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Legal Update
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UK implementation of FATCA

1. Introduction

1.1 As part of the Hiring Incentives to Restore Employment Act, the US government enacted the Foreign Account Tax Compliance Act (**"FATCA"**) on 18 March 2010. FATCA generally imposes significant due diligence, information reporting and control burdens on a range of non-US financial intermediaries and investment entities. These non-US entities include banks, other financial institutions, certain insurance companies, and investment funds and other collective investment vehicles (whether treated as a corporation, partnership or trust under US or non-US law), regardless of whether any of these non-US financial intermediaries or investment entities maintain accounts for US persons or, in the case of non-US investment entities, are owned by US persons. FATCA generally requires a 30% withholding tax to be imposed on: (i) foreign financial institutions (**"FFIs"**) that do not comply with such documentation and reporting requirements; and (ii) account holders that do not provide proper documentation to FFIs that enter into an agreement with the US Internal Revenue Service (the **"IRS"**).

1.2 In February 2012, the US Treasury Department issued proposed FATCA guidance. In the preamble to this proposed guidance, the US Treasury Department and the IRS stated that they were considering an alternative approach to implementing FATCA based on bilateral agreements between the US and foreign countries.

1.3 On 12 September 2012, the US Treasury Department announced its first inter-governmental agreement, an inter-governmental agreement between the UK and US governments (the **"IGA"**). The IGA, which is based on the reciprocal version[1] of the "Model I" inter-governmental agreement released by the US Treasury Department in July 2012, sets out an agreed method for certain UK entities that fall within the IGA definition of "financial institution"[2] (such UK "financial institutions" being referred to as **"IGA FIs"** hereafter) to be exempted from having to comply with FATCA by reason of complying with the terms of the IGA. In other words, an IGA FI that complies with the terms of the IGA and the applicable UK implementing regulations will be deemed to have complied with FATCA without having to enter into an agreement with the IRS or having actually achieved compliance with the applicable US regulatory regime.

1.4 In simple terms, the IGA provides that the UK will require IGA FIs to collect certain information relating to depository and custodial accounts held by US persons, certain interests in investment entities held by US persons and certain insurance policies or annuities that have "cash value" and which are held by US persons and report that information to Her Majesty's Revenue & Customs (**"HMRC"**) in its capacity as the competent tax authority. HMRC will then transmit such information to the IRS pursuant to the UK/US double taxation convention. In exchange, the US will not require each IGA FI to enter into a separate agreement with the IRS and will permit payments to be made to IGA FIs without the imposition of FATCA withholding tax.

1 The US Treasury Department has also released a version of the "Model I" inter-governmental agreement that does not provide reciprocity.

2 While the definition of a "financial institution" for the purposes of the IGA and a "foreign financial institution" for the purposes of FATCA are similar, there is a possibility that a UK entity that would otherwise be treated as an FFI for the purposes of FATCA may not be treated as a financial institution for the purposes of the IGA. Accordingly, it is possible that such an entity would be subject to full regulation as an FFI even though it seemingly was excluded from the definition of financial institution because the UK guidance regime viewed such entity as "low risk" from a tax avoidance perspective. An example of an entity that would not be treated as a financial institution under the IGA but would be treated as an FFI under the proposed FATCA regulations is a UK trust that does not have a professional trustee or manager.

1.5 In addition, the IGA is nominally reciprocal and provides for the IRS to provide HMRC with information on the US accounts of UK residents. However, there is currently no US domestic law that provides for the collection of information regarding UK residents. While there are US information reporting rules that require information relating to non-US investors to be transmitted to the IRS (e.g. the US bank deposit interest reporting requirements), there is currently no requirement to identify the investor's country of residence. The IGA contemplates that further negotiations between the parties will take place prior to 2016 in order to further establish the type of information required to be provided to HMRC by the IRS.

