G.A.T.C.A

A Practical Guide to Global Anti-Tax Evasion Frameworks

ROSS K. McGILL
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STUART LIPO

Global Financial Markets

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Ross K. McGill · Christopher A. Haye · Stuart Lipo

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A Practical Guide to Global Anti-Tax Evasion Frameworks

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Foreword

Tax evasion in the twenty first century is a highly sophisticated and a global activity, yet its history dates back to William III in the sixteenth century and some say, gave us the term ‘daylight robbery’.

The game today is played out across international borders and, for the most part, it uses the infrastructural weaknesses in the international financial system to move and hide financial assets to minimise the degree to which those assets can be held liable for tax.

An important part is also played by the sheer complexity of regulation, domestic law and collaborative frameworks that underpin the rules by which financial institutions in over a hundred countries must conduct the due diligence and reporting necessary to support objectives of counter-evasion measures.

Because much of this body of statute, regulation and framework is written so badly, evasion is made easier by it. Indeed, in the US in 2014, Senator Levin published an article[1] on how to avoid the US’s own anti-evasion regulation—FATCA, which focused in the main on how investors could exploit the loopholes in the regulation.

However, the due diligence and reporting associated with GATCA creates major problems for those tasked with implementing policy and procedure in financial institutions and in corporate board rooms.

To our industry’s detriment, some parts of the financial system have been complicit to a greater or lesser extent by providing access to, or even actively promoting investment structures, vehicles and methodologies that permit or encourage such evasion activity.

Governments have not historically had the tools to be able to detect tax evasion, let alone prevent it. Tax havens of course traditionally structur-

ally encourage it and those responsible for evading tax, have leveraged their home country's inability to search for their assets offshore. What one person calls tax arbitrage, another calls tax evasion, while others blur the landscape still further with terms such as tax avoidance and aggressive tax avoidance.

In all these cases, legal structures at the international level have been very fragmented and cooperation between countries has been relatively ineffective. However, one thread connects all these issues, and that is that the assets concerned are all in the global financial system.

The difficulty has always been that a home country would need to have evidence upon which to request tax information from another country and, even if that information could be obtained from a financial institution in that country, data privacy laws would often prevent the information getting to where it could be used effectively.

Faced with both social and economic pressures, governments have more recently engaged on a major evolution of this awkward principle of exchange of [tax] information towards an automatic exchange where the burden of collecting the information to be shared between governments, falls to the financial institutions within each country.

However, not all governments have implemented these structures consistently and even where consistency is possible, the frameworks leave enough room for variations. All of this causes major problems for financial institutions trying to comply whilst reducing risk and cost through operational efficiencies.

This book is intended to try to translate the often impenetrable language of tax into a more simple explanation of the structures underlying this automatic exchange of information and the practical issues it raises for financial institutions.

The variability within these frameworks and the understandable penchant for governments to name these frameworks, laws and regulations differently, has led to one term being used as a catch-all phrase—GATCA, meaning all those structures designed to encompass Global Account Tax Compliance Activities.

The authors are recognised subject matter experts in their field and have a special and well respected ability to translate the complexities of these regulations into simpler and more practical explanations that actually help financial firms not only to cope with regulatory compliance but also control operational costs and risk.

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Note

1. http://blogs.angloinfo.com/us-tax/2014/03/17/how-to-avoid-fatca-tips-from-us-senate-subcommittee/.

Preface

This book is written for those affected by the operational and compliance impacts of regulatory frameworks whose purpose is the detection, deterrence and reporting of potential cross border tax evasion.

While most governments have been, for the most part, eager to enter into arrangements that facilitate getting their hands on information about their resident's foreign held assets, the burden of collecting all this information has fallen to the financial institutions of each jurisdiction. The existing frameworks of Know Your Customer (KYC) and Anti Money Laundering (AML) do not completely meet the requirements of GATCA frameworks. Equally, where KYC and AML can be relatively easily compartmentalised within financial institutions, GATCA frameworks create new touch points and new dependencies in and between many different functions in a typical bank, brokerage or other financial institution.

So, this book is written, not just for compliance or legal staff but, as we will amply demonstrate, it is of importance also for sales, relationship management, operations, IT, marketing, on-boarding, risk management and of course the board.

The reason this book has been written is very simple. The regulatory frameworks that comprise GATCA are extremely complex. Most firms do not have sufficient resources to understand those complexities, let alone operationalise any of them in an intelligent way. The object of the book is not to provide a detailed analysis of these regulations. There are others who can do a better job and who focus on the principles and tax theory. While we will give the reader enough background and context to understand each framework, we choose to focus more keenly on the practical implications.

In other words, our job is to understand the theory and complexities and translate them into something that the reader might find useful in their day to day work.

Typically this means that we will be describing the kinds of challenges that we see every day in the international financial services markets. We see what happens when complex regulations hit small or medium sized financial institutions with little or no knowledge, low levels of exposure to the given markets and cultural or linguistic differences - they make compliance problematic at best and totally lacking at worst.

We have said on a number of occasions—regulators don't write regulations based on the size of the firms they regulate, their capacity or their exposure. They are usually written as one size fits all with little or no recognition given to medium and small financial firms. So, the problem really is that one size just does not fit all.

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Abbreviations and Acronyms

A-NFFE	Active NFFE
AEoI	Automatic Exchange of Information
AML	Anti Money Laundering
APA	Advanced Pricing Arrangements
AUP	Agreed Upon Procedure
BEPS	Base Erosion and Profit Shifting
BIAC	Business Industry Advisory Committee
BO	Beneficial Owner
C-DCFFI	Certified Deemed Compliant FFI
CbCR	Country by Country Reporting
CFA	Committee on Fiscal Affairs
CFC	Controlled Foreign Company
CIV	Collective Investment Vehicle
CRS	Common Reporting Standard
CSD	Central Securities Depository
DC-FFI	Deemed Compliant FFI
EAG	Expanded Affiliate Group
EEA	European Economic Area
EFTPS	US Electronic Federal Tax Payment System
EIN	Employer Identification Number
EoI	Exchange of Information
EU	European Union
FATCA	Foreign Account Tax Compliance Act (*misnomer*)
FATF	Financial Action Task Force
FDAP	Fixed, Determinable, Annual or Periodic income
FFI	Foreign Financial Institution
FHTP	Forum on Harmful Tax Practices

FI	Financial Institution
FIRE	Filing Information Returns Electronically
FISCO	Fiscal Compliance Experts Group
FWS	Full Withholding Statement
G20	Group of governments and central banks from 20 major economies
GATCA	Global Account Tax Compliance Activities
GDPR	General Data Protection Regulation
GIIN	Global Intermediary Identification Number
HCTA	Host Country Tax Authority
HIRE	Hiring Incentives to Restore Employment Act (2010)
HMA	Hybrid Mismatch Arrangement
ICG	Informal Consultative Group
IDES	International Data Exchange System
IGA	Inter Government Agreement
IP	Implementation Protocol
IPR	Interim Periodic Review
IRC	US Internal Revenue Code
IRS	US Internal Revenue Service
ISD	Investor Self Declaration
ITIN	Individual Taxpayer Identification Number
KYC	Know Your Customer
LOB	Limitation of Benefits
MAP	Mutual Agreement Procedure
MCAA	Model Competent Authority Agreement
MLI	Multilateral Instrument
MTC	Model Tax Convention
NP-FFI	Non-Participating FFI
NFE	Non Financial Entity
NFFE	Non Financial Foreign Entity
NGO	Non Governmental Organisation
NQI	Non Qualified Intermediary
NRA	Non-Resident Alien
NWFP	Non Withholding Foreign Partnership
NWQI	Non Withholding Qualified Intermediary
OECD	Organisation for Economic Cooperation and Development
OTC	Over the Counter
P-NFFE	Passive NFFE
PAI	Private Arrangement Intermediary
PE	Permanent Establishment
PFFI	Participating FFI
POA	Power of Attorney
PPT	Principal Purpose Test

PR	Periodic Review
QI-EIN	Qualified Intermediary EIN
QDD	Qualified Derivatives Dealer
QI	Qualified Intermediary
QSL	Qualified Securities Lender
R-DCFFI	Registered Deemed Compliant FFI
RA	Repurchase Agreement
REIT	Real Estate Investment Trust
RO	Responsible Officer
SaaS	Software as a Service
SSN	Social Security Number
SSNA	Social Security Numbering Agency
SWIFT	Society for Worldwide Interbank Financial Telecommunications
T-BAG	Tax Barriers Business Advisory Group
TCC	Transmitter Control Code
TIEA	Tax Information Exchange Agreement
TIN	Tax Identification Number
TP	Transfer Pricing
TRACE	Tax Relief and Compliance Enhancement
USWA	United States Withholding Agent
WFP	Withholding Foreign Partnership
WFT	Withholding Foreign Trust
WQI	Withholding Qualified Intermediary
WRPS	Withholding Rate Pool Statement
1042	US Tax Return for non-US Financial Institutions
1042-S	US Information Reports for non-US Recipients

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Part I

Background and Principles

1
Introduction

Tax evasion has been with us as long as taxes themselves. Idiomatically, death and taxes are renowned for being the only things that are certain in our lives.[1] It's hardly surprising, therefore, that we seem singularly engaged in efforts to evade both.

In England in 1696, King William III, short of cash, introduced the Window Tax[2,3] that led to many home owners bricking up as many windows as they could, in order not to have to pay it. In many cases, the social context to tax evasion has been very different from that which we see today. Tax evasion was often seen as the only way for people to protect themselves from the unfair treatment of their governments or, more commonly, their monarchs. In fact, the genesis of the phrase 'daylight robbery' to represent society being unfairly punished through the tax system, is often ascribed to the Window Tax of 1696.[4]

Today, the meaning of tax evasion has changed and is now more commonly associated with rich or super rich individuals hiding assets offshore, and corporations deliberately manipulating their affairs to reduce their liability to tax.

The line between evasion and avoidance has also been blurred in society's consciousness. In simplified terms, tax evasion[5] means knowing a rule or law that would lead to a tax liability and intentionally breaking it with malice of forethought. This would typically involve other illegal acts such as fraud and would be subject to criminal prosecution and penalties. Tax avoidance[6] on the other hand means finding a loophole or way around the rule so that the rule does not apply in the first place, or the effect is modified to reduce

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or eliminate the applicability of the tax. This latter implies that there is no illegal act being committed.

The existence of loopholes in tax laws through omission or, more commonly, ineffective drafting, grows in proportion to their complexity. The result of complex tax laws, is complex regulation of tax laws, to the extent that even regulations designed to combat evasion are, of necessity, also very complex—ergo, they also have loopholes. As Chief Engineer Scott says in Star Trek III, The Search for Spock 'the more they overthink the plumbing, the easier it is to stop up the drain'.[7]

Governments of all persuasions have, in more recent times, also been very adept on a social level at shifting the negative image that affected William III and the Parliament of the day, away from themselves as the 'greedy bad guys' and onto the very rich. In simpler times this would be seen as rather Robin Hood-esque, although it could be argued that it actually appears to be closer to 'take from the rich and…keep it to offset trade deficits and budget overspends'.

The increasing gulf between rich and poor in all parts of the world has only served to exacerbate this and make it easier to sustain, despite the fact that most of the 'poor' pay no tax at all and 'the rich' shoulder most of the burden in absolute cash terms.[8] In this way, governments are keen to present themselves as independent intermediaries or the stewards of our money, rather than collectors and spenders.

Whatever the history, or whether you believe that the principles or focus of regulations are well applied or not, the scale of tax evasion is agreed, by all, to be significant. The Tax Justice Network, in its 2012 report, indicated that the value of hidden assets globally, as at 2010, was between $21–$32 trillion.[9] That would, even on the most conservative calculations, mean a significant loss in tax revenues.

However, in the period 2008 to date, we have never seen such a concerted effort in and between governments to create a globalised framework to detect, prevent and deter such behaviour.

Traditionally, governments have very limited opportunities to detect evasion. After all, the simplest way to evade a country's taxation regime for investors is of course to ensure the assets on which tax can be assessed, are not held domestically. Equally, for corporations, the imperative is usually to optimise profits and returns for shareholders that naturally drives attention to all levels of the P&L, including that of taxation.

For corporations, tax evasion can take many forms, but given the legal issues surrounding this, they have historically been more apt to engage in tax avoidance in this community. Corporations can of course be investors them-

selves, particularly if they maintain large treasury balances. However, their greater concern is with the base taxation applicable to their primary trading activities. This has led to some very notable cases in which corporations have manipulated their tax base, perfectly legally, to a different jurisdiction in order to benefit from a lower tax rate on the principal.

The effect of this relocation, usually also associated with some changes to ownership and trading structures, is to reduce or *erode* the base level of profit on which tax is calculated in the home country (or where most of the substantial economic activity takes place). We should remember that for such companies there are several areas of the tax base that remain unaffected. These companies are still paying VAT, still employing people and still paying employers national insurance and such. So, sweeping generalisations based on changes to the tax on profits should be avoided.

This '[tax] base erosion' through 'profit shifting [by relocation]' has led to the OECD's BEPS framework that is one of the subjects of this book.

Investing offshore to hide assets and manipulating the tax base are the most basic tactics that have led governments to rest their attention on the single common denominator—the international financial services community.

While disparate efforts have been common, it is only really since 2010 that major inertia has built up in the international community, driven to a large extent by the G20 to forge strong detection frameworks. It is these frameworks that we seek to discuss in this book. They are:

- The US FATCA regulations
- The OECD Automatic Exchange of Information framework and
- The OECD Base Erosion and Profit Shifting framework

Together these frameworks, commonly referred to under the acronym 'GATCA' (Global Account Tax Compliance Activities), represent a step change, not only in the level of detail and technological focus associated with detection and reporting, but also a substantive step by the global community to act in concert.

Prior regulatory efforts had floundered on general principles of data protection and a manual methodology for exchange. In other words, tax information could be exchanged between governments but only on specific request and only where the requesting government could demonstrate cause i.e. no fishing trips as the Americans would say. The changes we are seeing have substance over this older model because they engage in '*automatic* exchange' and because the financial services industry is the ubiquitous source for the data and has the technology budget[10] to deliver it.

This book however, is not about history, it's about the present and the future.

We will not be dwelling, in this book, on the reasons, nor the ethics involved in tax evasion. This book will be focusing instead on the challenges, practical issues that are raised by these frameworks for the corporations and financial firms that are generally seen as the information gathering layer in these frameworks.

Notes

1. https://en.wikipedia.org/wiki/Death_and_taxes_(idiom).
2. https://en.wikipedia.org/wiki/Window_tax.
3. http://www.lincolninst.edu/publications/articles/window-tax.
4. http://www.phrases.org.uk/meanings/daylight-robbery.html.
5. http://www.investopedia.com/terms/t/taxevasion.asp.
6. http://www.investopedia.com/terms/t/tax_asp.
7. http://quotegeek.com/quotes-from-movies/star-trek-iii-the-search-for/6800/.
8. http://www.telegraph.co.uk/news/2016/04/26/nearly-half-of-britons-pay-no-income-tax-as-burden-on-rich-incre/.
9. https://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf.
10. http://www.idc.com/getdoc.jsp?containerId=prUS41216616.

2
Moral Outrage and Righteous Indignation

Context

From 2012 onwards we have started to see a strange phenomenon. A case of moral outrage and righteous indignation focused on the banking industry. Unfortunately, there was some fire where the smoke was. The case of Barclays Bank, and others, 'fixing' LIBOR, JPMorgan, HSBC and others, were mired at one point or another in similar cases where the 'public' were presented with all the bad bits about the banking industry at the same time. Banker's bonuses were also an easy target and the calls for more regulation of the banking industry were rife, as well as calls to split the larger banks into retail (low risk) and investment (high risk).

This focus on banking was only the latest in a series of high profile cases where the inner workings of an industry were opened up to scrutiny. We had previously seen the UK Parliament engulfed in an expenses scandal that saw the same reaction. In that case, members of parliament had (and have) a system of expenses since they need to be able to service the needs of their constituents locally, as well as be present in Parliament in London from time to time. How those expenses are claimed and what can be claimed were laid out in a set of rules. When it became clear that some members of parliament were 'abusing' the system, the resulting furore was aimed at them, even though, in many cases, a close scrutiny revealed that they were within the rules. It is interesting that no-one criticised those who made the rules for failing to devise a better system. It was the moral outrage that people could be 'self-centred' that drove Parliament to change the rules (relatively quietly) while pillorying those who had transgressed.

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In more recent times we have continued to see similar transgressions that would seem to indicate that it almost doesn't matter what regulation you put in place, someone will find a way around it. The Panama Papers leaks associated with Mossack Fonseca again highlighted that, despite years of previous outrage, those shouting the loudest were, at the same time, often breaking the very rules they were criticising.

FATCA

The object of FATCA is to prevent, deter, detect and correct tax evasion by Americans.

America has a voluntary tax system in which tax payers are expected to disclose their income both from domestic and foreign sources. At the same time, the US government claims the right to tax the global income of its citizens.

The US has some of the highest taxes on the wealthy in the western world. A wealthy American can expect to pay a marginal tax rate of around 40–50%. It is therefore natural to expect that some will find ways to hide their income and the cash reserves that generate that income.

Avoidance or Evasion?

Tax evasion is different from tax avoidance. Tax avoidance is the use of legal means to mitigate the amount of tax to be paid. This is often achieved by the use of specialist advisers who know and understand the loopholes and strategies which exist in any complex tax system (and all tax systems are complex). Tax evasion on the other hand is the deliberate breaking of the law to achieve the same objective.

No system is, of course, static. What, today, is tax avoidance, tomorrow may be deemed tax evasion, and so the tax system is in a state of constant flux with regulators trying to catch up with those in the markets trying to find innovative ways to avoid paying tax, or worse, evade tax.

In 2012 we also saw a moral dimension enter this space. The sub-prime crisis and financial crash of 2008, the following global credit crunch and subsequent double dip recession, the results of which are still with us today, were caused by two activities. First, financial institutions, led from the US, lending without adequate controls or oversight of whether those being lent to were capable of re-paying their debt. Second, the public, again led from

the US, accepted this 'easy money' in the knowledge that even small changes in the market would make it difficult or impossible to repay the debt that they had incurred. In other words, 'it takes two to tango'. There is usually an uneasy truce between the financial firms on the one side, who maintain strong lobbying presence in Washington, DC to argue for rules that allow them optimal freedom to pursue their business and profit led interests, and 'the public'. The public have their views too, but in many cases that view is seen through the lens of the media.

In 2012, we saw the triumvirate of public, media and financial services explode, when some of the activities of some of the banks and brokerage houses were found to be 'risky' if not illegal. No-one complains when someone takes a risk and the result is a win. But, equally, no-one seems to feel any sense of culpability in the current financial state of the world, quite the opposite. It was *all*, the fault of the financial services industry. The media certainly fed this monster and the politicians reacted as one might have predicted. Moral outrage. The outrage had to be 'moral' because otherwise, they would have had to recognise that (i) there were always two halves to the culpability and (ii) they were the ones who were (and are) responsible for the legal and regulatory framework that should act as the guardian.

Let me put it another way. If you borrow money and your lender does not do sufficient due diligence, then clearly they are culpable. But equally, and this is the part that people conveniently over-look, if you agree to borrow the money, there is both a legal and moral obligation on you to make sure that you understand the terms of the arrangement (you're the one signing the contract) and that you can repay the debt. If the debt goes toxic—there were two sides that agreed the terms. Let's not forget that we're not really dealing with complex financial instruments here, as some have led the market to believe. The sub-prime crisis that triggered all this, was about normal Americans signing up to mortgage deals that were too good to be true, and which they had good reason to know that they may have problems repaying. Yes, the financial firms were also culpable. The reason the products were too good to be true, was a lack of due diligence on the borrower's ability to service the debt, and the underlying principle that they were packaging this debt and risk up and laying it off in complex ways around the world, in order to be able to offer the easy money in the first place.

So, a most dangerous situation began to arise in 2010 and 2011. Even though there was culpability on both sides to create the global financial crash and continuing recession, the public, fuelled by the media, found the blame game way too easy, targeting the banks and brokers. Since the regulatory and legal frameworks could not be changed overnight by normal

means, capitalism had a new enemy—moral outrage. There are two problems with moral outrage. First, in our modern society, we use laws (and our appointed agents the politicians) to translate the 'majority' view of morality into a set of laws. The trick is to minimise the set of laws in order to maximise the degree of freedom that people have within their society whilst keeping them safe, well fed and able to help the society prosper. The question is how well 'people' determine what's 'moral'. When you're facing a mountain of debt (that you helped create), your job is in jeopardy and the world seems to be falling apart around you—is probably not the right time to be judging what's moral. Secondly, outrage. Well the problem here is simply that fire feeds fire. The media have played an important role in fuelling the 'outrage' part of this equation and the public have played into this at every step. It's usually politicians who are blamed for diverting attention from one thing in order to hide something going on elsewhere. In this case, the public had its attention expertly diverted by the media, who pointed the finger of blame at the financial services industry as the sole wrong-doer. The politicians, unable to use the framework of law and regulation to show how well they had it 'in hand' raised the hand of righteous indignation in order to be clearly seen on the same side as their electorate. Judgements about morality as the foundation for changes in law or regulation, are hardly best made when your emotional state is 'outrage'.

So, yes, the world was in a deep and continuing financial crisis. Yes, the financial services industry has a level of culpability. But the public share part of that blame. They put the politicians where they are. They accepted the easy money when it was there—they created the conditions in which the financial services industry acted. And the public believed the media when they created the fire of moral outrage.

This point is nicely made by the problem that UK comedian Jimmy Carr had in 2012. Mr Carr had used a special scheme, provided by an adviser, through which he ended up paying very little tax. This is tax avoidance. When this scheme came to light, it was with stunning speed that the then prime minister, David Cameron, announced to the nation that Mr Carr's activity, while technically legal, was morally reprehensible. This caused Mr Carr to apologise publicly and change his financial affairs—even though he had done nothing wrong. This highlights the dangers inherent in a moral attitude to tax. Mr Carr's only actual tripwire was that he had been specifically making a point of humorous outrage in his comedy sketches about how banks could get away with paying very little tax, by using, as it happens, the same sort of approach that he himself had already taken. True, that's an embarrassing situation, but neither the bank nor Mr Carr were

doing anything illegal. If anyone was to blame, it should be the regulator. They made the rules, and they didn't write them clearly enough to preclude what someone, at some future point, would view as wrong. Equally, Mr Cameron is not in charge of the morals of British society and had no right, in my view, to abuse his position as Prime Minister, in order to make a moral comment about an entirely legal activity. The reason is that, while accepting that the activity was legal, he created a reputational issue for Mr Carr because no-one, conveniently, drew the line between tax avoidance and tax evasion. The public, again fed by media oversimplification, essentially thought Mr Carr was evading tax, when he was actually just doing what he had every right to do under the rules of the time.

The people who usually 'bash' the wealthy are often those, who, were they put into the same position, would almost certainly do exactly the same thing. Morality is like Einstein's theory of relativity—it depends on the viewpoint of the observer.

I also want to take this opportunity, since it is relevant to the argument over FATCA, to make three more points.

My first is that whatever gets said in moral outrage about the wealthy not paying their fair share, all western governments know that most of the cash that pays for their country to work—comes disproportionately from the wealthy. Behind closed doors, the biggest angst in the tax system is trying to figure out where the tax line is, above which, the wealthy will start to move all their money elsewhere. It's a balancing act and sometimes governments get it wrong, but they do spend a lot of time trying to get it right. Overall, for example, both in the UK and the US, over 70% of the cash that government spends, outside of gilts, comes from taxes on the wealthy. Time spent by government fiddling with marginal tax rates for those at the bottom of the wealth pyramid is diversionary behaviour and makes very little real difference. There is also always a missing factor in this 'fair share' concept. It's the rich who create many of the jobs that those throwing the rocks have. The other major employer of course is government itself, via the public sector, and most of their money comes from…the rich.

In this climate, it's probably not surprising that wealthy Americans, in fact wealthy people everywhere, end up in some balance of tax avoidance. But that fire is not fuelled by the media in the first instance. That fire is fuelled by the accounting firms who analyse the rules for loopholes and create the avoidance plans. I choose not to call them 'schemes' as that's too close to 'scams'.

The irony is that those in relevant positions can hardly say that they don't know what's going on, nor that they could not stop it much more simply

and effectively than with FATCA. The biggest 'circuit' in the industry is the one where the people in the regulatory sphere, leave that public service for a while and usually end up in highly paid jobs at the accounting firms. Those same people, usually after a few years, end up cycling back into government service. The knowledge of what's going on has always been there.

So, my biggest challenge in looking at the context of FATCA is that the world which created FATCA, and in which it operates, is founded on moral outrage, a failure by the public to recognise or take their share of responsibility. The knowledge that the wealthy, the jobs they create and the taxes they do pay are a critical part of the equation and finally that, apart from the public, everyone else knows what is actually going on and diverts the public attention at relevant and opportune times. The question of today's society is not what's fair, nor what's moral. These are things, the perception of which can be manipulated. It's who decides what's relevant and when is opportune.

The framework in which this all operates, as we know, is law and regulation. The law in the this case is the HIRE Act and the regulation, what we've come to know as FATCA. Over the last twenty years, the world has undoubtedly changed. From a regulatory perspective, what the UK called 'light touch' regulation is actually what is more commonly known as 'principles based' regulation, as opposed to rules based regulation.

Both have their good and bad points and, with FATCA, we are headed firmly down the route of rules based regulation.

We all strive for certainty in an uncertain world. That imperative leads to the false proposition that with rules, you can contain, define and completely control a system. That, by having rules, you somehow create certainty out of chaos. Of course, any physics undergraduate will tell you that this is a frivolous position. You cannot measure or control a system without affecting the system in some way. Equally, the more complex the system, the more unlikely it is that your rules will be sufficient to encompass all possible permutations of how those rules might be interpreted, applied or avoided.

The converse in human society is to have principles e.g. do no wrong; do what's fair; do what's right. That's an equally frivolous position because, as I pointed out, who defines fair, wrong and right? Those value principles can and do change over time.

So, to regulate financial services, with a view to addressing tax evasion, a rules based system would have to be enormously complex—much more complex, by orders of magnitude, than the current tax system. Equally, a principles based system would need to have everyone outside and inside the system agreeing on what is right and fair etc. Neither system will ever

work without the other. Yet the public yearn, and the politicians and media hold out the view that it can somehow be achieved.

What does this have to do with FATCA? Well, FATCA is a reaction to my foregoing points and to the world in which we currently live. There are many outside the US that believe that FATCA is both disproportionate to its intent and politically the worst example of extra-territoriality seen in recent times.

Will FATCA achieve what it set out to achieve? Probably not; at least not in the way originally intended.

One of the biggest myths about FATCA is that it's a withholding tax system. It's not, it's a reporting system with penalties that just happen to be applied via a tax system. However, its convergence to IRC Chapter 3, the QI rules—which is a tax system, has some interesting consequences. It starts to create a system which has dual objectives—tax income and evasion deterrence. These have heretofore been separate issues. Moral outrage is bringing them together and I'm not sure that's a good thing.

The foregoing has addressed mainly the evasion pursued by individuals via the financial services system and the extension of FATCA into the OECD's AEoI and CRS is a matter of further discussion later in this book, as it triggers more of an operational and cost effect than one of moral outrage. However, tax evasion also takes the form of corporate misbehaviour and interestingly there is much more considered outrage in this area. Companies such as Amazon, Starbucks and Apple have all come in for criticism and, in some cases, investigation, for their tax strategies. Again, for anyone placed into a similar position and with a remit to serve shareholders, some of these strategies are understandable and, for the most part are defined as avoidance and not evasion. In this context again we see the effect of concepts of fairness and ethics that, while they have no legal force, can create seismic shifts in corporate behaviour on the basis that brand values, reputation and thus revenues, can be damaged by what, in any other business would be deemed a back office administrative activity. Many of these cases are raised in the public awareness by the increasing impact of social media, and of larger numbers of people expressing their views immediately and on-line. Earlier in 2017 United Airlines became very painfully aware of the speed with which brand reputation can be damaged. Many of those mentioned already have seen similar campaigns to boycott companies because of their perceived bad tax practices. This is what has also led to the OECD Base Erosion and Profit Shifting framework (BEPS).

It is difficult not to have some sympathy with a company that employs many thousands of people (who all pay taxes from their wages and indirect

taxes such as VAT on purchases they make with them) at hundreds of retail outlets (that generate business rate taxes) and that in turn support a myriad of secondary support industries. The fact that legislatures write inadequate laws, and regulators write overly complex and porous regulation, brings no outrage. In such cases, the argument from governments, on behalf of the people, that corporation tax from these firms is the sole (or even major) contribution to tax revenues is simplistic at best and disingenuous at worst.

3
Background and Principles

In order to give the reader the ability to understand GATCA both holistically and at the operational granular level, we must first set the scene. Some of that scene setting has already been done in the introduction, by providing some rather prosaic history. However, the desires of sixteenth century England to block up their windows don't give us much value today.

Avoidance and Evasion

It is important that we at least understand that what we call evasion today is increasingly an aggregate. The legal definition is reasonably clear, however, as we've seen, governments are invoking 'fairness' as a mechanism to include aggressive avoidance schemes into the definition of evasion. Where they are not doing this, they are often changing laws to make avoidance illegal under certain circumstances. The difficulty is that the lines are blurred and the use of fairness as a means by which to separate avoidance from aggressive avoidance seems fraught with risk.

Detection not Prosecution

However, for the readers of this book, it's a useful point to know that these frameworks are not designed to place the burden of such prosecutorial decisions onto financial institutions. We have heard, and seen, several media reports indicating that prosecutions have been filed under regimes such as FATCA. So,

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the first clarification here is that GATCA frameworks (which includes FATCA) are detection, reporting and information sharing structures, not prosecutorial as far as reporting institutions go. As we will describe in more detail later, the basis of all these frameworks is to create a system in which financial institutions are gathering information about account holders and applying certain rules in order to determine which are reportable. Now, these frameworks do all have penalty mechanisms. However, these are designed to enforce the due diligence and reporting activity and are not associated with any evasion per se.

The principle is that evasion, if it's occurring at all, will be happening because a tax payer is not declaring income that would otherwise form part of their tax base liability. The mechanism by which we get to that point varies depending upon whether you are talking about investments, where FATCA and AEoI would apply, or corporate tax where BEPS would apply.

Once that reporting information is received by a home country tax authority (HCTA), it is at that point that the HCTA can compare the aggregate of what they know their citizen has in offshore assets, to what they are declaring as their taxable base. In simple terms, if those two numbers don't match, then you have potential tax evasion. The important thing to recognise here is that the prosecutorial activity would occur based on the HCTA's domestic law applicable to the investor or corporation and not on the due diligence or reporting that preceded it.

Reportability

As described, the object of all these structures is to place a legal obligation on a financial institution to acquire enough information about their customers, to decide if they are reportable under a GATCA framework, to a foreign government, usually the tax authority of that government.

If you recall, the basis of much tax evasion is the movement of financial assets to different jurisdictions so that the 'home' jurisdiction has no direct line-of-sight to any income from those assets. There are several levels of complexity that flow from the concept of reportability and these, together with the challenges they present, are the subject of much detailed discussion in this book.

Adding to the Burden

Many readers will of course be aware that financial institutions already perform due diligence on their account holders. These are often based on regulation, the most common being Know Your Customer rules (KYC) and

Anti-Money Laundering rules (AML). The principle of GATCA is to leverage where possible, the work already being done by financial institutions in collecting data about their account holders. However, KYC and AML have different purposes from both each other and the purpose of GATCA. This means that the structure of these rules and the data collected under them may not always be sufficient for the purposes of GATCA frameworks. In particular, many of these other regulations do not require the collection of tax identification numbers, places of birth, the piercing of corporate structures to determine ownership, or due diligence on those with powers of attorney. All of these are necessary for the purpose of GATCA.

Exceptions and Exemptions

All these frameworks recognise that there are some areas that represent a low risk of tax evasion. So, to reduce the burden on these financial institutions, each of these frameworks includes exceptions and exemptions which means that the due diligence processes required to acquire the information do not need to be implemented in all circumstances by a financial institution.

We should also be clear on the difference between an exception and an exemption. Having adopted a rule, an exemption releases the subject from the application of that rule completely. An exception on the other hand means that the subject still falls under the rule but that, under certain circumstances, the rule is effectively suspended. In the UK for example, in the Value Added Tax regime, this is similar to the difference between being VAT exempt (an exemption) and being zero rated (an exception). It is important for readers to understand the difference because most exceptions are based on periods of validity after which the subjects again fall under the rule. In the US tax regulations portfolio, interest is subject to an exception for recipients that are not US persons. However, that exception is time limited. The practical result for financial institutions is that, in order to reduce the cost of enhanced due diligence, they will often compartmentalise their client base so that the enhanced effort is only pursued for those accounts that do not fall into exempt or excepted categories i.e. out of scope.

So, while exemptions and exceptions do indeed technically reduce the overall workload, at the same time, it creates a bifurcated process in which a financial institution must first determine if its customer falls within an exception or exemption category or not and then apply enhanced due diligence to only those customers that do not have an exception or an exemption. Enhanced due diligence is a term we use to describe any GATCA related information gathering that does not already fall within the scope of other regulatory rules such as Know Your Customer or Anti-Money Laundering rules.

Of course, in the interests of giving each jurisdiction as much control of its part of the framework, consistent with it still being capable of being a framework, each jurisdiction can choose where the lines are drawn for tax evasion risk. This, again multiplies up the workload on financial institutions in proportion either to the spread of their client base and/or the spread of their own business activities. It also creates added workload for financial firms because even though the terminology of framework leads one to presume some level of standardisation, the reality is very different.

Different Strokes for Different Folks

In addition, the customers of financial institutions can be of various different types. For direct customers, there may be a variety of investment vehicles available, some of which are extremely complex and may involve nested structures such as trusts, partnerships or nested corporately owned entities. So, GATCA frameworks typically create a separate set of rules for this. The first set, alluded to above, is designed to establish the types of account holder and size of assets that would be of sufficient level to warrant reportability.

The second set of rules is designed to make sure that financial firms performing their due diligence don't just stop at what they can initially see from KYC or AML. As regulators know (or think they know) which types of structure are most often used for evasion, they will establish another set of rules to force the financial institution to delve deeper into their client's structure in order to determine reportability. This leads us to the concepts of controlling persons (CP). In GATCA frameworks this usually means either (i) substantial ownership, usually via shareholding and/or (ii) effective control. In either case, the financial institution's 'customer' may appear not to be reportable under the general rules, however, delving deeper, it may be that this level is a front designed to protect the underlying controlling person from being subject to reporting.

For indirect customers, we must recognise that, if tax is going to be evaded, it will usually be based on income. The financial services industry has an incredibly complicated structure, but is most often described as a cascade or chain of intermediation. So, the direct customer of one financial institution, may have assets comingled with other customer assets in a chain of financial accounts. This would lead from the bottom of the chain, where the financial institution has a direct relationship with its customer (a beneficial owner), all the way to the top of the chain, where the identity of the ultimate beneficial owner is unlikely to be known. This is also not the end

of this level of complexity because the chain of intermediation is not necessarily singular. One beneficial owner may have accounts at several financial institutions. Financial institutions commonly have many, and several lateral relationships with other financial institution counter parties. So the effect is both vertical and horizontal—a 'cat's cradle' effect.

Happily for individual financial institutions, GATCA frameworks do not require collaboration between financial institutions unless they are part of a commonly owned group. This means that there is significant effort deployed in the information gathering rules to allow for HCTAs to use data received from many sources in a way that allows them to find (and aggregate) any given tax payer's information, even if they have accounts at many different firms in many different jurisdictions, and where their assets are hidden in structures where they are nominally hidden, but are controlling persons.

At least that's the theory. It is interesting that, despite forcing incredible spending both by tax authorities and by financial firms targeted on reporting, and despite the high profile objective of finding these tax evaders and extracting tax, penalties and interest from them to support governmental spending, there has, to date, been almost no publicity given to the results of all this activity. That said, as this book is published just prior to the first automatic exchange of information, it will be interesting to see (i) how long it takes HCTAs to analyse and act on the information and (ii) whether there will be any publicity for prosecutions and fines that would help give credence and validity to all the work put in by everyone in the industry.

The Framework Landscape

One of the difficulties in writing this book is the need to explain the legal basis upon which all this activity is based. There are two broad categories (Fig. 3.1).

USA

As far as the USA is concerned, FATCA is effectively a US law (the Hiring Incentives to Restore Employment Act 2010) that is underpinned by regulation, and below that Notices, Announcements, Publications and Revenue Procedures issued by the US Internal Revenue Service (IRS), serve to both explain, and vary, the original law or regulation. Both the law and the regulation are effectively extra-territorial compliance reach i.e. a set of rules

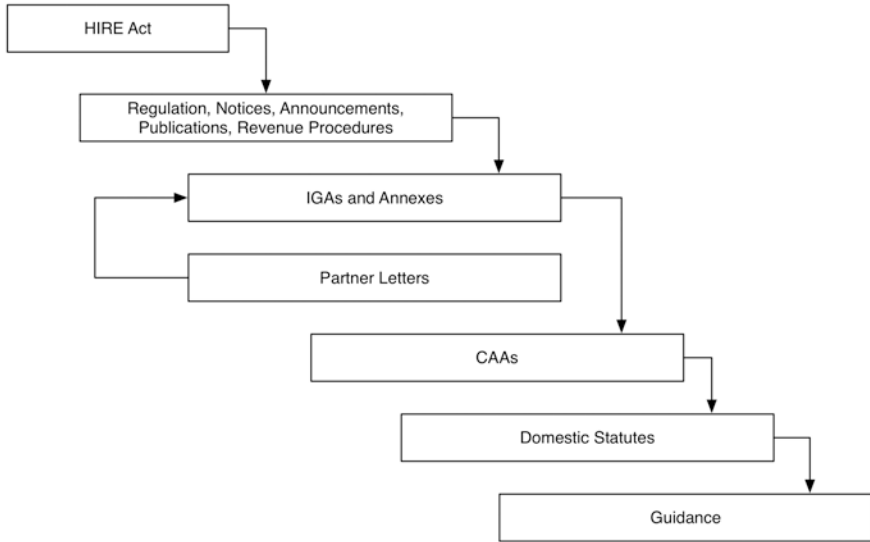

Fig. 3.1 Legal and operational basis of FATCA

applied to a non resident over which the USA has no formal legal jurisdiction. The motivation for compliance was, and is, inferred. The USA is the world's largest capital market, and no financial institution of any size can easily avoid exposure to it. So, they own the sandpit. If you want to play in their sandpit, you play by their rules or they will, using the chain of intermediation, find ways to exclude you from the sandpit or penalise you for being there and not following their rules.

FATCA was implemented separately from the similar but later Automatic Exchange of Information (AEoI) and, as such, FATCA is essentially a bilateral framework of a one-to-many type. The FATCA world has been made more complex because the original regulation would have failed utterly, despite the over-reach. That's because the USA was trying to force non-US financial institutions to report directly to them with information about their customers. This tripped over several country's domestic data protection laws—including all twenty eight member states of the European Union.

The result, as we all now know, were the Inter Governmental Agreements (IGAs) which cover most, but not all, of the world's tax jurisdictions. The IGAs themselves come in two different 'flavours' but the intent is the same, to allow financial firms in those jurisdictions to pass information to their domestic tax authority who then pass it along to the USA.

Even so, the IGAs are agreements between governments, and have no direct legal effect on financial institutions. So, in order to force the financial institutions themselves to perform, each government had to translate their IGA into domestic law. Some literally just copied and pasted, topped and tailed. We'll discuss all of this in more detail later, but in essence, the legal basis of FATCA is bifurcated.

In non-IGA jurisdictions the financial firms are directly subject to the extra-territorial regulations (based on the sandpit principle) and must sign a contract with the IRS that embodies those obligations or suffer financial penalties and/or exclusion from the market.

In all the IGA jurisdictions, financial firms are subject to their own domestic FATCA laws which in turn are expressions of the respective IGAs, which in turn are expressions of the primary US regulation and statute. In a further twist, even in IGA jurisdictions, the enabling feature of the IGAs is that they require a Competent Authority Agreement (CAA) to allow for the definitions and specific rules for the transfer of information.

OECD

The OECD's AEoI framework differs from the USA framework in that it does not start with primary legislation. Enabling legislation in each jurisdiction is implicit in the framework (Fig. 3.2).

The AEoI framework is based on the idea that many governments would want to collaborate to share information and thus the framework is built on the principle of Competent Authority Agreements (CAAs) of which there are two types—bilateral and multi-lateral. Below these CAAs, jurisdictions that sign up to the framework, are expected to review their domestic regulation, then add to it and/or amend it to the extent necessary to permit the exchange.

In the AEoI framework, unlike FATCA, there is also the concept of a Common Reporting Standard (CRS) that separately defines enhanced due diligence procedures, exemptions and exceptions. In effect, AEoI is made simpler because CRS defines what financial firms must do while AEoI defines what the governments must do.

We always get asked about penalties in our work because it's the first thing most firms are worried about when considering degrees of compliance. In AEoI frameworks, the penalties applicable to financial firms for not performing the required due diligence are effectively left to the individual governments to enact in their own jurisdictions. This contrasts to the FATCA

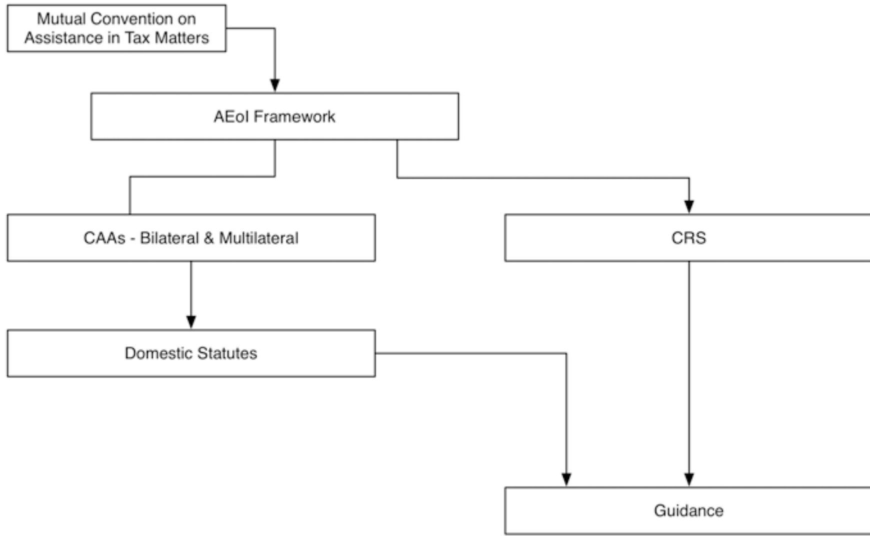

Fig. 3.2 Legal and operational basis of AEoI

regulation where the US sets the penalties which are usually viewed as far more stringent than those being applied in the rest of the OECD markets.

The Elevator Test

So, in summary GATCA is all about creating frameworks of regulation and legal structures that force financial firms to perform enhanced due diligence on some of their account holders, identify those that are reportable under the rules, package data relating these account holders and send that data in a prescribed way to a tax authority who may in turn share that information with other interested governments for the purpose of detecting tax evasion.

Variations in these frameworks allow, in principle, for taking some account holders and some investment structures out of scope for enhanced due diligence and reporting, thereby potentially reducing the burden on financial institutions.

The frameworks themselves at the CAA level prescribe the mechanisms for the transfer of data between governments including encryption, compression, digital signaturing and transfer protocols.

Issues of Substance

So, what do these different GATCA enabling methodologies create? The simple answer is complexity and risk. While AEoI had the benefit of FATCA before it and thus some opportunity to simplify, much of this has been lost through the fact that AEoI is a voluntary framework not a regulation.

The issues of substance, which we will spend much more detailed time on in the other chapters of this book, can be categorised by working from the beginning of one cycle to the beginning of the next.

Resource

The fundamental impact of GATCA frameworks is to add workload at the operational level, but, importantly they also add workload at many other levels.

Firms need to have sufficient knowledge to interpret the rules and monitor changes in the frameworks across anything up to and beyond a hundred jurisdictions. In our experience most firms have insufficient breadth and depth of knowledge.

Leadership and Ownership

In addition, as most firms tend to use a siloed business model, there is often a lack of coordination between departments, and an unwillingness for anyone to take the lead. While the burden of cost and risk often lies at the operational level, these issues are most often brought to prominence by the tax, legal or in most companies, the compliance functions. Leadership and ownership are usually the biggest issues to handle.

Given some level of leadership, resource constraints are usually budgetary and/or capacity based. Most firms under-estimate the cost of compliance both in terms of acquiring and maintaining knowledge, and of the additional costs associated with implementing compliance programs at a departmental level.

Capacity

Most firms also underestimate the capacity of their own businesses to adapt to these frameworks. It is a common approach to start from the presump-

tion that the additional workload can be spread out across existing staff. However, there is an increasing realisation, particularly expressed at international conferences, that financial firms have reached the limit of how much of the regulatory load can be absorbed with existing resource. Part of the difficulty, of course, is that the regulatory and compliance workload delivers absolutely no benefit to clients, quite the reverse. Some firms we know of have actually taken the radical decision to withdraw completely from some markets, notably the US, simply because the cost of compliance and risk associated with exposure to that market is too high and cannot easily be absorbed into the balance sheet nor easily passed on to account holders.

Risk

There are all sorts of risk in a financial firm. However, as far as GATCA is concerned, the risks can be summarised as operational and reputational.

Operational risk rises based on the leadership, ownership and capacity issues, are already noted. However, in dealing with many thousands of account holders, some of whom will need to be pierced for underlying ownership information, the issue is one of scale, and scope, of change compared to existing processes. Both KYC and AML are well established, but with GATCA, firms may now have to cope with account holders who are one thing under KYC, and another under GATCA.

Implementing due diligence procedures to cope with pre-existing and new account holders, creates relationship issues for clients who often do not understand the purpose of this new due diligence. In FATCA we already see many firms struggling with the fact that they must obtain a FATCA status from their account holder, usually with a W-8 form, that the firm cannot help the client decide which form in the series to complete (as that would be tax advice), yet often rejects the form as the wrong one when finally received. These operational minutiae require some very sophisticated analysis of each firm's current structure in sales and marketing, on-boarding new clients and maintenance of accurate records. All of this creates bifurcated processes, disparate policies and almost unmanageable control, oversight and training issues.

Technology

As with any new framework, there are new data that need to be defined, assessed, collected and curated. One of the biggest problems of GATCA

frameworks is the difference in definitions of terms that sound similar, and even differences of interpretation of terms that are the same in more than one jurisdiction. The US again exemplifies this issue, when acknowledging that trusts can be legally defined and tax-structured in different ways outside the US, than they are inside the US. Where the tax treatment is the same, there is no problem. However, if a trust is tax transparent in one jurisdiction and opaque in the other, we end up with two additional possibilities that regulation must handle. For the US, this created the concepts of a hybrid entity and a reverse hybrid entity. Why does this matter? It's not just a case that the account holder themselves must realise and understand the differences in order to present a truthful declaration of tax status to its financial firm(s), the financial firms must now be able to codify these differences into systems. At the core of GATCA, is the concept that an individual may have a liability to tax in more than one jurisdiction. Before GATCA, this data was something that most financial firms just did not collect. On-boarding only identified one tax datum. Now, they must ask 'in how many jurisdictions do you have a tax liability?'. They must have systems able to connect those jurisdictions to a single account holder. In addition, that potential multiplicity of connections has dependencies that may change, whether an account holder is reportable in one jurisdiction but not in another, even though they have tax liability in both. The US position with regard to trusts with alternate hybrid and reverse hybrid status, is a good example. In a GATCA world, the easy bit is amending a system to collect more data. The difficult bit is designing the system to understand the due diligence rules of a hundred countries (or more) in order to identify if any given client with a tax liability in those jurisdictions is in scope and therefore reportable.

There are, of course, already a plethora or reg-tech companies poring over GATCA with solutions that range from the narrow to the broad.

Principles

GATCA principles can thus be summarised as follows:

1. The purpose is to create an international information sharing environment between governments, based on legislative, regulatory and collaborative agreements, to facilitate the detection of tax evasion committed by residents of one jurisdiction, leveraging the tax rules of another jurisdiction by means of the movement of financial assets or profits;

2. The effect of GATCA frameworks is to provide an inter-governmental structure that allows for the transfer of personal or corporate data that would, in most cases, otherwise cause financial institutions to breach domestic data privacy laws;
3. Frameworks are designed to define enhanced due diligence procedures, definitions, exceptions, exemptions and use of investor self declarations (ISDs) to enable financial institutions to identify reportable account holders;
4. Frameworks are intended to create data protocols for the transfer of information (i) between financial firms and a tax authority, and (ii) between tax authorities in order to ensure the timely and secure sharing of information;
5. Penalties for non-compliance to due diligence and/or reporting criteria, are set by individual governments and applied, by them, directly to financial firms, while penalties for tax evasion, if and when detected resulting from information sharing, are reserved matters between the governments and their tax-payers.

With this background and these principles in mind, the rest of this book is dedicated to exploring the practical implications of a new GATCA world.

Part II

US Foreign Account Tax Compliance Act (FATCA)

4
Introduction to FATCA

In this part of the book, we will look at the US anti tax evasion regulations—FATCA.

FATCA is effectively Internal Revenue Code (IRC) Chapter 4 and is the US's unilateral attempt to prevent, detect and deter tax evasion by its citizens by means of (i) forcing non-US financial institutions to identify and report US account holders and (ii) legislate for US citizens to disclose foreign assets.

Financial firms outside the US often also come across IRC Chapter 3, that deals with the taxation of US sourced income paid to non-US residents. IRC Chapter 4, on the other hand, deals with *any* income paid to a US person outside the United States.

The term FATCA is an acronym for the Foreign Account Tax Compliance Act. There is actually no such legislation on the US statute books. The term, which is technically a misnomer, has entered into the general vernacular, even at the IRS, and originates from 2008 with the House of Representative's Bill HR3933 that went by that name but was never passed.

The basic text of what we now call FATCA has been sequentially moved, first from HR3933 to HR4213, the Tax Extender's Bill of 2009 and finally to HR2847—as Title V of the HIRE Act which passed into law in March 2010. So, whilst technically incorrect, I will, grudgingly, follow the general trend today and refer to the content and intent of Title V of the HIRE Act as FATCA.

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Understanding FATCA

The main problem that many people have is trying to understand what the IRS is trying to achieve and just how its going about it. In any normal tax system, there is a clear line between income and the tax that's due on that income. Therefore, the bulk of the work that gets done is simply a task of assessing whether there is any income and if so, applying a calculator to establish the tax. FATCA is not like that for three reasons.

Firstly and most basically its not a tax system—it's a due diligence and reporting system with the tax system being used as one of the ways to apply penalties to those who do not comply.

Secondly, the majority of the work involved is not applied to just a subset of the total account population. It is applied to the whole population of account holders in order to identify certain categories and take subsequent actions on each of them.

Thirdly, it involves sharing of information on the global income of residents of one country, with another, in principle, without the application of any tax.

Introduction

Background

There are various anecdotal threads to explain why FATCA exists and how it got into its current form. The most common is that FATCA exists because of political pressure from the US electorate as a result of the sub-prime financial crisis of 2008. This event focused attention on the financial services industry and highlighted occasions where wealthy Americans were hiding their assets outside the US and thus evading US tax. This is significant because the US claims the right to tax the global income of its tax-payers. The first major spotlight fell on UBS in Switzerland. There has been much written on the subject of the UBS case and of the way in which Switzerland had to change its privacy laws as a result of pressure from the US to disclose Americans with Swiss bank accounts. To avoid distracting the reader, I will not go into detail of how this developed. Safe to say that the UBS case, among other factors, was contributory to the concept of FATCA and therefore by inference, to the whole AEoI and CRS landscape that this book tries to bring together.

The principles of FATCA will be described in more detail later. However, in essence FATCA establishes the principle that non-US financial institutions must establish whether they have, anywhere in their customer base, any US person or any account holder who is substantially owned by or effectively controlled by a US Person.

As I've already described, FATCA began in 2008 but took until 2010 before it entered into law. What we know of today as FATCA is actually a section ('Title V') of the Hiring Incentives to Restore Employment Act. This Act was enacted by President Obama as part of his Stimulus Plan to trigger growth in the US economy. Almost all of the HIRE Act was aimed at giving domestic tax breaks to US businesses to encourage them to employ more staff. Ironically, those tax breaks were time limited and have all now ended.

However, under US law, any Act that is going to cost money to implement must have a cost benefit analysis performed and identify where the funds are going to come from to either offset or pay for the implementation. Hence the relevant Title in these Acts is called 'Offset Provisions'. In the HIRE Act these offset provisions ended up being predominantly the text of the original Foreign Account Tax Compliance Act. In other words, the penalties leveraged indirectly on non-US financial firms and/or their customers to the extent that they did not disclose whether they were US tax-payers, is designed to offset the tax breaks given by the US government to US businesses in 2010.

Voluntary System

Underpinning all this is the fact that the US tax system before FATCA was fundamentally a voluntary disclosure system. The rules for an American provide that tax payers should disclose any assets held in foreign bank accounts under the Foreign Bank Account Report filing or 'FBAR' for short. Equally, US tax payers should also be filing forms 1099 to declare any income from investments using box 6 of the form 1099.

However, any US taxpayer that wants to evade tax only had to fail to submit these documents and the IRS has no easy way of finding out what it does not know. The US taxpayer might have to suffer a 30% withholding as a result of hiding these assets and not disclosing that they are US persons, however, that's actually a good deal for them. Typically, an American rich enough to be able to afford to hide assets overseas and gain benefits from the scale of those assets would otherwise probably have been subject to taxes in excess of 45–50% if they had been declared inside the US. So, as one person

put it to me, 'if you could show an American that they could be subject to only 30% tax instead of 45–50% simply by opening up an account overseas, you'd have a queue outside your door'. So, the conundrum for the IRS was how, in such a voluntary disclosure system, to have any kind of control or oversight.

The IRC Chapter 3 regulations were supposed to be one step toward that objective. The problems that Chapter 3 has are that:

i. it relates only to US sourced FDAP income;
ii. it only works if most of the financial institutions affected are QIs

Since there are estimated to be only around 7500 QIs in the world i.e. most institutions are NQIs, the system, even after nearly two decades, doesn't meet the need.

And so we come to FATCA. There are many who thought that the best way forward to meet the US' need to identify its tax evaders, was to beef up the Chapter 3 regulations. This didn't appear to be the case as the HIRE Act was implemented, although we are now seeing signs that Chapter 3 and Chapter 4, from an operational standpoint at least, are being converged.

While most of this part of the book is focused on the impact for non-US financial institutions, the reader should not forget that FATCA, as implemented in the HIRE Act had two main elements not one.

The first element, as described elsewhere, contains the obligations and effects on non-US financial institutions and their customers of increased disclosure of beneficial owners. This is Title V, Subtitle A Part I comprising sections 501 and 502.

The second element is Title V, Subtitle A Part II. This is the obligation on US tax-payers to report foreign financial assets together with the penalties on them for failure to do so.

It is the first element that this part of the book is occupied with. From this perspective, we try to explain the following:

1. The essential principles of FATCA and the language being used to establish a framework whose legal basis is in the US Hire Act (2010), but which operationally is delivered in some markets through intergovernmental agreements and in turn domestic legislation, while in other markets delivery is through the HIRE Act (2010) together with contracts between financial firms and the IRS;
2. The key elements of enhanced due diligence. Here we are referencing the fact that the IRS has allowed foreign firms to rely heavily on pre-existing

Know Your Customer (KYC) regulation and anti money laundering regulation (AML). However, to force penetration of complex tax evasion vehicles and at the same time to mitigate some of the substantial workload, the rules on enhanced due diligence (i.e. beyond KYC and AML) are surrounded with complex, often jurisdiction specific, exemptions and exceptions based on account value thresholds and exempted investment vehicle types;
3. The main issues associated with dealing with situations where a failure to penetrate and/or disclose to the required level—either by a financial firm or by their customer(s)—leads to the need to financially penalise account holders and/or their financial institutions in IRC Chapter 4;
4. The predominant features of FATCA reporting including notably, not just reporting of US tax-payers, but also FATCA reporting of recalcitrant and non consenting account holders. We also make note of the separate reporting of FATCA penalties that are implemented in a converged fashion with IRC Chapter 3.

One of the largest problems faced by FATCA has been data protection. The concept of FATCA reporting would require a non-US financial firm to break its domestic data protection laws in order to meet the requirement to send data to the US. This was particularly problematic for the European Union Member States, as they have demonstrably higher data protection standards that the US and they also have Directives that make such transfers illegal under most circumstances. While there used to be a Safe Harbor principle in place, this has failed a legal review. However, we now see the General Data Protection Regulation (GDPR) due to go into force in 2018 that would again cause problems. The way around that, not just for the EU but for all non-US jurisdictions, has been the concept of an inter governmental agreement (IGA) that effectively takes the data protection issue away by raising it above the financial firm's operating and compliance level. This has required that IGAs signed between the US and other governments be translated by those other governments into domestic law. In effect, this has changed the operating model for FATCA. At the same time, the IGA principle needed to take into account other matters that would be relevant in such circumstances such as the possible existence of tax information exchange agreements and/or double tax treaties. In addition, during negotiations, it became clear that some governments wanted some level of reciprocity. The net result of all this is that IGAs can take multiple forms based on these variables, but that where they do exist, for the most part, FATCA reporting is a domestic issue for a financial firm with the actual transfer of data out of the juris-

diction being undertaken by the government itself. Any jurisdiction without an IGA is, in principle, subject directly to the FATCA regulation that requires a contract, similar to the QI contract in Internal Revenue Code (IRC) Chapter 3, that mandates levels of due diligence and reporting. In these latter jurisdictions, if there are data protection laws, the financial firm is required to obtain a waiver of these laws from its customers and, in the absence of such waiver, penalise them at 30% withholding for a period and ultimately close the account.

This model is made more complex because some governments have taken a long time to have these discussions with the US. In the face of a low take up, the US introduced the concept of 'in substance'. These are jurisdictions that have not actually signed an IGA but which are showing enough intent that the US is prepared to allow them to act as if an IGA had been signed. Great idea except that this creates the possibility that one could just keep going at in substance level without ever signing an IGA. The US has revoked this status for some jurisdictions, sending the signal that this is not acceptable behaviour. Several jurisdictions that have signed IGAs have failed to report on time or have notified the US that they will be deferring their reporting sometimes because they have not yet implemented enabling domestic law but also sometimes because they are not technologically ready.

The overall result, on the IGA front is one in which the model makes some kind of sense, but where the reality on the ground can, and is, very confusing for those affected. This also has implications for AEoI and CRS as we shall see in other parts of this book.

Of course, for individual firms, other than large multi nationals, there is usually only one jurisdictional set of rules to worry about. In all circumstances however, the largest impact of FATCA is usually the due diligence. The FATCA regulation comprises substantial definitional aspects used to help forms identify what they themselves are in relation to the framework and how they must act in certain sets of circumstances; as well as definitions relating to types of account holders in order to identify those in or out of scope of reporting. Finally, FATCA presumes that tax evasion will be occurring in high value accounts and so there are thresholds to consider as a trigger to any enhanced due diligence requirements beyond KYC and AML.

So, jurisdictional frameworks and due diligence apart, the cornerstone of FATCA for many is a Global Intermediary Identification Number (GIIN). This number, which is semi-intelligent, effectively allows financial institutions in a chain of intermediation to identify their status as complying with the relevant FATCA due diligence and reporting rules. On the one hand, in principle this means that in a multi layered chain of intermediation, if

each layer has a GIIN, all but the bottom layer, the one with the direct relationship with a direct account holder can effectively ignore many aspects of FATCA—with respect to the layer below, as the obligation flows, via the GIIN, to the ultimate intermediary. As we will see in later chapters the principle is not always either well understood or applied correctly in practice. While the number of GIINs globally, based on the definition of an entity that would need a GIIN, is over a million, the actual number of GIINs issued by the IRS is around 2,00,000. The IRC Chapter 3 regulations faced similar challenges and, even today, seventeen years after implementation, there are though to be only around seven thousand QIs out of a possible population of an estimated fifty thousand.

So, FATCA needs to be considered in context (i) to the difficulties that this regulatory structure has seen since its inception seven years ago and the resultant changes in its operating model and (ii) the response from the industry in which there are extremely wide variations in both understanding and practical compliance. In the following chapters we hope to provide more clarity not from the perspective of explaining the regulations line by line, but by using the principles of the regulations to highlight the challenges, loopholes and potential solutions that are available.

5
Principles of FATCA

In this chapter we will review the main principles and effects of FATCA which is the US version of the GATCA principles. We will leave the more detailed aspects of the regulations to later chapters. This will be a good chapter to read for those otherwise unfamiliar with FATCA. (Fig.5.1)

As we saw in the introduction and Part 1, in all common sense terms, FATCA is the father of GATCA. While international tax information sharing agreements existed before FATCA, they generally did not permit fishing expeditions by one tax authority to another and also often tripped over data protection and/or bank secrecy laws both of which minimised their effectiveness. FATCA was the first real attempt to codify a system to force disclosure of their customers to a foreign government.

What you believe FATCA to be about, depends on who you are.

If you are a financial institution, FATCA is primarily about due diligence, reporting and in the worst cases penalty withholding.

If you are a non-US account holder its going to be primarily about responding to requests from a financial institution to provide your Chapter 4 status i.e. self certification of the degree, if any, to which you are US, US controlled or US owned.

If you are a US account holder (or are to any extent US owned or controlled), its still about that self certification to the financial institution(s) at which you have accounts, but its also about that other part of the HIRE Act that mandates disclosure of foreign assets directly.

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Legal Basis and Structure

The legal basis of FATCA is, as noted above, the Hiring Incentives to Restore Employment Act (2010) often referred to as the HIRE Act. Title V Subtitle A of this Act contains several parts. Text in square brackets is the authors' to aid understanding. These are:

- Part I Increased disclosure of beneficial owners [by non-US withholding agents]
- Part II Under-reporting [by US Persons] with respect to foreign assets
- Part III Other disclosure provisions
- Part IV Provisions relating to foreign trusts
- Part V Substitute dividends and dividend equivalents

Part I, is what most people outside the US consider to be FATCA and sets out the basal definitions and terms for non-US financial institutions to perform due diligence, report on any US account holders and/or recalcitrants and non participating FFIs and apply a penalty withholding where necessary. These are what is commonly called Internal Revenue Code Chapter 4.

Part II of Title V sets out the obligations of US persons to declare foreign assets and income as an additional Section 6038D to IRC Chapter 6. This part also sets out the penalties for failure to disclose or underpay tax. To that extent, this portion of the Act applies to Americans while Part I applies to non-US financial firms.

Below the HIRE Act sit intergovernmental agreements (IGAs), Annexes, Competent Authority Agreements (CAAs), Partner Letters, Regulation and

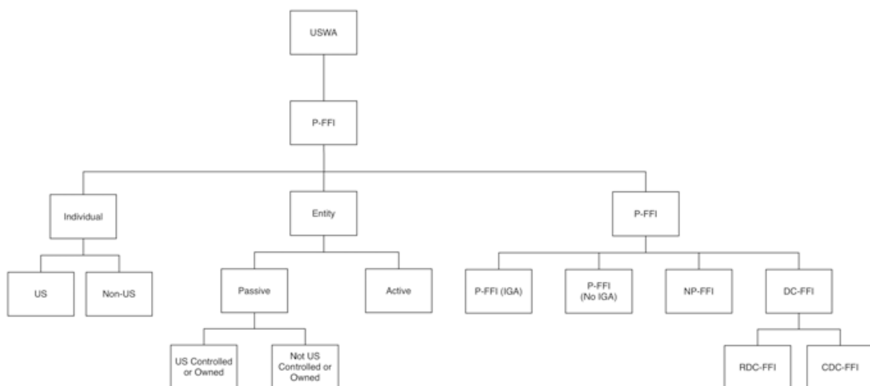

Fig. 5.1 Legal structure and basis of FATCA

Revenue Procedures. These form the thread of continuity between the statute and the operational rules that financial firms have to follow.

Main Provisions

The summary is that FATCA's main provisions are

i. to enforce reporting by non-US financial firms of US accounts maintained outside the US and
ii. to obligate US persons holding such accounts to disclose those accounts.

In this book, we will be concentrating on Title V Subpart A Part I i.e. the impact of FATCA on foreign financial institutions and their account holders.

Principles

The principles underpinning the objectives of FATCA are

i. Documentation;
ii. Reporting;
iii. Withholding.

How Does US Tax Evasion Happen

We must take as our starting point that Americans who have decided to evade some or all of their US taxes often do so by putting their money into non-US investment vehicles. That might typically be a simple bank or brokerage account held at a non-US financial institution. The account could be depository in nature i.e. cash, or a securities account containing equities, bonds or other financial instruments. What's happening here is that the American may be relying, as was the case with UBS and Switzerland, on domestic secrecy laws to prevent any information being revealed to the IRS. Alternatively, the American may choose a more 'furtive' method and hide their assets through one or more investment vehicles in which their assets are pooled or comingled with others. Other methods would include setting up chains of shell companies or other vehicles in various jurisdictions in order to make it more difficult for the American to be identified. What is usu-

ally happening here is that an advisor has identified a mechanism by which current regulation, usually Know Your Customer (KYC) or Anti Money Laundering (AML) can be circumvented at worst or, at best, where a weakness in the system of checks and balances can be found and leveraged.

The object, of course, is preparatory to tax evasion and not evasion in itself. There's usually nothing inherently wrong (morally or legally) with these investment strategies. There are many thousands of Americans who have legitimate bank accounts overseas. Ex-pats have and continue to be significantly affected by FATCA. The mere threat of FATCA caused several major banks to either close all accounts of Americans or to move their accounts to a US branch and even today, most financial firms are either very wary of accepting US clients or have stringent procedures in place to minimise the operational effects of this class of account holder.

The point at which having an account or investments overseas becomes evasion is when the American fails to disclose these assets to the IRS and pay tax on the income generated from them.

This is where FATCA comes in. FATCA creates a parallel system to the voluntary disclosure nature of the US domestic tax system.

FATCA leverages the fact that, in order to evade tax, there is one common point necessary to the act—a non-US financial account through which directly or indirectly, investment income is received.

Thus FATCA is essentially a system, designed to be extra-territorial in nature and to force the industry to find and report the global income of Americans.

The logical consequence of this is that the US had hoped that Americans would begin to voluntarily disclose their foreign assets rather than be reported by their financial institution first. The US has geared up to penalise all those Americans who appear on reports and for whom the IRS has no reconciling domestic US disclosure.

Accidental Americans

Its worthwhile at this stage to mention at least one of the unintended consequences of FATCA that has caused much angst. If you know you're an American (were born in the US or have a US Passport), you should (and are expected to) know, understand and meet the obligations to which you are subject under the US domestic tax system (and also now under the HIRE Act). In this respect, FATCA should be immaterial. If you are properly disclosing your offshore accounts and income and paying tax on them, whether

your financial institution files a separate report to the IRS about those accounts, should be of no consequence to you, since you've done nothing wrong and there will be no other impact.

If you are actually conducting tax evasion, clearly FATCA is a concern, although, on the basis that the criminals are always a step ahead of the cops, there appear to be enough loopholes and inefficiencies in FATCA to cause the sophisticated tax evader no more than a passing annoyance—they'll figure out another way. In fact, they probably already have. However, there's a third category. What if you don't think you are an American but actually, you are? This is the group that is actually severely impacted by FATCA. The US has specific rules about what determines US status for tax purposes and it is incredibly easy to fall into the trap (or just be in it) without knowing it. Given the politically charged issue of tax evasion and the degree to which its being wielded about by politicians like the sword of Damocles, those people (or CIVs) that get caught will be 'assumed' to have been deliberately evading US tax which will presumably bring down the full might of the IRS on their shoulders, both financially and reputationally.

If either of your parents was born in the US (Boris Johnson, Mayor of London; Winston Churchill are good examples). If you ever held a green card and not revoked it. If you've been physically present in the US for over a certain number of days over a 3 year period. Any of these criteria, known as US indicia, could put you over the line, even though you are not an American. Under their rules—you are and you should have known, disclosed and paid tax to the IRS. These are the people who will be most affected by FATCA and who cause most of the operational problems for financial institutions.

Principles

FATCA is based on eight principles.

- Intergovernmental Agreements and reciprocity
- Status in IRC Chapter 4
- Structure
- Global vs Local
- Identification
- Reporting
- Withholding and Account Closure
- Convergence to IRC Chapter 3

Intergovernmental Agreements (IGAs) and Reciprocity

This refers to the results of a major backlash against the US in 2012, where several industry groups and governments complained, both directly and via their financial institutions and industry associations, that two of the main planks of FATCA would cause significant legal problems. In fact, at that time, most financial institutions outside the US would have been forced to break their domestic laws in order to satisfy the US law—an untenable situation. These problems were data privacy laws and account closure sanctions. The problem is created by the concept of reporting within the regulations for those who are deemed, under FATCA to be US, and closure of long term recalcitrant accounts.

The base presumption prior to IGAs was that a foreign financial institution (FFI) would file reports directly to the IRS identifying those of its customers who are, in the eyes of FATCA, US (including here the concepts of substantial ownership and effective control). The problem is that these account holders often do have some protection of the domestic jurisdiction where the account is maintained, not least because the KYC and AML tests applied at account opening would not typically have resulted in US status for many of these account holders. To that extent, the account holder, as far as the domestic institution is concerned, is not US. Many jurisdictions have banking secrecy laws and their equivalents as well as data protection concepts that would then make it illegal for them to file these reports to the IRS.

Equally, FATCA contains the concept of withholding on recalcitrant accounts and then closure of the account if the account holder does not subsequently comply with information requests. This also poses legal issues for some financial institutions where domestic law prohibits the closure of some types of accounts.

The response to this backlash was the concept of a FATCA Partner Country giving rise to the idea of an intergovernmental agreement (IGA). The US essentially agreed to negotiate bilateral intergovernmental agreements with these FATCA Partner Countries to get round the legal problems that FATCA causes for those jurisdictions.

The principle characteristics of IGAs are that they

i. simplify the identification and documentation rules;
ii. identify exemptions and exceptions at a jurisdictional level;
iii. replace reporting to the IRS with reporting to domestic regulators and;
iv. remove the requirement to withhold on or close recalcitrant accounts.

Reciprocity

Clearly, the rest of the world was thinking ahead when the IRS started discussing IGAs. The US is not the only country with people evading tax and it was not long before the discussion of IGAs led to discussion of reciprocity. Other governments are keen to have US financial institutions disclose details of their own tax payers with US accounts so that they can make sure that their tax-take is optimised. The concept of a reciprocal IGA thus emerged. While the US as a government may engage in reciprocal IGAs, US financial institutions, like their non-US counterparts, weren't in favour of the implications of such reciprocity but slowly and surely they have reciprocated the information. Its also likely that, even with the concept of reciprocity enshrined in an IGA, that there will need to be changes to US law to allow for this information to flow and several years before US institutions are able and/or willing to submit to the reporting obligations this would imply.

In constructing the IGAs the IRS also took account of whether the target jurisdiction already has a tax information exchange agreement (TIEA) with the US and whether the target jurisdiction has an existing double tax convention (DTC) with the US.

The net result is that today, we have five types of IGA available.

- Reciprocal Model 1A with pre-existing TIEA or DTC
- Non-reciprocal Model 1B with pre-existing TIEA or DTC
- Non-reciprocal Model 1B with no pre-existing TIEA or DTC
- Model 2 with pre-existing TIEA or DTC and
- Model 2 with no pre-existing TIEA or DTC

These model agreements are all slightly different and each also has Annexes that can vary too. The Annexes typically act at the jurisdiction level to lay out any specific due diligence rules or exemptions relating to that jurisdiction.

The impact of FATCA was originally uniform across the world. The same, very complex rules and penalties, applied to everyone. The emergence of IGAs has significantly altered that landscape.

In Substance

That said, the IGA landscape is still a continually changing one. There have been some jurisdictions that were concerned that they had not enacted an IGA at the time that reporting was required. To solve this, the IRS imple-

mented the idea of an In-substance IGA. This is a jurisdiction whose financial firms can act as if the IGA has been signed, even though it has not been. Of course, this just raises the question of how long a given jurisdiction could go acting in substance before it would have to sign something. The IRS has signalled that it expects in substance jurisdictions to make best efforts to complete the process. So, there is an inherent threat for these jurisdictions.

Of course an in substance IGA is a simplistic description. For each type of signed IGA there is also an in substance version designed to apply for any jurisdiction that entered into the in substance category after July 1st 2014.

So when someone asks you about IGAs, remember that there are actually ten types of IGA.

If a firm falls into the definition of FFI, the first and biggest question is whether they and/or any subsidiaries, affiliates etc. fall within any one or more IGA jurisdictions. Those that do, face much simplified and much easier compliance. Those that don't, face the full force of the regulations.

This is analgous to the situation the industry already faces with IRC Chapter 3. In Chapter 3, we have regulation as one stratum. Below that we have QI agreements as a secondary stratum that modifies the regulations to provide specified benefits through contracts with the US government.

Status

Everyone outside the US falls into just three categories:

1. Individual
2. Non-Financial Foreign Entity (NFFE)
3. Foreign Financial Institution (FFI)

The object of these status types is to allow for different processes to be applied since the way and degree to which tax evasion might take place i.e. risk, will vary depending on this status. You'll notice that these are very high level categories which don't, for example, speak to the idea of beneficial ownership. This is because FATCA relies to a large extent on the fact that this tax evasion deterrence system does not exist in a vacuum. FATCA exists in a world that already uses common regulatory structures, including Know Your Customer (KYC), Anti Money Laundering (AML) and domestic reporting by financial institutions to their own regulators.

Its important to understand that these categories are definitional. I am often asked by small banks and brokers, whether they should be FFIs or not.

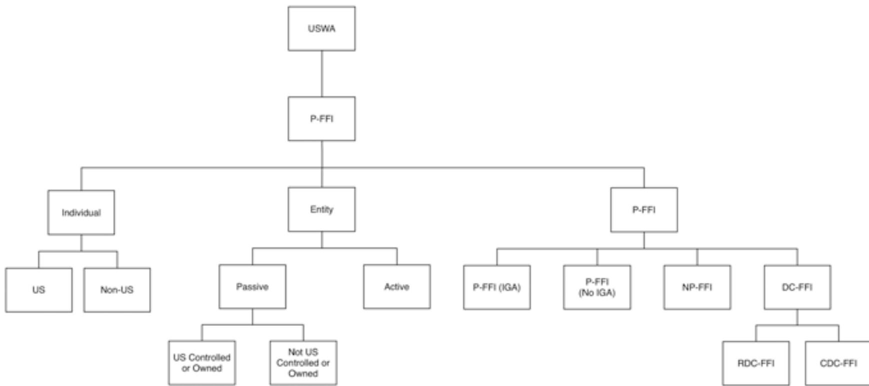

Fig. 5.2 Account structure holder under FATCA

The answer is that its not a question of choice. Their status, at this level, will be determined by reference to the definition. Within each of these categories there are some limited choices that can be made (Fig. 5.2).

For example, an FFI can, in principle, choose whether to 'participate' in FATCA or not. This leads to the subcategories of FFI—Participating FFI (P-FFI) and Non Participating FFI (NP-FFI).

In other areas, even at the sub-catgeory level there may be little or no choice. NFFEs for example have two sub-categories—'Active' and 'Passive'. Which sub category an NFFE fits into is definitional not optional, its not a choice they can make. Worse still, some of these definitional categories can change with time. In the example of an account holder that is an NFFE, their status as passive or active is determined in the most part by the proportion of their total income what is passive (e.g. investment income) as opposed to active (e.g. trading income). That proportion can change and would typically be published or calculable in the firm's accounts. The issue for the NFFE itself is that they will be self-certifying their status under penalty of perjury which would lead naturally to a risk requirement for someone to (i) know about the issue and (ii) monitor it so that these certifications are valid and not accidentally causing liability.

What is important to understand is that these definitional categories apply to everyone outside the US—for the purpose of determining the application of FATCA.

Its this unilateralism that has caused so much anger outside the US. The approach is effectively a 'negative proof' system requiring everyone and all firms to be categorised under a US definition in order to determine the risk that Americans will be there evading tax.

Remember that the reason for this scale of categorisation is that the US claims the right to tax the global income of its tax payers, not just US sourced income. It was rather ironic when, in January 2013, The European Union proposed the EU Financial Transactions Tax (EU-FTT) which would be applied to any transaction, anywhere in the world, including the US, where the securities involved in the transactions were sourced in EU Member State irrespective of where the parties to the transaction were located. The US responded vigorously to this proposal citing the unacceptability of the EU applying an extra-territorial tax that would impact the US. Many observers outside the US commented at the time that the US should look to its own extraterritorial tax rules before it complained about others adopting the same strategy.

There is one more very important point I want to make here and it goes to the way in which the IRS defines 'financial institution' and also 'financial account'. In the regulations, the definition of an FFI is very clear, but it contains a wider scope of what most people would determine to be a financial institution. This has major implications because, from a practical viewpoint, those firms that were traditional financial institutions prior to January 1st 2013, banks, brokers etc. already have many of the policies, procedures and systems that are the foundation of compliance for FATCA. For them, FATCA is a regulatory change of degree not kind. However, in their hunt for tax evaders, the IRS added, paraphrasing 'everyone else that's involved in the investment chain' and particularly collective investment vehicles (CIVs) into the definition of foreign financial institution. This was so that these investment vehicles, classic places for tax evaders to hide, could be caught up in the regulatory requirement to go find those Americans. In the absence of this widening of the definition, it would have been left to the traditional institutions to do this. However, the problem in this section of the definition is that these firms have not thought of themselves as financial firms before in quite this way. They have varying degrees of compliant systems and policies and procedures that are both legacy (i.e. old) and highly and narrowly specific to their market segment. The burden of FATCA compliance falls very hard on these firms unless they fall into one of the areas of deemed compliance or exemption.

Structure

In the same way that IRC Chapter 3 is a cascade system, IRC Chapter 4 is also cascade both in its identification concepts as well as reporting and with-

holding. It recognises that there can be a long chain of ownership between a source country income distribution and the final ultimate recipient. There may be financial institutions, FFIs, in between with different statuses and equally, in tax evasion strategies, there may also be layers of NFFEs within those structures. FATCA tries to determine the processes that are necessary given any permutation found in the chain. These include searches of databases for US indicia which might not get caught in KYC or AML, certification processes between layers e.g. between FFIs, FFIs and US withholding agents etc. and between the IRS and everyone in the chain.

Global Vs Local

In the final regulations the IRS recognised that there would be significant push back from those parts of the world and industry which believed that the impact of FATCA would be disproportionate to the likely population of tax evaders. The IRS thus established the general principle of global versus local, recognising that many firms' activities were so focused on their own local market that the opportunity for tax evasion is very low.

There are parts of the regulations that essentially codify this different approach. Of particular note for later discussion are the concepts of 'Local FFIs' and certain types of deemed compliant FFIs.

On the converse side, the IRS recognises that there are global players in the field and those with regional or multi branch, multi jurisdictional coverage. In this area FATCA has the concept of an expanded affiliate group or EAG that it uses to try to ensure that account holders cannot evade detection by entering at one point in the financial chain and having their account moved to a different part of the same group where lower compliance thresholds might apply. This addresses one of the flaws in the IRC Chapter 3 regulations, that still exists today, where Americans could relatively easily open an account at a QI and have that account moved to a branch that is a non-disclosing NQI, thus evading the disclosure rules.

Identification

The IRS in regulation has identified a number of areas where it believes either directly or as a result of lobbying, that tax evasion is low risk. These are called 'carve-outs', more technically—exemptions and exceptions. In the absence of a carve-out, the burden falls to FFIs to follow FATCA rules to establish whether and to what extent there are Americans in their account

base. In an IGA market this will be done according to the domestic legislation that followed an IGA. In a non-IGA market this must still be done directly according to the regulations and FFI Agreement.

The issue here, as I've said many times, is actually not the ex-pat or the American individual who declares him or herself as such at account opening. The difficulty lies in identifying tax evaders, who will be much more subtle in their activities.

This is also the most complex part of FATCA because there are so many different variables that need to be considered. There are three main variables that determine the identification processes required:

1. When the account was opened;
2. The value of the account
3. The documented status of the account

However, again, this will be discussed in more detail later. As a result of the identification process, two further processes or 'outputs' are basic to the principles of FATCA. These are

i. reporting and
ii. withholding.

When discussing these 'FATCA outputs' I usually cite three processes. The third applies when an account holder is determined definitively not to be an American, in which case, there is no further action, at least under FATCA.

Reporting

Reporting is the main objective of FATCA as far as financial institutions outside the US are concerned. IRS has, on several occasions noted that, while the stick is very large, in terms of financial non compliance penalties, it is not the [stated] intent to use the system for penalties. They prefer reporting compliance.

The reporting of Americans to the IRS should not trouble any American who is not evading tax e.g. ex-pats, unless of course they've 'forgotten' to declare their accounts on their FBAR reports or forgotten to file their FBAR reports.

The reporting itself, in terms of what data goes into the reports each year, has been phased in over the period 2015–2017. That's not to say that more

data will not be required in the future, particularly as FATCA becomes a parallel system to AEoI.

Reporting *only* applies to those occasions where there are accounts which are either definitively US (e.g. the account of an American) or which are either (i) substantially owned by or (ii) effectively controlled by American(s). This is an important point. Given that the data set required by the IRS is relatively simple, the actual act of filing these reports should be easy, at least for those FFIs that were traditional financial institutions before.

The US has already implemented an automated system for this reporting—the International Data Exchange System or IDES together with an international messaging system, ICMM. Both have now been in place for some time. There are similarities between IDES and the options available in the AEoI framework. Both, for example leverage the xml standard. Both also have requirements relating to data protection—digital signatures, encryption and compression.

Recalcitrance V Non-Participation

There is one other part of the reporting phase of FATCA that is important. The system provides presumption rules and sanctions for those who do not provide evidence of their status. If the account holder is an individual or an entity, these account holders are defined as recalcitrant. Account holders that are FFIs and who fail to provide evidence of their Chapter 4 status are presumed to be non-participating or NP-FFIs. This is an important distinction and the example I cite here is also a good one to show just how convoluted these regulations can be and thus difficult to operationalize.

As noted, FATCA reports include data about account holders that are deemed to be US, effectively US controlled or substantially US owned. However, that's not all. FATCA reports must also include data about any accounts that have failed to provide their financial institution with a Chapter 4 status. Many firms are aware that, if they are in an IGA jurisdiction, there is a suspension of FATCA withholding on so called recalcitrant account holders but most do not realise that this suspension only applies if the recalcitrant account holders are included in the firm's FATCA reports.

As the rules stand, for any payment of US sourced income a financial intermediary must apply Chapter 4 rules first, then Chapter 3 rules, subject to the principle of non duplicative taxation. So, the procedure that has to be adopted at the Chapter 4 level must include a reporting check. Many firms take a simplistic approach that they are not subject to FATCA withhold-

ing for their recalcitrant accounts because their IGA suspends that penalty. However, that penalty withholding is only suspended if the FFI concerned has included those recalcitrant accounts in its FATCA reporting. If they didn't, the withholding still needs to be applied.

Withholding and Account Closure

In the process of identifying and documenting account holders, its likely that some of those approached will have a level of reluctance about providing information and still others who will, in the nature of such things, merely be tardy.

The base presumption in FATCA is that anyone who is so called 'recalcitrant' is probably an American evading tax. Ergo, the US is missing some tax revenue from this presumed US account holder. In any event, as with any regulation, its of no power unless it has teeth. The teeth in FATCA are reserved for account holders that fit within either of these two situations. The teeth are basically:

1. A 30% withholding penalty on all FDAP income, gross proceeds and passthru payments and, for long term recalcitrant account holders (i.e. those who continue to suffer withholding and don't provide information;
2. Account closure.

The ultimate sanction of course is forcing account closure. However, this sanction does not appear in any IGA market, only in non-IGA markets.

Its also worth noting, because many forget, that there is another set of teeth that FATCA has and those are the sanctions that the IRS can take against FFIs themselves. Where recalcitrant withholding is reserved for account holders, the IRS has the ability to terminate FFI Agreements and take similar counter-measures as are in IRC Chapter 3 which may have significant reputational effects while the US remains the largest capital market.

The penalty withholding under FATCA has a curious effect. In most cases, financial firms have gone to extreme lengths to make sure that they have the Chapter 4 status of all their account holders. Where those account holders are FFIs, the trend has been marked—most firms will not allow an account to be operated by a non-participating FFI. The net result is that, in theory, in IGA markets there is very little FATCA penalty withholding going on. Recalcitrant account holders are reported and so there is no FATCA penalty. FFIs are required to provide GIIN's or some other firm of certification of compliance. Thus both bases are covered. To that extent, we could say that the system has achieved its objective. However, there are still USWAs today in 2017 that are

applying a FATCA penalty to their FFI customers. While we will discuss this in detail in later chapters, this means that account holders are being penalised for the actions of their financial intermediary. This is only an example, but highlights that even today, 7 years after the HIRE Act, the implementation of the regulations is still fragmented and not well understood.

Convergence

The final principle of FATCA is convergence. In the years 2010–2013, many commentators and professionals were very concerned that the complexity of IRC Chapter 3 would be duplicated in IRC Chapter 4. Their fears were well founded and FATCA in some ways, is more complex than 'QI' regulations. However, several major simplifications took place between 2010 and 2013. I have already alluded to one such, being the IGAs. I would argue however that, while the concept of IGAs should simplify compliance, the number and types of IGA and their variability means that the only real beneficiaries are those firms that operate in one market. For larger firms that operate either regionally or globally, IGAs make FATCA more complicated.

The other simplification is the convergence of IRC Chapter 3 and IRC Chapter 4 in certain operational respects. In particular, convergence means:

1. reliance on KYC and AML (a Chapter 3 concept) instead of enhanced due diligence (a Chapter 4 concept);
2. the use in FATCA of US tax forms W-8 and W-9 which are prevalent in IRC Chapter 3 and
3. use of Chapter 3 reporting forms 1042, 1042-S and 1099.

This convergence is both welcome and unwelcome at the same time. Its welcome in that, in principle, it offers a route to simplicity so that firms don't have two entirely separate sets of policy and procedure to deal with one tax jurisdiction. On the other hand, its unwelcome in that the route I reference has to change the IRC Chapter 3 system in order to be able to encompass both IRC Chapters. This causes enormous practical problems. The W-8BEN form is a good example. A prior revision of this was in 2006 and it remained unchanged until 2012 giving the industry a solid period to adapt and stick with a know documentary quantity.

In 2012, the IRS issued draft updates to the W-8 series splitting the W-8BEN into the W-8BEN and W-8BEN-E so as to integrate IRC Chapter 4 status information as well as the existing Chapter 3 status information. But the form went from one page to six pages in that one step. If the way in which IRC

Chapter 3 developed in 2001–2003, IRC Chapter 4 has seen further changes to these and other documents as continued 'consultation' with the industry highlights problems and resolutions with the IRS. The presumption that such changes aid compliance and reduce risk—thats a good thing. However, financial firms spend significant effort and money keeping up with these systems, assessing risk and putting new systems, policies and procedures in place—every time this happens. In a perfect world, firms would like certainty and stability for an extended period in which to recoup the cost of compliance. This has not happened in FATCA and I don't see it happening anytime soon.

In conclusion of this preparatory chapter, we've explored the six principles which underpin FATCA's objective to identify and disclose to the IRS any American with any assets in any foreign account or within any foreign investment vehicle.

Not much has changed since the introduction for FATCA and for it to work, the non-US financial services industry must:

1. decide which of the applicable **STATUS** i.e. FFI, NFFE, Individual apply to them and assess whether they are subject to any of each of the sub-statuses that exist which might mitigate their compliance load;
2. understand to what extent IGAs affect their compliance obligations and, based on this;
3. understand the **STRUCTURE** of their counterparties, accounts and account holders and where they sit in the financial chain with respect to others in order to understand their obligations, operational processes, interfaces and the risks;
4. assess their structure in FATCA to focus on the **GLOBAL vs the LOCAL** which may alter those policies and procedures both from a regulatory and from a commercial viewpoint;
5. design processes and procedures to meet the intent of FATCA to **IDENTIFY** Americans in account structures;
6. **REPORT** all those Americans together with information about their accounts, income and tax withholdings as well as information about recalcitrant accounts;
7. Penalise any account holders that are recalcitrant or non-participating with a 30% **WITHHOLDING** on FDAP income and gross proceeds, or implement an **ACCOUNT CLOSURE** unless the FFI is in a country with an **INTERGOVERNMENTAL AGREEMENT** which permits some of these to be abated and finally;
8. Understand the complexities and risks associated with the **CONVERGENCE** of IRC Chapters 3 and 4, particularly with regards to documentation and reporting.

6
Identification and Documentation

Of all the activities envisioned in FATCA, identification and documentation lie at the heart of the system and is, by far the most complex and challenging. This applies to both the financial intermediaries in the chain of investment as well as to the financial account holders. I would remind readers at this juncture that this book is not about a line by line explanation of the regulations—for several reasons. First, while the regulations were issued in early 2013, they have and will continue to develop over the years. Second, a line by line explanation would of necessity, be longer than the original (800 pages) of regulation and I suspect most readers would have lost the will to live well before that. My intention, as stated in the introduction is to provide the reader with an interpretation of key areas of the regulations—those that will provide the greatest operational challenges.

Intermediaries

FATCA is, like IRC Chapter 3, a cascade system as I have alluded to in previous chapters. The intermediaries in the financial chain, typically banks, brokers, custodians, depositaries, depositories and the like have an obligation to identify themselves and their FATCA status to their counterparties. This is achieved between counterparties through the use of the W-8IMY which, in the 2017 version, is eight pages long comprising twenty nine difference sections to encompass the different types of foreign intermediary

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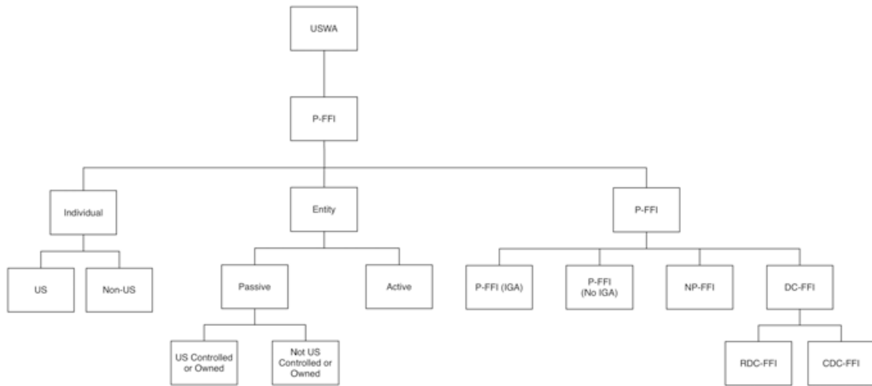

Fig. 6.1 Account structure holder under FATCA

that exist within FATCA regulation. This is the first place that there is clear convergence between IRC Chapter 3 and IRC Chapter 4.

The question is—what is an intermediary? And for this purpose, there is divergence. Based on the objective of the US government in IRC Chapter 4, to identify and report US persons with assets outside the US that may be evading tax, its clear that the traditional financial institutions constitute 'intermediaries'. However, collective investment vehicles offer an alternative route for the budding tax evader and so, in IRC Chapter 4 we see the new concept of a 'foreign financial institution' or FFI. This concept includes both the traditional financial services intermediaries, but also now includes the wider concept of collective investment vehicles too (Fig. 6.1).

Most traditional financial intermediaries (banks, brokers etc.) have resources and experience (legal, compliance, operations, tax) to be able to assess and comply efficiently, even with an expanded self certification like the W-8IMY. The problem is going to come from those firms that have not traditionally viewed themselves as financial institutions and the tier 2 and 3 banks, brokers etc. The largest single sector thus affected are the collective investment vehicles. While these firms do have regulatory oversight for the most part, these are not in the same category as the traditional institutions. Two other factors to take account of here are (i) language and (ii) culture. These problems have already been identified as major contributors to many of the failures and flaws of the IRC Chapter 3 regulations. If you draw a line from Washington DC eastwards, the degree of understanding (and therefore compliance) drops almost in an inverse square relationship to the distance. Not only are the forms becoming much more complex in terms of their length, they are written in tax technical American, not English.

Communicating the intent and requirements of these documents, even to traditional financial institutions, is a challenge at best. When you arrive as far as Asia, cultural differences start to pop up that compound the problem. If we take the declaration and the signatures as one small example, in that part of the world signatures are frequently 'chops' or graphical representations rather than what an IRS agent might normally view as a 'signature'. To my knowledge such 'chops' are not acceptable to the IRS.

I also mentioned elsewhere that the W-8IMY's increase in pages is based on the IRS trying to shoe-horn all possible states in which an FFI might exist. Many of these states are created due to carve-outs granted by the IRS under lobbying pressure e.g. Participating, non-Participating, Registered Deemed Compliance, Certified Deemed Compliance, Reporting, non Reporting, Model 1, Model 2 and so on. My biggest concern here, particularly bearing in mind the linguistic and cultural issues, is whether any given FFI has the awareness or real knowledge to be able to complete one of these forms intelligently. Whether or not they complete the form intelligently, it is certainly my experience that these firms rarely understand the consequences of the submission of such forms. So, its important for all these FFIs to understand that what you are giving a counterparty amounts to a set of instructions. Your counterparty will have the regulations plus internal policy and procedure against which to interpret your certified statements. If you are really lucky and you make some basic error, your counterparty might let you know in a helpful manner e.g. you can't tick these two boxes at the same time. Equally you may just have the form rekected if you make such errors.

The important thing to realise is that, from the day they are presented with the form, your certified status will result in concrete actions by your counterparty.

In particular. they will be 'relied upon' by upstream FFIs and USWAs, but without a serious program of education from both the IRS and industry as a whole, the lack of a robust control and oversight concept in FATCA leaves the field open for everyone to assume that everyone else knows what they are doing. And we know where that got the financial services industry in 2008.

When one drops below the level of FFI to NFFEs and Individuals, the use of KYC and AML documentation is encouraged by the IRS but the W-8 series is continually undergoing change as the industry develops. These self certifications still suffer the same linguistic and cultural issues as their forerunners and so, even tough these forms are used in their millions, the proportion actually fit for purpose is quite low. As with IRC Chapter 3, we have seen that this has not stopped many firms from still using them as if they are valid. This creates risk in the system that is often under-reported.

Identification

The original model for FATCA was based on the presumption that any firm that fell into the definitional category of 'foreign financial institution' would be obligated to search its entire customer base in order to identify any 'financial account' which was (i) held by a US Person or Persons, (ii) effectively controlled by a US Person or Persons or (iii) substantially owned by a US Person or Persons. This has been mitigated in the final regulations and now only applies to accounts that, in aggregate, are valued above certain limits. In other words, the order of events at an FFI is conceptually based on whether any given account (or aggregation of accounts) has a high enough value to cause the IRS concern that the account may be used for the purpose of tax evasion.

The reader will note that I use the word 'aggregate' a few times. Clearly, one of the simplest ways for our budding tax evader to get round the regulations, would be to just open up several accounts and keep the value of deposits and securities in those accounts below the threshold. The requirement to aggregate accounts which include any given person is supposed to get round that loophole, at least on a per FFI basis or per EAG basis.

An FFI would be expected to create their initial 'to do' list by first aggregating the values of all their account holders to pick up any that are using the multiple account principle. This of course does not really solve the problem, it merely creates a bigger one. What, for example would an FFI do if it has account holders who have joint accounts or who are registered as having an interest in a third account e.g. a trust. The logic would be that, in some way, the FFI will have to apportion the value in those accounts to those who are participants in it, in order to get the aggregation value. In my travels, many FFIs have identified this problem, not least in the insurance and private banking sectors. The net result tends to be that, while the regulations may permit the intended benefit of extracting low value accounts from the due diligence process, most feel that the effort involved is greater than the result. So most firms I speak to have indicated that they are doing the due diligence on *all* accounts irrespective of their value or aggregated value. This is an example of a common effect in the industry. The regulators will often use similar mechanisms to reduce the impact on low risk areas. However, financial forms themselves may choose not to use those benefits simply because its more costly and risky to create bifurcated processes than it is to apply one rule to all accounts (Fig. 6.2).

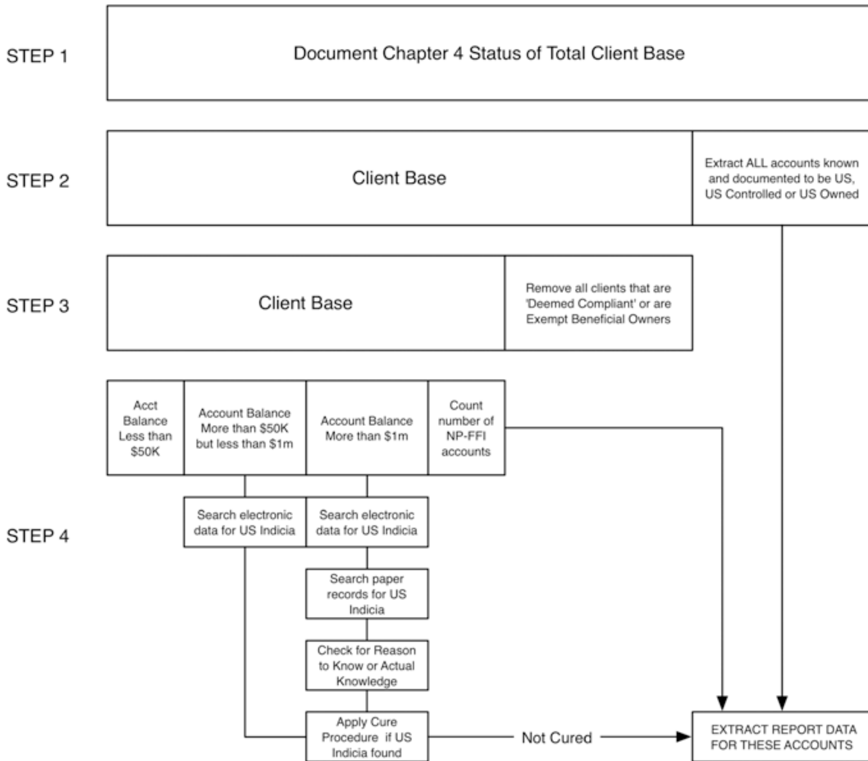

Fig. 6.2 Data extraction methodology for FATCA reporting

The second issue that faces FFIs once they have come to terms with the aggregation function, is that of a difference in procedure between accounts that were already open on January 1st 2013 and those opened up subsequent to that date. The procedural aspects are different in terms of the frequency with which due diligence needs to be done and they way in which it is conducted. In essence, this part of the regulations is differentiating pre-existing accounts from new accounts on the assumption that on a given day, a normal financial institution will have many more pre-existing accounts than new ones. Its also, in principle, easier to put a new process in place for new accounts than it is to implement a new process for all the other accounts you might have.

Now, it may seem rather odd that I am referencing 2013 as the cutover date. However, we are aware of quite a few financial firms that have never completed their due diligence on pre-existing accounts. We are also aware that there are several IGA jurisdictions where the terms of the IGA were

translated into domestic legislation as late as 2016 by means of 'copy and paste' from the IGA without changing any of the dates. So, the theory and the practice may not be the same thing here. In any event, the ultimate aim of the pre-existing account due diligence is to ensure that all FFIs obtain the Chapter 4 status of all their accounts at some point. Some have still not done so.

For those that did, this led to a rather quizzical scenario. In the regulations there is a requirement to search databases for 'indicia of US status', remembering that, in the principle of the regulations you would only be searching the database with resect to those accounts that were triggered by the aggregate value rule. The first incongruity is that, in modern databases, its just as easy to search based on a value criteria as it is to search on combinations of data strings in other fields such as text fields and the institution would have had to search its database to apply the value rule anyway. So there's no reduction in workload. The second incongruity is that FFIs who do not have searchable databases are not required to design or develop new searchable databases nor adjust their existing databases (if they are not searchable). I've yet to come across a database that wasn't searchable. Its rather in the DNA of modern databases that they are, by definition, searchable aggregations of data in structured form. So, it would seem that the limitation of searching only those databases that are searchable, is rather a moot benefit.

I would emphasise here that there is a difference between a database and 'paper records'. Depending on the conjunction of when the account was opened and its aggregate value, there may be both a requirement to search electronic databases as well as search paper records. This however leads us to further anomalies. Many financial institutions maintain their paper records in electronic form. In other words, the original paper may have been scanned and then the original is securely stored away. The difficulty is that the regulatory requirement to search paper documents may well cause expense and complexity for firms that will need to extract documents from storage before manually searching them. Even if they could search the electronic version of the paper form, the problem is that most scanning systems in financial institutions today do not store much in the way of 'metadata' associated with the content of the scanned image. Many will store only the name and type of document and some date based data associated with it. The content of the document is unlikely to be stored in searchable metadata.

This brings me to an important potential practical solution– XML tagging. The eXtensible Markup Language and its subordinate language XBRL (eXtensible Business Reporting Language) do offer a cheap (if not free), fast

and effective way to store data associated with documents which are 'text heavy'. In the current FATCA procedures, the IRS mandates XML in its IDES standard for FATCA reporting. So if original documents provided by a beneficial owner at the beginning of the FATCA process were allowed to be scanned, tagged and stored electronically, most financial institutions would be able to make massive cost (and associated risk) reductions in the management and analysis of documentation. When this is considered in the broader sense with what the OECD and EU are doing, some simple to manage, low cost yet secure methodology for soliciting metadata into KYC, AML and tax specific documentation makes what the Europeans would call a 'compelling argument' and the US would call a 'no-brainer'.

CIVs

I've titled this section 'CIVs' but what I want to include here is really any type of institution, firm or other legal entity that is not a traditional financial institution like a bank or broker.

These firms face enormous problems because their basic operating model is different from that of a traditional financial institution. To adapt to a FATCA landscape, there needs to be a much higher level of awareness as a precursor to operational compliance. In the funds industry for example, the principle of 'fund distributors' has been integrated into the FATCA model. As far as the US is concerned, its just trying to make sure that funds distributed outside the US are not used for the purpose of tax evasion. The regulations therefore expect fund managers to ensure that appropriate changes are made to fund distribution agreements in order that US Persons are excluded and, where they are found (e.g. by historical due diligence) they are either expelled from the fund or their assets transferred out. My point here is that the IRS has gone to some lengths to identify the high risk areas and, in an effort to show willingness to mitigate the full effects of FATCA, only require action to be taken where those high risk areas are. The funds industry, to give them their due, have responded to the distribution question quite well and most fund distribution agreements have been updated with relevant legal language to meet FATCA requirements.

So while laudable, all these 'carve-outs' serve to achieve is to create more complexity, more cost and more risk—and that's for those who make the effort to comply. For those who take a similar attitude to that which they evidenced with IRC Chapter 3, there may be a significant level of non compliance which goes almost wholly un-noticed.

NFFEs

I've spoken a great deal about the firms that fall into the definition of a 'financial institution', so called FFIs and below I will discuss some of the issues facing individuals later. In between the two are account holders who are neither individuals nor FFIs. These are called Non Financial Foreign Entities or NFFEs.

From the identification and documentation perspective, most FFIs would expect to receive a form W-8BEN-E from these customers since they are clearly not financial institutions. However, the IRS has indicated that some types of NFFE could be used as vehicles for tax evasion. Hence it has described two sub-categories of NFFE—'passive' and 'active'.

I try to explain these concepts by considering a corporation that makes widgets. Its main business activity is making and selling widgets. Its so successful that it build up a pile of cash. Such business entities may well develop a treasury function to make good use of that pile of cash, through investments. As long as the proportion of their income derived from such investments is less than 50%, they are considered 'active NFFEs' i.e. they actively make widgets. However, lets say that this company suffers a sharp decline in sales. Now, if the proportion of the invested funds exceeds 50% of the income, they will be considered 'passive NFFEs' i.e. the act of making widgets has become somewhat secondary to the act of receiving investment income. Of course the second type of passive NFFE would be a corporation set up originally with the intent of having more than 50% of its income from passive (i.e. non widget making) activities. For FFIs this category clearly presents its own challenges. Not least is the frequency and method by which an FFI can interact with its NFFE customer base to find out what the latest 'proportion' is. The net result of the calculation itself is mainly to determine the additional due diligence needed for passive NFFEs which would determine if they are reportable due to being effectively controlled by or substantially owned by US Persons for the purpose of FATCA. The natural answer would be by reference to the balance sheet or regular financial statements made by these entities. However, across the world, there is no set standard for the frequency of such reporting nor any automated method by which the information could easily be extracted.

Defining a US Person

Irrespective of whether or not any given firm chooses to adopt the principles of FATCA or adopt a more commercial approach, they all have one thing that sits at the core of FATCA and that's identifying anyone that is US.

This is one of those areas that can be very confusing. I have said many, many times that I think most financial institutions over-react to this issue.

On the one hand (i) the US claims the right to tax the global income of its citizens (which underpins FATCA) and (ii) what defines a US Person is well documented. The problem does not occur for a foreign financial institution, if their client is demonstrably US. If this is the case, the only FATCA output is that their account income will be reported by the FFI to the IRS (directly or indirectly) on an annual basis—that's it.

The problem occurs for those many thousands of people who do not believe themselves to be Americans. These might be residents of foreign (non-US) jurisdictions who:

- Once had a green card and did not revoke it (e.g. students)
- Had one of their parents born in the US
- Travel extensively in the US on a regular basis (the substantial presence test)

In all these cases, the account holder may be convinced that they are not US. These accidental Americans are the real problem for FATCA. Many of these people really aren't 'tax evaders' per se, but equally, the US, like many jurisdictions claims the right to tax these people's global income and ignorance is not considered bliss. The difficulty will come for any of these people, who tripped any of these rules, even unknowingly, is that if they have accounts with FFIs who have chosen not to separate out low value accounts (choosing a one size fits all solution), then they may well be reported to the IRS. Of course, if there are people with large balances or account values who have also no view that they are US, but trip these rules, they will be in for a much rougher ride.

From an FFI's perspective these rules are complex enough, but the data searches for US indicia required are not just the obvious ones such as 'address in the US' or possession of a US passport'. Some are very subtle. Having a telephone contact point is a common data element in most account records. Being able to separate out a telephone number that has a US format i.e. has the international dialling code +1 or the dialling code of a US dependency is more difficult to search for in an automated way.

Effective Control and Substantial Ownership

When it comes to indirect vehicles such as funds, the issue of being a US Person becomes a slightly different question—one of 'effective control' or 'substantial ownership'. In both cases there are rules defining what triggers additional due diligence and/or reporting. Effective control essentially means that an FFI has to identify whether the account has any associated instructions that would mean that a US Person or persons had effective control over the account. That would typically mean a power of attorney at the account level or a standing instruction on the account record to transfer assets and/or cash to another account that is again either a US Person or is in turn effectively controlled or substantially owned by a US Person or persons. You can see how quickly this can become difficult to manage.

Substantial ownership suffers similar practical issues. While there may some mechanism by which an FFI could determine with its customer whether, irrespective of the view of the customer, the facts indicate that the non-US customer is in fact substantially a US entity, the fact is that the initial interpretation could change with time. In other words, an account holder who discloses the proportion of its members that are US will need to indicate whether that proportion is liable to change and, if it does, over what period and to what degree. This information in turn will need to be used by an FFI to decide what frequency of repeat due diligence is necessary to maintain its standing as a 'good' FFI with the IRS. Remember, the irony is that this work needs to be done, even if the result is that the account holder is not substantially US owned. FATCA is very much a negative proof system.

The difficulty for any FFI (or NFFE) is that, for the most part, the types of documentation available to identify these issues are not in electronic form, they are in paper form. This means that, for most FFIs, there will be a gruelling analysis of account set up information and associated documents that will be both slow and costly.

Actual Knowledge and Reason to Know

The difficulties that FATCA presents so far have been in how certain facts can be identified typically in account records. Some, such as the address, as discussed, are relatively simple. Others such as telephone number in the US

are more subtle. More subtle still are the concepts of actual knowledge and reason to know.

Man Walks into a Bar

The biggest issue for firms that use relationship managers as the interface between the operational function and the account holder, is finding a way to address the reason to know and actual knowledge concepts.

My usual way of explaining this issue is to describe a typical scenario. A man walks into a bar. The man is a relationship manager for a major private bank. At the bar he meets another man, one of his clients. They are meeting socially.

The relationship manager knows that, according to the banks records his client is a UK resident with a UK passport that was provided at account opening. During the conversation, the client mentions that he travels a great deal to the US on business and mentions that he does this three or four times a year. The relationship manager has crossed the first line and now has 'reason to know' that his client's status may need to be reviewed. The conversation continues and the relationship manager is at pains to comment on the length of the queues at JFK airport. His client then smiles and pulls out what is clearly a US passport and says he doesn't have those problems. The relationship manager has now crossed the second line and has 'actual knowledge' that his bank's records are unreliable.

On the one hand, in a perfect world, there would need to be some mechanism for translating what could be deemed to be 'gossip' or 'heresay' into a record on the account holder's record. On the other, one can imagine a world where relationship managers begin every conversation with something like 'don't talk to me about any of the following…just in case.'

What we end up with is an identification and documentation system that is very, very complex. At its simplest, the 'financial institutions' in the chain must document themselves to their counterparties in the chain. But this will be with more complex documents and be less familiar to those who have not heretofore considered themselves to be financial institutions at all. These institutions will have to review the regulations, as well as what will be constantly changing 'triggers and thresholds', in order to figure out which account holders should be subject to which kinds of due diligence. The documentation process can then proceed apace—presuming everyone understands the documentation and its interpretation.

This is one area of significant overlap between FATCA and CRS. Both frameworks have similar principles of due diligence. Most financial firms have now adapted their on-board processes to ask not 'what jurisdiction are you resident in?' but 'how many jurisdictions do you have a tax liability in and what are they?' While this creates a systemic solution capable of storing the information, it does not solve the underlying issue that these things change and both investors and financial institutions need to understand the obligations they have to each other to keep these data current.

At the heart of FATCA however, certainly as far as financial institutions go, there is one major fatal flaw. The identification system is based, for the most part, on self certifications of Chapter 4 status made by their customers. If we take out of scope all those account holders that are neither truly US nor accidentally US nor controlled by either of these two, the reality is that if someone is really deliberately evading tax via an offshore account, they need do only two things. One, lie. Two, make sure that their financial institution has no 'reason to know' that they are lying. The system recognises that financial firms cannot be expected to be tax police nor investigators. The system also recognises that self certifications are the only practical method to obtain these statuses and therefore remove the liability from the financial institution and place it on the account holder. The problem is that if the account holder is prepared to knowingly break US law by hiding assets offshore and not disclosing them to their own tax authority, they are unlikely to have many qualms about lying on a self certification form. From a risk perspective therefore, financial firms should take extreme steps to validate these self certifications properly, not to satisfy the US regulators, but to ensure that there is little or no risk attributable to them should such a form be unreliable. The regulations do effectively provide this protection, but we still see many firms that have not grasped this at all well.

7
Simplifying FATCA

I have always found it rather ironic that FATCA is at its most complex in the advisory community. Here, we have to understand the whole thing in order to be able to opine on the impact for any given set of circumstances. Below the advisory community lie the global financial institutions whose sheer range of footprint means that they must understand and operationalize FATCA in multiple markets with a wide range of customer types. However, below this level lie regional and single market financial institutions where most of the complexity of FATCA goes away simply because many of the requirements don't apply for their more narrow set of circumstances e.g. if you are operating in just one market, you don't need to know about the IGA status of other markets, just your own.

In a similar way on the investment side global investors have similar issues to the global or regional financial institutions. Where they obtain some simplification due to structure (where they may obtain exemptions or exceptions), they must however handle issues such as fund distribution networks where FATCA has some say. Again, when it comes to single country investment vehicles such as pension funds, the impact of FATCA is much reduced simply to establishing and communicating your Chapter 4 status. In other words, as with all things tax, the answer is usually—it depends.

Irrespective of where you sit in the investment chain, one of the first questions, following close on the heels of understanding FATCA's basic principles, is—how do I minimise the risk and cost?

So, in this chapter, we will look at some of the ways in which the burdens of FATCA are reduced. These fall into two main categories:

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1. What the IRS has done and is doing structurally to simplify operational burdens; and
2. What the regulations and IGAs themselves do to reduce the workload on those who represent a low risk of US tax evasion.

Structural Simplification

The IRS, by inference, has learned a lot from the IRC Chapter 3 regulations. Those regulations suffer from some serious structural flaws that cause industry significant and, in many cases, unnecessary cost and risk. These flaws also damage the reputation of the US and the credibility of the regulatory structures it implements on the world stage. Unaddressed, there are many firms that currently do not feel any need to comply with FATCA on the grounds that they have not complied with IRC Chapter 3 for the last seventeen years and have not seen any impact on their business.

Even today in IRC Chapter 3 for example:

- there is no public listing of firms that have QI agreements;
- there is no listing of those NQIs that have been penalised for non compliance (no transparency);
- reporting can be either manual or automated depending on the number of information reports involved (no consistency);
- reporting standards are proprietary to the US (no international standard used);
- there is little or no public enforcement of the regulations—non-reporting NQIs routinely do not get penalised and under-performing QIs are rarely terminated (lack of credibility).

This places the US in the same boat, unfortunately, as every other tax authority in the world. It's a frequent complaint of the industry that regulators never seem to demonstrate an understanding of the concept of the value of an integrated global regulatory strategy—which is strange because it's precisely the lack of this that has caused many of the cross border regulatory and business failures of the last fifty years. Even today, as we see the AEoI framework rolling out across over a hundred markets, the US has not so far signed up—predominantly because they have FATCA.

However, happily some lessons seem to have been learned and the current regulations provide some relief.

Automation

One big difference between IRC Chapter 3 and IRC Chapter 4 is the sheer number of impacted firms that drives the need for automation.

In IRC Chapter 3, we estimate that there are currently around 7,000–10,000 QIs and at least 35,000 NQIs.

In contrast, the change in the definition of a foreign financial institution brought about in FATCA regulations massively increases the number of entities directly or indirectly affected by the regulations.

The measurement of engagement we have is via the issuance by the IRS of Global International Identification Numbers (GIINs) to FFIs. Between 2012 and 2014 the number of GIINs rose rapidly to around 100,000. Since then, the number has continued to grow albeit at a much lower pace. As at March 2017, the number of GIINs issued was just over 277,000.

I would note here that while the IRS gathers some significant data for each GIIN issued, to date the only published information is the name of the firm, its GIIN and the country. This makes validation of GIINs, required in a validation of a W-8IMY, manual and therefore somewhat cumbersome.

Market	GIINs	% of total (%)
Cayman	48,353	17.4
UK	29,549	10.6
Japan	19,187	6.9
Brazil	17,615	6.3
Luxembourg	11,812	4.3
BVI	10,279	3.7
Canada	9560	3.4
Other (223)	130,918	47.2
Total	277,273	

However, as the reader can see, over half those GIINs (52.7% as at March 27th 2017) were issued to financial firms in just seven markets with the remaining GIINs being issued to firms in the other two hundred and twenty three markets. This dynamic has not materially changed since 2012.

Notwithstanding this, its clear that while the QI regulations have to deal with perhaps a total of around fifty thousand firms in total, FATCA has to deal with perhaps nearer to a million such firms. In such an environment automation and indeed standardisation becomes a more compelling requirement.

The US provides for three types of automation relevant to FATCA.

1. The FATCA Portal. An automated sign up process for FFIs that enables them to obtain GIINs;
2. IDES. An automated mechanism for delivery of FATCA report data;
3. ICMM. An automated messaging, extensions filing and compliance management system—the International Compliance Management Model and
4. TIN Matching. A semi automated system to validate the social security numbers or international tax identification number (ITIN) presented on a form W-9.

At the other end of the process reporting in Chapter 3 is still somewhat fragmented by comparison. In Chapter 3 there are only two types of automation:

1. Information returns on forms 1042-S can be filed electronically at the Filing Information Returns Electronically (FIRE) portal and
2. QI/WT/WP account management system (unsurprisingly no-one has figured out an acronym for this) allows QIs (or withholding foreign trusts and withholding partnerships) to manage their QI Agreement, renewals and other Chapter 3 matters.

So, there is some level of automation in progress and we expect this to continue to evolve in the coming years. For financial firms, its important to ensure that, when planning compliance, the available automation is adopted. In some, but not all cases, the automation is mandatory.

Standardisation

Automation on its own is a good enough principle of convergence here. However, the cherry on the cake, so to speak, comes when standards are applied to that automation so that industry has a robust and consistent way to reduce costs through the re-use of code, policy or procedure in a standardised form.

There are many standards being used today across different parts of the financial services industry so the difficulty is not just lack of standards, its also a lack of consistency between standards where they exist, mainly due to the fact that each standard is developed in isolation of others.

The US has, for some time, been mandating its various agencies to adopt a more consistent approach to standards. In reporting terms, the Extensible Business Reporting Language (XBRL) is mandated in US law for all corpora-

tions to report their financial results. XBRL is a subset of the more generic Extensible Markup Language (XML). Both XML and XBRL have a couple of benefits over the more ubiquitous ISO standards 15022 and 20022 currently in use by many of the world's financial firms (but importantly not all firms that are FFIs under a FATCA definition). First, XBRL is easier and cheaper to implement. All that is required is a standardised taxonomy (dictionary) to identify data elements (tags) in what would otherwise be a text heavy document. This means that a range of documents can be made machine readable. XBRL readers are cheap (or free) and relatively easy to implement in any organisation, whether it be a major global bank or a small CIV. Second, its fast. Third, its open source. Once a taxonomy has been created, anyone can use it. They key of course is the fact that its mandated in regulation, so there's no choice. The problem for the industry is that there is another set of standards, already referenced, ISO15022 and ISO20022. ISO15022 is the current messaging standard used by over 8000 banks around the world. ISO20022 is its replacement and has been implemented by the majority. The problem is that the US financial institutions are, in relative terms, not great users or adopters of ISO standards. The ISO standards are much more complex and wide ranging in their use. Also, as I indirectly referenced, the ISO15022 and 20022 standards are usable by banks and brokers i.e. those firms that, today, count themselves as financial institutions. The standards are much more difficult to apply to the many firms and CIVs that do not normally think of themselves as financial institutions, but which have fallen into this category solely as a result of the definitional change in FATCA.

That said, FATCA reporting has, for some time now, been mandated to be in xml and most financial firms should find this relatively easy to implement. I would make two caveats to this statement. First, since its original release of the xml standard for FATCA reporting, the manual version of which is the Form 8966, there have been a number of changes and updates to the standard itself as well as to the amount and nature of the data to be reported using that standard. In and of themselves these should not be an issue, however, it highlights that the use of this standard is not a 'fire-and-forget' issue. Resource must be expended each year to understand any changes and updates that have occurred since the prior year's reporting.

Transparency

One of the most frustrating parts of IRC Chapter 3 is the opacity of the system. The IRS does not publish any information about the regime. No list of

QIs, no publication of audit findings (other than as referenced in changes to the regulations). No information about penalties applied and to whom. It is rather ironic that a system designed to force transparency by others should be so opaque itself. While the regime is not oriented to have penalties as an objective, its failure to apply them and, just as importantly, to make them visible to others if they did, is a major reason that non-compliance to IRC Chapter 3 is so rife, particularly in the NQI community. When we come to FATCA, this failure in IRC Chapter 3 may well have an unintended consequence in IRC Chapter 4. Let me exemplify with the following, that demonstrates the degree to which financial firms cannot afford to look at FATCA on its own.

There are around 35,000 firms classified as NQIs. Based on our view of the market, at least 70% of these have never filed a tax return or an information report. The number of clients each of these NQIs has of course varies widely from a few hundred (for a small local firm) to several hundred thousand (in the case of retail brokerages). For the purposes of this example, lets assume that an NQI has 10,000 clients each receiving both interest and dividends. The US Treasury's regulatory 'teeth' in the form of penalties could be applied from 2001 to 2017 i.e. sixteen years as a one off, plus ongoing annual penalties to 'motivate' compliance. For clarity, this has nothing to do with the tax involved. Most of the clients of these NQIs are undisclosed and taxed at 30%, so the US Treasury already has as much tax from these NQI clients as its ever going to get. The issue is reporting and disclosure failures by the NQI as a regulated institution.

The example NQI would have 10,000 clients each with two types of income and a requirement to report each beneficial owner per income type both to the IRS and to the recipient. That's a total of 40,000 forms 1042-S annually for sixteen years.

The IRS currently provides a cap on penalties of $3 million for IRS reporting failures and $3 million for recipient copy reporting failures. So a total exposure of $6 million per NQI. With 70% of NQIs not reporting, that's penalties forgone by the IRS of around $14.7 billion. The number is less important however than the intrinsic effect on the industry. Its not the money that's at issue here, it's the effect of having a penalty system and not being seen to apply it. Had it been applied, the levels of compliance would be much higher by now as we move into the convergent IRC Chapters 3 and 4 era.

Whats also interesting here is that the Chapter 3 rules are inherently a connected cascade system i.e. all the information is there to identify non-

compliant NQIs even though, without FATCA, the Chapter 3 system still permits an account holder to accept a 30% NRA withholding and not be disclosed. The FATCA reporting system is not connected hierarchically in the same way. Its true that financial institutions will identify lower levels in their reports but only to the extent that they are non-participating or recalcitrant. In Chapter 3 the totals of amounts paid and tax withheld must reconcile to the level above. In Chapter 4, if an account is reported as US, the data associated with that account is not reconciled in any independent way. In other words, FATCA reporting is opaque to individual financial firms and only gets aggregated when it arrives at the IRS.

In the early days of FATCA when guidance was scarce and reporting was looming, anyone questioned about how and whether any accounts would be included in a FATCA report based on exemptions, exceptions or de minimis account values etc., would reply that they would rather over-report than under-report. If in doubt, report it was the mantra. While the amount of clarification has increased of late, these are still complex regulations and many firms still approach this issue in a risk averse mode. Since there would appear to be little downside to over-reporting. For those who point to the rules associated with over-reporting (or inaccurate reporting), I point equally forcefully to the degree to which the Chapter 3 penalty rules have been applied.

Regulatory Simplification

There are several ways in which the consequences of FATCA can be mitigated.

1. If you fall into the FATCA definition of a Financial Institution:
    - (a) You may be in a jurisdiction with an IGA, in which case you will have lower identification burdens, potential for some country specific exemptions or exceptions, domestic reporting instead of directly to the IRS and no withholding or need to close recalcitrant accounts (provided you report these in your FATCA reports);
    - (b) You may be in a low risk category for tax evasion and be able to claim either 'certified' or 'registered' deemed compliance.
2. If you fall into the FATCA definition of an NFFE, you may have no substantial US owners or no US persons with 'Effective Control' or you may be an Active NFFE—any of which will reduce or remove FATCA compliance burdens.

3. If you are an individual, you should assess whether any indicia that might be held by a financial institution outside the US (in paper or electronic form), could result in your being classified as a US Person by that entity.

In the years since FATCA was first mooted, there have been (and continue to be) many lobbying groups who have tried to get the IRS to exclude their particular niche from the regulations. Equally there have been others who, rather than take a niche approach, have argued that the fundamental principle, finding US tax evaders is, with FATCA, rather like trying to crack a walnut with a sledgehammer. There is another group, American Citizens Abroad, that maintains that FATCA is un-American and should be repealed either for legal reasons or the potential impact of unintended consequences. The net result of all this lobbying is that, over time, the IRS has accepted some of these arguments. Collectively they are called ‘carve-outs’ although a more technically correct term would be exemptions and exceptions. In the rest of this chapter we will look at the main types of carve-outs and some of the practical issues associated with them.

The main objective of carve-outs is to provide some mitigation of the basic principles of FATCA which result from some aspect of an FFI’s business that provides IRS with comfort that tax evasion is ‘low likelihood’.

From an FFI’s position, the carve-out will significantly reduce the cost of compliance and thus make it more likely that they will in fact make attempts to comply.

We must remind ourselves, before we embark on this part of the chapter, that there is only one ‘input’ for FATCA and just three ‘outputs’.

1. The input is a review of accounts. The degrees to which these accounts are reviewable and reviewed and the methods that are used are the subject of some carve-outs.
2. The outputs are:
   (a) the account is US, substantially owned by US Persons and/or is effectively controlled by US Persons in which case the account is included in reports to the IRS (directly or indirectly);
   (b) the account is not US in which case there is no action required and;
   (c) the account is recalcitrant or non-participating in which case FATCA reporting, withholding or account closure may apply dependent on circumstances.

So, now, lets take a look at some of these ‘carve-outs. Most of my comments in thus section relate to FFIs since these will be the majority of those firms affected by FATCA.

Accounts Exempt from Review

Low Value Accounts

The main, and possibly the most practical argument of many that oppose FATCA, is that many Americans outside the US are not actually evading tax. It's a popular thought that if someone has an account outside their country of residence, that they must be avoiding tax at best and actively evading it at worst. This has already caused major problems for the many thousands of Americans who live and work outside the US. They have found it increasingly difficult to open and maintain simple banking facilities.

In the first Guidance Notices issued by the IRS, the model adopted was to have stringent documentation procedures on all FFIs with particular focus on certain types of account that were felt to be particular targets of tax evaders. This was changed in the draft and final regulations. In fact, it was the largest change I've seen in the IRS' position between guidance and regulation. Rather than target types of account, the regulations create the concept of an 'aggregated value of accounts'. Below this aggregated value, the hypothesis is that the account holder is probably not evading tax i.e. there is a low risk. This model, like its 'account type' predecessor, has practical problems—how and when do you value non-US dollar denominated accounts? How do you value securities in accounts as opposed to simple cash in depository accounts. How do you aggregate this data (many FFIs do not have systemic capability to aggregate these data). For example, a customer may have a financial account with an institution but also be a substantial owner in an entity with another account. Many firms operate different types of account on different systems and platforms that do not always 'talk' to each other., Firms are still facing this challenge where an account holder has both depository and custodial accounts as well as also being a substantial owner in other types of account. To some degree, the IRS has been lenient in its guidance, indicating that it does not expect firms to develop new systems to enable such granular aggregation. Aggregation need only be done to the extent that an FFIs systems are capable of aggregating the data. Of course, time will tell, but tax evaders are likely to be quite clever at identifying and exploiting loopholes in complex tax systems. It may be therefore that identifying FFIs with whom to open accounts, based on their systems capabilities, may become a focus for tax evasion activities, in the same way that data privacy laws achieved the same objective in prior years.

Then, there is the obvious—how would that system track an evader who simply opened up multiple accounts at multiple unrelated institutions such that no one institution had accounts that triggered the due diligence tests?

Deemed Compliance

Types of Deemed Compliance

The main object of deemed compliance is to allow the IRS to shift its FATCA focus away from the truly local, where evasion is 'unlikely', to the truly global, where they feel its more likely that opportunities to structure hidden assets will exist.

Deemed Compliance is essentially a way in which the IRS can identify certain types of account or investment strategy that, in their opinion, pose a low risk. The idea of deemed compliance merely means that the FFI concerned may not have to enter into an FFI agreement because its is already 'deemed' to be in compliance simply by reason of the way in which it exists in the financial services framework. This may be that the rules under which accounts are opened clearly precludes US persons or that the scope of the FFI's activities is so local that US persons are unlikely to target them as a method for evading tax.

The IRS has defined two types of Deemed Compliance—Registered Deemed Compliance and Certified Deemed Compliance. The concept of deemed compliance was first established in IRS guidance Notice 2011-34 and draft and final regulations merely expanded on this concept.

The important things to note about both of these categories, is

i. FFIs do not get the chance to debate whether or not they can be deemed compliant. The regulations define, for each category, the types of FFI that can fall into the definition;
ii. even if your firm falls into the definitional aspect of a deemed compliant FFI, this does not mean that you are automatically deemed compliant. For each category, each type of firm must meet certain criteria to be compliant. In other words, even though, for example, a qualified investment vehicle (QIV) is one of the types of FFI that can be deemed compliant, they will only actually be capable of certifying that status if they meet certain criteria. Ergo, there will be some firms that don't meet the sub-level criteria and thus, even though they could theoretically be deemed compliant, they fail the detail level tests to do so.

We should also be clear as to what the result of deemed compliance is. The carve-out is on the withholding aspect of FATCA. Remember, the three aspects of FATCA are documentation, reporting and withholding. Deemed

compliant status merely means that the withholding aspects of FATCA do not apply. Documentation and reporting obligations are still active.

Registered Deemed Compliance

In this model, an FFI that meets the relevant criteria can register directly with the IRS to declare their status. They must, as inferred above, make a formal attestation that they meet the procedural requirements of FATCA.

Types of FFI that are permitted to register this status are:

- Local FFIs
- Non reporting members of P-FFI groups
- Qualified Investment Vehicles (QIVs) and
- Restricted Funds

As noted above, simply meeting the definitional aspect is not enough. The following shows how this works.

Local FFIs

To meet registered deemed complaint status a local FFI must:

1. Meet certain licensing and regulation requirements
2. Have no fixed place of business outside their country of organisation
3. Not solicit account holders outside their country of organisation
4. More than 98% of account holders must be residents of the FFI's country of organisation
5. The FFI must be subject to withholding and reporting obligations in their own country of organisation
6. The FFI must have policies and procedures in place to preclude US persons that are not residents of the country of FFI's organisation

The IRS has indicated that, as far as the European Union is concerned, for the purpose of the definition of Local FFI, the EU is essentially one country. This means that, as far as 3 and 4 go, FFIs in the EU can solicit customers in any other EU member state and have less than 98% of customers in their own jurisdiction—and still be considered to be eligible for deemed compliant status. Brexit may create a problem here. As the UK exits the EU the above rule would fall apart for UK FFIs.

Non-reporting Members of a P-FFI Group

This category of registered deemed compliance applies only to firms that are part of a group and where one or more members of that group are participating FFIs (P-FFIs). The issue here is that there are many firms that are groups where one or more members of the group face difficulty meeting the requirements of FATCA. The most obvious is where one member of the group is organised in a country which does not allow a financial firm to send data about its customers to a foreign government in the form of a report. Clearly, this creates a problem for those members of the group that want to, and are capable of being fully fledged P-FFIs. So, the rules here are relatively simple. To be able to register as deemed compliant, you must:

1. Ensure that there is at least one P-FFI in your group;
2. Transfer all pre-existing US accounts to that P-FFI
3. Within 90 days of any new US account being opened, transfer the account to the P-FFI

Its also important to understand that the single country and non-solicitation criteria that apply for local FFI's do not apply in this circumstance.

Qualified Investment Vehicles

This category of registered deemed compliance is reserved for those investment vehicles that:

1. Are regulated as collective investment schemes and where
2. All direct interest holders in the QIV are:
   (a) P-FFIs
   (b) Deemed Compliant FFIs or
   (c) Exempt beneficial owners

Restricted Funds

The final type of FFI that can apply for registered deemed compliant status is restricted funds. There are a number of criteria that need to be met before a fund can satisfy this requirement.

1. The fund must be regulated as an investment fund by its country of organisation
2. Each distributor of the fund must be one of the following:
   (a) A P-FFI
   (b) A Registered Deemed Compliant FFI
   (c) A non registering local bank
   (d) A restricted distributor
3. All distribution agreements must prohibit sales to US persons, N-PFFIs and passive NFFEs
4. Prospectuses for these funds must also reflect the distribution agreements in terms of their restrictions.

Certified Deemed Compliance

If, as an FFI, you do not fall into one of the categories that permit registering for deemed compliant status, all is not lost. You may be able to meet the criteria for certified deemed compliance. Certified Deemed Compliance is open to the following types of FFI:

- Non registering local banks
- Retirement plans
- Non-profit organisations
- Owner documented FFIs
- FFIs with low value accounts

The difference between registered deemed compliance and certified deemed compliance is that registered status is by registration with the IRS. Certified DC status is obtained by making a certification to a withholding agent. There is no communication to the IRS. Equally, it is therefore theoretically possible that an FFI that meets the criteria, may certify DC status to one withholding agent, but not another. The certification itself is via the revised form W-8. As in the previous section, we will review the criteria necessary for an FFI to meet certified DC status.

Non Registering Local Banks

To meet the criteria to be a certified DC-FFI, a non registering local bank must:

1. Offer only basic banking services;

2. Operate only in their country of organisation;
3. Have balance sheet assets of less than $175m and, if they are part of an expanded affiliate group, their total group balance sheet assets must be less than $500m.

Its easy to see both here and in registered deemed compliant status how the criteria have been developed to isolate truly local financial firms from the more global.

Retirement Plans

One of the most vociferous interest groups pushing back on FATCA was the pension industry and not least because the definition of a retirement plan, in the US is different than the definition of a pension plan. That discrepancy led to some concerns. In the regulations, this has to some extent, been mitigated by defining retirement plans (including pension plans) as capable of certified deemed compliant status. However, of all the types of firm able to have C-DC-FFI status, retirement plans have the most complex criteria to fulfil. They are:

1. The plan must be organised as a pension plan or retirement plan in its country of establishment or operation;
2. Contributions to the plan must:
   (a) Be limited by reference to earned income and be sourced only from one or more of—the employer, employee or government
   (b) Be excluded from 'income' of the beneficiary and/or taxation of the attributable income must be deferred
   (c) Be sourced at least 50% from employer or government
3. No single beneficiary can be entitled to more than 5% of the assets of the plan.

Non Profits

Another class of certified DC-FFI are non profits. To be eligible for this status, the FFI must:

1. Be established and maintained in its country of residence
2. Have exclusive purposes e.g. religious, charitable, artistic, scientific, cultural etc.

3. Have no shareholders or members with proprietary interests and
4. Be subject to restrictions on private inurement of assets or income.

Low Value FFIs

One of the main thrusts of these carve-out provisions is to remove from the equation, any account types that either represent a low risk of tax evasion or where the amounts involved are so de-minimis that its more effort than its worth to pursue. The final type of certified deemed compliance is for those FFIs who only have low value accounts.

To qualify for this type of deemed compliance, the FFI must:

1. Have no financial account with a balance of more than $50,000 and, if the FFI is also part of an expanded affiliate group,
2. The EAG must have less than $50m in assets on its balance sheet.

As a a final remark on these two broad categories of deemed compliance, I would remind the reader that the mitigation of the regulations is only with respect to withholding.

NFFEs

Most of the carve-outs that IRS has given are to FFIs. The population of FFIs far exceeds the population of NFFEs—non-financial foreign entities. However, both for FFIs who have to document them, and for the NFFEs themselves, there is one 'carve-out' of note.

IRS has defined two types of NFFE—Passive and Active. Every time I describe the difference I get the same quizzical look, because the difference is not intuitive.

Consider a firm that makes widgets. It may be very successful at making widgets and accrues large cash balances. It would be natural for such a firm to make the most of its cash balances and invest the money. So, this firm's income is made up of revenue from widget sales and revenue from investments. There's a second element to the calculation here. We must now also look at the assets of the company and ensure that less than 50% of the assets produce 'passive' income. In this case, as long as both these conditions are met, the NFFE is 'active' (A-NFFE). I like to phrase it as—it 'actively' makes

widgets as its reason for existence. The converse would be any firm that derives more than 50% of its income from investments. These firms are 'passive' NFFEs (P-NFFE). Its passive NFFE's that cause the main risk of tax evasion.

Practical Issues

All these carve outs are all well and good. However, they do create their own problems in a very practical way.

Deemed Compliant FFIs

The most obvious problem is for the entities that supposedly fall into these categories. Its important to remember that being, for example, a QIV, does not automatically mean that the fund is deemed compliant. There are a number of steps:

1. Each entity must know that it falls into the definition of an FFI.
2. It must know that it falls within a deemed compliance category.
3. It must know what the criteria are for the particular type of deemed compliance.
4. It must apply those criteria to its status to determine whether it meets those criteria.
5. If it does meet the criteria it must apply the rules to gain that status:
   (a) provide a certification to its withholding agent(s) if is of a type for certified deemed compliance or
   (b) register with the IRS if it is of a type for registered deemed compliance
6. if the criteria for any given status can change with time, it must put in place controls to monitor how these changes could affect its deemed compliant status and finally,
7. if it does not meet the criteria for deemed compliant status, it must decide whether to 'participate' and sign an FFI agreement with the IRS or become a non-participating FFI by default.

I have expounded this process in some detail because it makes it that much clearer that there will need to be a process of research by means of which the FFI understands that it even has this problem.

The most common call I get is either from an FFI or from one of their clients. The call from the FFI is usually asking how they can help their client without giving tax advice i.e. they want to guide their client to what they

believe is the correct form and correct method of completion. If I get a call from their client, its usually because their FFI cannot help in this regard and they want the same guidance. As with all things in tax, the issue is risk.

So the main practical issue here is one of awareness. Certainly, the traditional financial institutions at which these entities would have accounts, will create some downward awareness, since they will need to know the status of their customer under IRC Chapter 3 also. However, since the IRS is using a variant of the self certification form W-8BEN, the information flow will be limited, in order to avoid the liability of giving tax advice. The advisory and vendor community will also be present, but often, this information comes very late, usually at a point where the FFI is already failing in compliance.

FFIs

In this context, an FFI would be the traditional financial institutions at which a deemed compliant FFI would have accounts. The deemed compliant concept can cause problems here too.

The most obvious is systemic. In order to truly 'know' and manage their customer accounts, FFIs need to have technology systems capable of assigning deemed compliant status to their customers. This will be difficult enough. However, as noted, some of the criteria for this status can change with time or other factors. FFIs therefore need to have systems which can manage changes in deemed compliant status together with the changes in processing, reporting and withholding that these might entail.

And so we see that while deemed compliant status may remove workload and risk, its very structure creates workload and risk in other areas.

Inter Governmental Agreements (IGAs)

These have been a massive talking point since they were first raised and continue to be today. The concept grew from the lobbying carried out by the industry. This lobbying pointed out that many countries have:

Data privacy laws preventing the transmission of personal data outside the country;

1. Trust and fiduciary laws preventing the closure of certain types of account
2. Statutory provisions mandating that certain types of person have 'statutory rights' to hold financial accounts) and;
3. Laws preventing financial institutions from withholding and remitting tax on behalf of a foreign government.

All of the above caused a problem for the original concept of FATCA since they were (and are) used in FATCA as part of the reporting regime or as part of the enforcement regime.

In essence, the IGA concept has simplified FATCA for those FFIs that are located in countries whose governments sign IGAs.

The Model 1 and 2 IGAs basically remove any requirement on an FFI to close accounts of recalcitrant account holders or withhold any penalty on them.

Its very common outside the US for firms to believe that an IGA makes FATCA go away entirely, which is of course not true. They certainly appear to offer a massive simplification for the industry but equally, due to their reliance on other existing regulation as an offset, they sometimes water down not just the practical application of the regulations but also the concept of FATCA. To the outside world, the original concept of FATCA was truly frightening, not least for its extraterritoriality and associated costs of implementation. The IGAs have offered simplification but also bring into question how hard the IRS is really prepared to push given that they created the IGAs in the first place because of push back from other governments.

In conclusion to this chapter, FATCA remains a complex set of regulation. How any one firm or individual is affected is not easy to predict. The ways in which firms can mitigate FATCA through carve-outs or IGAs will cost almost as much, if not more, than the cost of meeting the original regulations without carve-outs.

8
FATCA Withholding

In this chapter we will look at the main 'stick' that the US government has to enforce FATCA—financial penalties. FATCA withholding is a penalty system designed to motivate compliance. This should not be confused with any penalty ascribed to an account holder found guilty of tax evasion.

Penalty not a Tax

To understand the context of a FATCA penalty withholding, the reader should remember that FATCA is actually a due diligence and reporting system in which the subjects are US persons. The regulations place obligations either directly, in non-IGA jurisdictions, or indirectly via IGAs and related domestic legislation on non-US financial institutions. As one might expect, most FATCA projects have at their heart an objective to reduce the impact of FATCA both from a risk and cost perspective. This clearly means that financial firms take steps to reduce the incidence of anything that might result in a FATCA penalty.

The first way to do this is by reducing the number of accounts that are in scope of FATCA due diligence.

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Reducing the Risk of FATCA Withholding

From a total population of account holders, FFIs have the ability, using the rules to reduce the number of accounts on which they need to perform the due enhanced due diligence of FATCA. They can do this naturally, by applying the filters of (i) threshold account balances and (ii) the degree to which their customers are other Participating FFIs (P-FFIs) or deemed compliant or exempted beneficial owners. This is often achieved commercially by adopting policies that preclude, by policy and systemically, accounts being opened by those who would create the extra work.

For individuals and entities there are several methods to take accounts out of scope of FATCA penalties. These include, for example, structures that are exempted in IGAs and their Annexes.

With respect to FFIs, its common today for financial institutions to block any other financial firm from opening an account or accounts where they are acting on behalf of underlying clients (i.e. as an intermediary) unless they can provide a valid global intermediary identification number (GIIN) or provide some other certification of compliance. This is because in a chain of intermediation, the worst case scenario is having a financial firm as an account holder with the risk of them having either improperly implemented their obligations or having undisclosed and unreported US persons in their client base. The presence of a GIIN or certification of deemed compliance isolates the risk for each level in the chain as the obligation falls to the certifying level.

However, unless these two methods, in combination or separately remove all additional due diligence, there is still the possibility that some accounts will require that enhanced due diligence and therefore that some either will not be able to, or refuse to provide the required information.

Recalcitrance and Non-Participation

This is where FATCA withholding penalties arise and for them are reserved the concepts of ‘recalcitrance’ and ‘non-participation’ and resultant FATCA withholding.

Recalcitrance is a reserved term. It is reserved for account holders that are individuals or entities. Non-Participation is a term that only applies to FFIs. I frequently come across people in the industry who do not understand this difference and so I make the point explicitly here. The IRS is effectively separating out the populations of account holders that are other financial institutions from the population of account holders that are individuals or entities.

What has happened in the industry is a continuing reaction, starting at the top of the chain, with US withholding agents. The larger organisations are certainly adopting policies to preclude as far as possible, any recalcitrance or non participation. This is happening at lower levels in the chain too, but at these lower levels, it much more difficult. This is because, at the higher levels in the chain, US withholding agents and large FFIs (e.g. expanded affiliate groups) are much more likely to have other FFIs as customers. Indeed, its common that central securities depositories (CSDs) often only have financial institutions as customers (also commonly called participants). At lower levels, the proportion of an FFI's customer base, presuming them to also be traditional FIs (e.g. banks and brokers) are more likely to include a larger proportion of direct customers that might be NFFEs or individuals. If the FFIs down the chain are not traditional FIs, then the point in the chain that this workload (and risk) occurs is much higher up.

So, at some point there is likely to be enhanced due diligence going on where the information available to an FFI is insufficient or, where there are US indicia, the explanation for these indicia are insufficient. At this point FATCA withholding must take place.

I would have to say that, based on my experience, most FFIs misinterpret the regulations, particularly when it comes to the use of the thresholds and the incidence of US indicia. Many firms, for example, appear to believe that the incidence of US indicia immediately makes an account reportable in FATCA, where this is not actually the case.

As one would imagine, FATCA withholding is not as simple as it sounds. So, here are a few observations that will hopefully bring the subject into rather more clarity, if not understanding.

Purpose

The point of FATCA withholding is to penalise a recalcitrant or non participating account holders and essentially incentivise them to provide required information so that an FFI can adequately document them and obtain their Chapter 4 status. In the IRC Chapter 3 world of QIs and NQIs, most wealthy Americans would view the 30% withholding tax on FDAP income as a 'good deal' because, if they were to invest in the US and declare their income, they'd be more likely to suffer a tax rate between 40 and 50% or more.

In the world of IRC Chapter 4 (FATCA) the 30% withholding still applies, but it is only the starting point, not the ending point. While it's a personal viewpoint and is challenged by some of the accounting firms,

I remain of the firm belief that its important to understand that FATCA withholding is *not* a tax. It's a penalty applied for failure to comply with documentation procedures. The penalty is, its true, applied via the tax system, but this is not a tax on income based on the taxability of that income.

Now, the opponents to this viewpoint point out that one could probably take the position that you would have to presume, as a default, that a recalcitrant account holder is *probably* an American engaged in tax evasion. In which case, the IRS is missing out on tax from this person and that therefore, the FATCA withholding on this account is in lieu of domestic US tax that the IRS would expect to receive. There is some logic to this, since the regulations also say that FATCA withholding can be 'reclaimed', but only as an offset to a US tax liability. This latter of course presumes that the account holder who was penalised has a US tax liability in the first place. The converse of this rule is of course that any recalcitrant account holder who is not US, will be unable to reclaim any FATCA withholding that was applied.

The IRS has gone to some pains to point out that it does not seek the revenue from penalties as an objective of FATCA, it would prefer to have compliance to the core principles of the regulations. This further distances FATCA withholding from a true tax. That said, if one reviews the US Treasury estimates of the amount of money expected to be received by the US from FATCA withholding, the number is a significant number of billions of dollars. At a time of financial crisis and a debt of over $19Tn, it would be easy to see why some commentators would have difficulty accepting the IRS position.

Withholding Issues

So, with the context of how and when penalty withholding occurs, we can identify some of the practical aspects of the withholding itself. First on the list is what types of income are subject to FATCA penalties.

FDAP

In IRC Chapter 3, we see the concept of FDAP income. This is an acronym that's stands for any income that is Fixed, Determinable, Annual or Periodic. For the purposes of most investors this equates to dividends and bond interest, although the IRS has over thirty different income codes that fall into

the FDAP category. FDAP. Importantly 'gross proceeds' are not currently included in the definition of FDAP.

In FATCA withholding, the IRS is clearly trying to make the stick much bigger than in IRC Chapter 3. They've done this by including gross proceeds. This means that, if an account holder is recalcitrant, an FFI will have to calculate and withhold 30% on future payments of dividends and interest (FDAP) and 30% on gross proceeds. So, for example, if an account holder is recalcitrant, an FFI will have to calculate the difference between the buy and sell for each trade and apply 30% tax to the proceeds (i.e. profit) on the sale. This, much more than FDAP income, will be a deterrent for investors.

Application of FATCA Penalties

The withholding itself does not appear to be an issue, and we have seen several occasions where financial institutions have applied a FATCA penalty 30%. I say 'appear' because I have seen several instances where firms have applied FATCA penalties incorrectly and others where a financial firm has been subject to a 30% withholding on payments but is not aware of whether this withholding is a Chapter 4 FATCA penalty or a Chapter 3 tax on US sourced income.

In the chain of intermediation and payments, once we have excluded all those accounts that are compliant, if we still have penalties to apply, these must be applied in a systematic way. For example, if an FFI is about to make a payment to another FFI that represents separate payments to a number of underlying account holders, the downstream FFI will potentially have to inform the upstream FFI of the proportion of the payment that is subject to a FATCA penalty. In referencing the Chapter 3 operating models, where this situation occurs, the financial firms can opt to operate a FATCA rate pool account. This account would be omnibus in nature but allow the downstream FFI to isolate the assets of account holders that must be penalised. The key thing for the reader to remember here is that for any payment of US sourced income, FFIs must apply Chapter 4 (FATCA) rules first, then, to the extent that there is any remaining Chapter 3 tax liability. This FATCA pooled account method will also help when reporting season approaches. I would reiterate here what was said in the preceding chapter—many think that FATCA reporting is about preparing data files for the IRS with respect to US account holders. The more holistic view is that reporting consists of

this plus reporting of recalcitrants and non consenting accounts as well as separately reporting of penalties applied by financial firms in the chain.

Systems Issues

As one might imagine, all of FATCA poses problems of a varying scale and scope depending on your status and position in the chain of accounts. Therefore the types of systems issue that might flow from FATCA withholding, depend on where you are in that chain and what your status is.

FATCA Withholding not a Tax

One of the most difficult systems issues is that the tax being withheld is (i) not a tax and (ii) must be applied with the non-duplicative rules. This has importance because many of the tax related data elements in most institution's books of record are also connected to domestic reporting requirements. It is therefore important to ensure that there is no contamination between deductions from income resulting from tax as opposed to a penalty.

This is made more complex for institutions higher up the chain because of the many types of exemption and exception being granted—the so called 'deemed compliance'. While this provides some relief from withholding complexities, it does mean that larger organisations must have better ways of documenting this deemed compliance among the population of their clients so that they know which accounts can be withheld and which do not need to be withheld. If deemed compliance were just one category, it would be hard enough, but there are two sub categories registered and certified.

In similar vein, the matrix of system flags also becomes complex because FFIs higher up the chain will also be more likely to come across clients who are not only deemed compliant but also may be resident in IGA countries.

Of course, traditional financial institutions will have basic banking or brokerage systems in place from which these types of system issues can be resolved through development. Software and outsource vendors are also very active in understanding these challenges to provide solutions to these firms. The real challenges are in the lower level FFI population who, do not normally consider themselves to be financial institutions. These firms will have very little systemic capability to deal with FATCA since many of their processes (and therefore systems) are highly specific to their needs within their market vertical. For example pension funds will have systems oriented on

the needs of the pension fund industry. That may include reporting but is unlikely to include systems capable of meeting FATCA requirements. Deemed compliance may help these types of FFI, but that will depend on whether they meet the criteria for deemed compliance.

Passthru Payments

As we know, the financial services industry is a cascade and parallel system with global inter-connectivity both vertically from withholding agents down to investors via a range of intermediaries; and horizontally between connected members of the banking and brokerage communities.

So, there are two scenarios in which FATCA withholding can apply. First, when the recalcitrant account holder is being withheld directly by the FFI who has the account holder as its customer. Second, where the withholding must be done by an FFI further up the chain and ultimately at US Withholding agent level. This principle is already set through the 'election' that a Participating FFI (P-FFI) can make to withhold or be withheld upon when it signs up with the IRS. Direct FATCA withholding should not be a major issue, other than systemically. However, if an FFI elects to be withheld upon, there needs to be a mechanism by which upstream institutions know how much to withhold. The reverse, seen from above, is that the payment made by the upstream entity is actually not being made directly to a recalcitrant account holder but to an intermediary who will 'pass through' the payment to its customer, minus the penalty. This payment is called a 'Passthru Payment'.

Now, the fact is that the pass thru payment concept was deferred from the original regulations until 2017 and following Notice 2015-66 is now deferred to 2019. Even then, its final form will need to be substantively different from what has been described in guidance. This is because the published model received so much negative comment from the industry and no simplified model has been found in the interim. That said, and with those caveats, I will describe the system the IRS came up with, in brief, simply to provide some background and insight into how the IRS establishes such models.

Passthru Payment Percentage

The key problem of passthru payments is how to establish what proportion of any payment originating upstream in the payment chain, is allocable to a given downstream recalcitrant account holder. In the financial chain there is

a further complicating factor. That is what proportion of the payment being made is a withholdable payment under the regulations and what proportion is not withholdable. In a long chain of payment the IRS wanted to avoid the problem of allocation statements being sent upstream for these calculations to be made, following which the payment could be made. The time frames involved would have made this impossible. The result was the creation of an independent reference system that could be used by anyone in the payment chain, to calculate how much to withhold. That reference system was called the Passthru Payment Percentage or PPP, which is the first of three variables in a passthru payment calculation. There are actually four variables—one being whether the payment is being made to a recalcitrant account holder or not. Since, if the answer is no, there is no calculation needed (as there isn't any penalty being applied), I've assumed, for this discussion, that this variable is set at 'yes'—the account downstream is recalcitrant (Fig. 8.1).

In the guidance the Issuer as well as all FFIs in the chain between (and including) a US Withholding Agent, would establish and regularly publish a PPP number to the IRS who would then make this available presumably at the FATCA online portal. The PPP would represent that proportion of the entity's balance sheet which was US vs non-US assets. If any FFI in the chain did not publish their PPP or it was found to be out of date, everyone else in the chain could assume that the PPP was 100%.

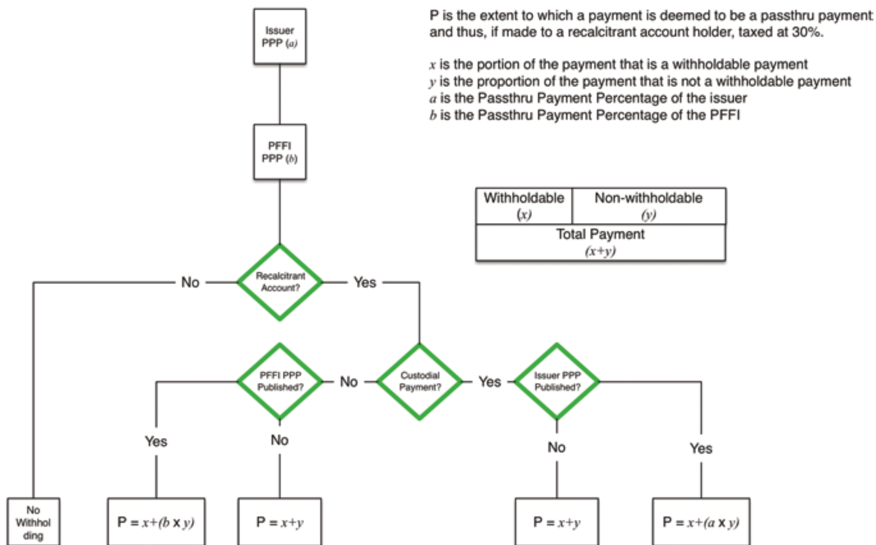

Fig. 8.1 Pass-Thru payments withholding methodology

The object of the PPP was to be used in a formula by an upstream intermediary when making a payment, potentially in lieu of knowing the actual allocation to the recalcitrant account holder.

The second variable in the PPP formula is determined by the payor and is the proportion of the payment that is 'withholdable'. For example, a payment being made may consist of a portion that is a dividend and a portion that is a return of capital. One is withholdable, the other is not. Equally, if it can be ascertained, this could also be that proportion of the payment that's being made to a recalcitrant account holder as opposed that proportion which is not. This would be effective if, for example, a downstream FFI was maintaining an omnibus account at an upstream FFI or USWA. However, this would require, as with IRC Chapter 3 that the downstream entity provide a withholding rate pool statement or equivalent to the upstream entity. What would be more likely in this scenario would be that the downstream FFI would have several rate accounts at the withholding agent and move the assets of recalcitrant account holders into a 'FATCA withholdable' account.

The third variable in the PPP equation is the nature of the payment as either custodial or not.

So, to explain the diagram, lets presume that an Issuer (via a USWA) is about to make a payment to P-FFI:

- x is portion of the payment that is withholdable
- y is the portion of the payment that is not a withholdable payment
- a is the PPP of the issuer
- b is the PPP of the P-FFI

The payor must first decide whether the payment about to be made is custodial or not. If it is, the payor must establish whether the Issuer has a valid and up to date PPP by reference to the IRS database. If the answer to this question is 'yes', then the payor can calculate how much to withhold as a penalty as:

$$P = x + (ay)$$

where P is the extent to which the payment is deemed to be passthru and, on which 30% tax should be withheld. In other words, the default position is to apply 30% withholding only to that portion of the payment that is withholdable plus a 30% withholding on the non-withholdable portion reduced by the factor of the Issuer's PPP. If the Issuer's PPP is not published or is not up to date, the formula changes to:

$$P = x + y$$

In other words, as a result of the failure of the Issuer to meet its obligations, the 30% withholding penalty would be applied to both the withholdable and non withholdable portions of the payment.

If the payment is not custodial in nature a similar calculation and method takes place. However, the PPP used on this side of the model is not that of the Issuer, but that of the P-FFI i.e. *b* not *a*. So, the payor making a non-custodial payment where its own PPP is published and up to date would calculate the portion of the payment to tax at 30% as:

$$P = x + (by)$$

To complete the picture, if the P-FFI's own PPP is not published or not up to date, then the payment would be taxed in its entirety at 30%:

$$P = x + y$$

So, using this model, all payments of withholdable amounts made to recalcitrant account holders are taxed at 30% as a penalty. A payor making a payment that it knows to be a passthru payment, calculates the additional withholding penalty to be applied by reference to the type of payment (custodial or non-custodial) and the independent variable of the PPP of either itself or the Issuer as registered at an IRS database.

Simple really. As noted, I've made this description brief (i) because it doesn't come into effect until 2019 (according to Notice 2015-66) and (ii) it probably won't look like this in its final form anyway.

Non Duplicative Taxation

There is a connection between IRC Chapter 3 and IRC Chapter 4. In fact, as time goes by, its clear that the number of points where IRC Chapter 3 and IRC Chapter 4 converge is increasing. However, in cash terms, there is a principle underlying IRC Chapter 3 and IRC Chapter 4 called the principle of non-duplicative taxation. I find this rather incongruous since FATCA withholding is a penalty not a tax, whereas the tax withheld in IRC Chapter 3 is a true tax. Nevertheless, in principle, if an account holder is subject to a 30% tax in IRC Chapter 4 (by being recalcitrant or non participating), then there is no further taxation imposed by reason of IRC Chapter 3. This makes sure that an income payment cannot be taxed at 60% by applying a penalty under one IRC Chapter, then adding the tax in the other IRC Chapter.

Deferral

So, now we have a FATCA withholding system that has several idiosyncrasies. First it must apply not just to FDAP but also to gross proceeds. Second, it must be applied both to direct accounts but also, to the extent that it applies, also to any passthru payments that are made, according to the rule.

The industry has uniformly commented to IRS that the method provided for in the guidance is unworkable. IRS has since provided for a deferred implementation of FATCA withholding and, of course, it has removed the concept almost entirely for any FFIs that are within FATCA IGA jurisdictions.

The deferral takes the form of a delay to the point at which FATCA withholding commences and second, even when it does commence, what it is applied to continues to be phased in over a number of years.

Conclusion

So, in this chapter we have learnt that FATCA withholding is a penalty system designed to motivate compliance by both account holders and the FFIs at which they have accounts.

FATCA withholding is a penalty not a tax, albeit it is applied using the tax system. In one of the increasing number of overlaps to other regulatory systems, FATCA withholding, when applied, must be reported on information returns 1042-S and on the tax return Form 1042 and can be managed operationally with the use of FATCA rate pool accounts.

We also learned that while FATCA withholding is very specific, in that it only applies to those accounts found to be recalcitrant or non participating, that's where the simplicity stops.

There are areas where this FATCA withholding can be made easier including:

1. Precluding recalcitrance or non participation by closing accounts and/or filtering out account applications that don't meet the required level of disclosure;
2. Being in an IGA country (where withholding is removed from some account types as an obligation provided certain reporting conditions are met) and
3. Having FFI clients that have GIINs or are deemed compliant.

In terms of being prepared, the challenge is to meet not only the different levels of withholding i.e. withholding on FDAP plus gross proceeds, but also meeting the challenge of implementing a completely new system to handle passthru payments if and when it is announced whilst having a system that is adaptable to the changes that happen in Chapter 3 and 4.

In a very real sense, industry is of the opinion that, apart from the current envisioned model being completely unworkable, its likely, based on past history, that the penalty model will continue to change and evolve over the coming years.

If the IRS has achieved one thing, it has certainly been to provide a strong motivation to the industry to substantially the reduce the incidence of FATCA withholding, not because of the size of the penalty, but because of the operational complexities associated with handling it, in the absence of commercially filtering such accounts out of the population.

9
Reporting

Reporting is the fundamental objective of IRC Chapter 4 from the perspective of FFIs and NFFEs. The entire focus of this set of regulation is to force FFIs to identify then report any financial account that is US, substantially US owned or effectively US controlled.

The difficulty, as we have outlined elsewhere, is that some FFIs would be unable to report to the IRS without breaking their domestic data privacy and/or banking secrecy laws. So FATCA has evolved a complex methodology by means of which the data gets from the FFIs to the IRS avoiding those legal pitfalls.

Report Routes

In simple terms, there are two reporting models—direct and indirect. Where there is an IGA in force, reporting goes from the FFI to its local tax authority and from there to the IRS. Where there is no IGA in force, reporting goes directly from the FFI to the IRS.

From a reporting perspective, the world thus falls into three categories:

1. Financial institutions resident in IGA jurisdictions
2. Financial institutions resident in In-Substance IGA jurisdictions and
3. Financial institutions resident in non-IGA jurisdictions

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In Substance Risk

FFIs that are resident in in-substance IGA jurisdictions must take extra care. This is because 'in substance' status can be withdrawn if the jurisdiction concerned does not demonstrate good faith efforts to get an IGA signed. There is therefore an additional risk factor for FFIs. Consider that in substance IGA markets may or may not have appropriate legal structures in place to force FFIs to provide the information and also in substance tax authorities may not have developed the tools needed to either receive or send reports to the IRS. In addition, the risk for FFIs is that they make policy and procedure based on a presumption that their jurisdiction will eventually sign an IGA. However, the IRS has withdrawn in substance status form some jurisdictions, that leaves the FFIs in those markets to re-establish policy and procedure and re-align their processes to a non-IGA reporting model.

Technology

The IRS has implemented two systems, the International Data Exchange Systems (IDES) and the International Compliance Management Model (ICMM). IDES is essentially the data submission portal for FATCA reports and ICMM is a messaging and account management system specific to FATCA regulations.

IDES and ICMM will be used by (i) a tax authority in an IGA jurisdiction and (ii) FFIs in non-IGA jurisdictions.

Report Data

The contents of the FATCA reports have changed over the years, starting with very simple data sets and currently having a larger data set.

The data set for 2017 (i.e. the data set with respect to 2016 due to be reported by March 31st 2017 for FFIs in non-IGA and Model 2 IGA jurisdictions and September 30th for FFIs in Model 1IGA jurisdictions) is as follows:

- US Account Holders
  - Account holder name
  - Account holder US TIN
  - Account holder address

  - Account number
  - Income paid
  - Gross proceeds paid to custodial accounts
  - Account balance or value

- Passive-NFFEs
  - Names of substantial US owners
  - US TIN of substantial US owners
  - Addresses of substantial US owners

- Recalcitrant/non consenting account holders
  - Number of accounts
  - Aggregate balance or value

At present, this data set remains the same for reporting through to 2019.

I would make the point here that, if you are resident in an IGA jurisdiction, you may be under the impression that there is no FATCA withholding on a recalcitrant account. While a true statement, it is also an incomplete one. The FATCA withholding on recalcitrant account holders is suspended, contingent on these accounts being reported in the data set shown above. To the extent that they are not included in the above data set, then FATCA withholding would apply, even in an IGA market, because the suspension would not be activated. In answer to the question of how the IRS would ever know, the answer would be in the Periodic Review requirement and also under the domestic legislation in such markets that transfers the obligations of the IGA onto the domestic FFIs.

In general, FATCA reporting is seen by most firms as fairly mature and it is certainly less challenging than IRC Chapter 3 reporting which still causes major problems seventeen years after its imposition.

Recalcitrant and Non Consenting Accounts

I would also note here the term 'non-consenting account holder'. There are effectively three terms the reader needs to know in relation to any account holder that does not provide a Chapter 4 status to an FFI requesting one.

The term 'recalcitrant account holder' is an IGA specific term that applies only to individuals and entities. Non-Participating is a term for an FFI i.e. not an individual or an entity. Non Participating is not specific to either IGA or non-IGA markets i.e. you can have an NP-FFI in either.

Non consenting is a specifically non-IGA term. Those FFIs in non-IGA jurisdictions are subject to the original US (extra-territorial) regulation. In that model, an FFI is required to obtain the Chapter 4 status of its account holders. Where the account holder fails to do this and cites data privacy or similar laws restricting their ability to do so, the FFI must request that the account holder provide a waiver of those laws in order to complete the process and get a Chapter 4 status. If the account holder refuses to do this or cannot do this, the account becomes non consenting. Again, non consenting status applies only to individuals or entities. From a reporting perspective therefore, when requesting data about recalcitrant and non consenting account holders the IRS is essentially looking to see what kind of a population of account holders an FFI has failed to get the requisite disclosure from that would allow them to know if there were any US Persons in those accounts.

Overlap to Chapter 3 Reporting

I do want to make one reference to IRC Chapter 3 because there is overlap between Chapter 4 and Chapter 3 reporting to the extent that there is any FATCA withholding.

FATCA reporting as described above does not deal with withholding, it deals with reporting of accounts that are US or substantially owned or controlled by US Persons. The data associated with those reportable accounts is about income, gross proceeds and account balances. However, FATCA withholding, if applied, does have to be reported, but not via the IDES system. FATCA withholding, if applied, is reported using the Forms 1042-S that are traditionally associated with IRC Chapter 3. In recent years, the IRS has increasingly used the Forms 1042-S to include FATCA data. In particular, financial firms that are providing 1042-S information returns to other financial institutions are required to identify the Chapter 4 status of the payee and also that of any intermediary withholding agent.

In addition to identifying the Chapter 4 status of recipients, if FATCA withholding was applied then a separate information return would be required. For clarity, in IRC Chapter 3 QIs and NQIs are required to formulate their information returns based on the type of income and any applicable exemption or exception codes. In the most common example, an NQI reporting dividends and interest paid to one recipient would be completing two information returns 1042-S, one coded for dividends and one for interest.

So, FATCA reporting is not just about IGAs and IDES or Forms 8966—these are all to do with the data sets attributable to reportable accounts. The

second side to FATCA related reporting is related to any FATCA withholding that was applied, which must be reported on thre 1042-S forms and will also be reflected in the firm's annual tax return on Form 1042.

Cybersecurity

As you can imagine, there is quite a lot of data travelling around at specific times. Its no surprise therefore that security is a key issue. The contents of these reports include such sensitive items as names, addresses, tax ID numbers, bank account numbers etc.

IDES has an enrolment procedure that includes obtaining a digital certificate according to the IRS options, creating an account, validating your GIIN and digital certification and waiting for enrolment approval.

The requirements of the IDES system means that data submissions themselves must meet a series of security related policies before data can be submitted. These include:

- Compilation to IRS's xml schema
- Compression
- Encryption
- Digital Certification

Once the IRS has your IDES submission, there are a number of checks made on the file, failure of any one of which, can cause the file itself to be rejected. The rejection itself will arrive in the ICMM system that is the management and messaging system associated with IDES.

The pass/fail approach is based on a number of tests:

- Does the file de-crypt properly (i.e. was an approved encryption service used);
- Does the file de-compress properly (i.e. was an approved compression tool used);
- Does the file have a correct digital signature;
- Are any cyber threats detected in the file;
- Are there any viruses detected in the file;
- Does the schema match the approved schema (which is where most failures will occur if the FAQs at thre IRS IDES site is anything to go by);
- Does the file identifier match the submitter's account record

So, submitters need to be aware that this is not just like uploading a spreadsheet.

The most common users of IDES will of course be the tax authorities in Model 1 IGA jurisdictions and so many FFIs will not come into contact with it.

However, FFIs in Model 1 IGA jurisdictions will need to follow guidance from their tax authority regarding the way in which the report data files are submitted to them. There are therefore two risk points in these jurisdictions—the point at which FFIs submit their data to their tax authority and the point at which the tax authority submits the data to IDES.

Notwithstanding this of course, each domestic jurisdiction may, and has, come up with its own guidance and its own systems and methodology by which the data is to reach them. The UK for example has created a single registration portal for FATCA, AEoI, CRS and CDOT (Crown Dependencies and Overseas Territories) as well as a system for submitting reports for all jurisdictions where there is an obligation to report. For small one-jurisdiction firms this should be manageable but for multi jurisdictional firms, it become rather complex and its not clear that the concept of an expanded affiliate group or of consolidated compliance will help.

Part III

OECD Automatic Exchange of Information (AEoI)

10
Introduction to AEoI & CRS

So in this part we will be looking at the OECD framework on combatting tax evasion, the Automatic Exchange of Information ('AEoI') of which the Common Reporting Standard ('CRS') is a part.

For over 20 years the OECD has designed and updated standards for the automatic exchange of income types found in the OECD Model Tax Convention, with a view to ensuring that information can be exchanged and processed quickly and efficiently in a cost-effective manner and in 2012 the OECD delivered to the G20 the report "Automatic Exchange of Information: What it is, How it works, Benefits, What remains to be done", that summarises the key features of an effective model for automatic exchange of information.

The main success factors for effective automatic exchange of financial information are:

1. a common standard on information reporting, due diligence and exchange of information,
2. a legal and operational basis for the exchange of information; and
3. common or compatible technical solutions.

From this grew the CRS and AEoI with the CRS being released in 2014.

The easiest way to understand the larger picture is to remember that the principles behind the framework are based on two ideas.

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First, financial institutions conduct due diligence on their account holders to identify 'reportable accounts' and transmit that data to their domestic tax authority. This is handled by the Common Reporting Standard.

Second, each of those 'host country tax authorities ('HCTAs') then shares that data with its counterpart tax authorities by transmitting it to them according to a set of rules for data aggregation, protection, security etc. and at specified times. This is handled by AEoI and in particular under a system of Competent Authority Agreements ('CAAs') between governments.

This, as the reader will gather from Part 2 of the book, is a much simpler and more elegant solution than the US FATCA framework. FATCA's complexity came about when the US issued regulation aimed directly at foreign financial institutions without any intermediation with the governments whose domestic regulators were overseeing those institutions. This meant that in some countries compliance with the FFI Agreement would automatically mean that a financial institution would be breaching its domestic data protection laws in order to meet the US requirement—not a tenable situation. This in turn led to an entire level of complexity known as the 'intergovernmental agreement' or 'IGA' of which, in FATCA there are multiple varieties.

It is also important to understand a key difference between FATCA and AEoI. FATCA is a law in the US (US Hiring Incentives to Restore Employment Act 2010) that has subordinate layers of regulation that to a large extent are an expression of extra-territorial reach. This, as we have seen, is not without its critics.

AEoI on the other hand is not a law. Its foundation is a framework created by working parties from a variety of backgrounds and countries, under which governments can agree to implement their own laws, affecting their own institutions for a common purpose (exchange of information). To that extent, the financial services industry has been much less antagonised by AEoI than it has been by FATCA. The more elegant operational approach is also likely to engender a more positive compliance response.

Finally, so we are all on the same page, the reader needs to understand one final aspect of this framework. AEoI is not an enforcement tool. Each government that has signed up for AEoI has done so for a number of reasons. However, the most important reason is the detection and deterrence of tax evasion. AEoI has no prosecutorial intent or ability, but the piece that's missing is data. Without AEoI and the collaboration between governments that underpins it, governments would have no effective ability to detect or deter tax evasion when it is structured outside those country's territorial reach. The US alone, with FATCA has made a substantive effort here, but that is based

materially on the presumption that the US market, being the largest capital market, is somewhat unavoidable for investors. However, the extra-territorial reach of FATCA and its complexity did not win the US any friends and compliance efforts within the industry have, as a result, been infected with a 'de minimis compliance' approach that may, in the long run dilute the effectiveness of the principle.

Returning to the point, in order to fight tax evasion, governments need data about their citizens and their accounts outside of their territorial reach. The principle of CRS here is to create that common standard for data so that all countries are requiring their financial institutions to gather the same data. The AEoI principle sets the standard for moving that data to the receiving governments. However, its there, and not within either CRS or AEoI that prosecutorial rules begin to apply. Its only *after* a government has received an AEoI package from its counterparts, that it can analyse that data and compare it to disclosures made by their citizens on their domestic tax returns.

To that extent, AEoI must be viewed as an 'enabling' framework and not a prosecutorial one. With these principles in mind, we can begin to break down AEoI into meaningful areas.

11
Principles of AEoI-CRS

In this chapter we will look at how Tax Administrations and financial institutions are affected by the principles of the Automatic Exchange of Information (AEoI) and the Common Reporting Standard (CRS).

We will break this down into sections of Legal Basis & Structure, Operational Issues and Cyber Security. AEoI and CRS are not laws, and therefore are predicated on having a domestic legal basis in which to operate i.e. force financial institutions to meet the requirements of the AEoI preparatory stage—CRS. Those legal bases, their complexity and inherent variability, give rise to operational issues such as definitions, exclusions and operational issues of due diligence necessary to isolate the information for reporting. The data itself is highly sensitive, but the framework, how it works and how it is structured and timed are all highly public. That leads to concerns over data privacy (only being reported if its properly required under the rules) as well as cyber security threats.

Legal Basis & Structure

By now the industry is getting used to complex legal structures in regulations and AEoI-CRS is no different. For clarity, CRS is a subset of AEoI with each subset having a different purpose that works in tandem to create the international tax structure, in this case, the Standard. CRS deals with the responsibilities of financial institutions to document their account holders and engage in enhanced due diligence (Fig. 11.1).

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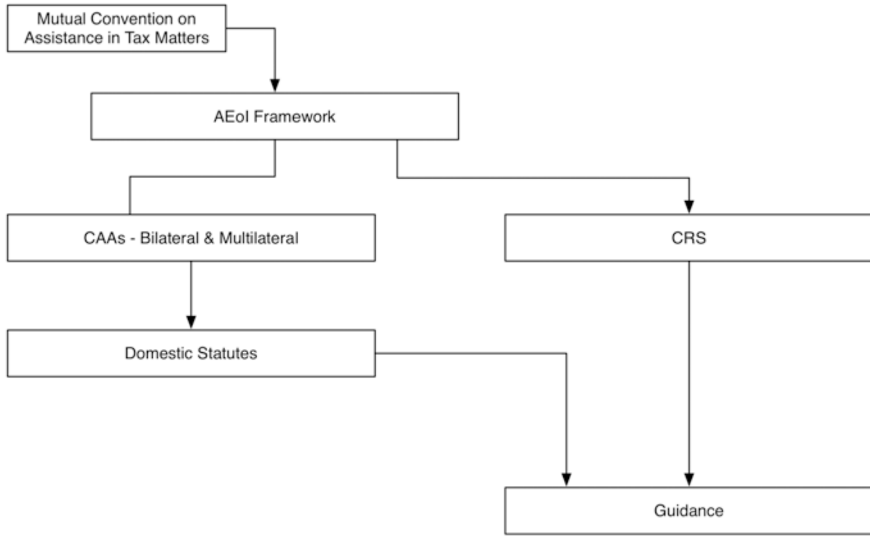

Fig. 11.1 Legal and operational basis of AEoI

AEoI represents the bilateral or multi-lateral obligations of governments, essentially the Tax Administrations, towards each other and the security of the data packages and the transmission of data between each other.

However, there is a small silver lining, in that because the Standard is based on FATCA and is meant to build on the FATCA Model 1 IGA, FIs and jurisdictions that have signed up to FATCA under the Model 1 IGA should have a base understanding and hopefully a better grasp of what is expected of them. This doesn't make implementing the Standard, any easier. In fact it probably makes it slightly harder, as IT systems may not be able cope with and be able to do both types of reporting and may need to be developed in order to hold the relevant information needed for both sets of reporting. Therefore FIs and Tax Administrations may have to invest in further systems or pay to outsource in order to comply. Let us not forget, that there is also the use of terminology where the Standard may be and is on a number of occasions different, which we have discovered from our experience will cause confusion.

In this chapter 'the Standard' will be mentioned on more than a few occasions and to understand it we should know the concepts, which are:

- Availability of information
- Reporting by FIs
- Secure Automatic Exchange of Information

The standard consists of four fundamental components, which we will look at throughout this chapter. The four components are:

- Model Competent Authority Agreement (CAA)
- Common Reporting Standard
- Commentaries on CAA and CRS
- CRS XML Schema

We shall attempt to have a brief overview of the concepts before we delve into the components of the Standard and the implementation of the Standard.

The first requirement is for information and data to be available and this should, in our experience, be collected at the account opening process, which is done through a combination of AML, KYC and Self Certification forms together with the account details.

The Standard does provide a uniform set of detailed due diligence and reporting rules for FIs to follow and apply to ensure consistency in the scope and quality of information gathered and exchanged. These due diligence and reporting rules are, as we have mentioned earlier, the CRS. The requirements specify: the financial institutions that need to report, the type of accounts that are to be reported, the due diligence procedures to determine which accounts they need to report, and the information that needs to be reported. The OECD have learnt from the IRS and the FATCA system when it comes to what information needs to be reported and in order to limit the opportunities for taxpayers to use loop holes or worse, evade, their information being shared by shifting assets to institutions or investing in products that are not covered by the model, they have come up with a reporting regime that has a broad scope across three dimensions. These dimensions are:

- **The scope of financial information reported**: A comprehensive reporting regime covers different types of investment income including interest, dividends and similar types of income, and also addresses situations where a taxpayer seeks to hide capital that itself represents income or assets on which tax has been evaded (e.g. by requiring information on account balances).
- **The scope of account holders subject to reporting**: A comprehensive reporting regime requires reporting not only with respect to individuals, but should also limit the opportunities for taxpayers to circumvent reporting by using interposed legal entities or arrangements. This means requiring financial institutions to look through shell companies, trusts or similar arrangements, including taxable entities to cover situations where a taxpayer seeks to hide the principal but is willing to pay tax on the income.

- **The scope of financial institutions required to report**: A comprehensive reporting regime covers not only banks but also other financial institutions such as brokers, certain collective investment vehicles and certain insurance companies.

The information that needs to be exchanged under the Standard and that is required by the FIs to collect and report to the Tax Administration is specific and highly confidential. Both the FIs and the Tax Administrations need to ensure that they are able to (i) exchange that information and (ii) must do so in a secure manner to protect the data.

Now that we have had a brief look at the concepts, we can have a deeper look into the fundamental components of the Standard.

The Competent Authority Agreement (CAA) has a principal role to play in the framework of the CRS/AEoI structure, in addition to translating the CRS into domestic law, a key component of its successful implementation is the international framework that will allow the automatic exchange of CRS information between jurisdictions. The CRS' CAA, not to be confused with the FATCA CAA, specifies details of information and when this is to be exchanged.

As mentioned earlier, the granular is never simple and as with most things, there are options available to jurisdictions. Just like FATCA and its IGAs, there are three types of Model CAA; the Multilateral Competent Authority (MCAA), Bilateral & Reciprocal CAA and Non-Reciprocal (i.e. for when a jurisdiction does not have an income tax treaty). Jurisdictions are typically using the multilateral convention agreement because the Multilateral Competent Authority Agreement (MCAA) and is aimed to be the most efficient way to provide a way to effect global exchange of information and is fairly simple and standardised (see Appendix 3).

Tax Administrations can alternatively rely on a bilateral agreement, which is typically a double tax treaty or some sort of tax information exchange agreement. In addition to this alternative agreement method, certain CRS exchanges will take place on the basis of the relevant EU Directive, agreements between the EU and third countries and bilateral agreements, such as the UK-CDOT agreements. As you can see, the international legal framework and granular can start to seem and look complex very quickly and that is before we realise that there are now over 100 jurisdictions and 87 signatories for the Agreement and committed to AEoI.

The Model CAA links the CRS and the legal basis for the exchange (such as the Convention or a bilateral tax treaty) allowing the financial account information to be exchanged. The Model CAA, as one would imagine, con-

sists of a number of whereas clauses and contains seven sections. It provides for the modalities of the exchange to ensure the appropriate exchange of information. The whereas clauses contain representations on the domestic reporting and due diligence rules that underpin the exchange of information according to the competent authority agreement. They also contain statements and requirements on confidentiality, safeguards and the existence of the necessary infrastructure for an effective exchange relationship between all parties informed in the chain. It also contains a section dealing with definitions under CRS and AEoI, while covering the type of information which is to be exchanged, the time and manner of the exchange and the confidentiality and data safeguards that must be respected and adhered to.

All Model CAAs have the following information:

- the underlying legal instrument under which the information will be exchanged;
- the precise information to be exchanged and the time and manner of that exchange;
- the format and transmission methods, and provisions on confidentiality and data safeguards;
- details on collaboration on compliance and enforcement; and
- details of entry into force, amendments to, suspension and cancellation of the CAA.

This should mean that complexity decreases, but once again there are some options and jurisdictions are given some leeway. This means that we come to the granular complexity in this area. Jurisdictions have some freedom to specify other provisions in the CAA but only if both signatories (jurisdictions) agree. It must be said that, it is only some freedom because the CAA does provide specific areas for optional provisions, which are:

1. allowing for direct contact between the exchange partner jurisdiction's tax administration and their partner's domestic financial institutions in relation to minor errors or non-compliance;
2. phasing in the exchange of information in relation to gross proceeds;
3. providing for the alternative method of calculating account balance or value.

As you can imagine and see from the brief outline above, the CAA is a detailed document and it should be, considering what it is trying to achieve and ensure.

The CRS component focuses on the due diligence rules for FIs to follow to collect and then report the specific information and data, which underpins the AEoI. This means that jurisdiction that are implementing or are thinking about implementing CRS must have rules and laws in place to ensure FIs report the required information. This alone is an operational issue, the rules need to be passed down to FIs to allow them time to change their processes in order to comply.

Just like with FATCA, the due diligence requirements once again play an important part in the regulations and requirements, both for pre-existing and new accounts. The review system (reviewing financial accounts) under CRS is similar to FATCA, with low and high value accounts, self-certifications certificates, AML, KYC documentation and Actual Knowledge and Reason to Know all playing crucial parts in the implementation of the Standard's due diligence requirements under the AEoI/CRS framework.

We have mentioned in the first few sections of this chapter how CRS/AEoI are similar to FATCA, however, FIs and Tax Administrations should be wary, because as much as the Standard and AEoI/CRS are based on FATCA (and looking to develop the basis of this legal structure), there are still a number of changes and differences. The major differences to be aware of are in the Defined Terms or Definitions and of course the removal of US indicators seeing as the Standard is a global financial network structure. These differences will have an affect on the operational side of FIs and Tax Administrations who are currently dealing with the FATCA regime.

The xml schema should be used for exchanging the information and standards in relation to the safeguards and confidentiality, transmission and encryption of the required data between the FIs and the Tax Administrations. Again, FIs and Tax Administrations that have signed up to and have been reporting under FATCA will have a familiar dread, because they will have an understanding of the potential complexity that packaging the data into a file can cause, let alone obtain the relevant information and reporting on time.

Operational Issues

Now that we have covered the basics, it is only fitting that we try to explain what and how these basics will impact the players in this regime. First off, you will be glad to know that just like FATCA and the QI regulations there is a portal for AEoI, aptly named, the Automatic Exchange Portal, where FIs

and Tax Administrations can obtain or rather delve into, the various documents and vast information relating to CRS and AEoI.

One of the first and major operational issues is that the MCAA does not become viable until the domestic legislation is sorted and all data privacy and confidentiality requirements are met and agreed. Then there is a further step in that even after the jurisdictions have signed the agreement, they have to provide a notice stating that they wish to exchange the information with one another. So as one can see, even from the get go, there is an operational cost just to get your foot in the door. This is therefore a critical step in the exchange of information and falls on to the Tax Administrations and Governments to complete. This then has to be put into Domestic Law and passed down to the industry and FIs to ensure that they are aware of the change in regulations and obligations.

Once all the legal basis and contracts are signed and complete, the operational and implementation processes for FIs and Tax Administrations will start.

For some the issues regarding operations and processes could be as small as just one link in the chain or it could mean starting entirely from scratch because both the Tax Administration, FIs (the whole jurisdiction) is new to this type of regime and have had no previous dealings with FATCA. So, in essence these Tax Administrations and FIs will have an increased operational cost, both in time and money spent on understanding and implementing this change in process and more importantly attitude of people to accept the regulations.

The lucky ones, and they should consider themselves lucky, are the FIs and Tax Administrations that have had previous involvement with FATCA. This is because through FATCA FIs would have been collecting the information and reporting this to the IRS and the fact that there are a number of similarities between FATCA and CRS and thus they may have only a minimal job in order to implement CRS/AEoI into their processes and be compliant. However, just because and even though there are at times, minimal differences between FATCA and AEoI/CRS, there is of course complexity and cost in managing, monitoring and implementing compliance and procedures, and so everyone in the chain should be cautious when implementing new regulations.

The cost implications of the Standard will vary for each country and FI, depending on the current state and the readiness (developing countries tend to be in a less ready state than developed countries), as well as the scale of information to be exchanged, both sent and received data that is likely to occur. Costs will come in the form of both time and financial.

These costs are imposed both on the financial institutions, that provide the information to the Tax Administrators which is to be exchanged, and the Tax Administration who then verify and transmits the data, but not before it has been unpackaged into the various jurisdictions, then sent to the treaty partners. The data and information has to be unpackaged by the Tax Administrations because the FIs are sending the information individually, so say for example, a jurisdiction has 10 FIs, these FIs send their information to the HTCA, but each of these 10 FIs have clients that are represented in 10 partner jurisdictions. The Tax Administration has to un-package the FIs' data and regroup the various underlying clients and information into the partner jurisdictions, once this is done, the data is then ready to be sent to the partner jurisdiction's Tax Administration. The Tax Administrations will also have to manage and use the information received from treaty partners. As you can see from this small and fairly basic example, both FIs and more importantly Tax Administrations need to have the necessary administrative and IT structures in place in order to protect the confidentiality of this data as well as to store and manage this enormous data set (Fig. 11.2).

As you can imagine from just reading the above, there is some real concern in the industry with regards to this 'new' tax information sharing world and that concern is mostly leaning towards the Developing Countries. This

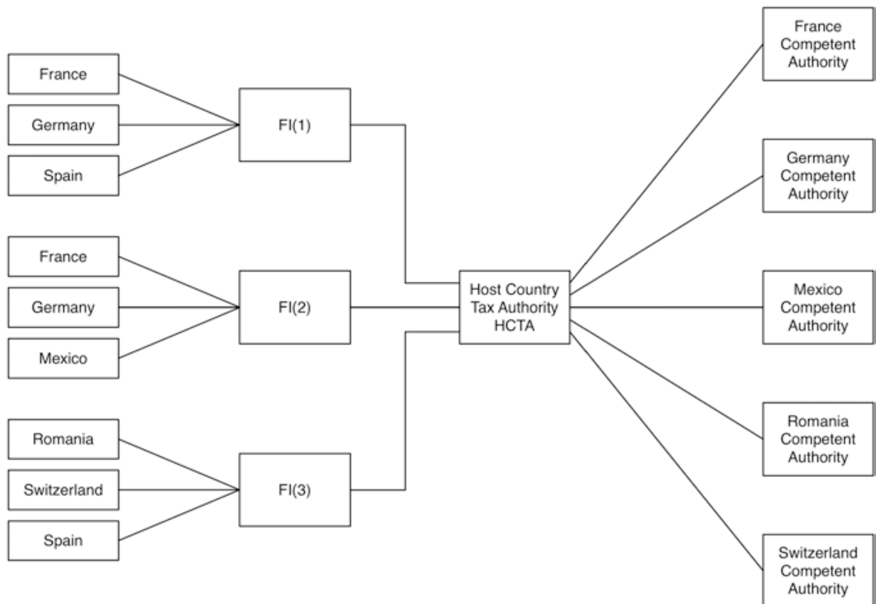

Fig. 11.2 Information flow in CRS/AEoI

is because with most regulatory changes, countries that are not in a state of readiness, will suffer the most. Its not all doom and gloom because luckily with the CRS/AEoI these Developing Countries and FIs (this is not just useful for them but all jurisdictions, countries and FIs) will be able to follow the four key steps but Developing Countries will, in a way have to start from scratch if they have had no dealings with the FATCA regulation framework. The Tax Administrations, FIs and local financial laws may not be near the standard of developed countries and could come under more scrutiny when trying to be compliant and sign up to CRS/AEoI.

As mentioned above, it's not all dire because the four key steps that we mentioned above that look to give a helping hand, though they may seem logically, are a helpful starting point. These key steps are:

- Understanding
- Consultation
- Legislation and International Agreements
- Implementation—IT, Training and Administration

Tax Administrations and FIs have to understand what is expected. This can be done through the use of the CRS Portal and consultation with industry experts. By understanding what is required both as a Tax Administration and FI, they will be able to assess if their current compliance and internal infrastructure framework will allow them to meet the requirements of the Standard and as might be the case, usually is in our experience, will need to update and document changes to the compliance programme, infrastructure and framework to allow the FI and Tax Administration to change their processes and meet their obligations and the requirements of CRS/AEoI.

This change in the regulations and the Standard do not just affect FIs but also Tax Administrations and local laws. FIs and Tax Administrations will require technical and administrative capacity and software to send and receive astronomical amounts of data because there are now already over 10,000 permutations of bilateral exchange relationships activated with respect to the jurisdictions committed to the CRS, with first exchanges scheduled to take place in September 2017. The structure of the reporting and data transfer is going to be time consuming to say the least.

The compliance framework should consist of a number of things, which from our experience of best practice in the industry includes; documentation, forms, processes and procedures and IT solutions. This type of framework, infrastructure, should be adopted by the Tax Administrations and FIs to try and make the implementation and overall experience of this regulation as efficient as possible.

This compliance framework and infrastructure is much the same that FIs and some Tax Administrations use for their FATCA processes, with AML, KYC and Self-Certification Forms once again playing key components in this structure and the documentation of reportable accounts being essential in order to establish whether or not they are reportable.

On the subject of documentation, there is however an important difference regarding the Self Certifications. Unlike the W-8 series designed by IRS, where the signee is signing under penalty of perjury in the US courts, the CRS forms are not. In addition, there is no single standard for these forms. The British Banker's Association (BBA), the OECD's Tax Relief and Compliance Enhancement (TRACE) and CRS groups have all designed slightly different variants of these certification forms to be used as the equivalent of the W-8 series under FATCA. The other difference with these certificates is other than the TRACE versions; there is currently no request for treaty benefits on them and therefore, would not be able to be used under the FATCA/QI regime. This adds additional work for FIs when documenting their accounts but should not be viewed as a heavy task because the FI is already collecting most, if not all the required information anyway under FATCA and the addition of an extra form is not onerous. The question then becomes, which form to use between BBA, TRACE and CRS. The decision is entirely up to the FI.

The MCCA outlines the information that needs to be reported on Reportable Accounts and this again is very similar to what is needed under FATCA. The information that is required under the MCCA is:

- the name, address, TIN(s) and date and place of birth (in the case of an individual) of each Reportable Person that is an Account Holder of the account and, in the case of any Entity that is an Account Holder and that, after application of due diligence procedures consistent with the Common Reporting Standard, is identified as having one or more Controlling Persons that is a Reportable Person, the name, address, and TIN(s) of the Entity and the name, address, TIN(s) and date and place of birth of each Reportable Person;
- the account number (or functional equivalent in the absence of an account number);
- the name and identifying number (if any) of the Reporting 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 or period, the closure of the account;
- in the case of any Custodial Account:

(1) 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
(2) the total gross proceeds from the sale or redemption of Financial Assets paid or credited to the account during the calendar year or other appropriate reporting period with respect to which the Reporting 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 not described, 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 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.

Obtaining all this information, may for some, present itself as an issue but with a strong onboarding process and procedure, FIs will be able to gather all the relevant information regarding the account in one easy process. The key to gathering this information is due diligence, which will have to be done on both new accounts and pre-existing accounts.

As we have seen in FATCA when FIs are trying to comply and execute due diligence on pre-existing accounts, they more often than not encounter clients that are reticent to provide further documentation, even if this is just a single form or bit of information. They most common reason we hear is; 'as we are an existing customer why should we provide this' or 'why do we need this'. Therefore issues may arise and from our experience, do happen more than not. The key is for the FI to manage this and to not obtain the additional information or documentation, because failure to do so will mean that the FI has failed to meet their obligations, which will have consequences. As CRS/AEoI is new and with only the fist exchanges of information happening in September 2017, time will only tell to see what and how this is enforced.

There are a number of trigger points that will make an account reportable and these are known as Indicia. FIs have to be aware of these as they may change an account from being non-reportable to a reportable account. The indicia are as follows:

- identification of the Account Holder as a resident of a Reportable Jurisdiction;
- current mailing or residence address (including a post office box) in a Reportable Jurisdiction;
- one or more telephone numbers in a Reportable Jurisdiction and no telephone number in the jurisdiction of the Reporting Financial Institution;
- standing instructions (other than with respect to a Depository Account) to transfer funds to an account maintained in a Reportable Jurisdiction;
- currently effective power of attorney or signatory authority granted to a person with an address in a Reportable Jurisdiction; or
- a "hold mail" instruction or "in-care-of" address in a Reportable Jurisdiction if the Reporting Financial Institution does not have any other address on file for the Account Holder.

The review and due diligence on accounts is important because if any of the indicia listed are discovered and are associated with the account, then the Reporting FI must treat the Account Holder as a resident for tax purposes of each Reportable Jurisdiction for which an indicium is identified. However, the FI can elect to apply one of the applicable exceptions to that account, should that account fall into that specific category.

The CRS' exceptions for a Reporting FI are that it is not required to treat an account holder as a resident of a Reportable Jurisdiction if:

a. the Account Holder information contains a current mailing or residence address in the Reportable Jurisdiction, one or more telephone numbers in the Reportable Jurisdiction (and no telephone number in the jurisdiction of the Reporting Financial Institution) or standing instructions (with respect to Financial Accounts other than Depository Accounts) to transfer funds to an account maintained in a Reportable Jurisdiction, the Reporting Financial Institution obtains, or has previously reviewed and maintains a record of:
   (i) a self-certification from the Account Holder of the jurisdiction(s) of residence of such Account Holder that does not include such Reportable Jurisdiction; and
   (ii) Documentary Evidence establishing the Account Holder's non-reportable status.
b. the Account Holder information contains a currently effective power of attorney or signatory authority granted to a person with an address in the Reportable Jurisdiction, the Reporting Financial Institution obtains, or has previously reviewed and maintains a record of:

(i) a self-certification from the Account Holder of the jurisdiction(s) of residence of such Account Holder that does not include such Reportable Jurisdiction; or
(ii) Documentary Evidence establishing the Account Holder's non-reportable status.

This just goes to show how clued up the FIs and compliance team need to be when it comes to reportable and non-reportable accounts.

This must be all sounding familiar and as can be seen from the above, the 'cure' to finding indicia is once again a Self Certification Form, just as with FATCA but as stated before, the forms under CRS are not (currently) signed under penalty of perjury like the IRS W-8 series.

While we are on the subject of information reporting, the CRS has defined a few terms that are very important with regards to how FIs need to identify the accounts that will need reporting. Some of these terms will be familiar to FIs because, as we have stated before, CRS is based on FATCA Model 1 IGA and therefore they have borrowed, improved and/or built on the definitions from the FATCA regime.

FIs need to be wary of this apparent closeness and not to fall into the trap that is happening all to frequently in the IRC Chapter 3 and IRC Chapter 4, where we are experiencing that FIs are confusing the two and interchanging terms between the two chapters, thus causing themselves issues.

The definitions regarding reportable information is as follows:

- The term **"Reportable Account"** means an account held by one or more Reportable Persons or by a Passive NFE with one or more Controlling Persons that is a Reportable Person, provided it has been identified as such pursuant to the due diligence procedures described in Sections II through VII.
- The term **"Reportable Person"** means a Reportable Jurisdiction Person other than: (i) a corporation the stock of which is regularly traded on one or more established securities markets; (ii) any corporation that is a Related Entity of a corporation described in clause (i); (iii) a Governmental Entity; (iv) an International Organisation; (v) a Central Bank; or (vi) a Financial Institution.
- The term **"Reportable Jurisdiction Person"** means an individual or Entity that is resident in a Reportable Jurisdiction under the tax laws of such jurisdiction, or an estate of a decedent that was a resident of a Reportable Jurisdiction. For this purpose, an Entity such as a partnership,

limited liability partnership or similar legal arrangement that has no residence for tax purposes shall be treated as resident in the jurisdiction in which its place of effective management is situated.

- The term **"Reportable Jurisdiction"** means a jurisdiction (i) with which an agreement is in place pursuant to which there is an obligation in place to provide the information specified in Section I, and (ii) which is identified in a published list.
- The term **"Participating Jurisdiction"** means a jurisdiction (i) with which an agreement is in place pursuant to which it will provide the information specified in Section I, and (ii) which is identified in a published list.
- The term **"Controlling Persons"** means the natural persons who exercise control over an Entity. In the case of a trust, such term means the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions. The term "Controlling Persons" must be interpreted in a manner consistent with the Financial Action Task Force Recommendations.
- The term **"NFE"** means any Entity that is not a Financial Institution.
- The term **"Passive NFE"** means any: (i) NFE that is not an Active NFE; or (ii) an Investment Entity described in subparagraph A(6)(b) that is not a Participating Jurisdiction Financial Institution.
- The term **"Active NFE"** means any NFE that meets any of the following criteria:
  (a) less than 50% of the NFE's gross income for the preceding calendar year or other appropriate reporting period is passive income and less than 50% of the assets held by the NFE during the preceding calendar year or other appropriate reporting period are assets that produce or are held for the production of passive income;
  (b) the stock of the NFE is regularly traded on an established securities market or the NFE is a Related Entity of an Entity the stock of which is regularly traded on an established securities market;
  (c) the NFE is a Governmental Entity, an International Organisation, a Central Bank, or an Entity wholly owned by one or more of the foregoing;
  (d) substantially all of the activities of the NFE consist of holding (in whole or in part) the outstanding stock of, or providing financing and services to, one or more subsidiaries that engage in trades or businesses other than the business of a Financial Institution, except that an Entity

does not qualify for this status if the Entity functions (or holds itself out) as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund, or any investment vehicle whose purpose is to acquire or fund companies and then hold interests in those companies as capital assets for investment purposes;

(e) the NFE is not yet operating a business and has no prior operating history, but is investing capital into assets with the intent to operate a business other than that of a Financial Institution, provided that the NFE does not qualify for this exception after the date that is 24 months after the date of the initial organisation of the NFE;

(f) the NFE was not a Financial Institution in the past five years, and is in the process of liquidating its assets or is reorganising with the intent to continue or recommence operations in a business other than that of a Financial Institution;

(g) the NFE primarily engages in financing and hedging transactions with, or for, Related Entities that are not Financial Institutions, and does not provide financing or hedging services to any Entity that is not a Related Entity, provided that the group of any such Related Entities is primarily engaged in a business other than that of a Financial Institution; or

(h) the NFE meets all of the following requirements:
   i. it is established and operated in its jurisdiction of residence exclusively for religious, charitable, scientific, artistic, cultural, athletic, or educational purposes; or it is established and operated in its jurisdiction of residence and it is a professional organisation, business league, chamber of commerce, labour organisation, agricultural or horticultural organisation, civic league or an organisation operated exclusively for the promotion of social welfare;
   ii. it is exempt from income tax in its jurisdiction of residence;
   iii. it has no shareholders or members who have a proprietary or beneficial interest in its income or assets;
   iv. the applicable laws of the NFE's jurisdiction of residence or the NFE's formation documents do not permit any income or assets of the NFE to be distributed to, or applied for the benefit of, a private person or non-charitable Entity other than pursuant to the conduct of the NFE's charitable activities, or as payment of reasonable compensation for services rendered, or as payment representing the fair market value of property which the NFE has purchased; and

v. the applicable laws of the NFE's jurisdiction of residence or the NFE's formation documents require that, upon the NFE's liquidation or dissolution, all of its assets be distributed to a Governmental Entity or other non-profit organisation, or escheat to the government of the NFE's jurisdiction of residence or any political subdivision thereof.

All this information should be gathered from the FIs system and once all the information is in place, the data needs to be reported. This needs to be done in a specific way and should meet the OECD Standard Transmission Format, for which there is of course a schema document, the CRS User Guide. Compliance teams for both the Tax Administrations and FIs need to study and understand this and the use of the IT and admin infrastructures working together to create the required file will allow a clearer understanding and an efficient process, whilst reducing the possibility of errors. Of course the Tax Administrations can only create their file once they have received all the data from their various FIs.

The schema explains and goes through how the data should be structured and just like the FATCA regime, this is very specific and detailed.

As with FATCA, FIs will have options of how to report. FIs will be able to report directly or use of third party companies. Each has their own pros and cons. The major pro of reporting directly is that it is obviously more financial cost efficient, while the major con is that it will be more time costly and dependent on man power. The reverse can be said for using a third party, it will be more financially costly but will probably cost you less manpower time. So FIs just need to be able to send data and should feel lucky.

On the other hand, Tax Administrations need to be able to send *and* receive data and process the data received both from their local FIs and other jurisdictions. Tax Administrations have to do quite a bit of work but if they have the IT infrastructure set up then this work will be easier. The work the Tax Administrations need to do is to 'un-package' and 're-package', the data received from their local FIs because this information and data will then be sent to the relevant jurisdictions to complete the cycle. As explained in our previous example with regards to the cost involved in information reporting, Tax Administrations could be sending this information to a number of partner jurisdictions as well as receive data, so it is important that the schema is followed, to allow the ease of transfer and receipt of this data. The sending jurisdiction Tax Administration may need to correct some of the data, which would be done during the un-packaging and re-packaging stage of this pro-

cess, this will allow for the data to be received and processed in the same systems it was sent.

As one can see, there could be some testing times to come in ensuring that obligations and requirements are met. The OECD have laid out four core requirements that they feel will help to implement the Standard and these are:

- Translating the reporting and due diligence rules into domestic law, including rules to ensure their effective implementation
- Selecting a legal basis for the automatic exchange of information
- Putting in place IT and administrative infrastructure and resources
- Protecting confidentiality and safeguarding data

These core requirements are not just for FIs but also aim to help Tax Administrations, as can be seen from the first point where Tax Administrations need to translate the reporting and due diligence into domestic law. These requirements will take time and effort to implement, understand and of course, will cost the FIs and Tax Administrations a substantial amount both in a financial and time aspect.

The reporting of information follows the Country by Country Reporting (CbCR) under the OECD's BEPS (see Part 4 of this book), this alone can be a operational issue because it needs to be implemented and documented whilst any changes to the processing and procedures need to be updated in the internal manual. This means that this CbCR document needs to be monitored on a regular basis to ensure that what is being done is correct and up to date.

FIs have to declare any reportable accounts, in the currency in which the account is (are) denominated. Currency conversions in relation to thresholds must be calculated with a spot rate as of the last day of the reporting period.

As we have mentioned and alluded to on a few occasions already, there is a lot of work to come for FIs, compliance teams and Tax Administrations. It all starts with preparing action plans which leads to implementing plans to meet CRS/AEoI requirements.

Cyber Security

The main issue that has and that is still playing a major part in the uncertainty of FATCA and now CRS/AEoI is the protection of the confidential information during the transfer of data from FIs to Tax Administrators and then again to partner Tax Administrations.

The uncertainty is not just coming from beneficial owners but also FIs, Tax Administrations and Governments, basically, everyone in the chain.

While the AEoI framework focuses quite heavily on data security and transmission standards, the transmissions will have a lot of moving parts. The 'moving' parts are when FIs have to obtain, gather their clients' data, storing this data on their systems and then once a year these FIs will need to report the information to the HTCA, this movement of data would be classed as a 'moving' part, but this is the first of many.

Once the HTCA has this information from all the reporting FIs then will then have to un-package all the data they have received, another potential moving part, into the partner jurisdictions and send this on to them to be processed, definitely a moving part.

With all these potential points of entry and feeder points into what should be a secure transmission network can only naturally create concern. It is understandable, account holders don't want their data and information to be stolen whilst the FIs and Tax Administrations don't want to be responsible for any loss of data or worse identity theft. So we can see why there is still a lot of public and industry concern and insecurity regarding the global transfer of highly confidential information, even though transfer of data as been happening for many years, both domestically and internationally.

To try and alleviate these concerns, the Standard has extensive guidance on confidentiality and safeguarding data and is stipulated in the MCCA.

FIs and Tax Administrators need to invest in IT and back office systems that will offer 'bullet proof' data protection and a risk assessment needs to take place of any existing IT infrastructure to determine current state of affairs to ensure they meet the Standard's requirements.

Conclusion

The intent of this chapter was not to go into the granular detail, but more to use some elements of the granular detail to highlight some of the issues that all actors in the chain will have to handle.

For any of this to work, the AEoI and CRS framework must be adopted by a variety of governments each of which may take different lengths of time to enact the primary and perhaps secondary legislation needed to give a legal basis to apply rules to financial institutions. In addition, there are some jurisdictions that are not currently in the process but which may joining it at some point. Finally, to the extent possible, some of the AEoI and CRS

frameworks have areas where governments can choose different definitions and/or reporting obligations. Each as a sender of data will have to receive, unpack and re-pack data before sending to other governments. Each as a receiver will be receiving data from multiple other governments, unpacking it, analysing it and comparing it to disclosures from their own tax payers. All of this, while providing significant challenges for governments, also provides a major headache for financial institutions that must have resources capable of monitoring these changes and designing and implementing systems and operational processes to be compliant.

The financial institutions themselves will need to handle operational diversity. Most are already affected by FATCA and so they will need to understand the similarities and differences between their existing commitments to the US government (directly or indirectly) and those of the OECD framework adopting jurisdictions. They will need to analyse those differences particularly to identify the nature of their counterparties and clients, apply CRS rules to assess whether they are reportable with respect to any of the 100 plus AEoI jurisdictions and then create due diligences procedures to use available self certifications in onboarding processes as well as one off processes for pre-existing account holders. To be cost effective, these CRS based processes must leverage any possible commonalities to FATCA so that GATCA reporting becomes, as far as its practicable, a single holistic concept.

Finally, by far the most challenging issue will be client relationship management. If FATCA and QI have been anything to go by, the degree to which a financial institution supports its customers and counterparties, will determine how much pain is felt at all levels. Recall that all the activity of AEoI has absolutely no benefit to a financial institution and none to its customers. The only beneficiaries of all this activity are the tax authorities.

12
The Common Reporting Standard

While the general picture painted in the introduction to this part of the book is simple, it's important to understand that while the generality is simple, the granular is often not so simple.

We would like to observe that, of all the areas of international taxation that we cover in our business, the OECD web site is by far the best, most clear and comprehensible and also the most complete. It is for this reason that we do not feel the need to reproduce material from their site into this book as the reader will very quickly be able to find and download detailed content. Our intent in this book is to provide some commentary in a very practical way to the consequences of the material.

The financial services sector has grown internationally with very little operational coordination. Nowhere has this been more so that in the area of taxation where national governments jealously guard their sovereignty over what is, after all, their income stream.

In our experience, regulators are also incredibly bad at writing effective regulation, despite the common incestuous relationship between regulators and those who are regulated in this industry. So, its refreshing that, in the main, CRS was not written by regulators and perhaps that's why its so much easier to understand, if not easier to implement.

It is to this background that we should consider first, who is involved in the chain of intermediation. There are many actors in this play. While financial institutions are at the heart of CRS and are the source of the data to be shared, many financial institutions commonly outsource portions of their roles to third parties such as administrators. These third parties thus also become

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entangled as the regulators seek to ensure that the control systems applicable to the financial institutions are also taken on by their agents and counterparties.

Actors in CRS

The Common Reporting Standard, at the time of writing, is in its second edition. The basic items covered in the standard relate to the due diligence procedures to be performed in order to identify reportable accounts, the information to be aggregated for such accounts and the reporting to a domestic tax authority in preparation for that authority's transfer of information under the rules of AEoI.

That sounds simple. However, CRS takes some account of the conditions of the financial services operational framework. However, first, lets identify the actors in this play.

Account Holders

The primary actors in CRS are the financial institutions at which financial accounts are held and through which, potential tax evasion could take place. CRS provides definitions for the different types of account holder and what is a reportable account. The term Reportable Account Holder (RAH) means an account held by one or more Reportable Persons or by a Passive NFE with one or more Controlling Persons that is a Reportable Person. Bearing in mind that the simplest structure is one in which a direct beneficial owner individual operates an account directly at a financial institution, some financial accounts are held by beneficial owners structured within investment vehicles, these might be partnerships, trusts, family foundations, hedge funds etc., all of which are aggregating investment capital in some way. Some countries have special types of such vehicles such as SICAVs, SICAFs, OECIVs (open ended collective investment vehicles), pension funds, UCITS funds and SPVs (special purpose vehicles). As you can imagine, the number and types of these collective vehicles is large. Some represent particular risks as vehicles for tax evasion, while others do not. Account holders can also be persons corporate, also known as entities (as opposed to individuals). These are generally of two types—passive and active, reflecting the same approach as FATCA. As far as both the US and OECD are concerned passive entities also called passive non financial entities are high risk for tax evasion, while active NFEs are not. We will explain the issues this creates later.

Financial Institutions

Financial Institutions under CRS/AEoI there are separated into reporting FIs and non-reporting FIs.

The term Reporting Financial Institution is rather helpfully defined as any Participating Jurisdiction Financial Institution that is not a Non- Reporting Financial Institution'. This effectively allows the framework to define exemptions and exclusions to the reporting requirement such that any firm that does not fit an exemption or an exclusion will be, by inference, a reporting financial institution. The most obvious are:

- Depository Institutions
- Custodial Institutions
- Investment Entities
- Specified Insurance Companies

Non-Reporting FIs under the Defined Terms of CRS is actually quite a list, but these include for example:

- a Governmental Entity, International Organisation or Central Bank, other than with respect to a payment that is derived from an obligation held in connection with a commercial financial activity of a type engaged in by a Specified Insurance Company, Custodial Institution, or Depository Institution *or*
- a Broad Participation Retirement Fund; a Narrow Participation Retirement Fund; a Pension Fund of a Governmental Entity, International Organisation or Central Bank; or a Qualified Credit Card Issuer *or*
- an Exempt Collective Investment Vehicle *or*
- a trust to the extent that the trustee of the trust is a Reporting Financial Institution and reports all information required to be reported pursuant to Section I with respect to all Reportable Accounts of the trust.

Tax Administrations

Tax Administrations are just as important in this chain, because they receive the final data. They also have to send the data received from their local FIs to their partner Tax Administrations.

Implementing CRS

Knowing who the actors are is only the first step. The next step is to understand what due diligence impact CRS will have on your business.

If you are an account holder, you will be subjected to requests for information from financial institutions where you operate accounts. If you're a tax administration you will need to interpret CRS to allow for the receipt of reports from your financial institutions as well as provide them with guidance on interpretation. However, the biggest impact will be if you are a financial institution.

Knowing that you have a due diligence requirement starts a process of segmenting customers in different ways than those you may have been used to. At present, most systems categorise an account holder based on Know Your Customer (KYC) and Anti Money laundering (AML) regulation. You may also have been subjected to FATCA due diligence and reporting. As the latter is already relatively mature, you, and your systems, may be capable of allocating further tags to account holders such as status in IRC Chapter 4 (FATCA). This kind of data flag usually runs in parallel to the normal operational systems of a financial institution simply because it is there only to determine if data associated with the account holder and the account are reportable to the US government. As such, this flag is a singular case where CRS is a multiple case.

In CRS, as with FATCA, the framework takes as it start point the existence of KYC and AML data. However, because CRS takes effect in a specified time frame, as with FATCA, there is a concept of pre-existing accounts and new accounts with different rules for each. In fact, there are a number of variables to consider, namely:

- When the account was opened—new or pre-existing;
- Value of the account—low or high;
- Nature of the account holder—individual or entity;
- Existence of partner jurisdiction indicia—paper records or 'actual knowledge' of a relationship manager;
- Nature of the account—depository or custodial;
- Place of incorporation or birth.

In addition, CRS embeds the concept of de minimis thresholds. In FATCA these are used to reduce the number of accounts subject to enhanced due diligence, presumably because low value accounts are unlikely to be a source

for tax evasion. CRS has a similar de minimis threshold concept whose application is dependent on three factors—whether the account is pre-existing or new, whether the account is low or high value and whether the account holder is an individual or an entity. While the intimation of CRS is that this is being done to recognise the relative difficulties of obtaining self certifications, its more likely that this will result in more work for the financial institutions who will have to overlay due diligence procedures with bifurcations based on these factors - and fewer reported accounts for the tax authorities. To the authors, the beneficiaries would seem to be the tax authorities, not the financial institutions.

	Entity	Individual
Pre-existing	De Minimis $250,000	No de minimis
New	No deminimis	No de minimis

Now, at this stage, we need to make something clear that is of major significance. The CRS is a framework not a law and not a regulation. To that extent, CRS in many places uses the term 'may' not 'will', leaving the door open for any jurisdiction to make up its own mind and thus create more operational difficulties for its financial institutions. The reality is technically much worse in that even when there are definites such as exchange of information, jurisdictions can adopt the framework either on a reciprocal or non reciprocal basis, yet adapt the exchange timing itself based on a number of factors.

If…then…

If that was all it was, it would be complicated enough. However the CRS also contains the concept of what is termed 'boolean logic'. For those of us without maths degrees, this translates simply to a set of rules that determine whether an account is reportable and if so, what is to be reported. These 'IF-THEN' conditions really cause problems and in particular, sometimes they are more complex e.g. IF…AND…THEN…. or IF…OR…THEN…

We usually use these rules to create decision tree diagrams to help clients understand how the status of their clients results in one or more different actions. These are then often included in compliance policies and procedures, not least because they are much easier to understand than the long form text descriptions and they describe the dependencies between sets of information more accurately. These decision trees also provide very

clear instructions to IT departments that will need to review for potential improvements, to systems and/or risk reduction. Some examples of how this works are shown in the table below.

IF…	AND…	THEN…
Account is individual pre-existing	account is a cash value insurance contract	No review of account is required
Account is low value individual	RFI has a residence address in its records	RFO may treat residence address as residency for tax purposes.

Structure of CRS

As one might expect, the structure of CRS is relatively simple in concept and so too is the AEoI document published by the OECD, now in its second edition. The AEoI Standard document is separated into three sections plus annexes. Section I provides an introduction while Section II A is the core Model Competent Authority Agreement (CAA) and Section II B is the Common Reporting Standard (CRS).

The structure of this standard is relatively simple to work through. The CRS itself is providing information about what needs to be reported and how the due diligence procedures 'may' be applied. Therefore, the first act of any CRS project should be to establish whether your particular jurisdiction has applied the CRS 'as is' or whether there have been any changes to it as it transitioned into domestic law, whether that be as changes to definitions or as changes to the rules (either of which could alter the number of reportable accounts and also the operational processes necessary to identify them.

Many of the due diligence concepts and indeed, several of the procedures are modelled on FATCA. The main three principles are:

- Defining the nature and amount of information to be reported;
- Defining the scope of accounts subject to reporting and;
- Defining which financial institutions are required to report and those that are not.

Finally, the Standard also includes, in Section III B various commentaries relating to the CRS. However, what most people want to know about CRS is—what do I do now?

Segmenting CRS Strata

From a holistic viewpoint a reporting financial institution (RFI), once it has determined that it has a reporting obligation, should be segmenting its customer base into the following strata:

- Pre-existing individual
- Pre-existing entity
- New individual
- New entity

The date for cross-over between new and pre-existing will of course be embedded in the domestic legislation that is enacted to transition CRS into law for the RFI's market.

Entity sub-classifications are similar to FATCA i.e. passive and active non financial foreign entity P-NFE and A-NFE respectively. CRS also has the concept of controlling person (CP) that describes what, in FATCA would include both control by substantial ownership and effective control.

In terms of reviewing these account strata for CRS status, an RFI would need to establish first whether any de minimis threshold needs to be applied that would remove portions of each strata from any review—thus reducing the workload. In the CRS itself, pre-existing individual accounts, new individual accounts and new entity accounts are suggested not to have any de minimis applied i.e. all accounts in these strata should be reviewed. At the risk of repetition, this is what CRS says as a recommended standard. That does not mean that the standard was adopted in any given jurisdiction. You will need to review your jurisdictional law to see whether your legislature copied and pasted CRS or whether it made changes.

Once this segmentation is complete and a reviewable account base has been identified, the due diligence procedures themselves should be applied. In most cases, this will consist of a review of either paper records or electronic records or both plus solicitation of a self certification of CRS status. This is a more complex area for entities than it is for individuals and the difficulty should not be underestimated. We are aware even today of financial firms that have not properly completed due diligence under FATCA or the QI regulations and are finding ways to report that do not trigger any compliance issues.

Application of Due Diligence

So, now that we have identified the actors and described the preliminary activities of assessing account strata for review, the actual due diligence requirements will apply to the remaining subset of an RFI's account base. Remember at all times that all this preparatory activity is designed to isolate data for the purpose of reporting.

CRS already includes an equivalent to the US W-8 forms, although the OECD's documents—called Investor Self Declarations (ISDs) are noticeably simpler whilst at the same time generalising the intent. The US form seeks only to identify IRC Chapter 4 status as US or non-US before moving into sub categorisations. The OECD's ISDs on the other hand must take account of the fact that any one account holder may have tax liability in more than one jurisdiction and that there may be a reporting obligation to that jurisdiction. So, where the W-8 form in effect asks 'do you have US reporting liability?' the ISD asks 'where do you have tax liabilities?'. In addition, returning to our variability theme, here too the OECD notes that the investor self declaration template can be varied e.g. information requests can go further than those recommended, although there is a strong suggestion that the minimum requirement should be that shown in the standard.

So, in effect, the information available to an RFI is represented by:

- KYC
- AML
- ISD (Individual, Entity and Controlling Person)
- Actual Knowledge

This information may be held in paper records and/or electronically. From a risk perspective, and if FATCA was anything to go by most firms will choose to use a form of ISD. However, CRS also requires a similar search for what are termed 'indicia'. These are similar to the FATCA concept of indicia but must be assessed on a much broader basis and with a much more robust monitoring and change management approach.

For example, consider an RFI in a jurisdiction with CAA arrangements with sixty other jurisdictions. The annoying thing for the RFIs here is that they have no control over how many jurisdictions their government will choose to engage with for exchange of information nor the rate of increase in number of those exchange arrangements. However, the RFI in this example must search for indicia that relate to any of the partner jurisdictions. The

most simple model of course is one in which account holders have simple arrangements in which they are operating a foreign account but only have one jurisdiction to which their data will be reported. This would be complicated by an individuals with, say, dual citizenship, but its unlikely that the number of jurisdictions to be reported for individuals will exceed two or three. In the case of entity account holders however, the situation can easily be much worse. CRS provides for several different types of controlling person (CP). So there could easily be many CPs for any one entity account holder and each may have tax reporting liabilities in different jurisdictions. So, the due diligence procedure for entities is a much more complex task. Not only will there be documentation and validation procedures required for the entity itself, but also for each of the CPs and, if there are multiple CPs with multiple jurisdictional tax reporting liabilities, then the account data for that one entity may well be reported to several jurisdictions based on each CP's involvement with that entity. This constitutes a significant workload, particularly in wealth management and private banking where complex, sometimes nested vehicles are in place between an account holder and the ultimate CPs below it.

CRS also has some confusing terminology in that it references accounts for review as well as accounts for reporting. We find that its not uncommon for RFIs to think that a reviewable account is the same thing as a reportable account. This is not so.

A reviewable account is one that meets certain criteria (value, structure etc.). A reportable account is one that meets reporting criteria (foreign or CP).

Now, the CRS does provide a recommendation that, for example, pre-existing entity accounts are not reviewable, identifiable or reportable unless their value exceeds $250,000—however, the same portion of the CRS also states that this provision can be over-ridden by the RFI (and presumably by the domestic legislation). So, yet again, we see that CRS may in some respects be simpler than FATCA, but that in others, usually because of the multiplicity of reporting destinations, it creates more complexity.

We do not intend here to go into each and every review procedure from the CRS since these are perfectly well documented in the CRS itself. However, what we are trying to achieve here is a base of understanding that the policies and procedures that financial firms will have to adopt for CRS do have some important differences from FATCA and the sheer number of countries that have CAA arrangements in place means that the preliminary part of CRS implementation—understanding and documentation/due diligence are the foundation of any firm's compliance efforts.

We have found it common that firms rarely prioritise these preparatory elements. In particular:

- establishing a clear prioritisation and resource allocation;
- creating a monitoring and change management plan to keep track of changes to the standard and also, and more importantly, to the local legislation and guidance (which have already changed since issue by the OECD and also by some governments)
- identifying all the key affected parties within the organisation and making sure there is a training and personal development plan in place.

Report Data Gathering

This is embedded in Section I of the CRS and again, based on the potential variability between the standard and what gets passed into domestic law, RFIs should assess the differences if any when preparing policy and procedure.

Size Matters

The variability and number of jurisdictions involved also makes it more difficult for large financial institutions, particularly those with a multi jurisdictional operational basis e.g. international branches or sub custody networks. This means that larger firms will need to work out a many-to-many due diligence system in which each branch must meet its own local due diligence requirements and each will be separating out reportable accounts with respect to multiple possible reporting jurisdictions. Smaller, single jurisdiction firms will only have a one-to-many problem to solve with only one set of guidance to worry about.

So, we have looked at who the actors are. We've looked at the filtering mechanisms that financial firms can use to (i) reduce the number of accounts for review and (ii) identify the ones that are reportable.

Technical Delivery

There are two forms of technical delivery involved in CRS. The first is the delivery of data from a reporting financial institution. The second is the unpacking and re-packing of that data by a domestic tax authority in preparation for its delivery to partner jurisdictions under the CAA framework.

Most jurisdictions that have 2017 as the first exchange year have already set out the technical basis for both these elements. There are clearly some basic issues that reporting financial firms need to consider data privacy and data security.

Some tax authorities are providing a technical platform or portal with varying degrees of security to allow their reporting firms to upload data directly to their servers. Some are also embedding requirements for file certifications, encryption, compression and file validation processes.

Control and Oversight

Now, the biggest difference between FATCA and CRS/AEoI lies in the control and oversight function. In FATCA, as with IRC Chapter 3, the US unilaterally establishes a complex oversight system including the concepts of responsible officers, requirements for written compliance programs and finally a requirement for a triennial independent periodic review. The IRS has the potential; for direct intervention at this stage, should any failures be found. In addition, FATCA embeds the obligation that a responsible officer must proactively notify the IRS of any event of default or material failure. This structure exists because financial institutions are essentially contracting with the US as a foreign state. Where they are not contracting directly, they are subject to the domestic translation of the FATCA arrangements via the relevant IGAs and lower level competent authority agreements. While the name is the same and the intent is generally similar, the OECD CAA is different from the US CAA. The OECD framework takes as its starting point that oversight will be based purely on domestic law. This is understandable because CRS/AEoI is a framework not a regulation.

Section 4 of the Model OECD CAA essentially provides, at that level, for a collaborative stance on both compliance and enforcement. This means that each jurisdiction must provide its own financial institutions with rules, guidelines etc. relating to the importance with which they view failures of due diligence and/or reporting.

Again, this makes it relatively simple for small single jurisdiction institutions and proportionately harder for those in expanded affiliate groups, even with a common compliance programme.

The Model CAA talks about rules and administrative procedures as well as effective implementation and compliance. These are hard enough to follow when they are well defined, but in this case, the weakest link will be in those jurisdictions where there is either no political will or focus to support

an international agreement or presumably where doing so may damage the financial industry. So, we still end up with a framework that can only operate effectively to the extent that its participants apply similar levels of focus to this issue.

What most firms seem to be doing in practice is leveraging the similarities between FATCA, US IRC Chapter 3 and CRS. Since the definitions are similar (but not the same) and the purpose is the same, many firms we see are embedding compliance and operational procedures within a single GATCA framework. So firms that are reviewed triennially for their FATCA compliance are making sure that their CRS processes are under similar scrutiny.

Conclusion

What begins as a seemingly simple and cohesive model for due diligence rapidly falls foul of the same issues that have plagued the US FATCA system since 2010. Namely that it does not matter what direction you approach this issue from, the reality is much more complex in implementation than the model would have you believe. The top level concept of a globally agreed methodology to identify and report account holders to their home jurisdictions, cascades into a multiplicity of caveats and definitional issues. Account holders don't just have cash accounts, they have securities accounts and insurance contracts. They construct their assets into sometimes complex vehicles and of course, at the time of implementation there may be old accounts and new accounts. Beyond the definitional issues the CRS rules can come into force at different times. There are a number of jurisdictions set to exchange data in September 2017 and others set for 2018. Firms with a disparate client base must have not just operational processes for due diligence, they must have monitoring processes in place to keep track of the changes in reporting scale and scope as new jurisdictions come into play and data requirements of existing exchange agreements evolve.

Clearly, this plethora of intrusive questioning both to identify the tax status of an account holder but also to penetrate many accounts and similarly do due diligence on underlying parties in order to identify persons of significant control, places a substantial burden on relationship management and account opening functions. If these people get it wrong, or the systems they use are inadequate, the rest of the framework rapidly falls apart. The old saying 'garbage in—garbage out' is true in this sense. We already see, on a regular basis, failures of understanding at investor level leading to incorrect or unreliable certifications being made. We also see, equally regularly,

failures of due diligence processes to correctly validate the reliability of these forms and informational review. We routinely see firms taking a 'lowest common denominator' approach to compliance in the knowledge that they are unlikely to get caught and, if they do, the penalties are an acceptable business cost given that these obligations do not sit at the core of most firm's business models.

A Wider Approach

The AEoI framework also discusses the concept of a wider approach designed to reduce costs for the industry. This approach provides a CRS set of guidelines that effectively deletes the enhanced due diligence rules in favour of making any account reportable if its owner or controlling person is not a domestic resident. While this looks on the surface like a good idea and would certainly reduce the number of variable processes that a financial firm would need to adopt and maintain, to us it rather raises the question of purpose. If the purpose of CRS and AeOi is to detect and deter tax evasion, that pre-supposes that evasion is an activity for the wealthy, hence the enhanced due diligence and focus on high value accounts. If financial institutions are going to remove this filter and report everyone, this will result in foreign governments receiving much more data, of which a substantial amount will not be in relation to tax evasion at all. However, it does seem to satisfy the increasing international trend amongst governments to acquire data and information about the activities of their residents outside their home country as a general principle. As such there are probably some notable governments for whom such data would be very useful, albeit unrelated to tax evasion e.g. political dissidents. This should be of serious concern to those interested in data privacy generally as it seems to go beyond the purpose for which the framework was designed while at the same time providing no check balances. This would also provide a greater risk of cyber-hacking as the value of data would increase substantially.

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Automatic Exchange of Information

AEoI has two elements and, for the most part, readers may be understandably interested in the first more than the second. The first part of AEoI occurs at the end of CRS and is represented by the transfer of account report data from a reporting financial institution to its domestic tax authority. The second and probably more recognisable is the transfer of report data between tax authorities.

We have already noted that the actual data elements themselves may change both over time and between particular jurisdictions. We have also noted that the nature of this data is highly sensitive and would, under normal circumstances, fall foul of data protection regulations and laws of many countries. It does also constitute a major cyber risk (See Chap. 20). The structure of AEoI effectively recognises these problems in its derivation from FATCA that suffered the same issues. The data protection legal issue was the main driver of the FATCA Inter-Governmental Agreements (IGAs) that took the cross border aspect of the data transfer away from financial institutions and placed it at governmental level. This of course then led to the need to put some structure in place to force financial institutions to compile and present this data domestically so that their governments could effect the cross border part of the transfer requirement. This is what led to the US Competent Authority Agreements (CAAs) that underpin FATCA many of which required both primary and secondary legislation in each jurisdiction.

In the same mode, AEoI of course does not start as a law or regulation but nevertheless arrives at the same end point with CAAs and domestic legislation.

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Timing

Ask most people when AEoI transfers take place and they will tell you, September of each year. Technically, the model CAA in AEoI provides a space for the parties to the agreement to specify their own timing. However, we must remember that there are two stages of AEoI. In order for a government to have data to transfer, it must first receive it from its own reporting financial institutions. The number of these will change over time and there will be changes to the scale of reporting as the industry is not immune to mergers and acquisitions, nor to the incidence of new products and of course new account holders. Therefore, there needs to be, in each cycle, a period in which reporting financial institutions are required to perform CRS, compile and protect their data before sending it to their domestic tax authority. We would note here that the CRS piece cannot be assumed to be static. In the first cycle, it is true that firms will need to complete due diligence on pre-existing accounts (however those are defined from a date perspective in a CAA). However, the financial services sector is always in a state of volatility—new customers, old ones changing structure, new ones connecting to old ones etc. So, there is effectively a delta in the effort each year adding to the CRS effort and resulting in additional data sets being added to the reporting requirement.

Timing is also important in order to make sure that the report data itself, to the extent that its possible, is with respect to a consistent time period. The Standard assumes that a calendar year is the basis of the reporting data. This in itself will cause problems for tax authorities. This is because not all jurisdictions have a calendar year that matches their domestic tax reporting year. The UK for example uses a twelve month period ending on March 31st while the US uses the twelve month period ending on December 31st. So, in their efforts to analyse reporting data when received, there will be some countries that are receiving information about their tax-payers that effectively cross between one domestic reporting season and another.

There is also timing variability within the AEoI standard based on when a given CAA is signed, when it goes into force and the status of the underlying domestic legislation. This can result in a bifurcation of transfer activity in the early years of any given CAA. For example, if two jurisdictions have signed a CAA but only one has managed to enact the required domestic legislation, then, in principle, of the two, only one will be able to transfer data to the other in the first year of the agreement. The AEoI standard provides for that variability and allows jurisdictions to bilaterally arrange their affairs essentially on the basis that the direction of travel is understood and agreed, but that the early years may be different for each party as they come towards the standardised model from different starting points.

We should not omit here the effect of reciprocity. The principle behind AEoI is that in a bilateral exchange, each jurisdiction is agreeing to send the other the report data about the other's tax-payers. Again, while this is the required and hoped for end-point, the standard recognises that this might not be the case either from a principle perspective or from a timing perspective. From the principle perspective, its entirely expected in AEoI that one jurisdiction may be to the other a high risk of tax evasion but that the converse may not necessarily be the case. In this case the jurisdictions may elect to transfer only in one direction.

Manner of Exchange

The main element involved in any such global standard as AEoI is to make sure that the data is pre-formatted in a way that makes it easy to translate. The AEoI standard sets this as the extensible markup language, more commonly known as xml.

The manner of exchange, as its written into the standard is, like many other aspects, both specific and vague at the same time. This is in the nature of cross border collaborative bodies that have to contend with complex and variable situations and counterparties who often view tax as a highly sensitive subject where control is rarely ceded to another party. So, when it comes to the CAA, Section 3 is very short and merely states that the parties to the agreement will figure out when and how information will be shared and with respect to which reporting years if they don't both have appropriate legislation in place. That's it.

When it comes to confidentiality and safeguards, Section 5 is even shorter—just two short paragraphs essentially noting that confidentiality is a matter between the two parties and their domestic laws and that each party will notify the other if there is any breach of confidentiality or failure of safeguards. That's it. Its not entirely surprising, given the complexity, that the AEoI framework establishes the principles that parties should adopt with respect to each other while devolving the detail wherever possible to the individual parties concerned. However, this fact must be front and centre for any firm seeking to comply with CRS and AEoI. Firms should not approach this subject thinking that the OECD has provided detailed rules or guidance on every single aspect of how AEoI and CRS should work in every jurisdiction and with every possible permutation of circumstance at every type of reporting firm. They can't.

The AEoI Standard Edition 2 also contains what appears at first sight to be very helpful commentaries on each of the operative sections of the AEoI and CRS standards. As previously noted however, these in turn suffer from the

innate variability and flexibility that such a standard needs to be able to get common traction across a number of governments. So, for example, the commentary on Section 3 paragraph 3 of the standard that relates to the time and manner of exchange of information contains three important observations.

First that the standard envisions a transfer of data within nine months of the year to which the reported data relates. This is where we get the common views that reporting is due by September each year. However, we note that the wording here is 'within nine months' not 'nine months'. The implication is that counterparties to the CAA are free to agree a time frame of less than nine months if they wish. The commentary gives the example of the EU Savings Directive in which reporting is due within six months.

Second, the same commentary notes that the field in the CAA for the year of first exchange is left blank so that counterparties can decide this for themselves.

For firms that are single jurisdiction operations, these issues will be of smaller impact. Larger firms with multi jurisdictional operating units will have a massively increased level of complexity.

Third, despite the parallel and prior requirement from FATCA that gross proceeds become reportable, the AEoI standard has replicated the variable for reporting of gross proceeds. In other words, the reporting in FATCA started with a basic data set then progressively added data, specifically gross proceeds, because it was recognised that financial firms would need extra time to develop systems to be able to capture this data. The CAA in AEoI replicates this principle by allowing the counterparties to a CAA to set a separate date for the addition of gross proceeds to reportable account data. The reason set out is similar to that of FATCA. However, we observe that the industry has known about the technical requirement to capture gross proceeds data with respect to the US since 2010 and, at the time of writing, most firms will already have developed this capability.

Transmission Standards

The AEoI standard is equally sanguine about the method of transmission as long as certain principles are followed. Those relate to encryption and transmission with underlying assumptions about transmission, security, integrity and privacy.

We observe that reporting in the US IRC Chapter 3 regulations by non-US financial firms is now seventeen years old. Each year brings numerable changes to the US standard that affects most firm's ability to properly tag data in their systems. The US now has two web based portals for the delivery of

these data sets (QI and FATCA) only one of which is mandated to use xml. Despite all that, we still see firms struggling to understand and implement a methodology that gets them to the point of being able to file a report with minimal business impact. In fact, the US deadline of March 15th is commonly extended by most firms to April 14th and yet, even with an additional month, we still find firms and the people within them at panic stations in the weeks prior to and after the deadline. This, in a model where the files are definitive, not variable. AEoI does not mandate specific methodologies, only principles. This may suit the governments, but is unlikely to suit the financial firms providing the data. The mechanism is not new. I spent two years as part of an EU committee remitted to consider an effective withholding tax model for Member States. The model we came up with had ten principles which, in implementation would have revolutionised the withholding tax landscape and removed two of Albert Giovannini's barriers to the free movement of capital in the EU. The problem was not in the principles. These had been put together collaboratively by business people and government representatives. The problem was in implementation. As one EU Commissioner put it—'if we go for an EU Directive, that will take years during which the landscape will change, the players will change and those whose interests are served by a complex and slow moving system will find ample opportunities to derail the process. If we go for a voluntary process, we will certainly get those markets which are already close to the optimal operating model to voluntarily adopt the framework, but others will be slower to change, leading to a fragmented system in which the principles may be agreed, but the detail is always variable and fractured, meaning that the benefits foreseen are never realised.'

AEoI fits this latter model too. Given that transmission standards are bilaterally permissible, it begs the question of what happens when one standard is adopted by one market and a different standard is mandated by another. The AEoI Standard, in an inferred acceptance of the problems this would create, does also talk about a more internationalist approach but only to the extent that 'thought should be given' to designing such a mechanism.

We should also observe that while the technical concept of reporting is relatively simple, a technical platform to manage both the delivery to a domestic tax authority as well as between tax authorities must be very much more complex. The US model is again a useful comparator. The US reporting model has complex validation filters which on receipt of data, test that data against certain rules. That simply ensures that the file meets certain criteria some of which relate to the file structure (number of fields, data types, data order, checksums etc.) while others relate to the way in which the data is protected (digital certification, encryption, compression etc.). The con-

cept of an internet based delivery system also brings the need for a messaging mechanism. The US started out with fax, then email and has most recently changed over to the International Compliance Management Model (ICMM) in which messaging about the files (receipt delivery, validation result, bad file notices etc.) can be contained. We think it likely that, in the same way that AEoI had FATCA as its progenitor, a globalised tax evasion GATCA style report delivery and messaging system will need to emerge and will probably be based on the US model.

Conclusion

So, where does this leave us? The amount of material related to AEoI could easily be mistaken for a detailed set of rules by means of which financial institutions, investors and governments have both certainty and clarity. Nothing could be further from the truth. The extent of the material is a reflection of the diversity contained within the framework which is, in turn a reflection of the need to enable as many counterparties as possible on a world stage, to be able to engage in principle with the AEoI concepts because AEoI is, after all is said and done, a voluntary framework.

The CRS provides definitions and due diligence rules, but each of these can be varied on a bilateral, multilateral or indeed unilateral basis and yet stay within the framework. The automatic exchange rules built into CAAs leave much of the detail about what, how and when data must be transferred (i) between financial institutions and HCTAs and (ii) between tax authorities. The net result for most financial firms is that they will need to apply substantial resource on an ongoing basis to analyse the data they need to extract and report as well as monitor the changes in signatories and timing of reports between tax authorities. The wider approach referenced earlier in this part of the book would technically alleviate some but not all of these issues.

The commentaries appended within the Standard are useful to the extent that they provide examples of how these variables could be treated in a variety of situations. However, these will only likely be a partial map to the particular circumstances of any given firm. Below are some observations about resource and focus that firms would need to adopt in order to properly administer AEoI:

- Identify scale and scope for AEoI
  - Policy with respect to 'wider approach' defines efforts required in CRS and therefore data volumes in AEoI together with risk associated with sharing data that would otherwise not constitute reportable accounts;

- Identify resources required
  - The common compliance approach envisioned for expanded affiliate groups could be adopted commercially to centralise or provide some commonality of approach within GATCA i.e. group together compliance efforts related to AEoI with BEPS and FATCA.
  - Create a unified approach to sharing of information, resources and skill sets. AEoI, like FATCA is one of those challenges that cannot be addressed effectively in the traditional financial services siloed business model.
- Identify and respond to issues of cyber-risk, data protection and security associated with collation of AEoI information, storage preparatory to submission and correct submission to HCTAs
  - If you are in an EU jurisdiction, review the impact of the General Data Protection Regulation (GDPR) that comes into force in April 2018. While the AEoI framework leverages the same legal arguments as FATCA to sidestep legal prohibitions on financial institutions moving data to a foreign jurisdiction, there is still debate about whether these arguments will still hold true under GDPR and in particular in those jurisdictions that choose to apply the 'wider approach' model.

We have alluded to cyber security several times in this chapter, but the fact is that GATCA frameworks generally all have the same challenge. We have therefore chosen to discuss this vital element in a chapter of its own in Part 5 of the book.

From an operational perspective both the transfer of information from a reporting financial institution to an HCTA and between CAA partner jurisdictions are really relatively simple data movements. The real efforts for financial institutions lie in the CRS preparatory phase. That said, AEoI still also represents a reputational issue and potentially a legal issue for financial firms simply because they are the start of the chain of activity. An investor whose data is sent to a foreign government and who feels damaged by that act or by the consequences of that act, will look first to the institution that released the data. Whether or not there is a legal challenge possible is not the point, particularly if jurisdictional guidance replaces CRS with the wider approach CRS under which a potentially larger account base may get reported. One of the opinions we often make to clients is that marketing functions should be involved together with legal and on-boarding and relationship management simply because the way in which such issues are handled with clients can affect how those clients react when AEoI occurs with their data.

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Operational Issues of AEoI

AEoI is certainly not the first international effort at detecting tax evasion but it certainly represents a game changer in terms of the efforts taken to address some of the issues that made earlier attempts less effective. That said, this new framework, like its progenitor, causes structural and operational problems for reporting financial institutions and issues of competence and data security for tax authorities.

In addition, the very scale and scope of the effort and the variability inherent in trying to get over a hundred tax jurisdictions to cooperate in a standardised and automatic way means that compromises must be made at the operational level of the standard in order to avoid a complete collapse under its own weight. Whether the OECD has achieved this remains to be seen and this will, to a large extent, depend on a continuing focus by the governments concerned both in terms of the problem that tax evasion represents to them and the amount of money they are prepared to spend in achieving those self stated objectives.

In this chapter we will note some of the operational issues that flow from AEoI together with some of the industry and even firm level responses to those challenges.

Understanding

We still get calls today, seventeen years into the US QI regulations and seven years into the FATCA regulations from people who are just coming to realise that they are impacted by cross border compliance obligations and having little or no infrastructure in place to handle them. This leads us to some

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interesting observations. First, that all these rules and frameworks appear to have a consistent flaw in that those primarily subject to a set of compliance or due diligence rules can seemingly go for years without being detected, deterred or penalised. Second that those imposing the rules rarely provide for sufficient transfer of knowledge to those that are subject to them. We spoke with one regulator who believed that because they had held just one seminar in Hong Kong attended by two hundred delegates, that they had effectively addressed their obligation to inform and educate the market in its entirety. While AEoI is not a regulation and, as noted, the OECD's support material is excellent, there is sufficient variability in AEoI to substantiate a much greater engagement by the industry in collaborative discussion particularly within industry interest groups (currently almost entirely absent) as well as between each tax authority and its reporting financial firms. This is necessary because each tax authority will need to assess its position either bilaterally or multi laterally with its CAA counterparties before being able to construct a clear set of guidelines for its own reporting financial institutions.

There is also an almost complete lack of communication going on with investors and those who actually hold accounts at these institutions. We see financial institutions actively avoiding discussion with or support for clients (i) because they don't understand the framework or their firm's position with regard to it in the first place, (ii) because they are not equipped or trained to handle the questions that clients raise and (iii) because they are afraid of crossing that 'tax advice' line in the sand that most financial firms desperately want to steer clear of (and with good reason). However, as I noted to one listener at a conference, that's hardly a way to run a service industry and it does seem to us that in many ways, regulation is creating a barrier between customers and financial institutions. In this context AEoI is about addressing concerns that customer may have that their account data is being tracked in this way at all and that it may also be inadvertently included in a data transmission. So, we feel that one of the largest problems with AEoI is knowledge, understanding and, ironically, the sharing of that information through the chain to the account holder.

Language and Currency

Not all countries in the AEoI standard use the same alphabet. This may cause an issue where, for example, a reporting jurisdiction may have opened accounts using the English (Latin based) alphabet (26 letters) whilst the receiving jurisdiction, which is going to want to match report records to its domestic tax-payers, may store this data using Cyrillic script letters (33 letters)

or Chinese scripts etc. Variations in spelling on account records may make it difficult to aggregate account data effectively and certainly anyone actively engaged in tax evasion would naturally leverage this to reduce the likelihood of their accounts being connected within an institution with multiple business lines or reduce the likelihood of their accounts being caught in an aggregation procedure within an expanded affiliate group of financial firms under a common compliance model. The net effect of this would be that even if reported separately, a foreign receiving tax authority may not be able to parse the data intelligently enough to realise that the data represents one account holder.

The Standard does make concessions to currency variability although the complexity at the end of the day is likely to make any meaningful analysis of account data by a receiving tax authority very dubious.

Focus

As with many cross border and very general purpose frameworks, the actual impact on any given firm will usually be a small subset of the total. The difficulty exists in planning the road to compliance in an intelligent way. There is often a gap between the senior management (budgetary control) of a firm and the functional aspects of that firm. Typically we see that the senior management have the lowest levels of awareness and have these matters brought to their attention by lower levels in the firm. Immediately this generates the problem of focus. There are many such issues vying for senior management attention and not all functional heads are fully trained and able to properly communicate the relative importance and impact of some regulations on the business. If they don't do a good job of communication and/or senior management don't pick up and translate those messages into a priority, then the opportunity is lost either until someone else fixes the communication problem or worse, the firm gets caught by a regulator. Some firms have an independent regulatory oversight function however, in our experience the independence tends to translate into a lack of connection to the business model leaving senior management with briefing papers that explain the potential problem but do not connect that to the business priority.

Packing and Unpacking

AEoI presents two operational issues. The first is for reporting financial institutions and the second is for tax authorities themselves.

Packing

Assuming that reporting financial institutions have managed to get appropriate due diligence processes in place under CRS, they will need to have adapted their record keeping systems to store certain data elements attached to each account holder. Where these have historically been KYC and AML related, CRS requires a more multi-dimensional approach simply because the end result is a multi-dimensional one containing multiple tax authorities as ultimate potential receivers of the data. So, where KYC and AML may only be storing a single data element, CRS will require potentially multiple data elements in a one-to-many relationship. This would occur for example if an individual account holder had a tax liability in more than one jurisdiction. It is often not even clear to the account holder that this might be the case. A point of example would be the US where there are six possible tests on an account holder that might result in a US tax liability. So, imagine, at one level that an account holder was born in country A but maintained accounts at financial institutions in countries B, C and D. the account holder may have been educated in country C where they may have taken on employment to subsidise their education. They may, for a variety of reasons travel frequently to country D and trip over a substantial presence test. Any of the three foregoing may inadvertently trigger a tax liability in countries A, C and D.

What we end up with in this example is a situation where each financial institution in each country may have to report the same account holder to each other country using the same account data. This would be multiplied pro rata if the account holder operated multiple accounts at each financial institution.

Now consider that this same account holder also happened to be a controlling person (CP) involved in the management of several opaque (corporates) and transparent entities (partnerships or trusts) in countries C, F and G. The CRS due diligence process will theoretically identify this controlling person and associate the entity account as a reportable account because for the CP relationship. Now the financial institutions in each country will be reporting the individual's accounts and also the entity accounts for which that individual is a CP. Notwithstanding the ability of the individual to mess this system up with minor variations to spelling or moving assets around below reporting thresholds, these financial institutions have a more complex data aggregation job than at first appears. Different types of financial institutions will of course be more at risk with these issues—private banks, wealth management

firms etc. All of this aggregation and data packing is therefore based on this extremely complex set of CRS rules. The packaging itself will of course need to meet the domestic regulator's rules on how this should be done in xml before being packed up. What this implies is a significant operational issue for most financial firms. They will need to obtain and retain resources capable of understanding and monitoring the framework. They will need training resources to maintain corporate memory. They will need a substantial attention to systems resources so that data records are adequate to this increased data requirement as well as the algorithms necessary to extract the data into the required segments before translation into xml. On this point I would note that virtually every firm we are aware of starts off with data extraction from proprietary or third party systems into spreadsheets. From there they can independently review the data and manipulate it. Only once this cycle has been repeated until 'good' data is apparent do they then translate this into xml format. The lesson to learn is that its unlikely that firms will depart from this operating model anytime soon. So, it would be dangerous to assume that the CRS portion of AEoI is merely about due diligence. The domestic transmission portion of the exchange will be equally challenging.

Consider now, the second element of AEoI, that between the different governments. While many financial firms will think this is 'not their problem' we would make some comments to the contrary later in this chapter.

Unpack and Re-Pack

The most obvious issue for tax authorities is the workload involved and the resources available to them to accomplish it. Tax authorities are relative late comers to the digital world and there is a very large disparity between them when it coms to technological stance. That said, the problem they have can be stated very simply. What they receive are data files from each reporting financial firm in their jurisdiction. Each of those data files may well contain account records representing data that must be shared with multiple other jurisdictions. That data will on receipt also, in principle be digitally certified, encrypted and potentially compressed. So, there will be an unpacking ceremony in which the data packets will need to be unpacked from their containers because the data will need to be re-assembled in a different form for onward transmission to other governments.

Once the data is unpacked it is technically at risk of data breach since it will be in open form. Obviously an interim step will then be to make sure that the data received matches the required xml formats and, to that

extent, each authority will have to implement a messaging procedure to handle communications with domestic senders about files that do not pass the many structural and security checks that will need to be in place. This will also require published deadlines for domestic reporting and remediation procedures to make sure that the tax authority is in a position to properly exchange the files and meet its CAA obligations.

The tax authority will now have the job of peeling apart each submission based on the destination jurisdiction to which each account data record relates. What follows will be a re-packaging of that data, then, as necessary a re-assembling of the security and formatting according the agreements made between the exchanging parties. It is in this step that, in our example of earlier in this chapter, the account data of our sample account holder may have to appear in more than one destination submission.

Competency

All tax authorities have one primary role and that is normally that of collecting taxes. In the normal way of things the vast majority of those taxes will be declared and paid domestically. While the absolute numbers for global tax evasion may be large, its clear that when broken down by individual jurisdiction, we will end up with a cost of implementation that potentially equals or exceeds the amount of tax that is being evaded. What's worse is that its very unclear that many of the smaller jurisdictions have the wherewithal or competency to implement this framework in any consistent or reliable way. By definition, tax authorities focus on domestic tax-payers.

The AEoI framework bestows obligations on each of the hundred plus committed tax authorities to build and implement control and oversight rules, manage compliance monitoring, implement data receipt, unpacking, quality assurance, re-packing and submission processes with foreign governments that are not in their core mission statements and for which we suspect they are barely likely to be able to deflect resources towards. All this effort and the only benefit will be if the sending jurisdiction has a reciprocal arrangement in place via their CAA so that at least they get equivalent data from other jurisdictions. The problem there of course is that receiving such data in a reciprocal agreement places additional burdens on the tax authority concerned to unpack the data and, to the extent possible, match this data to domestic tax-payer records and extract any mis-matches as potential tax evasion.

What's obvious of course is that from any population of received data under AEoI, (i) some proportion will be over-reporting or unrequired

reporting due to ineffective controls or clarity from tax authorities; (ii) a large proportion of the remainder will not represent tax evasion because the income will have been declared and tax paid correctly; (iii) some tax evasion will be detected but this will not result in prosecution (deterrence) nor in any substantive tax collection due to domestic corruption, special deals or the sensitivity of the government to the individuals concerned…or something else.

While these matters are certainly latterly an operational issue for tax authorities, we should not underestimate the sting in the tail. If this system does truly detect tax evasion in a systematic and consistent way, the financial firms at which these account holders operated their accounts will be spending significant sums on reputation management, legal defences, improvements to systems, policies and procedures mandated by regulators and, most of all, relationship management and brand marketing issues, all of which would flow directly from any substantive failure in the AEoI portion of a GATCA framework. It is true that the Standard also includes some observatory notes that the legal framework expected to be in place to support AEoI must have, as part of its structure, the expectation that tax authorities have adequate procedures to protect data. The Standard includes a questionnaire that highlights these issues that will be discussed in more detail in our chapter on cyber risk. Safe to say however that despite these control structures, these protections do not always work and we have seen some spectacular examples of data breaches, not least the Panama Papers in recent times. If one were to observe to the global community that a single framework has led to a regular collation and transfer of account information and personal identities relating to the highest value bank accounts in and between all the major countries of the world, that, we would prudently offer, would represent a target of immense proportions and immense values. To leave such matters as handled via existing domestic mechanisms may be to leave the door open. The operational issues of AEoI, if not addressed effectively, can thus create an extreme weak point in the framework.

Part IV

OECD Base Erosion and Profit Shifting

15
Introduction to BEPS

24 hour televised news, websites and social media based news sources have helped shape a world in which we are consumers of increasingly productised news. The rolling, repetitive and socially sharable content structure of the media landscape in which we find ourselves sees conversation surrounding notable events that lasts longer and is far more widespread than in the past. Furthermore, the need to entertain as well as inform places considerable pressure on traditional and new media outlets to find content that engages their audience—and there are few things in this world that stir the public interest quite like news that a prominent company hasn't paid very much tax.

The tax planning practices of multinational companies have never received the level of public interest that they do today—and of course that public interest translates fairly quickly into political interest. Countries that once welcomed foreign corporations with open arms and enticing taxation opportunities are now facing significant pressure from their electorates to makes sure these corporations pay their way. A few decades ago, if you had asked a man on the street to name a tax haven, he would probably name a small island somewhere that most of us couldn't easily locate on the map. However, ask the same question today and many will point to major global economies, or in a mordant display of self-awareness, their own capital city.

The feeling that multinational companies don't pay enough tax is more than just a problem of public perception. People are acutely sensitive to the idea of fairness, particularly in financial transactions. When taxpayers see monumentally profitable global enterprises like Apple and Google paying an

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effective tax rate of just a couple of percent, it undermines the legitimacy of the entire tax system. A significant body of academic work has been undertaken to establish a causal link between the perception of fairness in a tax system and the level of taxpayer compliance. While there is no clear consensus, the Organisation for Economic Co-operation and Development (OECD) believes that there is sufficient evidence of the link. Moreover, it believes that the problem is sufficient enough to take significant action.

It is easy to focus solely on nations that have encouraged these types of arrangements, those that are willing to sacrifice tax revenue in favour of wider social, political or economic goals. However, this does not tell the whole story. National markets and economies the world over are facing significant strain from increasingly outdated and insular approaches to international taxation—it is the weaknesses in these fragmented domestic legislations that create opportunities for tax base erosion and profit shifting arrangements. Tax base erosion is a serious issue for developing countries as they generally rely heavily on the income provided by corporate taxation, particularly that provided by multinational enterprises.

The issues are not simply a matter of lost revenue for governments. There is growing support for the suggestion that base erosion is a substantial contributing factor to poverty, inequality and unemployment in developing nations. It is perhaps important to note that tax avoidance alone is not the cause of these issues, and it is just one of many aspects of globalisation that can have a negative impact on developing nations. One of the key BEPS issues however is the distortion of competition between international and domestic businesses. When a multinational takes advantage of a tax planning strategy that is not available to a domestic business, the playing field is far from level. A situation in which an enterprise may obtain a competitive advantage through aggressive tax avoidance can significantly distort the competitiveness of a market.

The incentive for multinational enterprises to employ tax avoidance strategies is substantial. While it is hard to quantify exactly how much tax revenue is avoided each year, a number of cases have brought the scale of the issue into the public eye. For example, through the use of a variety of profit shifting methodologies (which we will discuss in depth later), Apple managed to obtain an effective tax rate of just 3.7% on it's non-US income in 2013. By way of contrast, the average taxpayer in the UK has an effective tax rate ten times the amount Apple reported.

The news media are of course quick to criticise companies for employing actions to shift profits, perhaps forgetting that businesses have an obligation to return profits to shareholders. This is not to say that businesses do not have ethical responsibilities as well, but that it is in the nature of the modern media to place blame. This blame is, in my opinion at least, misguided.

Taxation on a national scale is extremely complicated. In order to produce a system that caters for the myriad needs of the Government and its taxpayers without negatively impacting prosperity, growth and competitiveness it has to be this way. Therefore it stands to reason that taxation agreements between nations have the potential to be substantially more complex. It is in this complexity, and in the mismatches between taxation philosophies that opportunities arise to avoid taxation for those that have the incentive and resources to do so. So if, like the media, you are keen to find someone to blame for corporate tax avoidance, I would suggest you look globally towards those that have crafted both national and international legislation, along with tax treaties, trade agreements and other cross border policies. Some of the legislation in question dates from the early 1900s, while some is much more recent. So if you will forgive the cognitive laziness, that narrows it down to a few tens of thousands of individuals. Sadly, that's just not as attention grabbing on a front-page as the naming and shaming of a multinational company.

While it is easy to make light of the situation, the previous comment does cast a spotlight on the problem itself. The legislation that governs international taxation is a patchwork of bespoke, ill-fitting laws, many of which were never intended to operate in the globalised environment in which we find ourselves today. Furthermore, the legal framework on which much of this regulation rests pre-dates the computer age and all of the advantages and challenges that have come from constant connectivity.

It would be unfair to suggest that Governments have not adapted to the challenges brought by new technologies. However, the legislative process is slow by its very nature, while the pace of development in information technology and communications has been blistering. It is perhaps understandable that legislation to counter international taxation issues posed by new technologies, for example digital products, has not been quick to implement.

The challenge that legislators have faced in the wake of the unprecedented developmental pace of IT systems is something that is relatively easy to digest. However, a number of base erosion and profit shifting issues stem from much simpler, more established legal apparatus. For example, the concept of permanent establishment, which determines whether a company maintains a taxable presence within a country, is an area of potential abuse that is popular with those seeking to avoid cross border taxation. Tax treaty shopping is another methodology that exploits outdated or insufficiently robust legislations.

The point to take away here is that there is a plurality of reasons that base erosion and profit shifting issue occur. Given the diverse nature of tax avoidance methodologies, the legislations that they circumvent, and the jurisdictions in which they occur, it follows that the proposed solution is itself diverse.

The OECD/G20 Inclusive Framework on BEPS

The growing commentary surrounding the use of aggressive tax planning strategies by multinational enterprises has ensured that BEPS is now, more than ever, at the forefront of policy-makers minds. BEPS issues generally arise from gaps or mismatches in tax rules between nations. However, the profit shifting strategies that are employed by many multinational enterprises are diverse, flexible and are impacted (or not, as the case often is) by numerous laws that are themselves diverse and disparate. It stands to reason then, that these gaps and mismatches can only be successfully addressed with the implementation of regulations that treat the system as a whole, rather than on a nation-by-nation, rule-by-rule basis. The OECD, an organisation that has always had an interest in international tax legislation, sees its position as an intergovernmental organisation that represents much of the first world as an important player in the fight against BEPS.

The OECD motivation to tackle the BEPS issue is two-fold. First, the organisation is keenly aware that unilateral action by individual nations will not fully address the problems caused by BEPS. Secondly, it has raised concerns that political pressure to undertake action by nations in isolation could lead to duplicative taxation of businesses. The impact of such actions could have far reaching economic and social consequences. The need to provide a globally coordinated, holistic approach is obvious.

The measures suggested by the OECD are designed to strengthen, modify or outright replace national practices. Countries that have committed to the BEPS Project have committed to implement domestic rules based on the recommendations put forth by the OECD as well as revise bilateral tax treaties based on the forthcoming Multilateral Instrument (more on this later). The BEPS Project recommendations take the form of minimum standard, best practice and common approaches designed to facilitate the convergence of national legislation on international tax issues. Many of the outputs are considered to be soft law and are of course not legally binding. However, there is an expectation from the OECD that the 4 minimum standard BEPS Actions will be adhered to by all participants.

The BEPS framework itself is a diverse package of measures that address a number of areas of international taxation that have provided opportunities for aggressive international tax planning. The BEPS Package is split into 15 subject areas, called 'BEPS Actions', each addressing a different type of BEPS issue. The objective of the BEPS Actions is to create a modern, cohesive, international tax framework, with each of the actions forming part of a holistic treatment of the wider system. The outputs of each of the BEPS Actions provide governments with domestic and international instruments to tackle tax avoidance.

The BEPS Actions

1. Address the tax challenges of the digital economy
2. Neutralise the effects of hybrid mismatch arrangements
3. Strengthen controlled foreign company (CFC) rules
4. Limit base erosion via interest deductions and other financial payments
5. Counter harmful tax practices more effectively, taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of permanent establishment (PE) status
8. Assure that transfer pricing outcomes are in line with value creation—intangibles
9. Assure that transfer pricing outcomes are in line with value creation—risks and capital
10. Assure that transfer pricing outcomes are in line with value creation—other high risk transactions
11. Establish methodologies to collect and analyse BEPS data and actions to address said data
12. Require taxpayers to disclose their aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanisms more effective
15. Develop a multilateral instrument

The expectation is that once implemented, the outputs from the BEPS Actions will restore taxation in instances where income would have otherwise gone untaxed. Furthermore, the measures themselves are designed with the intention of removing the possibility of double-taxation occurring.

The BEPS Actions represent a broad selection of the key areas of corporate tax avoidance. For those unfamiliar with the methodologies employed by multinational enterprises to reduce their tax obligation, here is a brief overview of the most common practices.

Transfer Pricing

Transfer pricing is a term that is used to describe the price and other conditions attributed to a transaction between entities in a multinational group. From a BEPS perspective it is transfer mispricing that is the real issue. Transfer mispricing as you may well have guessed is the act of altering the value of a transaction between group entities to obtain a benefit.

Transfer pricing is a normal activity for multinational groups and is not itself an abusive practice. However, transfer mispricing is a popular strategy to reduce taxation within large multinational groups. In its simplest form transfer mispricing can be used to artificially inflate profits in a low tax jurisdiction and inflate losses in nations where the tax rate is high.

Hybrid Mismatches

Hybrid mismatch arrangements are a form of cross-border tax avoidance that exploit the differences in the way entities and financial institutions are treated in different nations. Generally these arrangements make use of the ability to deduct an expense in both jurisdictions, or to deduct an expense in one jurisdiction for which there is no corresponding receipt. These are referred to as double-deduction and deduction/non-inclusion mismatches respectively.

Permanent Establishment

Permanent establishment is a term used to describe situations when a business has a taxable presence in a nation. In general, tax treaties between countries specify that the profits of a foreign entity are only taxable if that entity has a permanent establishment in that country. A company may find it has a permanent establishment in a foreign nation if it (a) establishes a fixed place of business in the country in question, or (b) if it uses an agent to conclude contracts on its behalf in the country in question.

Businesses create permanent establishments as a normal part of operating multi-nationally, and the practice itself is not considered to be problematic. However, as is often the case, insufficiently robust regulation has provided opportunities for some businesses to avoid creating a permanent establishment in a foreign nation they operate in, and therefore avoid taxation on the profits generated there. Many of these arrangements make use of regulatory gaps surrounding the use of agents conducting business on behalf of the company, such as commissionaire agreements.

Tax Treaty Abuse

Despite the widespread adoption of anti-abuse laws globally, tax treaty abuse remains a significant BEPS issue. The most common form of treaty abuse

is tax treaty shopping. This practice involves the passing of income through entities/individuals that are based in a tax treaty jurisdiction to obtain a preferential tax rate.

Controlled Foreign Company (CFC) Rules

A controlled foreign company is an entity that is legally registered in a nation that is different from the residency of its controlling owners. In general, controlled foreign company rules are designed to prevent entities from shifting profits to foreign subsidiaries in low tax jurisdictions.

Interest Deductions

The mobility and interchangeability of money is a common thread within many tax avoidance strategies. BEPS Action 4 looks at payments that are legally distinct from, but economically equivalent to interest payments. Such payments are a popular tool for multinational enterprises to avoid restrictions on the deductibility of interest.

For enterprises that seek to generate deductions and therefore reduce taxation, the creation of intra-group loans is common practice. Other methodologies involve the use of third-party or intra-group financing to generate tax exempt income, and the use of high-tax jurisdictions to locate third-party debt.

The Multilateral Instrument

At the core of many of the BEPS issues are the discrepancies between different nations treatment of tax. The bilateral tax treaties that exist between nations, of which there are thousands, compound these issues. One of the more ambitious aspects of the BEPS Project is the development of a Multilateral Instrument that aims to swiftly and coherently implement the measures developed in the course of the BEPS Action Plan. The Multilateral Instrument sits alongside existing bilateral tax treaties and provides amending text that supersedes the original. This may not sound worthy of note in and of itself, however, consider the OECD estimate that there are over 3,000 bilateral tax treaties in place worldwide and the magnitude of the task of modifying all of these to meet and maintain a new standard.

Implementation

The BEPS Project is (at the time of writing) an ongoing process. Final reports for each of the 15 Actions were in place by the end of 2015. However, there are a number of areas outstanding, relating mostly to implementation standards, and the peer-reviewing of remaining draft elements. The implementation of the BEPS Action recommendations is starting to happen, with many of the G20 countries quick to apply elements of some of the earlier recommendations to domestic law. However, much of the BEPS Package relies on the development of the Multilateral Instrument, designed to replace the thousands of bilateral tax treaties that exist between BEPS Project partner countries. At the time of writing, the multilateral instrument has been published and is awaiting implementation in the mid part of 2017. The BEPS Action Plan uses a number of mechanisms to bring the standards and recommendations into law, including changes in domestic law, modifications to the OECD Model Tax Convention alongside the Multilateral Instrument.

A large number of the outputs of the BEPS actions are actioned through amendments to the OECD Model Tax Convention on Income and Capital, referred to hereafter as the Model Tax Convention. The Model Tax Convention provides the basis of over 3,000 bilateral tax treaties globally. These treaties make up a network of income and corporate tax systems that cover most of the globe. Analysis by the BEPS project has found a number of weaknesses in the Model Tax Convention, each of which is addressed throughout the BEPS actions, that are detailed in the following chapter.

The Model Tax Convention came into existence in the 1950s, and is now in its 14th version. The relevance of this statement is more than mere historical curiosity; it serves to highlight one of the principal issues that the BEPS project has attempted to address. Despite being the document upon which the majority of the worlds bilateral tax treaties are based, there is a surprising lack of uniformity in critical areas between these treaties. This lack of uniformity creates opportunities for tax avoidance. Tax treaties are complex documents, often negotiated and modified over the space of decades, with carve-outs and special dispensations added as and when necessary. It is not hard to understand then that consistent application of the Model Tax Convention is not something that has come easily, historically speaking.

The Multilateral Instrument is the tool that the OECD intends to use to rectify this issue. The instrument aims to swiftly and coherently apply changes made to the Model Tax Convention (and by extension the BEPS

specific changes). In doing so the OECD hopes to eliminate the discrepancies that occur in key aspects of tax treaties, creating a more robust global tax landscape. The Multilateral Instrument sits alongside the tax treaties that are already in place, overriding the relevant parts. This allows nations to quickly implement changes, without the need to undergo time consuming and costly renegotiations of their bilateral treaties. With over 3,000 such treaties in place, if the multilateral instrument is successful, it will represent a significant step forward in international tax legislation.

Reaction to the BEPS Action Plan

Commentary surrounding the BEPS Project is varied. The two biggest concerns raised by multinational enterprises relate to the possible need for their restructuring, as well as the increased reporting requirements. The OECD position on the former is that multinational enterprises should not have to restructure their businesses as long as their legal and tax structures reflect the underlying economic reality of the business itself. That is to say, businesses that operate in a jurisdiction for the sole purpose of the tax benefits may well face difficulties in the wake of the implementation of BEPS. Regarding the second issue, the new country-by-country reporting requirements will make larger companies, their tax and other financial information visible to a wider audience than it is at present, while increasing the compliance burden significantly.

The reality of the situation is that there are a considerable number of multinationals that will see a significant impact as a result of the implementation of the BEPS Project objectives. Companies that operate structures that take advantage of international tax loopholes will likely see an increased tax burden and therefore the threat of reduced profitability. The companies that operate the most aggressive strategies may find that the corporate and intergroup structures that are currently implemented do not produce desirable outcomes moving forward.

Smaller enterprises should be shielded from the impact of BEPS related legislation and this is the OECD stated goal. The application of de minimis thresholds, and annual revenue standards in a number of the Actions, should ring-fence SMEs from the direct impact of new legislation. As is often the case, it is indirect consequences that are harder to predict. Should the BEPS outcomes prove very effective at combating corporate tax avoidance we could see a widespread reshaping of the economies of some nations, and indeed this is the warning presented by some commentators on the subject.

This brings us to one of the biggest areas of concern surrounding the OECD/G20 BEPS project—uncertainty. A commonly held complaint of the Action final reports is that they are not very final. As you will see later in this section, some of the recommendations are more detailed and prescriptive than others, leading to the worry that interpretations may vary between jurisdictions, which may in turn lead to an increase in disputes. However, once fully implemented the reality may well be different from the negativity of the echo chamber that has arisen from certain sources, particularly those that offer professional solutions to these new “problems”.

BEPS Associate Countries (As of March 2017)

Andorra	Costa Rica	Iceland	Malaysia	Saudi Arabia
Angola	Côte d’Ivoire	India	Malta	Senegal
Argentina	Croatia	Indonesia	Mauritius	Seychelles
Australia	Curaçao	Ireland	Mexico	Sierra Leone
Austria	Czech Republic	Isle of Man	Monaco	Singapore
Belgium	Denmark	Israel	Netherlands	Slovak Republic
Benin	Democratic Republic of the Congo	Italy	New Zealand	Slovenia
Bermuda	Egypt	Jamaica	Nigeria	South Africa
Brazil	Estonia	Japan	Norway	Spain
British Virgin Islands	Finland	Jersey	Pakistan	Sri Lanka
Brunei Darussalam	France	Kazakhstan	Panama	Sweden
Bulgaria	Gabon	Kenya	Papua New Guinea	Switzerland
Burkina Faso	Georgia	Korea	Paraguay	Turks and Caicos Islands
Cameroon	Germany	Latvia	Peru	Turkey
Canada	Greece	Liberia	Poland	Ukraine
Chile	Guernsey	Liechtenstein	Portugal	United Kingdom
China (People’s Republic)	Haiti	Lithuania	Romania	United States
Columbia	Hong Kong	Luxembourg	Russia	Uruguay
Congo	Hungary	Macau	San Marino	

Andorra	Denmark	Kazahkstan	Portugal
Angola	Democratic Republic of the Congo	Kenya	Romania
Argentina	Egypt	Korea	Russia
Australia	Estonia	Latvia	San Marino
Austria	Finland	Liberia	Saudi Arabia
Belgium	France	Liechtenstein	Senegal
Benin	Gabon	Lithuania	Seychelles
Bermuda	Georgia	Luxembourg	Sierra Leone
Brazil	Germany	Macau	Singapore
British Virgin Islands	Greece	Malaysia	Slovak Republic
Brunei Darussalam	Gurnsey	Malta	Slovenia
Bulgaria	Haiti	Mauritius	South Africa
Burkina Faso	Hong Kong	Mexico	Spain
Cameroon	Hungary	Monaco	Sri Lanka
Canada	Iceland	Netherlands	Sweden
Chile	India	New Zealand	Switzerland
China	Indonesia	Nigeria	Turks and Caicos Islands
Columbia	Ireland	Norway	Turkey
Congo	Isle of Man	Pakistan	Ukraine
Costa Rica	Israel	Panama	United Kingdon
Côte d'Ivoire	Italy	Papua New Guinea	United States
Croatia	Jamaica	Paraguay	Uruguay
Curaçao	Japan	Peru	
Czech Republic	Jersey	Poland	

Fig. 15.1 List of BEPS associates

The countries that are now involved with the BEPS project are listed on the previous page and represent around 84% of the world's economy. Each

of the BEPS Associates have agreed to implement the BEPS minimum Standard, which comprises of four of the BEPS Actions (Fig. 15.1):

1. Action 5—Counter harmful tax practices
2. Action 6—Prevent treaty abuse
3. Action 13—Re-examine transfer pricing documentation
4. Action 14—Make dispute resolution mechanisms more effective

Further to the above, almost all of the countries listed have agreed to implement Action 15—The Multilateral Instrument, a mechanism designed to quickly and cohesively implement the changes made to the Model Tax Convention into law.

The minimum standard requirements hit to the core of 3 key types of tax avoidance strategies used by multinational enterprises: treaty shopping, preferential tax regimes and transfer pricing. The final standard is concerned with revision of the dispute resolution mechanisms provided in the Model Tax Convention.

16
BEPS Actions Part I

Action 1: Address the Tax Challenges of the Digital Economy

The information technology age has made the world a considerably smaller place. Connectivity rather than distribution often defines the market place, while products that were once bound by the necessity of physical presence can now also exist in the realm of the virtual. While the worlds of communication, information, banking, retail and media in particular have changed dramatically over the last 2 decades; regulation is rarely as quick to react to the influence of new technologies.

It is perhaps understandable that the slow moving nature of government does not lend itself to proactive governance, or indeed, all that effectively to reactive governance. When legislation is implemented in the midst of an emergent technology, it is often rushed and ineffective. When one watches a UK parliamentary debate on an information technology matter, it is instructive to picture those that implemented the UK Locomotives on Highways Act of 1865. The result of which being that automobiles were limited to 4 MPH in the countryside and 2 MPH in the city, as well as requiring a person carrying a red flag to walk ahead of the vehicle for safety reasons. Such regulations seem completely ridiculous when viewed through the lens of history, but at the time they represented a Government's best efforts to legislate for an emergent technology.

While individual governments have implemented their own 'red flag acts' to counter the tax challenges of the digital economy, the truly borderless nature

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of the virtual world presents both difficulty to regulators and opportunity to those that have the resources to exploit the fragmented nature of international tax legislation. The overriding purpose of the BEPS project is to present a framework for global tax legislation that provides financial opportunity and efficiency whilst simultaneously shutting down avenues for tax avoidance.

The digital economy, little more than a buzz phrase a few years ago, is increasingly intertwined with the traditional economy, making clear distinctions between the two more difficult and arguably less important. The OECD itself notes that while the challenges posed by the digital economy are not unique to BEPS, some of its aspects greatly influence important BEPS areas. Transfer Pricing schemes, Permanent Establishment and CFC issues are all to some extent facilitated or indeed exacerbated by ICT. With that in mind the outputs of Action 1 are interwoven with those of other BEPS Actions (3, 7, 8, 9 and 10) and cannot be viewed in isolation.

The BEPS Action Plan has identified a number of areas in which the digital economy creates difficulties and/or inconsistencies that existing international tax legislation may be ill prepared to deal with:

- A company may have developed a significant digital presence in the economy of another country without being liable to taxation;
- How should value be attributed to the generation of marketable, location-relevant data through the use of digital products and services?
- New business models, including digital businesses dealing only in intangibles have arisen. How should this income be characterised?
- How to ensure the effective collection of VAT/GST in the supply of cross border digital goods?

In addition to the above, the BEPS project acknowledges that the traditional tax paradigm, which generally analyses assets and risks is challenged in particular by ecommerce, app stores, online advertising and cloud computing.

The majority of the issues highlighted in Action 1 are addressed individually in other Actions (3, 7, 8, 9 and 10 in particular). However, the Final report on Action 1, published in October 2015 made a number of recommendations regarding:

- The artificial avoidance of permanent establishment (Action 7);
- Limiting offshore deferral or profit sharing via more robust CFC rules (Action 3);
- Increased scrutiny in situations in which transfer pricing is used to shift profits to low tax jurisdictions, (Action 8–10), and;

These points highlight the challenges posed in the taxation of stateless income, and are justifiably addressed individually. In addition, the Action 1 report makes several recommendations regarding the taxation of digital goods.

The treatment of digital goods from a tax perspective has historically been an area in which companies have found opportunity for favorable tax planning measures. The report highlighted two specific types of VAT/GST transactions through which BEPS concerns could arise. Firstly, the remote supply of digital goods and services to VAT exempt businesses, and secondly, the remote supply of digital goods to a centralized location for resupply within a multinational group that is not subject to VAT. The final report concludes that implementation of the OECDs VAT/GST guidelines will minimise tax planning opportunities in this area.

What Impact Will This Have on Affected Businesses?

Implementation of the material recommended in Action 1 is hard to discuss in isolation as the outputs are made with reference to and in conjunction with the other action points. These are discussed in more detail later in this chapter. However, it is possible to talk more generally about the potential impact on in scope businesses that is posed by the BEPS Project outputs.

Technologies are evolving faster than tax legislation. However, the BEPS project provides a regulatory framework that attempts to address many of these issues by providing recommendations that remove outdated concepts that are no longer relevant to the current climate.

One concept at the core of many of the BEPS outputs is the idea that tax frameworks need to be more flexible. As the advance of technology vastly outpaces the implementation of regulation, the way in which new rules are drafted must account for this. With respect to taxation of aspects of the digital economy, jurisdictions are already taking action individually and collectively through the implementation of the BEPS Actions. This represents significant alteration of the regulatory landscape, in particular with respect to digital products and other digital intangibles. The takeaway here is that businesses need to be prepared for the implementation of significant amounts of legislation in an area that up until now has been at best, lightly regulated. If tax regulation needs to be more flexible to meet the needs of a changing landscape then it follows that businesses too must become more flexible to meet the challenges posed by more widespread regulation.

To prepare fully for the changes brought by Action 1, businesses will need to assess and manage the digital elements of their supply chain from a tax perspective. Current models may be ineffective moving forward, and therefore the way in which digital elements are structured must be properly assessed. As jurisdictions gradually implement the OECD VAT/GST guidelines, businesses will need systematic flexibility to be able to cope. The other obvious knock on effect of this is that companies with significant activity in digital products will likely face a rise in their effective tax rate.

Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements

The BEPS Project identified Hybrid Mismatch Arrangement (HMAs) as a significant obstacle to competition, and the efficiency, transparency and fairness of markets. Mismatch arrangements are a prevalent tax avoidance strategy used by multinational enterprises to take advantage of cross-border tax rule differences to minimise their effective tax rate. The OECD argues that such arrangements result in significant erosion of the taxable bases of the countries concerned. As part of efforts to increase the coherence of international corporate income tax, the OECD has made recommendations regarding the redesign of domestic legislation, alongside modifications to the OECD Model Tax Treaty to address the threat posed by hybrid mismatches.

HMAs, otherwise known as Hybrid Mismatch Outcomes, are a form of cross-border tax avoidance that exploit the differences in tax-treatment of entities and financial instruments in different tax jurisdictions. Generally hybrid mismatches involve opportunities to deduct the same expense more than once, or deduct an expense without the corresponding receipt receiving proper taxation. These arrangements arise from hybrid financial institutions, hybrid entities and from arrangements involving the exploitation of Permanent Establishment rules (see Action 7).

The BEPS Action 2 report highlights a two-pronged approach to combatting the use of HMAs. By altering the tax treatment of either the deduction or the receipt, the OECD/G20 aims to negate the types of tax mismatches that are created with these arrangements.

The BEPS project has specified two sub-types of HMAs; deduction/non-inclusion mismatches and double-deduction mismatches. A deduction/non-inclusion mismatch occurs when a business specifies a tax deduction on a payment for which there is no corresponding taxable income for another

person or business. Whereas, double-deduction mismatches arise when two different taxpayers seek tax deductions for the same payment, or, when one taxpayer seeks deductions for two different taxes.

Many of the recommendations made in the Action 2 report are to be implemented through changes to domestic law of all participating countries. The heart of the recommended legislation specifies a primary rule (designed to deny a tax deduction) and a defensive rule, which is to apply in circumstances where the primary rule does not apply (e.g. there is no HMA rule in the counterparty jurisdiction). The defensive rule varies depending on the type of mismatch involved. In the case of deduction/non-inclusion mismatches, the defensive rule states that should the payer jurisdiction fail to neutralise the mismatch, the payee jurisdiction must include that payment as ordinary income. In the case of double-deduction mismatches the defensive rule requires the payer jurisdiction to deny the deduction if the parent jurisdiction does not neutralise the mismatch.

What Impact Will This Have on Affected Businesses?

As the Action 2 report outcomes largely focus on domestic measures, Businesses that operate multinationally will need to closely monitor legislation and guidance from relevant national tax authorities. In response to the arrival of domestic regulations, multinationals will need to review transactional structures, especially in reference to those that are designed to obtain tax efficiencies. Companies that find themselves to be adversely impacted by new regulation may need to assess whether to reorganise or eliminate hybrid elements entirely.

At the time of writing, few tax authorities have issued official guidance on BEPS Action 2. HMRC (The UK tax authority), being one of the first to do so, has invited commentary on its draft guidance. That said, there are suggestions within the industry that many countries will now move quickly in the hope of securing their share of the taxable income available in hybrid mismatches between territories, and in the process securing their own tax bases.

With little in the way of concrete legislation in place from domestic tax authorities it is difficult to assess the best course of action in the short term for in scope businesses. Furthermore, long term planning for multinationals that employ hybrid structures may be all but impossible. However, busi-

nesses that operate structures that involve arrangements including hybrid financial instruments, disregarded payments, and import mismatch arrangements in particular should pay close attention to the specific implications of new HMA rules. If rules are implemented effectively and in a harmonised fashion, it is possible that hybrid mismatches will fall out of favour with tax planning accountants.

Ultimately, if the BEPS project succeeds in halting, or severely limiting the use of HMAs, we are likely to see a shift in the behavior of multinational groups. However, as the old saying goes, when one door closes, another opens. In shutting down HMAs, motivated businesses and opportunistic tax authorities will likely find another avenue for tax efficiency.

Action 3: Strengthen Controlled Foreign Company (CFC) Rules

A Controlled Foreign Company (CFC) is an entity that is legally registered and conducts business in a tax jurisdiction that is different from the residency of the controlling owners. Many jurisdictions already implement some form of CFC rules, however, as with other aspects of international taxation, the lack of a unified approach leads to gaps and mismatches that give rise to BEPS opportunities.

The aim of CFC rules in general is to prevent the avoidance of tax through shifting of profits to low tax foreign subsidiaries. The BEPS project stated aim is to encourage territories to adopt CFC rules, and for those with CFC rules already in place, to bring them in line with the new OECD standard.

The OECD itself has not conducted significant work with respect to CFC rules in the past, however the new rules represent an approach towards a harmonised standard, which is consistent with the wider goals of the BEPS Action Plan. The final report sets out a series of 6 recommendations that nations may choose to implement to prevent companies from shifting income into foreign subsidiaries. The recommended CFC rules form the following six building blocks:

1. **Definition of a CFC**
   The final report makes two recommendations regarding defining a CFC, first a broad definition that will apply to corporations, transparent entities and permanent establishments, and second, the application of both legal and economic control tests.

2. **CFC exemptions and threshold requirements**
   The Action 3 final report sets out that CFC rules should only apply after the application of provisions such as de-minimis thresholds, and tax rate exemptions. Furthermore, such rules should only apply to CFCs that are subject to meaningfully lower effective tax rates than those in their parent jurisdiction.
3. **Definition of income**
   The final report recommends that CFC rules only apply to certain types of income, and sets out a non-exhaustive list of approaches that CFC rules could use for such a definition.
4. **Computation of income**
   CFC rules should use the rules of the parent jurisdiction to compute the CFC income that is attributed to shareholders. Furthermore, the report recommends that CFC losses should only be offset against the profits of the same CFC.
5. **Attribution of income**
   Rules should ensure that when possible, the attribution threshold should be linked with the control threshold and that income attributed should be calculated with reference to proportionate influence or ownership.
6. **Prevention and elimination of double taxation**
   The issue of prevention of double taxation is a key one to many of the BEPS outputs. The Action 3 report recommends several approaches to ensure that double taxation is prevented, for example by allowing a credit for foreign taxes actually paid, including intermediate parent companies under a CFC regime.

The report recognises that nations have differing policy objectives and have designed the recommendations to have some flexibility in the implementation of CFC rules. A number of territories have already updated their CFC legislations to reflect the Action 3 recommendations. Furthermore, EU member states are required to implement CFC rules as part of the Anti Tax Avoidance Directive (ATAD) by the end of 2018.

What Impact Will This Have on Affected Businesses?

While the outputs of Action 3 are not part of the minimum-standard package, a number of nations have acted quickly to implement or modify CFC rules in line with the OECD recommendations. As is the case with many of

the BEPS outputs, businesses that operate CFC regimes will need to monitor the implementation of new CFC regulation in both their home jurisdiction and any other nations in which they operate. For companies operating CFC regimes in the EU, the picture is a little clearer, with implementation of the ATAD by the end of 2018.

Whatever uncertainty remains, the course of action is broadly similar for businesses that are likely to be impacted by strengthened CFC rules. In scope multinationals should conduct a through impact analysis to identify the best course of action moving forward. Those that operate some types of CFC regimes will find that these strategies will be rendered less, or totally ineffective. Many will find that operating CFC regimes no longer provides a realistic economic benefit, and as such, will have to revise structures to accommodate this new reality.

Action 4: Limit Base Erosion via Interest Deductions and Other Financial Payments

It is no secret that multinational groups make use of the mobility and interchangeability of money to achieve tax efficiencies. Disparity between jurisdictional rules on the location of debt, alongside variances in taxation rates have fostered an environment in which multinational groups are able to multiply the level of debt at group entities via intra-group financing. Furthermore, financial payments that are legally distinct from, but are economically equivalent to interest are popular tools to circumvent restrictions on the deductibility of interest.

BEPS Action 4 seeks to address base erosion issues that arise in three basic scenarios:

- The use of high tax jurisdictions to locate third party debt.
- Using intra-group loans to generate interest deductions in excess of the group's actual third party interest expense.
- The use of third part or intra-group financing to fund the generation of tax exempt income.

The recommended approach specified in the Action 4 Final Report involves the implementation of a fixed ratio rule. This will limit an entity's deductions for interest (and interest like payments) to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA). The report

states that this should apply to entities in multinational groups as a minimum standard, with ratios ranging between 10 and 30%. Furthermore a group ratio rule has been recommended that is based on the external net interest to EBITDA ratio for the worldwide group.

In addition to the recommended approach, the report suggests the following elements that a country may implement to achieve more robust base erosion protections:

- A de minimis threshold, to reduce impact on entities with a low level of net interest expense.
- An exclusion for interest on loans used to fund some public-benefit projects.
- The carry forward of disallowed interest expense and/or unused capacity for use in future years.
- Targeted anti-abuse rules to prevent circumvention.

What Impact Will This Have on Affected Businesses?

As the OECD report contains a number of optional elements, implementation of the Action 4 recommendations is unlikely to be uniformly applied across jurisdictions. However, of the governments that have published draft or final legislation, many have opted to include most or all of the recommendations. With this in mind, impacted businesses in jurisdictions that have not already adopted any legislation in this area would be wise to assume a "worst case scenario" approach to planning.

At the time of writing few governments have fully advised their position on BEPS Action 4 implementation, with even fewer having actual legislation in place. As with several other BEPS actions the UK has been one of the first to publish both draft and final legislation, with the rules coming into force on April 1st 2017. The UK have elected to implement a 30% fixed ratio and a £2m de minimis threshold. While it is by no means set in stone, there is speculation that implementation of the BEPS Action 4 recommendations in other territories may take a more hardline approach.

What is immediately clear is that these rules are likely to impact the use of tax relief for interest expenses. This is likely to lead to an increased effective tax rate for groups that currently employ operational structures that make use of intra-group loans and other activities to capitalise on interest deductions. The scale of this impact for many will be determined by the value of

the fixed ratio as it is applied by the relevant jurisdiction. Ultimately groups will have a strong incentive to ensure that the allocation of debt amongst group entities relates to where profits are generated.

Action 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

The OECD has a considerable body of published work on the subject of harmful tax practices. BEPS Action 5 seeks to revamp the work set out in 'Harmful Tax Competition: An Emerging Global Issue' (1998) alongside its Forum on Harmful Tax Practices (FHTP). The concerns outlined in the 1998 report relating to the use of preferential tax regimes for artificial profit shifting are perhaps even more relevant today, with the tax practices of multinational businesses occupying significant front page real estate. The Action 5 outputs therefore are focused upon the FHTP, rather than towards national tax authorities, or governments as in the other BEPS Actions.

It is no secret that globalisation, alongside technical advances, has presented many opportunities to use the mobile nature of financial activities and intangible assets to obtain a geographic tax advantage. The OECD stance is that such practices unfairly erode the tax bases of other countries, shifting the tax burden towards less mobile tax bases, such as labour, property and consumption. The Action 5 recommendations seek to address these issues by reducing the distortionary influence of taxation on the location of mobile financial and service activities. The lofty goal of which is to promote free and fair tax competition, whist enhancing the ability of countries to react to the harmful tax practices of others.

In Action 5, the OECD has tasked the FHTP to expand its work relating to harmful tax practices, paying particular interest to preferential tax regimes within the context of BEPS. The focus of this work relates to regimes that apply to income from geographically mobile activities such as financial and other service activities as well as the provision of intangibles. Other preferential regimes, such as those designed to bring investment in plant, equipment and buildings are out of scope.

In the context of BEPS a preferential tax regime is considered to offer some form of tax preference compared to the general tax rules of the relevant country, such as reduced tax rates or preferential repayment terms. The work of the FHTP has established the following criteria to determine whether a preferential regime is considered to be a harmful tax practice:

1. The regime imposes no/nominal taxes on geographically mobile activities.
2. There is a lack of effective exchange of information.
3. There is a lack of transparency in the operation of the legislative, legal or administrative provisions.
4. No Substantial Activities. There is an absence of a requirement that activity be substantial, suggesting that the jurisdiction may be attempting to attract transactions that are tax driven.

A regime that has been determined to be potentially harmful using the factors outlined above will be determined to be actually harmful by analysing whether the regime has harmful economic effects. If a regime is found to be harmful the nation in question may either abolish the regime or modify it so that the features that create the harmful effect are removed.

Substantial activities (or lack therof) were considered to be of lesser importance in the determination of whether a regime was preferential in the 1998 report. However Action 5 has elevated the status of this aspect, and it now features in the 4 principal factors outlined above. The Final Report recommends that substantial activity is to be determined using a "nexus approach" which makes use of expenditure as a proxy for activity. Essentially, a regime may only grant preferential benefits to the extent that the taxpayer undertook the income generating activities that were required to produce the income accounted for by the preferential regime.

Another aspect of Action 5 will require information on tax rulings to be spontaneously exchanged with other national tax authorities. 6 categories of rulings are to be exchanged:

1. Preferential regimes.
2. Unilateral advanced pricing agreements or other cross-border transfer pricing rulings.
3. Cross-border rulings that provide for a unilateral downward adjustment of taxable profits that are not directly reflected in the taxpayer's accounts.
4. Permanent Establishment rulings.
5. Related party conduit rulings.
6. Any other type of ruling agreed by the FHTP that in the absence of information exchange would give rise to BEPS concerns.

Preferential regimes that relate to intangibles, and particularly intellectual property (IP) regimes are singled out specifically by Action 5. Under the nexus approach tax benefits will only be granted in cases where income from IP arises where actual research and development was undertaken by the tax-

payer themselves. Therefore, expenditures for R&D activities undertaken by related parties are not qualifying IP expenditures.

The nexus approach goes further to close off what are considered to be abusive uses of IP regimes. Under the nexus approach, only patents and other assets that are functionally equivalent will qualify for tax benefits. This is intended to close off the widely used loophole in which group members are able to use licensed trademarks and other marketing IP to obtain tax benefits.

What Impact Will This Have on Affected Businesses?

While the OECD has been working in the area of preferential tax regimes for many years, it is the new focus on substantial activity that will likely see a significant change in behavior. This change in focus will result in more regimes being considered to be harmful and thus outlawed or amended.

With the changes to IP regimes seemingly closing off a number of widely used avenues for tax avoidance by multinational enterprises, the impacts of BEPS Action 5 will likely be widespread. As a result of these changes, IP regimes will need to be amended to meet the needs of the nexus approach, otherwise they may be considered harmful going forward. The upshot of this is that businesses that employ strategies that involve the transfer of IP and other preferential tax regimes to obtain tax benefits may well no longer see economic justification for such activities. Furthermore, the agreed nexus approach takes expenditure into account as a proxy for economic activity. Thus in scope businesses will need to track expenditures to be able to demonstrate the nexus between their expenditures and income to tax administrations.

Action 6: Prevent Treaty Abuse

Tax treaty shopping and other forms of treaty abuse remain a significant BEPS issue, despite widespread implementation of domestic anti-abuse laws. While generally designed to eliminate the burden of double taxation, tax treaties can themselves lead to double non-taxation. To combat the threat to tax bases posed by treaty shopping, limitation on benefits clauses/articles have become significantly more widespread in bilateral tax treaties.

Treaty shopping usually involves the passing of income through entities or individuals that are based in a treaty jurisdiction—thereby obtaining a pref-

erential tax rate that would not otherwise be available. Historically, many countries have encouraged the use of their jurisdiction for treaty shopping, hoping to encourage the presence of multinational companies—sacrificing tax revenue for wider political, social and economic goals. However, this position is becoming significantly more unpopular under the pressure of increased public scrutiny into the tax affairs of nations. Willfully encouraging entities to erode the tax base of a home jurisdiction is becoming a more difficult point to argue politically.

The Action 6 reports have focused on the development and modification of model treaty provision alongside recommendations relating to the design of domestic rules to prevent the granting of inappropriate treaty benefits. Furthermore, the report has established further guidance regarding the purpose and nature tax treaties.

In addition to a clear statement that tax treaties should not be intended to generate double non-taxation, the Action 6 final report contains two approaches to remediate the treaty shopping issue. The first recommendation involves limitation-on-benefits (LOB) rules based on simplified version of the US model. The second is the so called 'principal purpose test' (PPT), a more general anti-abuse rule that is designed to deny benefits to transactions that exist for the principal purpose of obtaining treaty benefits.

Tax treaties between OECD members follow the guidance of the OECD Model Tax Convention. Action 6 modifies the Model Tax Treaty to clarify that the purpose of a tax treaty should not be to generate double non-taxations. The new wording expressly states that jurisdictions that enter into a tax treaty should "intend to eliminate double taxation without creating opportunities for tax evasion and avoidance".

The limitation-on-benefits rule is designed to limit the availability of treaty benefits to entities that meet certain conditions of the Model Tax Convention. The conditions are based on the legal nature, ownership and activities of the business, and seek to ensure that there is a sufficient link between the entity and the state in which it is claiming residence.

The Principal Purpose Test referenced earlier will also be implemented in the modified Model Tax Convention. The test will determine whether the principal purpose of a transaction or arrangement is to obtain tax treaty benefits. The PPT will deny benefits to those that fail, unless it is established that those benefits would be in accordance with the object and purpose of the treaty.

Countries that have committed to the BEPS Project are expected to implement the minimum standard level of protection against treaty shop-

ping outlined in the Action 6 Final Report. This will require the inclusion of an expressed statement in all tax treaties that the purpose of the treaty is to eliminate double taxation without creating opportunities for non-taxation, or reduced taxation through avoidance or evasion. In addition countries must implement:

1. The combined approach of LOB and PPT rules; or
2. The PPT rule alone
3. The LOB rule alongside a mechanism that will eliminate conduit-financing arrangements.

What Impact Will This Have on Affected Businesses?

All of the BEPS associates are required to implement the minimum standard measures of Action 6. However, at this stage it is unclear when full implementation of the OECD recommendations will occur, as many jurisdictions are awaiting implementation of the multilateral instrument (see Action 15). With the preceding sentences in mind, it is difficult to make firm predictions regarding the effect BEPS Action 6 will have on businesses.

Jurisdictions that have signed up to the BEPS Project will have to ensure that tax treaties implement safeguards to prevent treaty abuse and treaty shopping. The timing of these rules coming into effect is not totally clear due to the nexus with the multilateral instrument (more on this in the next chapter). The multilateral instrument will see implementation throughout the latter half of 2017, after which we should see nations quickly implementing the minimum standard BEPS measures.

Multinational businesses that make use of structures that gain tax efficiencies through the use of treaty benefits should pay close attention to the implementation of these rules at a domestic level. Those that have implemented structures with the sole purpose of gaining treaty benefits to which they would not normally be entitled will likely find that new anti-abuse rules remove the advantages of those structures. From a practical perspective, companies that engage in this type of activity should prioritise the performance of an impact analysis—the rise in effective tax rate that will likely follow these changes may well outweigh the benefits of current operational structures.

Action 7: Prevent the Artificial Avoidance of Permanent Establishment (PE) Status

Though the concept of permanent establishment (PE) predates the OECD Model Tax Convention, it is fair to suggest that it is this document that has proliferated it's use through countless tax treaties. With the concept of PE being so central in the determination of cross border taxation, it is perhaps unsurprising that it has become an area of concern from a base erosion perspective.

The Model Tax Convention established the definition of PE that is embedded by OECD members in their bilateral tax treaties. However, the BEPS Project has identified that the current definition of PE is insufficient, giving rise to the avoidance of PE status and therefore taxation.

In general, tax treaties establish that the profits of a foreign entity are only taxable in a State if that entity has a permanent establishment in that State. Under the current Model Tax Convention, PE can arise in one of two ways:

1. Where a non-resident establishes a fixed place business.
2. Where a non-resident has an agent concluding contracts on its behalf.

While it is the latter of the two situations that has created significant scope for entities to artificially avoid creating a permanent establishment, the former definition is unsuitable in a world where an increasing number products and services are becoming virtual in nature. Although determining what constitutes a permanent establishment sounds relatively simple in theory, in practice it represents a significant grey area, open to both intentional exploitation and accidental non-compliance.

Action 7 aims to tackle common tax avoidance strategies that are used to side step the current definition of PE, usually achieved thorough agency (commissionaire) arrangements and similar strategies. The outputs from Action 7 are focused on amendments to the OECD Model Tax Convention.

Commission arrangements can broadly be described as a situation in which a person sells a product in a jurisdiction in its own name on behalf of a foreign enterprise that is the owner of the product. This type of arrangement allows an entity to avoid a permanent establishment in that jurisdiction, and therefore avoid any related liability for taxation. As the seller of the products does not itself own them, it is not liable for taxation on profits derived from the sale itself, only on any commission generated. The updated definition in Article 5 of the Model Tax Convention now specifies that a

company shall be deemed to have a permanent establishment if an agent acting on their behalf "habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise". Furthermore the definition of independent and dependent agents has been tightened to reflect the aims of Action 7.

Article 5 of the Model Tax Convention contains a number of exceptions to the definition of PE. These exceptions generally covered activities that would be considered to be of preparatory or auxiliary nature. However, in the intervening years the way business is conducted has seen considerable changes. Activities, which once would have been deemed as preparatory or auxiliary in nature, may now represent core business activities. These issues are significantly exacerbated by the almost exponential development rate of the digital economy. For example, the wording of these exceptions gave opportunity to avoid creating a PE for those selling digital products. To close down this loophole, the wording of the exceptions clauses in Article 5 has been tightened. In addition anti-fragmentation rules will be implemented to prevent an entity from appearing as several smaller entities to make use of the "preparatory or auxiliary" exception.

As is the case with many of the BEPS actions, implementation is currently an ongoing project. At the time of writing, only Australia has final legislation in place, having taken unilateral action on PE issues through its Multinational Anti-Avoidance Law (MAAL). Most other nations are awaiting the implementation of the multilateral instrument (Action 15).

What Impact Will This Have on Affected Businesses?

The changes to PE status will have an effect on many businesses that operate internationally. Moving forward, many businesses may find that their current operating models could result in the creation of new permanent establishments. The direct and immediate impact of this is an increased compliance burden and therefore cost. Businesses that operate these models to obtain tax efficiencies may also see an increase in their effective tax rate. In addition, as is the case with many of the action outputs that require modifications to tax treaties, there is an increased risk of disputes and the inherent risk of double taxation.

Businesses that operate internationally should evaluate how the changes to the Model Tax Convention may impact their current operational struc-

tures. How much of an impact these changes may have will depend on two factors. Firstly, the extent to which relevant jurisdictions implements the new rules, and secondly, whether current business structures will actually fall under the redefined PE definition. In the short term it is imperative for businesses that feel they are in scope to monitor the implementation of the Action 7 outcomes in countries in which they operate or invest.

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BEPS Actions Part II

Action 8, 9 & 10: Assure that Transfer Pricing Outcomes Are in Line with Value Creation—Intangibles, Risks and Capital & Other High Risk Transactions

Transfer pricing rules are used to determine the conditions (including the price) for transactions within a multinational enterprise group that result in the allocation of profits to group companies in different countries. For example, when a UK subsidiary of Company X buys something from a French subsidiary of Company X, the price that is determined by the parties to the transaction is the transfer price. Transfer pricing is a normal aspect of multinational groups and is not, in and of it self, illegal or abusive. However, the act of transfer mispricing, which seeks to minimise tax expense by artificially manipulating the price of a trade is considered to be an aggressive tax evasion strategy.

Opinions vary as to how much of a factor transfer pricing is on tax base erosion. However, the volume of trade that occurs within multinational groups is now significantly higher than that which occurs between unrelated companies—the scope for potential lost tax revenues is enormous.

Traditional approaches to transfer mispricing involve artificially reducing the cost of an item in one transaction and inflating it in another. Take a look at the following example. GlobalWidgets is a multinational enterprise that has 3 group members, one in Asia, one in a tax haven jurisdic-

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Ross K. McGill et al., *G.A.T.C.A.*, Global Financial Markets,
DOI 10.1007/978-3-319-61783-1_17

Fig. 17.1 Simple Transfer Pricing in BEPS

tion and one in the US. GlobalWidgets is able to use their group member in the tax haven country as an intermediary to artificially reduce their tax bill by modifying the prices of transactions. When a widget is manufactured at GlobalWidgets Asia it is sold on to the tax haven branch at almost cost price, ensuring that the Asian branch records very low profits, and therefore low tax liability. The tax haven country then sells the widgets to GlobalWidgets USA at almost retail price, ensuring that GlobalWidgets Tax Haven records very high profits, but escapes taxation, as they are in a tax haven. The high cost of the widget means that the US branch makes a very small profit margin, again ensuring they bear very little tax liability (Fig. 17.1).

In the above example, through the manipulation of pricing between group entities GlobalWidgets was able to minimise its tax bill in the two high tax nations and record all of their profits in the low/no tax country. While this is a simplified example, it is broadly representative of the types of arrangement that are employed by many of the worlds largest multinational companies. This type of arrangement has gained significant press coverage over the past few years with a number of prominent US multinationals in particular receiving significant media (and therefore public) scrutiny of their business structures. While transfer mispricing is occurring globally, and on a reportedly massive scale, there are already regulations in place that are designed to stop abusive transfer pricing models.

The most common legal approach to neutralize transfer mispricing is referred to as the “arm’s length” principal. This states that the price of a transfer between group members should be the same as the price would be if two unrelated parties were participating in the transaction. In theory this principle ensures that tax is paid on transactions in a manner consistent with domestic companies. While many companies do in fact work to ensure that

their structures use the arm's length principal as a basis for transfer pricing, there are also many that use it as an opportunity to avoid taxation.

As referenced previously, the arm's length principal looks good on paper, however, its practical application has limitations. In a growing globalised economy, where intangibles such as a company's brand or logo reflect significant real world value, it may be all but impossible to quantify fair market value for such transactions. Furthermore, the waters become quite muddied when dealing with the value of information, such as patents, trademarks and other intellectual property. It is in the realm of intangible assets in particular that the scope for transfer mispricing has been tremendous. BEPS Action 8 specifically looks into the creation of rules to ensure that transfer pricing of intangibles is in line with value creation.

It is not just the transfer pricing of intangibles that the BEPS Project has concerned itself with. Actions 9 and 10 focus on risks and capital, and high risk transactions respectively. The former relates to the allocation of profits to risk and how returns to funding may not reflect activity undertaken by the company. The latter looks at other high risk areas, including profit allocation resulting from non-commercially rational transactions (recharacterisation), transfer pricing methods that divert profits from the most economically important activities of the multinational group, and high risk payments between group members (such as management fees and head office expenses).

The OECDs aim with Actions 8–10 is to ensure that transfer pricing rules secure outcomes that see operational profits allocated to the economic activities that generate them. The mechanism through which this is to be administered is through modifications to the OECD's "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", hereafter referred to as "Transfer Pricing Guidelines" (TPG). These guidelines, alongside the Model Tax Convention established the concept of the arm's length principal, and form the cornerstone of the transfer pricing rules for a significant proportion of bilateral tax treaties globally.

A perceived weakness of the current Transfer Pricing Guidelines is an over reliance on the contractual allocation of functions, assets and risk. This has been found to be vulnerable to manipulation. The revised guidelines occupy the better part of 180 pages and granular analysis of the outcomes is impossible in the space we have available here. With that in mind, the following represents a brief overview of the most important aspects of the Action 8–10 Final Reports.

Delineation of Transactions

The revised transfer pricing guidelines introduce the concept of "accurate delineation of a transaction", or assessing how the behavior of the parties to a transaction relates to any contractual terms. Essentially this ensures that any transfer pricing analysis is performed on the basis of what is happening in reality, rather than the terms set out in a contractual arrangement. The process for accurately delineating a transaction is a 5-step review process of:

1. The transactions contractual terms
2. The functions, assets and risks of each party
3. The characteristics of the property transferred or service provided
4. The economic circumstances of the parties and market in which the parties operate
5. The business strategies pursued by the parties.

The information that is generated by this process is expected to be documented.

The guidance provides a new six-step process to allow for the delineation of a transaction in relation to risk:

1. Identify economically significant risks
2. Determine how these risks are contractually assumed by the associated enterprises
3. Determine through a functional analysis how the parties to the transaction operate in relation to the assumption and management of economically significant risks. In particular, determine which party encountered upside or downside consequences of risk outcomes, and which parties have the financial capacity to assume the risk
4. Interpret the information in 1–3 and determine whether the contractual assumption of risk is consistent with the conduct of the associated parties and other facts of the case by analysing:
   (a) Did the associated parties follow the contractual terms
   (b) Did the party assuming risk have the financial capacity to assume the risk
5. When the party assuming risk does not control the risk or does not have financial capacity to assume the risk, apply the guidance on allocating risk; and

6. The actual transaction, as accurately delineated by considering the evidence of all the economically relevant characteristics of the transactions, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions.

Intangibles

In broad terms, the definition of intangibles for the purposes of Transfer Pricing will now include all intellectual property. The new guidelines define an intangible as something that:

1. Is not a physical asset or financial asset;
2. Is capable of being owned or controlled for use in commercial activities; and
3. Whose use or transfer would be compensated had the transaction been between independent parties in comparable circumstances.

The new guidance focuses on the principle that when determining the value of an intangible for transfer pricing purposes that determination should reflect what would be agreed upon between unrelated parties in comparable circumstances. Entitlement to returns from the use of intangibles belongs to entities that develop, enhance, maintain, assume the risk etc. for the intangible, rather than those that legally own it. Further guidelines have been implemented for hard to value intangibles.

Risks

The assumption of risk by a party to a transaction can have a significant impact on the use of the arm's length principle. The revised guidelines ensure that transfer pricing is not based on contractual payments that do not reflect economic reality, that allocations of risk are represented only when they are supported by actual decision-making.

The above represents a tip of the iceberg view of the modifications to the transfer pricing guidelines. The breadth and detail needed to sufficiently describe the ins and outs of the document would require a book to itself.

With this in mind it is best to move on to consider the practical implications of the new transfer pricing guidelines.

What Impact Will This Have on Affected Businesses?

The core concept at the heart of the new transfer pricing guidelines is to bring transfer pricing outcomes in line with value creation. If the measures outlined in Actions 8, 9 and 10 are implemented broadly, and early indication suggests that this will likely be the case, then we will likely see a significant change in the way transfer pricing is used by multinational enterprises, particularly with respect to intra-group transactions.

The use of transfer pricing as part of wider tax planning measures is widespread amongst multinational enterprises and as such the new transfer pricing guidelines will likely have far reaching consequences for companies that are not adequately prepared. Impacted businesses will need to review their current transfer pricing methodologies with a view to both ongoing compliance and the economic viability of such activities in the future. Moreover, paying close attention to the announcement and implementation of new transfer pricing measures by relevant national tax authorities is of critical importance.

As is the case with several of the other BEPS outputs, there are likely to be a number of different interpretations of the OECD recommendations on transfer pricing, and impacted businesses will need to prepare for such eventualities. This will require the allocation of adequate resource to analyse the impact of new measures and to make any necessary adjustments. Transfer pricing is a fundamental part of doing business within multinational groups, and transfer mispricing is a common route towards tax efficiency. Therefore, we would expect to see a great many companies that will need to implement changes as the new transfer pricing guidelines come into force. As is usually the case, businesses that plan early and commit adequate focus and resources will find the process less painful than those that drag their feet.

The key takeaway from the introduction of new transfer pricing guidelines is that impacted multinationals need to critically assess how they approach financing arrangements and other payments within their group structures. Transfer mispricing is currently a fundamental component of the tax planning measures of many multinational groups, and the impact of the new transfer pricing guidelines could be severe for many.

Action 11: Establish Methodologies to Collect and Analyse BEPS Data and Actions to Address Said Data

Action 11 is unique amongst the BEPS Actions in that it does not contain any proposals, standards or recommendations for changes to international tax rules. Instead, the work of this area is focused upon measuring the size, extent and impact of BEPS activities as well as identifying indicators of BEPS methodologies.

The work of Action 11 is greatly intertwined with the reporting and disclosure requirements specified in Actions 5 (harmful tax practices), 12 (mandatory disclosure) and 13 (transfer pricing documentation and country-by-country reporting). By increasing cooperation between the OECD and national tax authorities, and by the collecting and sharing of data it is hoped that BEPS methodologies can be identified and neutralise more quickly. By their nature, BEPS activities fly under the radar, using complex methodologies to avoid disclosure, reporting and transparency measures. It follows then that identifying BEPS strategies is a significant challenge—Action 11 seeks to aid in this by providing methodologies to identify, quantify and assess BEPS.

An issue that is referred to at many points throughout the BEPS Action plan documentation is that the scale and quality of available data has made it challenging to truly asses the extent of BEPS and the related impacts. Action 11 seeks to both quantify the impact and scale of BEPS and to provide guidance for improving the measurement of BEPS going forward.

The Action 11 final report specifies activities that are indicators of BEPS:

1. The profit rates of multinationals in low tax countries compared to those in high tax counties.
2. Differential profit rate compared to effective tax rate.
3. The effective tax rates of multinational enterprises when compared to domestic-only operations.
4. The concentration of Foreign Direct Investment (FDI) vs GDP.
5. The separation of intangibles from the location of their production.
6. Debt from related and third parties is concentrated in high tax jurisdictions.

Further to discussion surrounding how best to measure BEPS and the related impacts, the Action 11 report provides evidence of the tax planning

methodologies engaged in by multinational enterprises, based on what is considered to be the best available data. The report contains a comprehensive empirical analysis of the issues surrounding BEPS and the effectiveness of previously deployed BEPS countermeasures. This is perhaps not of interest to companies that are impacted by BEPS, but serves as a useful reference point for economic impact analysis and other areas of academic research. Furthermore, the analysis provides a backdrop and intellectual justification to the rest of the BEPS actions.

The final report also offers six recommendations to improve data and analytical processes to understand BEPS and better prepare BEPS countermeasures:

1. The OECD should work with all OECD members and BEPS Associates (including all G20 countries) and any country willing to participate to publish, on a regular basis, a new Corporate Tax Statistics publication, which would compile a range of data and statistical analyses relevant to the economic analysis of BEPS in an internationally consistent format. Among other information, this publication would include aggregated and anonymised statistical analyses prepared by governments based on the data collected under the Action 13 Country-by-Country Reports.
2. The OECD should work with all OECD members, BEPS Associates and any willing participating governments to produce periodic reports on the estimated revenue impacts of proposed and enacted BEPS countermeasures.
3. The OECD should continue to produce and refine analytical tools and BEPS Indicators to monitor the scale and economic impact of BEPS and to evaluate the effectiveness and economic impact of BEPS countermeasures.
4. Governments should improve the public reporting of business tax revenue statistics, particularly for MNEs.
5. Governments should continue to make improvements in non-tax data relevant to BEPS with wider country coverage, such as for FDI associated with resident SPEs, trade in services and intangible investments.
6. Governments should consider current best practices and explore new approaches to collaborating on BEPS research with academics and other researchers. Governments should encourage more research on MNE activity within tax administrations, tax policy offices, national statistical offices (NSO), and by academic researchers, to improve the understanding of BEPS, and to better separate BEPS from real economic effects and non-BEPS tax preferences.

What Impact Will This Have on Affected Businesses?

As Action 11 has no outputs there is no direct impact on businesses that are considered in-scope within the BEPS Action Plan. However, the final report goes to great lengths to assess that scale of the problem, empirically and academically framing the issue of tax avoidance strategies used by multinational enterprises. The takeaway here is that the OECD is deeply committed to the BEPS issue and into the effectiveness of BEPS countermeasures. Action 11 (and the related parts of Actions 5,12 and 13) provides a new toolkit for governments, tax authorities economists and other academics to analyse BEPS strategies. The work conducted in action 11 can be viewed as an effort to improve both the data the OECD collects, and the measures developed to counteract BEPS.

When Action 11 is viewed alongside the ever-increasing public interest in the tax affairs of multinationals, it is possible to infer that the OECD is looking to the future and any further measures it may need to develop to neutralise BEPS risks. This is an opportunity for businesses to review structures that are in scope for the current BEPS Project and those that may be considered to be just outside the remit (for now). Long-term strategy should take into account the possibility that the goalposts may once again be moved.

Action 12: Require Taxpayers to Disclose Their Aggressive Tax Planning Arrangements

One of the biggest challenges that tax authorities face in the sphere of cross-border tax planning is access to comprehensive and timely information about such strategies. At the risk of repeating myself, legislation is more often than not a reactive process, it follows therefore that the quicker an authority can identify and understand a problem, the quicker they can propose a solution. Early access to relevant information is the remit of Action 12, with the outputs promising to provide tools designed to increase the information flow on tax risks to authorities and policy makers.

The BEPS Action Plan called for recommendations regarding the design of mandatory disclosure rules for aggressive and abusive transactions or

structures. These recommendations were to take into account the administrative costs for both tax authorities and businesses while adopting a modular approach that would cater for individual jurisdictions needs and specific risks. Furthermore, such rules would allow jurisdictions that do not have mandatory disclosure rules to design legislation that would fit their specific needs to obtain early information about potentially abusive or aggressive tax planning measures. Ultimately, the Action 12 outputs are intended to minimise the use of tax avoidance strategies by reducing the information gap between taxpayers and national tax authorities.

The Action 12 outputs are delivered as a series of recommendations and there are no minimum standard or other compulsory elements. The recommendations take the form of design principles for mandatory disclosure rules as well as key objectives for nations in designing their own mandatory disclosure regimes. The key objectives of mandatory disclosure rules are as follows:

1. Mandatory disclosure regimes should be clear, easy to understand and balance the compliance cost to taxpayers with the benefits obtained by the tax authority. Furthermore they should identify the schemes to be disclosed and remain flexible enough to respond to new risks. Such rules should ensure that information is collected and used in an efficient fashion.
2. The primary objective of such regimes is to increase transparency. This is achieved by providing the relevant tax authority with early information about aggressive and abusive schemes and their promoters. Further to the primary objective is need for such measures to act as a deterrent.

The Action 12 report specifies a number of key design considerations that should be implemented in order to design an effective mandatory disclosure regime. The design features consider who, what and when information should be reported alongside the consequences of failure to report. A number of nations have already introduced disclosure initiatives, and it is upon these that the OECD has based its recommendations.

The report specifies that nations that wish to introduce mandatory disclosure regimes should:

1. Implement rules to impose disclosure on both the promoter and taxpayer. However, the primary obligation for disclosure may be imposed on either party;
2. Include a number of hallmarks (specific and generic) that trigger the requirement for disclosure. Such hallmarks should target features of commonly

promoted schemes, for instance, the requirement for confidentiality or the payments of certain fees. Cross-border hallmarks should focus on specific BEPS outcomes;
3. Establish a mechanism to track and link disclosures;
4. Link the timeframe for disclosure to the date in which the scheme is made available to the taxpayer or promoter;
5. Introduce a penalty framework (including penalties of a non-monetary nature) that is consistent with other domestic laws.

As is to be expected with the implementation of recommendations that are both modular and voluntary in nature, the application of measures inspired by Action 12 has been inconsistent thus far, and there is considerable variety in the way in which these recommendations have been approached by the BEPS associate nations. While some nations have moved to implement new mandatory disclosure regimes, many have yet to indicate how they plan to proceed. Nations that already have mandatory disclosure rules in place have to some extent modified legislation in line with the OECD outputs, however as is probably becoming clear, there is little cohesion in this area. Further to the above, there are also a number of nations that have either made no indication of their plans, or that have indicated that they do not intend to implement new legislation in this area.

What Impact Will This Have on Affected Businesses?

During the consultation phase of the BEPS project concerns were raised that the Action 12 outputs would lead to inconsistencies in application of mandatory disclosure rules, and at the time of writing there is little evidence to suggest that this is otherwise so. While inconsistencies in application could lead to further BEPS risks, the real concern from the perspective of impacted businesses is that inconsistencies from one nation to another could lead to duplicative reporting.

As we are still in the dark about implementation over a large portion of the BEPS associate nations, there is little in the way of broad analysis that can be conducted in this area. However, the realities of such a situation require that businesses monitor and prepare for new domestic legislation and the compliance obligations that go hand in hand with it.

Action 13: Transfer Pricing Documentation and Country by Country Reporting

Action 13 represents the reporting arm of the BEPS Action Plan. The rules developed in Action 13 contain requirements that multinational enterprises provide relevant national tax authorities with information about the global allocation of their economic activities and taxes paid among countries as well as transfer pricing data.

The primary goal of Action 13 is to increase transparency, through the use of documentation and reporting mechanisms. The country-by-country reporting template will provide tax authorities with information regarding a company's global allocation of income, assets, taxes paid etc. as well as information about the location of activities between the jurisdictions in which the group operates. Conversely, the transfer pricing documentation (master file and local file) will provide tax authorities information on aspects like intangibles and the allocation of risk. The final report includes revisited standards for transfer pricing documentation alongside a template for country-by-country reporting of income, taxes paid and other measure of economic activity.

The OECD have included a three-tiered approach to transfer pricing documentation, outlined below:

1. **The Master File**—Multinational enterprises must provide tax administrators with high-level information regarding their worldwide operations and transfer pricing policies. This master file must be made available to all relevant tax administrations.
2. **The Local File**—Multinational enterprises must provide detailed transactional transfer pricing documentation in a local file that is specific to each country. The information contained in this file must identify material related party transactions, the amounts in those transactions and the transfer pricing determinations that have been made by the company with reference to those transactions.
3. **Country-by-Country (CbC) Report**—Large* multinational enterprises are required to file an annual country-by-country report for each jurisdiction in which they do business. This document will provide a breakdown of revenue, profit (before and after tax), as well as income paid and accrued. Furthermore the report must include details of the number of employees, capital, retained earnings and assets in each jurisdiction. Multinational enterprises must also identify each entity within the group doing business in each jurisdiction and the business activities each entity engages in.

*The reference to "Large multinational Enterprises" in the description above refers to multinationals with a consolidated group revenue above a set threshold. We have seen this threshold implemented at €750 million.

Action 13 is one of the BEPS Minimum Standards and as such will be implemented by all of the BEPS Associate nations. However, due to the implementation mechanism requiring modification to domestic law and the drafting of competent authority agreements, there are small variations in the way the rules are applied, principally timing & materiality thresholds.

For in scope companies, country-by-country reporting is one of the more unpopular aspects of the BEPS Action Plan. During the development of these measures there was considerable debate as to whether the country-by-country reports should be made public, to increase transparency. Indeed, a number of nations, NGOs and other action groups were strongly in favour of such a measure. In the end the OECD decided that these reports should only be made available to the home tax authority of the parent company. While some see this measure as a blow to transparency, many businesses are still concerned by the level of disclosure necessary. The issues of ultimate data privacy and the potential for public disclose in the event that these documents are obtained from a tax authority proving a realistic problem.

What Impact Will This Have on Affected Businesses?

Country-by-country reporting requirements began for the financial year beginning 1st of January 2016. For larger multinationals that meet the requirements, this is an entirely new form of reporting that was previously not required.

The updated transfer pricing documentation requirements will also present an area of potential risk to multinationals. Affected companies should carefully review the changes specified in the Action 13 final report and amend policies and procedures to reflect the new requirements. Furthermore companies should act early to ensure that they have access to the relevant data necessary to fulfill the requirements of the enhanced transfer pricing documentation.

The country-by-country reporting requirements are a new step in corporate taxation and it remains to be seen how national tax authorities will use the information. There are concerns that tax authorities may misuse the information provided or use the report as the basis for a tax fishing expedition, though the OECD has reserved the right to suspend reporting in the

event of reported misuse. What is likely however is that problematic information in the country-by-country reports could provide a tax authority with the impetus and necessary information to audit, providing detail that would have previously been unavailable.

Of considerable concern to many companies is the increase in risk of reputational damage brought forth by the new transparency requirements. While many are focused on the tax and organisational challenges brought by the BEPS outputs, the potential for reputational harm is an aspect that should not be overlooked. The increased transparency demands brought into play by Action 13 represent one of the more serious aspects of the BEPS Project—the information disclosure requirements introduce a significantly greater level of scrutiny into the tax planning operations of multinationals. The new transparency requirements introduce significant risks relating to information security and the concern that such information could make it into the public domain. With this in mind, affected businesses should dedicate realistic resources to the reporting and documentation issue. The first country-by-country reports are due to be filed on December 31st 2017.

Action 14: Make Dispute Resolution Mechanisms More Effective

In referencing the potential impacts that the BEPS outputs may have on in-scope businesses, an increase in tax disputes is a common theme. The BEPS Project is clearly focused on eliminating opportunities for cross-border tax avoidance, but acknowledges that the prevention of double taxation is also a critical aspect of an efficient global tax system. While the outputs are designed to eliminate uncertainty for compliant taxpayers and unintended double taxation, the need for an effective dispute resolution mechanism is an integral part of achieving the desired results.

Jurisdictions that have adopted the OECD Model Tax Convention have available to them a dispute mechanism called the Mutual Agreement Procedure (MAP). This mechanism was designed to provide an alternative to conventional domestic legal dispute remediation methodologies. While most tax treaties do contain a MAP a common complaint is that the process is inefficient and difficult to access. Indeed, there are jurisdictions with a significant backlog of MAP disputes.

The work of Action 14 is intended to strengthen the effectiveness and improve the efficiency of the MAP process. New measures will mitigate the risks of uncertainty and unintended double taxation by ensuring the consist-

ent and proper implementation of tax treaties (in part through the multilateral instrument).

Through adoption of the principles outlined in Action 14 countries will agree to adhere to a number of minimum standards (outlined below) as well as a complimentary set of optional best practice policies. The minimum standard will:

- Ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- Ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- Ensure that taxpayers can access the MAP when eligible.

The best practice elements are:

- Countries should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes.
- Countries should develop the "global awareness" of the audit/examination functions involved in international matters through the delivery of the Forum on Tax Administration's "Global Awareness Training Module" to appropriate personnel.
- Countries should implement bilateral advanced pricing arrangement programs.
- Countries should take appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending. Such a suspension of collections should be available, at a minimum, under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy.
- Countries should implement appropriate administrative measures to facilitate recourse to the MAP to resolve treaty-related disputes, recognizing the general principle that the choice of remedies should remain with the taxpayer.
- Countries should include in their published MAP guidance an explanation of the relationship between the MAP and domestic law administrative and judicial remedies. Such public guidance should address, in particular, whether the competent authority considers itself to be legally bound to follow a domestic court decision in the MAP or whether the competent authority will not deviate from a domestic court decision as a matter of administrative policy or practice.

- Countries' published MAP guidance should provide that taxpayers will be allowed access to the MAP so that the competent authorities may resolve through consultation the double taxation that can arise in the case of bona fide taxpayer-initiated foreign adjustments—i.e. taxpayer-initiated adjustments permitted under the domestic laws of a treaty partner which allow a taxpayer under appropriate circumstances to amend a previously-filed tax return to adjust (i) the price for a transaction between associated enterprises or (ii) the profits attributable to a permanent establishment, with a view to reporting a result that is, in the view of the taxpayer, in accordance with the arm's length principle. For such purposes, a taxpayer-initiated foreign adjustment should be considered bona fide where it reflects the good faith effort of the taxpayer to report correctly the taxable income from a controlled transaction or the profits attributable to a permanent establishment and where the taxpayer has otherwise timely and properly fulfilled all of its obligations related to such taxable income or profits under the tax laws of the two Contracting States.
- Countries' published MAP guidance should provide guidance on the consideration of interest and penalties in the mutual agreement procedure.
- Countries' published MAP guidance should provide guidance on multilateral MAPs and advance pricing arrangements (APAs).

What Impact Will This Have on Affected Businesses?

Adoption of the minimum standards set out in Action 14 is expected by almost all of the BEPS participants, as this is mandated by acceptance of the multilateral instrument (see Action 15). For businesses that have little faith in the MAP due to the backlog of cases and/or unwillingness for a jurisdiction to participate this may offer some needed relief. However, a number of the best practice suggestions contained in the Action 15 final report are already in place in a number of treaties. With this in mind, some businesses involved in disputes may see little or no change to their circumstances.

Beyond those that are currently in dispute, other businesses that operate multinationally should consider the benefits of building the use of the newly modified MAP into their compliance programs. Monitoring developments in this area, particularly from national tax authorities will enable a business to react quickly and effectively in the event of dispute.

Action 15: Develop a Multilateral Instrument

Many, if not most of the BEPS Actions highlight issues that have grown out of the discrepancies between how nations treat taxation. The bilateral tax treaties between nations are intended to resolve some of the issues created by these discrepancies, such as double-taxation. But while tax treaties mitigate some problems, others are compounded. The result is that some functions of bilateral tax treaties that are currently implemented help facilitate tax avoidance. Coupled with this are issues that arise from the lack of standardisation in bilateral treaties, despite the best efforts of the OECD and other organisations to do so.

The OECD Model Tax Convention has been adopted as the basis of many tax treaties globally. However, when changes are made to the convention, discrepancies can occur between the standard set out by the Model Tax Convention and the treaty itself. Ultimately, a standard is only a standard if it is applied uniformly. While the preceding sentence is a frustrating tautology, it does serve to highlight the need for universal adherence.

One of the more ambitious aspects of the BEPS Project is the development of a Multilateral Instrument that aims to swiftly and coherently implement the measures developed in the course of the BEPS Action Plan. In doing so the OECD hopes to eradicate the discrepancies that arise between supposedly similar tax treaties, creating a substantially more robust anti-tax avoidance framework.

The scale of the issue created by currently implemented tax treaties should not be underestimated. Many treaties that are in place today focus on the issue of double taxation, using principles developed by the League of Nations in the 1920s. While the elimination of double taxation and the distortion of trade that it can bring are important aspects of international taxation, the challenges posed by globalisation and the digital economy have exposed a number of exploitable gaps in these treaties. With over 3,000 bilateral tax treaties in place between nations, some negotiated over the space of decades, there are considerable differences in the details of the treaties themselves. It is in these differences that opportunities for BEPS can arise.

The OECD sees that BEPS Project as an opportunity to bring tax treaties in line with the Model Tax Convention. The BEPS Project outputs feature numerous changes to the Model Tax Convention; therefore without some sort of multilateral effort the problems would remain unsolved. It is arguable in that case, that the Multilateral Instrument is the lynchpin of many of the BEPS outputs. Without such a measure, renegotiation of those 3,000 plus

tax treaties could potentially take decades, by which time, the BEPS Project outputs may well be out of date themselves.

Rather than rewriting or modifying articles in current tax treaties, the multilateral instrument will sit alongside treaties that are currently in place, overriding the relevant parts. This methodology will allow for timely implementation. The modular nature of some aspects of the multilateral instrument will require that countries specify which aspects of the instrument they will opt in/out of at the time of ratification.

The multilateral instrument makes provisions for the implementation of measures covered in four of the BEPS Actions:

1. Action 2—Hybrid mismatch arrangements
2. Action 6—Treaty abuse
3. