powers to make secondary legislation in the form of Regulations to give effect to the IGA (and other similar agreements).

The Regulations, which came into force on 30th June 2014, are known as "The International Tax Compliance (United States of America) Regulations 2013" 2014; S.I. No.1506), and are at http://www.hmrc.gov.uk/fatca/index.htm

Very briefly, the Regulations set out the reporting requirements on financial institutions, including the due diligence procedures needed to apply to identify and then report relevant account information.

Regulation 11 obliges a reporting financial institution to "establish and maintain arrangements that are designed to identify reportable accounts" and Regulation 12 to prepare in respect of "2014 and every following calendar year" a return setting out a wealth of information "in relation to every reportable account".

Failure to comply with obligations under the Regulations can be met with nominal financial penalties and daily default penalties. The provision of inaccurate information in annual reports under Regulation 12 attracts higher penalties. A penalty is subject to appeal as to liability or as to quantum. Penalties are enforced as if they were income tax charged in an assessment, and due and payable.

Quite recently, on 28th August 2014, HMRC issued 181 pages of guidance notes, promising standalone updates as US regulations change, and a 6 monthly review in February 2015.

The HMRC guidance identifies the scope of FATCA and the UK legislation implementing the IGA: it applies to financial institutions based in the UK, which are referred to as "UK Financial Institutions" ("**UKFI's**").

In order to determine how the legislation applies the guidance states is necessary for a financial institution to consider a number of questions:

- Am I a Financial Institution?
- Do I maintain Financial Accounts?
- Are there indicators that any of the account holders' are Specified US

Persons?

- After applying the relevant due diligence, do I have any Reportable Accounts?

The guidance states that the first step to be undertaken by an entity or its representative is to establish whether, for the purposes of the IGA, the entity is a financial institution. This will determine the extent of the obligations that need to be undertaken.

FATCA introduced the concept of a Foreign Financial Institution (FFI), which applies to non-US entities that meet the definition of a financial institution. Under the IGA, UK entities are regarded as UKFI's if they fall within any one of, or more than one, of the following categories.

- Depository Institution - §2.26
- Custodial Institution - §2.27
- Investment Entity - §2.28
- Specified Insurance Company - §2.29
- Holding Companies and Treasury Centres of Financial Groups - §2.30

Each category of UKFI is determined by set criteria, which must be met. Where an entity does not meet the definition then the entity will be regarded as a Non-Financial Foreign Entity ("**NFFE**") (see §2.6).

Under the IGA, UKFI's will be classified either as a Reporting UK Financial Institution or a Non-Reporting UK Financial Institution (such as the Bank of England). As long as UKFI's are in compliance with the UK legislation then they will not be subject to any withholding tax on their US source income under S1471 of the US Internal Revenue Code.

Let me take an example of when an Insurance Company becomes a UKFI according to HMRC's guidance notes.

Under §2.29 Insurance Companies will be treated as a Specified Insurance Company

only when the products written are classified as *Cash Value* Insurance or Annuity Contracts, or if payments are made with respect to such contracts.

Therefore Insurance companies that only provide General Insurance or term Life Insurance should not be Financial Institutions and neither will reinsurance companies that only provide indemnity reinsurance contracts.

A Specified Insurance Company can include both Insurance Companies and the holding companies of insurance companies. However, a holding company itself will only be a Specified Insurance Company if it issues or is obligated to make payments with respect to Cash Value Insurance Contracts or Annuity Contracts.

Insurance brokers are normally part of the payment chain and therefore should not be classified as a Specified Insurance Company. This will not be the case where they are obliged to make payments under the terms of the Insurance or Annuity Contract.

Practical Realities

More than 30 jurisdictions (including Cayman Islands, Gibraltar, Guernsey, Jersey, Isle of Man and the Virgin Islands) have established IGAs to apply and enforce FATCA, and 40 more have formed agreements in principle with the US.

The scale of FATCA's reach is immense and institutions are only waking up to it slowly in this country.

One statistic I have seen is that some 77,000 financial institutions worldwide have registered under FATCA with the US authorities. That, I suspect, will increase as awareness of FATCA's reach increases.

FFI's are expected to register by 1st January 2015 for a so-called global intermediary identification number ("**GIIN**") provided to any US tax payers demonstrating that they do not need to withhold tax on payments. In the UK, UKFI's (those UK reporting financial institution registered under FATCA) are also required to submit their first returns to HMRC by 31st May 2015.

While new account clients can self-certify on introduction to an institution, compliance is a struggle for institutions in the case of historic clients where the necessary level of data is not available.

Despite the fancy talk of reducing costs, the true burden of FATCA as against the likely additional return to the US tax payer (estimated to be a mere $800 million a year) might be tens of $ billions.

FATCA fever

So enthused was the UK Government by FATCA that in 2012 it announced in the Autumn statement plans to adopt its own version of FATCA, by employing the US-UK IGA as a model for similar arrangements for the exchange of tax information between the UK and the three Crown Dependencies of Jersey, Guernsey and the Isle of Man as well as seven Overseas Territories including the Cayman Islands, BVI, TCI and Gibraltar. Many had been signed by November 2013. The UK did not need the threat of a 30% withholding tax to get these dependences and territories to sign up: political power was sufficient.

The UK version is affectionately known as "Son of FATCA" and the timeline for implementation of the UK version is aligned with the US FATCA.

But that is not an end of FATCA fever. Other FATCA type legislation is on the horizon. The EU is considering rolling out similar regulations, and the OECD has developed the Common Reporting Standard, acronymically dubbed "GATCA", the Global Account Tax Compliance Act. In May 2014, all the OECD members, as well as Brazil, China and India agreed to implement GATCA from around 2017.

This is no surprise. As you may remember me telling you, in February 2012, the parties to the US joint statement committed to working with among others, the EU and OECD, to developing a common model for the automatic exchange of information, including the development of reporting and due diligence standards.

Thus there are multijurisdictional problems in compliance with regimes that may well differ in detail and execution. So for example, while HMRC's guidance notes run to

181 pages, the Cayman Islands' equivalent runs to a little shy of 200 pages. Other countries will doubtless be in the throes of issuing similar guidance documents, all somewhat different to the other. Getting to grips with them all is not just going to be a headache for institutions and lawyers in the UK.

Concluding remarks

Inevitably there is a tension between the exchange of tax information and the privacy of a client's affairs – in this context, the liability to disclose information for tax purposes as against the non-revelation of confidential client affairs. However, where tax is concerned, there is no contest, if there ever was.

In this country as well as in jurisdictions across the globe, tax systems are pushing back on complex tax evasion.

It is to be expected that governments worldwide will be increasingly keen to participate in obliging financial institutions holding information about their citizens and corporations to reveal all on a multilateral, international scale for the mutual benefit of their treasuries.

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