Have you got the X-FATCA?

PAUL CREAN asks whether all entities are aware of their FATCA and common reporting standard status.

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Many smaller entities appear to believe that the FATCA and common reporting standard legislation relates only to large traditional financial organisations with US investments, and can be safely ignored.

However, many trusts and personal investment companies will also be caught by the definition of financial institution. They have to register and report regardless of whether they have US investments or, for the common reporting standard, US account holders. Even when a trust or personal investment vehicle is not a financial institution, it may find that financial information about shareholders and beneficiaries is being reported to tax authorities for scrutiny.

How the legislation evolved

From 1 January 2016, all UK entities – companies, partnerships, trusts, branches or other forms of legal arrangement – are potentially subject to four tax information exchange regimes. Collectively known as automatic exchange of information (AEOI) agreements, these are:

- United States Foreign Account Tax Compliance Act (FATCA);
- Crown dependencies and Gibraltar regulations (CDOTs);
- common reporting standard (CRS); and
- EU directive on administrative co-operation in tax matters (DAC).

KEY POINTS

- All UK entities may be subject to the tax information exchange regimes.
- Definition of a financial institution.
- Active or passive non-financial entities must also comply with the legislation.
- Differences between the different regimes.

The UK FATCA legislation entered into force in 2014, with the first annual reporting deadline in May 2015. Reporting under the CDOTs will occur for the first time in May this year and will be subsumed into reporting under the CRS from May 2017.

The AEOI legislation as a whole requires financial institutions to report financial information about customers who are tax resident outside the UK or, if dual resident, tax resident elsewhere in addition to the UK, to overseas tax jurisdictions through HMRC. Failure to do so can lead to penalties. For example, a French individual or company with a UK bank account is reported through HMRC to the French authorities. Overseas domestic legislation is also being enacted, so information will be flowing out of foreign jurisdictions in similar fashion to the UK.

Although the legislation is aimed at financial institutions, others also need to be clear on their status. This is because financial institutions will ask them to self-certify when opening bank and custodial accounts, investing in them, or even generally transacting with them. In short, every entity will have an AEOI classification (or classifications) and need to know what it is.

Myths and legends

Despite it being more than five years since FATCA was enacted by the US government in the HIRE Act 2010, several myths about it persist which could prove problematic as the AEOI network expands. So, let's bust some of them.

Disbelieving client: The entity I work for is not a financial institution and therefore we can ignore the legislation.
Myth-busting fact 1: It is true that financial institutions are responsible for identifying and reporting non-UK customers.

Non-financial institutions do not have an active obligation. However, the definition of a financial institution is widely drawn and not limited to banks, large funds, custodians or regulated entities. There are many 'accidental' and unsuspecting financial institutions as a result.

The definition includes entities that invest, manage or administer funds or money on behalf of others, or hold financial assets and are managed by a financial institution.

Many non-regulated entities are caught, including:

- trusts (even small family trusts) that have a corporate trustee or whose assets are financially managed by a bank or asset management type firm;
- brokers;
- private equity houses;
- venture capitalists;
- collective investment vehicles, carry vehicles and other entities within fund structures (limited partners, limited liability partnerships);
- personal investment companies (PICs) managed externally; and
- nominee companies and entities holding legal title to financial assets.

In the UK alone, more than 25,000 entities have registered as financial institutions, of which almost 9,000 are trusts. Most of these would not have thought of themselves as financial institutions before FATCA.

Disbelieving client: I don't have US investments or US clients, and therefore FATCA is irrelevant to me. (This is the classic statement, and anyone who advises on FATCA will not have to wait long before they hear it.)
Myth-busting fact 2: FATCA is now part of UK domestic law. Financial institutions have to comply. Further, even if the institution believes there are no US accounts, it must be able to prove it has no US clients. These include green card holders, people born in the US, US citizens with dual residency, and non-US nationals tax-resident in the US. Can the institution be sure that it does not have any 'accidental' Americans? In the past, most clients' acceptance procedures will not have sought to capture this level of detail. As of 1 July 2014, new client acceptance protocols must be in place to deal with this.