1.6 Following the signing of the IGA, HMRC published a consultation paper in the UK on the implementation of the IGA. Once responses had been received, HMRC published a summary of responses along with draft regulations to implement the IGA (the **"UK Regulations"**) and draft accompanying guidance (the **"Guidance"**). This note sets out a summary of the UK Regulations and the Guidance, explaining how the IGA is expected to be interpreted into UK law.

2. Current status of implementation

2.1 The UK Regulations are currently in draft form only and will remain that way until some time after the Finance Bill 2013 receives royal assent, as that will bring into force the power for the UK Treasury to make final implementing regulations.

2.2 The Guidance is also currently in draft form only. Furthermore, it is worth noting that, in the UK, guidance issued by HMRC is generally non-binding. There is no suggestion that the Guidance will be any different, and it should therefore be read as indicative of HMRC's interpretation of the UK Regulations, and not as conclusive evidence of how the UK Regulations would be interpreted in a court of law.

2.3 There are still a number of gaps in the Guidance, and HMRC is seeking further comments on both the UK Regulations and the Guidance. This consultation process is expected to end on or around 13 February 2013.

2.4 It is anticipated that other countries may look to the UK for ideas on how to implement their own inter-governmental agreements.

3. Key features of the UK Regulations and the Guidance

Types of institutions

3.1 There are four categories of IGA FIs:

(a) custodial institutions;

(b) depository institutions;

(c) investment entities; and

(d) specified insurance companies.

3.2 The UK Regulations propose to implement these categories in a manner that broadly corresponds to the definitions in the IGA, but the Guidance expands on the basic definitions, giving the following colour:

(a) examples of entities that would be custodial institutions (brokers, custodial banks, trust companies, clearing organisations and nominees); and

(b) a statement to the effect that insurance companies that only provide general insurance or term life insurance will not fall within the definition of specified insurance companies.

3.3 In addition, the UK Regulations provide an interpretation of the definition of "depository institution" that accords with existing UK regulatory concepts in response to concerns (identified in the consultation) that the IGA definition ("*any entity that accepts deposits in the ordinary course of a banking or similar business*") could catch entities in the UK that might not be intended to be FFIs subject to FATCA under the US regulatory regime, such as solicitors or credit card providers. The UK Regulations therefore provide that a depository institution is either:

(i) a person carrying on the regulated activity of accepting deposits (i.e. where money received by way of deposit is lent to others or any other activity of the person accepting the deposit is financed wholly or to a material extent out of the capital of or interest on money received by way of deposit)[3]; or (ii) an electronic money issuer (i.e. electronic money institutions, credit institutions, the Post Office, credit unions, municipal banks, and the National Savings Bank)[4]. The Guidance indicates that this definition is expected to cover institutions including, among others, savings or commercial banks, credit unions, industrial and provident societies, building societies and entities that issue pre-paid credit cards.

3.4 Further to the above, the UK Regulations and Guidance also provide information on how the following specific types of entities in the UK will be treated for the purposes of the IGA.

3.5 Collective investment vehicles: The Guidance indicates that the definition of "investment entity" in the IGA includes collective investment vehicles as well as fund managers, investment managers, fund administrators, transfer agents, depositories and trustees of unit trusts, which may go further than the US regulatory regime with respect to investment managers and similar service providers. For collective investment vehicles, the financial accounts for which there may be a FATCA reporting requirement are the equity and debt interests in the vehicle. Where the fund pools both the contributions of participants and any profits or income out of which payments are made to participants, and where the property of the fund is managed as a whole by the scheme operator (with participants in the fund having no right of day-to-day control)[5], the collective investment vehicle will itself be the reporting IGA FI for those accounts (irrespective of other entities within the structure that may fall within the definition of investment entity); according to the UK Regulations, this means that:

(a) for a collective investment scheme constituted by a person, that person is the reporting IGA FI;

(b) for a collective investment scheme constituted by a trust scheme, the trustees are the reporting IGA FI; and

(c) for any other collective investment scheme, the manager or operator of the scheme is the reporting IGA FI.

3.6 The Guidance also states that fund distributors (including independent financial advisers, fund platforms, wealth managers, brokers, banks, building societies and insurance companies) may fall within the definition of investment entity due to their role in distributing a collective investment vehicle. Distributors that act in an advisory-only capacity (e.g. some independent financial advisors) will not be treated as IGA FIs, whereas distributors that hold legal title to assets on behalf of customers will be IGA FIs. In most cases, such entities will be treated as custodial institutions as they will be holding assets on behalf of others, unless specific factors indicate to HMRC that a particular entity is better characterised as an investment entity.

3.7 Trusts: The Guidance provides that, in most cases, a trust will not fall within one of the four categories of IGA FIs set out at paragraph 3.1 above but will instead be classed as a non-financial foreign entity (**"NFFE"**)[6]. However, a trust managed by another investment entity would be classed as an investment entity, and a unit trust would also fall within the definition of investment entity.

3.8 Under the UK Regulations, trustees acting on behalf of trusts will be an IGA FI where they are either a remunerated independent legal professional or a provider of trust or company services. (Note that the treatment of trustees may not be the same under the US regulatory regime.)

3 Article 5 Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

4 Regulation 2(1) subparagraphs (a)-(e) and (h)-(j) Electronic Money Regulations 2011

5 i.e. where the fund is a collective investment scheme as defined in s235 Financial Services and Markets Act 2000

6 An NFFE is defined as any entity that is defined as such under applicable US Treasury Regulations and is also not a financial institution as defined in the IGA. NFFEs are divided into passive NFFEs and active NFFEs, which are defined in the IGA. Only the accounts of passive NFFEs are subject to information reporting by reporting IGA FIs; however, such a reporting IGA FI must undertake the due diligence necessary to characterise the NFFE.

Pursuant to the IGA, if the trustee fulfils the due diligence and reporting requirements on behalf of the trust, in relation to the property subject to the trust (which is to be treated as a custodial account for the purposes of the UK Regulations), no other IGA FI (i.e. the IGA FI at which the trust's account is located) would be obliged to conduct information reporting with respect to the financial accounts maintained by the trust.

3.9 Where the trustee is not an IGA FI, the IGA FIs that hold accounts for the trust will need to follow the relevant due diligence procedure for NFFEs as applicable.

3.10 Partnerships: Under the IGA, a partnership is an entity, but the precise type of entity will depend upon the activities undertaken by the partnership. If a partnership is treated as an IGA FI, it will need to review any equity interests when identifying financial accounts that must be reported under the IGA.

Treatment of groups

3.11 IGA FIs are defined as: (i) financial institutions resident in the UK (excluding overseas branches of such financial institutions); and (ii) UK located branches of non-UK financial institutions.

3.12 Each separate entity (including subsidiaries and branches) that is an IGA FI will have a separate reporting requirement based on the accounts it holds. However, to determine whether such entity is required to report those accounts (based on the reporting thresholds), it will have to aggregate them with any other accounts held by related entities, whether in the UK or otherwise (provided that the IGA FI's computer system is capable of linking the accounts). For more detail on aggregation, see paragraphs 3.18-3.21 below.

Types of accounts

3.13 The objective of FATCA is to cause non-US financial institutions to provide information on non-US financial accounts held by US persons. Under FATCA, there are reporting obligations in relation to the following types of accounts: depository accounts (which the Guidance indicates can include pre-paid credit cards), custodial accounts, certain equity and debt interests issued by investment entities and certain types of insurance contracts and annuity contracts. It is worth noting that reporting obligations apply to equity and debt interests issued by investment entities only where these interests are not regularly traded on an established securities market. In the case of a partnership, potentially reportable interests will include either a capital or a profit interest; in the case of a trust, potentially reportable interests will include an interest held by either any person treated as settlor or beneficiary of the trust, or any other natural person exercising ultimate effective control over the trust.

