FATCA - The New UK Landscape

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1. Background

The term "FATCA" has been in circulation for what seems like a very long time. However, recent developments have substantially altered the landscape of FATCA in the United Kingdom. Now that the application of FATCA to UK financial institutions has taken on a discernable shape, this Briefing Paper explains that shape, how it has developed and what further developments might be expected.

The US Hiring Incentives to Restore Employment Act 2010 (known as "HIRE"), introduced the Foreign Account Tax Compliance Act – FATCA. The genesis of FATCA is the desire by the Internal Revenue Service (IRS) to combat tax evasion by US persons through the use of undeclared non-US accounts. As the US personal tax system is based on citizenship, US persons do not need to be resident in the US for US tax to apply to them.

To meet the IRS' policy objective, FATCA seeks to make foreign (as in non-US) financial institutions ("FFIs") its information gatherers, imposing extensive reporting requirements. FFIs will include certain banks, funds, insurers, trusts, partnerships and other institutions and entities holding investments, money or property for the benefit of others. FATCA's reach extends across the globe. Under FATCA, FFIs are obliged to provide information on US account holders to the IRS. The US legislation has teeth – sharp ones - a failure to comply can (where there is no "intergovernmental agreement" in place – see below – and even in some cases where one is in place) result in a 30% US withholding tax applying to certain US-related payments to the non-compliant FFI.

Field Fisher Waterhouse LLP, amongst others, has been involved in the process of shaping the UK approach to FATCA compliance. Andrew Prowse, a tax partner, is a member of one of the HMRC sub-committees established to raise awareness of FATCA and to discuss its implementation in the UK.

2. G5 Developments

Financial institutions and their advisers became concerned early on that compliance with FATCA could cause non-compliance with their domestic laws, for example breaches in data protection laws, as well as giving rise to onerous administrative burdens.

The G5 countries, being the UK, France, Germany, Italy and Spain, approached the US government to explain their concerns and, together with the European Commission, worked to address these problems.

The solution arrived at by the G5 and the IRS is for FFIs to report information to their domestic tax authorities, who will in turn pass that information to the IRS through existing double taxation agreements and information exchange agreements. Some reciprocity was sought (and has been obtained), giving G5 countries rights to obtain information on US accounts held by G5 taxpayers.

On 8 February 2012, the G5 and the US issued a Joint Statement setting out their preliminary agreement. On 26 July 2012, a further joint statement announced publication of a "Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA".

3. The Model Agreement

The model agreement is the template on which each agreement between a G5 member and the US will be based.

The broad framework of the model agreement is that, taking UK FFIs as the example:

- domestic compliance impediments are addressed;
- 30% US FATCA withholding tax will <u>not</u> be imposed on income received by UK FFIs (other than where there is significant non-compliance with the Agreement);
- UK FFIs will <u>not</u> have to apply FATCA withholding tax on payments that *they* make (e.g. to US account holders);
- information gathering and reporting requirements will be more aligned with other domestic due diligence rules; and
- low-risk UK institutions and products will be exempted from FATCA compliance.

The UK-US Agreement

On 12 September 2012 the UK and US governments signed a bilateral agreement, based on the model agreement.

On 18 September 2012 HMRC issued a consultation document: Implementing the UK-US FATCA Agreement (a bilateral agreement based on the G5-US model agreement). Final legislation on the UK implementation of the UK-US Agreement will be included as part of the Finance Bill 2013 process. The draft Finance Bill 2013 is expected to be published in December 2012.

The UK-US Agreement is around 30 pages long, compared with the almost 400 pages of FATCA regulations in the US and so on that count alone represents a marked improvement for UK FFIs. However, as many UK FFIs will be part of a larger international group, FATCA compliance across the group may necessitate examining the UK-US Agreement, the direct rules in the US and other model agreements between the US and other jurisdictions. In most cases it is not likely to be a straightforward exercise.

Foreign Financial Institutions

In simple terms, the UK-US Agreement obliges UK FFIs (except those that are excluded FFIs and except in relation to exempt products) to obtain and report to HMRC detailed information on accounts held by certain US persons, as well as certain other information. Key, therefore, is what is meant by an FFI.

In practice FFI's are likely to include banks, insurance companies, mutual funds, hedge funds, private equity funds, leveraged buy-out funds and similar funds. It is likely that most funds will be FFIs.

The four types of UK FFI are:

- Custodian Institutions;
- Depository Institutions;
- Investment Entities; and
- Specified Insurance Companies.

Custodian Institution

This is "*any entity that holds, as a substantial portion of its business, financial assets for the account of others*". That will be the case if the "*entity's gross income attributable to the holding of financial assets and related financial services equals or exceeds 20 percent of the entity's gross income*" over certain periods.

It remains to be seen what "related financial services" means.

In the funds context, platforms and others who hold legal title to interests in funds on behalf of investors are likely to be custodial institutions, as are those who hold legal title to the assets of the fund itself.

Depository Institution

This is "*any entity that accepts deposits in the ordinary course of a banking or similar business*", and is not to be confused with a depositary within the funds context.

Investment Entities

This is "*any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:*

trading in money market instruments…; foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;

individual and collective portfolio management; or

otherwise investing, administering, or managing funds or money on behalf of other persons".

The definition is to be interpreted consistently with the meaning of "financial institution" in the Financial Action Task Force Recommendations. The definition has caused some debate within the funds sector, particularly around the risk of investment managers, fund administrators, transfer agents and unit trust trustees all being separate FFIs (whilst in fact maintaining no financial accounts) from the underlying funds and so each having reporting obligations by virtue of the "*otherwise … administering or managing funds or money…..*" test.

HMRC has proposed adopting a similar position to the IRS on the application of FATCA reporting to funds, being that the fund is responsible as an FFI, but that the investment manager or other service provider makes the reports on behalf of the fund.

It remains to be seen how the Agreement will in practice deal with umbrella funds and sub-funds (often operating separately from the umbrella fund) and which fund or funds must comply, as well as the international issue of fund structures comprising entities in different jurisdictions.

HMRC has engaged constructively and conscientiously with industry and practitioners throughout the UK-US Agreement process. It is to be hoped (and expected) that HMRC will issue guidance to clarify these and other practical aspects arising from the proposed FFI definitions.

Specified Insurance Company

This is "*any entity that is an insurance company (or the holding company of an insurance company) that issues,* *or is obligated to make payments with respect to, Cash Value Insurance Contracts or an Annuity Contract*".

Excluded FFIs

These comprise institutions which are considered to be of nil or low risk of being utilised for US tax evasion by US taxpayers.

They include:

- certain UK government and international organisations;
- the Bank of England;
- pension schemes or other retirement arrangements established in the UK;
- certain non-profit organisations (including charities); and
- certain institutions with a local client base (including investment trust companies, venture capital trusts and building societies), provided particular conditions are met.

In the funds context, there is a danger that many parts of the fund structure will be caught within one or more of the UK FFI definitions, in respect of the same fund. The Trustee will hold legal title to the assets. The Fund Manager will carry out the investment management, or delegate it to others. There will also be the fund itself, which may or may not have legal personality. Some of those entities may be in the UK, whilst others may not. Clarity is needed as to which entity is expected to be the relevant UK FFI, in order to avoid burdensome and expensive duplication. It makes sense for all concerned to centralise FATCA compliance. Complexity is likely to arise where the fund structure includes FFIs (within the relevant definitions) both within the UK and outside the UK, so that different rules apply and so that central compliance will be difficult or impossible to legislate for.

Whilst it makes sense for the fund itself to have the obligation to comply with FATCA, the fund will wish to consider how best it can discharge that obligation. It may well conclude that the fund manager or operator should be required contractually to deal with the obligation. If so, the contract with the fund manager will need to set out the terms of the arrangement. In turn, the fund manager will want to ensure that it has the ability to provide the compliance service to the fund (i.e. that it has or can obtain or have access to the relevant account holder and account data) and that where appropriate (which is likely to be in most cases) the obligation is sub-contracted to a third party service provider.

Exempt Products

Certain products will not be "reportable accounts" and therefore will effectively be outside the scope of FATCA where established in the UK and maintained by a UK FFI. These include:

- pension schemes registered with HMRC and pension arrangements where annual contributions are limited to £50,000 and funds cannot be accessed before age 55 (except in cases of serious ill health);
- ISAs;
- Junior ISAs;
- Child Trust Funds;
- Save As You Earn Share Option Schemes approved by HMRC;
- Share Incentive Plans approved by HMRC; and
- Company Share Option Plans approved by HMRC.

Discussions are ongoing between industry, practitioners and HMRC with a view to expanding this list where agreement can be reached with the IRS.

The international dimension

An FFI is one of the four classes of financial institution, but this only applies to UK FFIs – i.e. to those resident in the UK for tax purposes (and to UK branches), but excluding any "related entities "(e.g. subsidiaries) and branches located outside the UK. As such, any FFI not resident in the UK will not be able to avail itself of the UK-US Agreement (except for any UK branch it may have) and instead will be subject to another bilateral agreement if one is available, or to the less favourable direct compliance with FATCA.

Accordingly, for FFIs there will be three scenarios:

- direct FATCA compliance;
- FATCA compliance through one or more of the G5 Model Agreements (or similar agreements which the US enters into with other countries); and/or
- FATCA compliance through one or more other model agreements (not based on the G5 model) which the US enters into with other countries.

Direct agreements with the IRS may be extremely burdensome for foreign FFIs. Under the agreement, the FFI will be obliged to deduct and withhold tax on so-called "passthru" payments made to recalcitrant account holders and to other FFI's who are non-compliant (or non-participating). The IRS has stated that it will publish a list of participating FFIs, for the use of withholding agents to enable them to determine the withholding tax requirements. Non-US persons can be withholding agents for the purposes of FATCA withholding. FATCA withholding obligations can apply to any person who has control, receipt, custody, disposal of payments of US source income to an FFI. So, for example, a fund holding US government securities or US stock in an investment account for a foreign investor would qualify as a withholding agent.

The diagram **on page 8** shows the complexities in the context of an international business.

Where a UK FFI has "related entities" or branches outside the UK (in a jurisdiction that prevents it from being a participating FFI or deemed compliant FFI, where there is no FFI agreement with the IRS), this will not impact on the UK FFI's FATCA-compliant status under the UK-US Agreement provided that:

- the UK FFI annually reports aggregate payments made to them;
- the relevant entity reports to the fullest extent possible under the laws in their jurisdiction and identify themselves to withholding agents; and
- broadly the related entity does not solicit US accounts held by persons resident outside its jurisdiction and is not used to circumvent FATCA obligations.

In other words, the UK FFI must in effect treat such entities outside FATCA partner countries as if they were account holders of the UK FFI and therefore must carry out the same account checking and reporting functions in respect of such "accounts" held by group entities as they do for directly held accounts.

4. What will an FFI have to report?

Considerable detail will have to be reported to HMRC. A US Reportable Account is any account (which can include equity or debt interests) held by a US Person or by a non-US entity with one or more controlling person who is a US Person (subject to certain exceptions). "Person" here includes a US citizen, resident individual, partnership, corporation or trust.

For US Reportable Accounts, a summary of what information must be reported is set out in **on page 9**.

In addition to US Reportable Accounts, for each of the calendar years 2015 and 2016, a UK FFI will have to report the name and aggregate payments made to each "nonparticipating financial institution" (NPFI). An NPFI is an institution (or branch of an institution) which has been listed as such by the IRS or has not entered into an FFI Agreement with the US (in a case where it cannot benefit from an intergovernmental agreement).

In order to comply with the reporting obligations, the FFI must also comply with detailed due diligence obligations, the aim of which is to identify US Accounts – i.e. those accounts in respect of which reporting is required – and NPFIs. These requirements raise challenging questions in some cases. For example, where data on value is required, what is the appropriate valuation methodology? In some cases this will be obvious, but in others less so – for example illiquid real estate interests.

The specific due diligence requirements are beyond the scope of this briefing, but it may be helpful to note that there are various thresholds aimed at reducing the compliance burden for FFIs. For example:

- pre-existing individual accounts with a balance or value of $50,000 or less as at 31 December 2013 do not need to be reviewed (unless there are multiple connected accounts). They would only need to be revisited if they subsequently exceed $1m;
- pre-existing individual accounts with a balance or value in excess of $50,000, but of less than $1m (lower value accounts) at any calendar year end have reduced due diligence requirements;
- pre-existing individual accounts with a balance or value in excess of $1m at any calendar year end (high value accounts) are subject to enhanced due diligence requirements;
- for new accounts (i.e. those opened on or after 1 January 2014):

⇒ the lower value threshold for deposit accounts remains at $50,000, but there is no threshold for custodial accounts or for equity interests in funds, for example, and so this de minimis has only limited application – this could be very burdensome where a fund has many small investors – e.g. retail funds;

⇒ where a new account needs to be reviewed, a self-certification must be obtained; and

- there are different thresholds and due diligence requirements in relation to NPFIs.

It is likely that common formats will develop for submitting account information. It is hoped that these will apply across the world, so that common systems can be prepared and implemented to capture and submit the appropriate data. The HMRC Consultation Document is encouraging, saying that the Government "*will continue to discuss these issues with the US, EU, OECD and other FATCA Partners to work towards as consistent approach as possible".*

A UK FFI will, as has been said, generally submit account data to HMRC. However, it will need to register with the IRS as an FFI. There is a lack of clarity over exactly how this registration process will work, but it is expected to be an on-line process, resulting in a registration number. The registration requirements will be aligned with the applicable reporting requirements.

What about FATCA withholding?

A compliant or deemed compliant UK FFI will not have to operate FATCA withholding tax or be subject to it. Furthermore, it will not be required to close the accounts of recalcitrant holders.

When do the new reporting requirements take effect?

There is some complexity on this question, because the rules are to be phased in to give FFIs time to prepare their systems to gather and report the required information. Furthermore, the IRS announced in October 2012 that the timelines for FATCA compliance, where not subject to an intergovernmental agreement, will be extended (representing a closer alignment between the direct compliance timelines and the timelines under the intergovernmental agreements).

For calendar year 2013 onwards the following information on US person's financial accounts is required:

- name, address, US TIN or date of birth if no US TIN available;
- account number (or functional equivalent);
- name and identifying number of the reporting institution; and
- account balance or value.

For calendar year 2015 onwards - in addition to the above:

- for Custodial Accounts - the total gross interest, total gross dividends and the total gross amount of other income generated with respect to the assets held in the account;
- for Depository Accounts - the total gross amount of the interest paid or credited to the Account; and
- for any other account - the total gross proceeds paid or credited to the Account Holder.

For calendar year 2016 onwards - in addition to the above:

- for Custodial Accounts the total gross proceeds from the sale or redemption of property paid or credited to the Account

The first year in which reports will be required is 2015, when reports for the calendar years 2013 and 2014 must be reported.

Generally, the information will have to be reported to HMRC by 31 March after the end of the calendar year to which the information relates, with the exception of the first year of reporting, which is likely to be split into two phases: 2013 data being reported to HMRC by 31 March 2015 and 2014 data being reported by 30 June 2015.

Non-compliance is likely to be dealt with through HMRC's penalties regime, although HMRC are considering whether any variations specific to FATCA compliance will be necessary. However, punitive withholding taxes may apply where there is a significant and prolonged non-compliance with the Agreement.

Nominated Individual

HMRC is consulting on whether it would be useful for there to be a nominated individual at each FFI to act as a point of contact on FATCA matters and to sign off on compliance matters (to be nominated by the FFI and not to be personally liable for any penalties). This is to be contrasted with the direct FATCA requirement (which does not apply to a UK FFI) of having a "responsible officer" personally liable for FATCA compliance.

What do I need to do?

If you are or think you are potentially within the scope of FATCA and have not yet considered how it will apply to you, you should take advice urgently.

The application of FATCA should be considered in respect of each entity in and each branch of the business, whether in the UK or elsewhere, so that all of the FATCA requirements for each jurisdiction can be understood fully and an action plan developed.

Your systems, in terms of the questions you ask of investors and in terms of account information and intra-group arrangements should be checked carefully to ensure that they can accommodate the requirements of FATCA and any necessary changes made.

It's not just about getting the right systems in place to ensure FATCA-compliance. There is also the legal aspect in terms of ensuring that appropriate provisions are included in fund documentation, prospectuses and contracts so that there is a legal mechanism in place to enable FATCA compliance and to allocate risk and responsibility.

Inevitably, there will be uncertain areas where the FATCA rules do not perfectly fit the underlying facts.

Remember that FATCA is something of a moving feast. Changes have been made to the regime over the course of the year to date and more changes are likely. This applies in respect of the IRS position, where more guidelines are expected to be published in the near future, and to the UK-specific position, where HMRC is due to respond to the replies to the consultation on the implementation of the UK-US Agreement. Draft guidance from HMRC is due in December 2012.

A great deal of work has been done by Governments, institutions and practitioners across the world in an effort to make FATCA workable, but there remains a great deal of work to be done.

If you would like any advice on FATCA, please contact Andrew Prowse, a partner in our Tax Group, or your usual firm contact.

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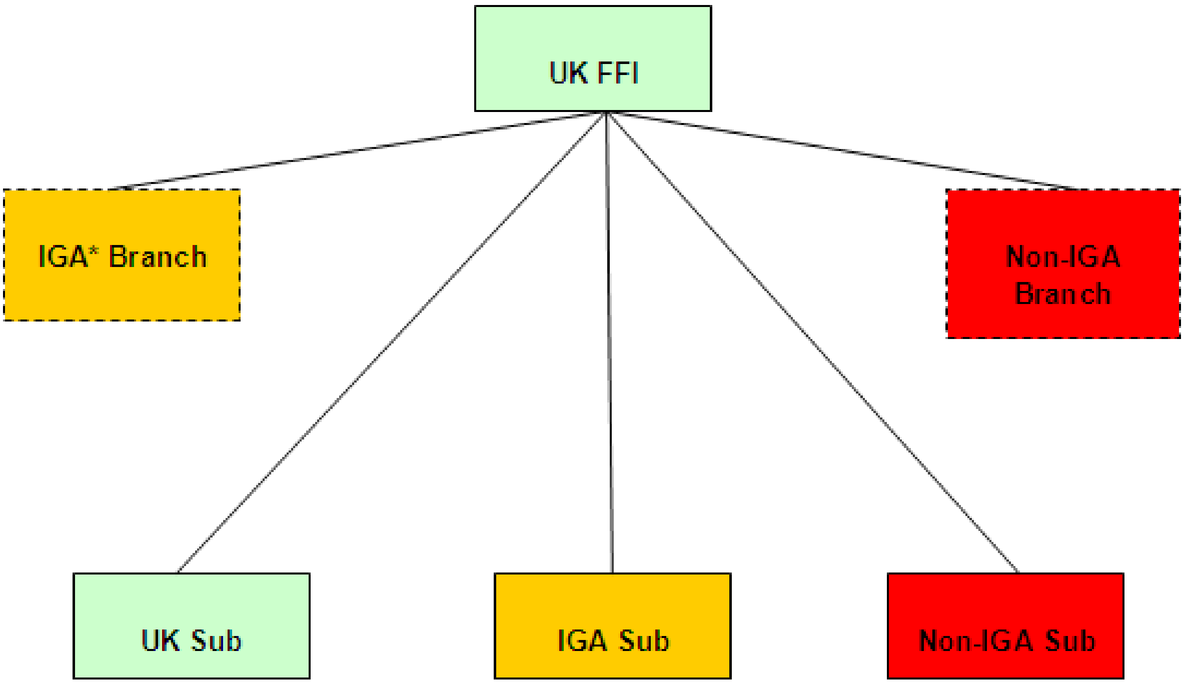
Example International Structure



US-UK Agreement Applies

Anticipated Partner Jurisdiction FFIs – they must report directly to their local tax authority or to the IRS (depending on the type of Model IGA in question) under their IGA

Report to IRS directly

* IGA – Intergovernmental Agreement

Information to be Reported

The name, address, and US Taxpayer Identification Number of each "Specified US Person" that is an Account Holder of such account and, in the case of a Non-US Entity that, after application of the stipulated due diligence procedures, is identified as having one or more Controlling Persons that is a Specified US Person, the name, address, and US Taxpayer Identification Number (if any) of such entity and each such Specified US Person;

The account number (or functional equivalent in the absence of an account number);

The name and identifying number of the Reporting United Kingdom Financial Institution;

The account balance or value (including, in the case of a Cash Value Insurance Contract or Annuity Contract, the Cash Value or surrender value) as of the end of the relevant calendar year or other appropriate reporting period or, if the account was closed during such year, immediately before closure;

In the case of any Custodial Account:

- the total gross amount of interest, the total gross amount of dividends, and the total gross amount of other income generated with respect to the assets held in the account, in each case paid or credited to the account (or with respect to the account) during the calendar year or other appropriate reporting period; and
- the total gross proceeds from the sale or redemption of property paid or credited to the account during the calendar year or other appropriate reporting period with respect to which the Reporting United Kingdom Financial Institution acted as a custodian, broker, nominee, or otherwise as an agent for the Account Holder;

In the case of any Depository Account, the total gross amount of interest paid or credited to the account during the calendar year or other appropriate reporting period; and,

In the case of any account which is not a Custodial Account or Depository Account, the total gross amount paid or credited to the Account Holder with respect to the account during the calendar year or other appropriate reporting period with respect to which the Reporting United Kingdom Financial Institution is the obligor or debtor, including the aggregate amount of any redemption payments made to the Account Holder during the calendar year or other appropriate reporting period.

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