Even if a UK financial institution has no US clients, under the wider AEOI legislation – and domestic UK law – unless all its accounts are held by UK-only tax residents, it should expect to have a reporting obligation. Again, new client acceptance procedures should be in place such that, from 1 January 2016, the tax residency of all new clients must be established.

Disbelieving client: All my customers/account holders are other entities; I have no individual account holders.
Myth-busting fact 3: Are all the direct investors financial institutions? It is true that when account holders are financial institutions this is a 'chain terminator'. In other words, the institution maintaining the account can rely on the financial institution account holder to investigate its own operations and report as required under FATCA. However, the original institution still has to validate the FATCA status of its account holders to confirm they are in fact financial institutions and demonstrate that this has been done, if requested. This is to be achieved through a review of existing anti-money laundering (AML) and know your customer (KYC) data and following up any red flags that indicate reportable accounts.

Further, non-financial institution accounts are not, in themselves, chain terminators – otherwise an individual seeking to sidestep AEOI would simply incorporate. A financial institution has to look behind a non-financial institution account holder in some circumstances and identify natural controlling persons in a manner similar to that already imposed by AML requirements.

Account holders can also include those holding a financial institution's debt and equity, so it may be necessary to look more widely than first thought.

Disbelieving client: I cannot identify my ultimate controlling persons. I am a company in the middle of a group and do not have that information. It's impossible.
Myth-busting fact 4: Controlling persons have to be identified in line with AML and KYC regulations. AEOI requirements aside, entities are already obliged to provide th is information, and these new agreements are taking their lead from existing UK requirements. How has the trust or partnership managed to open a bank account, engage a professional adviser or take out a loan without providing this information? The information is available – ask whomever has responsibility for KYC compliance.

Disbelieving client: Perhaps we do have a trust that holds stocks and shares, but we still don't have any account holders. All the trust has are beneficiaries, a few individual trustees, one corporate trustee and the settlor. Oh, there is also a personal investment company. The company is owned by my family, me and my cousin in France – she lent the company money on which we pay interest. My wife was born in the US, but has lived here since being an adult, and one of my daughters is now working on Niue in the south Pacific. An investment manager looks after the assets, but it basically just ticks over with a little outside help.
Myth-busting fact 5: For trusts, financial account holders are defined to include trustees, beneficiaries, settlors and other natural persons exercising effective control over the trust. For companies, account holders can include holders of debt and equity holders in the entity. In this instance, there are quite a lot of account holders, and at least three of them are non-UK tax resident.

Disbelieving client: If I have understood this correctly, hundreds of thousands of entities will be submitting information to hundreds of tax authorities, concerning possibly millions of individuals and companies, and these tax authorities will all be exchanging this information with each other. As someone famously said about Facebook, it all sounds like the most tremendous waste of time. Is this really going to happen?
Myth-busting fact 6: This may be a semi-myth bust. It may yet prove to be a tremendous exercise in information-sharing that will lead to not as much as the tax authorities hope. The poem by Phaedrus about a mountain labouring and giving birth to a mouse springs to mind. We simply do not yet know to what extent the data will be interrogated, and how many individuals'

tax affairs will be investigated. Clearly, it will demand a huge amount of resources, and one might reasonably anticipate that the authorities will take a risk-based approach concentrating on the financial institutions and clients deemed to be of most concern.

Still not worried?

Every entity must have an AEOI classification, and an entity is pretty much any structure regardless of whether it is tax transparent. If it is not a financial institution, it will be an active or passive non-financial entity (NFE). FATCA uses the term NFFE (non-financial foreign entity) while CRS/DAC uses the term NFE. NFE is used in this article to encompass both abbreviations.

Broadly, an active NFE has income of which 50% or more must be from non-passive sources. Typically, passive sources of income are dividends, interest, rent, royalties, and net gains from the sale of passive income-producing assets. An NFE that is not active is passive.

Active entities are largely off the hook from an AEOI point of view. They do not report and are not reported on. Passive NFEs are, however, affected – passively: although they have no reporting obligations, they may be reported on.

So, if a trust is not a financial institution – perhaps it is a small family trust with stocks and shares and bonds that is managed by family members – it is likely to be a passive NFE.

A UK financial institution which has identified passive NFE account holders has to identify the natural controlling persons (see myth-busting fact 3). If these individuals are US persons, they will be reported under FATCA; if resident in DAC/CRS countries, they will be reported under these regimes; and if resident in the crown dependencies or Gibraltar under CDOT. (Financial institutions in the CDOT countries will also be reporting information to HMRC through their in-country authorities.)

Controlling persons are defined in several ways. For trusts they are trustees, beneficiaries, settlor, protector and any other ultimate controller. For companies, they are typically defined as shareholders owning more than 25% of the share capital.

So, if a family trust has an ordinary high-street bank account, details of it, including names and addresses of controlling persons, can be the subject of a report to HMRC.

Suddenly a lot of people will find that information about them and their financial affairs is being submitted to overseas tax authorities for potential scrutiny. The passive NFEs may want to think about how to communicate that message to those affected and also to make sure that the information they are handing over is correct. For their part, the individuals have an additional incentive to ensure that their tax affairs are up to date.

Compare and contrast

So far, we have treated the different regimes as largely identical, apart from dictating differently to where the information on account holders should be sent. It is worth stressing again that although FATCA was the start, CDOT, DAC and CRS reporting is in effect FATCA for the rest of the world.

It is a reasonable starting assumption that, if an entity is a financial institution under FATCA, it is highly likely to be one under the other regimes and the same should apply for active and passive NFEs. There are, though, several differences.

Below the headline classification of financial institution in the FATCA legislation, there are numerous sub-categories. These are not exactly matched across the AEOI regimes. FATCA provides for a larger category of exemptions and concessions than do the DAC or CRS. Entities that may be exempted from reporting under FATCA, such as certified deemed compliants, may not be exempted under CRS or DAC, although in many cases the reporting may be a nil return.

Under FATCA, controlling persons are defined as those holding more than 25% in a company, in line with existing UK AML and KYC requirements. Many clients have therefore not identified (and not reported) any. The interpretation of controlling person under CRS is more onerous. In effect, it adopts the wording in the Fourth Money Laundering Directive, even though it is not yet in force. Namely, if there are no 25% shareholders, the controlling persons of the entity will be the natural person(s) who hold(s) the position of senior managing official. In other words, under CRS, there will always be at least one controlling person.

As a result, individuals holding senior positions may have to be reported even if they have no shareholding in the entity they manage. This may come as an unwelcome surprise to passive NFEs. It may well be that the FATCA interpretation of controlling person will also be widened or that financial institutions will start widening the definition under FATCA unilaterally.

If I close my eyes will it go away?

Financial institutions have a responsibility to verify account holders and report under domestic legislation. NFEs have a responsibility to provide complete and correct information to financial institutions, when asked. NFEs are self-certifying that the information they supply is correct.

When account holders do not provide the requested information, they can be treated as 'recalcitrant' and reported to the tax authorities on that basis.

Financial institutions are also obliged to inform any holders of reportable accounts of the fact that these have been so classified before submission of data to the tax authorities.

Finally, because registration and reporting under FATCA began in May 2015, HMRC already has the means to analyse the UK entities registered with the IRS against those that ultimately reported. This is an obvious starting point for investigating self-confessed financial institutions that have not filed a FATCA return, and for establishing a list of those expected to file a CDOT or CRS return, even though there may be valid reasons for the mismatch.

A little time spent now putting process in place and verifying an individual entity's or group's AEOI structure is time well spent. ■

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