3.14 The Guidance provides that, where an account is jointly held, the balance or value in the account is to be attributed in full to all the joint holders of the account (both for aggregation and reporting purposes). (Note that where an account is jointly held by an individual and an entity, the reporting financial institution will have to apply the procedures for both individuals and entities to that account. This may be different to the treatment that would apply under the US regulatory regime.)

3.15 The treatment of certain other types of accounts, namely designated and undesignated accounts, segregated accounts, dormant accounts and accounts of deceased persons, is yet to be determined, with Guidance to be provided in due course.

Value threshold for reporting

3.16 Under the IGA, UK financial accounts held by US persons will be reportable where their value exceeds specified thresholds (which vary depending upon the nature of the account).

3.17 The IGA provides that the UK may offer IGA FIs the opportunity to elect to report all UK financial accounts held by US persons, rather than merely those that exceed the reporting thresholds. However, respondents to the HMRC consultation expressed concern that, while potentially favourable in terms of compliance (and associated costs), opting to report accounts where this is not legally required would breach the UK's data protection legislation. HMRC has therefore proposed an alternative strategy in the UK

Regulations, namely that reporting IGA FIs will be obliged to report all UK financial accounts held by US persons unless they elect to report only those accounts that exceed the value thresholds. This does not correspond with the IGA, and HMRC has indicated that it is concerned about requiring more of IGA FIs than is strictly required by the IGA, but has included this in the current draft legislation on the basis that it would appear to avoid challenge under data protection laws.

Aggregation

3.18 Where an IGA FI's computer system is able to link multiple accounts to a single customer (e.g. by name and address or by customer/taxpayer number), irrespective of whether the computer system totals the balances of those accounts, that IGA FI will be required to aggregate the accounts it holds for each individual or entity (e.g. the Guidance notes that a custodial institution will need to consider all the financial accounts of its customers, irrespective of whether the customers' underlying interests are in different collective investment vehicles.) Aggregation is not required to take account of products that are treated as exempt for the purposes of FATCA, either via the US regulatory regime or the IGA.

3.19 It is also worth noting that, for the purposes of determining whether a reporting threshold is satisfied, aggregation must factor in financial accounts held by related entities (both in the UK and elsewhere outside the US) of the IGA FI (provided that the computer system links accounts across related entities). However, if aggregation confirms that there is a reporting requirement, each FFI will only be responsible for reporting the accounts it holds and will do so in accordance with the procedures in its own jurisdiction.

3.20 As noted above, in relation to a joint account, the value of the entire balance is aggregated to each joint account holder.

3.21 For the purposes of aggregation, a negative account balance is to be valued as nil.

Passthru payments

3.22 The IGA provides a temporary solution to the requirement under FATCA to withhold tax on passthru payments by requiring an IGA FI to report the aggregate value of payments made to any non-participating FFI[7] (whether this be a UK or other non-US entity). This will apply to payments made during the years 2015 and 2016, with an ongoing strategy (for the years 2017 onwards) to be determined between the UK and the US at some point in the future.

3.23 All payments to non-participating FFIs must be reported if the payment would be subject to FATCA withholding tax if such payment were made from US sources (i.e. both US and non-US source payments are reportable). However, the Guidance clarifies that payments for non-financial services, goods, and the use of property made in the ordinary course of business are not subject to reporting. Such payments include, for example, wages, office and equipment leases, software licenses, transportation, freight, etc., but do not include dividends or certain types of interest which would therefore be reportable.

Mechanics for reporting information to HMRC

3.24 The UK Regulations require reporting IGA FIs to provide the required information to HMRC by 31 May in the calendar year following the calendar year to which the information relates (note the exception for the first reporting year, 2013, where the deadline for providing information to HMRC will be 31 March 2015 rather than 31 May 2014). In accordance with the IGA, the information required to be reported will be phased in gradually over the first few years.

3.25 Although a timetable for reporting has been proposed, the format of reports and the way in which IGA FIs will submit that information to HMRC are both yet to be finalised.

7 A non-participating FFI is defined in the IGA by cross reference to the applicable US Treasury regulations. Under the US regulatory regime, a non-participating FFI is any FFI that has not entered into an agreement with the IRS to provide information regarding US persons or any FFI that is not required to enter into such an agreement pursuant to applicable US regulatory guidance.

Guidance on what constitutes non-compliance and UK penalty regime

3.26 The IGA sets out provisions for collaboration on compliance and enforcement between the IRS and HMRC, and the UK Regulations and the Guidance indicate how the UK proposes to implement these provisions to bring FATCA compliance within its domestic penalty system. Essentially, the UK proposes a system of financial penalties, ranging from £300 to £3,000, for failure to comply with obligations under the UK Regulations. This is in addition to the IGA provision that, where a significant non-compliance is not resolved in 18 months, the relevant IGA FI will be declared to be a non-participating FFI, unless alternative arrangements are made directly with the IRS.

3.27 It is worth noting that the Guidance also provides examples of breaches considered to be minor errors (e.g. incomplete data fields, corrupt data, incompatible format) or significant non-compliance (e.g. intentional provision of substantially incorrect information, deliberate or negligent omission of required information, ongoing or repeated failure to register/supply accurate information/establish appropriate governance or due diligence processes, repeated late filing or failure to file a return).

4. Further Considerations

4.1 Since the IGA was signed between the UK and the US in September 2012, the US has entered into additional inter-governmental agreements with other countries, including Denmark, Mexico and Ireland. It is worth noting that the IGA added three new articles that were not included in the July 2012 "Model I" inter-governmental agreement: (i) a "most favoured nation" clause; (ii) an article providing for consultations between parties if difficulties arise during implementation and for amendments by written mutual consent; and (iii) an article making clear that the annexes form an integral part of the IGA. All three of these articles were also included in the inter-governmental agreements signed with Denmark, Mexico and Ireland.

4.2 Although all four inter-governmental agreements were based on the "Model I" template, the agreements are not identical to one another. While the US Treasury Department appears to be working towards ensuring that inter-governmental agreements are generally consistent with one another, overall conformity is likely to be impossible due to differences in local implementation regulations.

4.3 In light of the fact that the UK was the first country to enter into an inter-governmental agreement with the US, and is therefore the most advanced in terms of implementing an inter-governmental agreement, the UK Regulations and the Guidance may be viewed by other jurisdictions as a baseline model for implementation of their own inter-governmental agreement (whether or not negotiations with the US have yet been finalised). However, such jurisdictions may choose a different approach to that taken by the UK, resulting in a different implementation regime for different jurisdictions. This possibility is of particular significance to multinational groups, which may find themselves dealing with multiple reporting systems.

5. Latest FATCA regulations

5.1 The final FATCA regulations, TD 9610, were made publicly available on 17 January 2013 and will be published in the Federal Register on 28 January 2013 (and will be effective as of that date). These final regulations are very lengthy and are approximately 150 pages longer than the proposed FATCA regulations. The final regulations clarify their effect on a financial institution located in a jurisdiction that enters into an inter-governmental agreement using the "Model 1" framework and appear to conclude that such a financial institution is not subject to the final regulations to the extent that it complies with the terms of the relevant inter-governmental agreement. Accordingly, it would appear that a UK financial institution that complies with the UK implementing guidance would not also be obliged to comply with the FATCA regulations. We note, however, that there may be aspects of the final regulations that could impact a UK financial institution and exempt the entity from FATCA or otherwise affect the burdens imposed upon it (e.g. for a UK financial institution that is a "controlled foreign corporation" within the meaning of the US Internal Revenue Code).

If you have any query in connection with anything in this alert, please do not hesitate to get in touch with your usual Mayer Brown contact or one of the contacts referred to below:

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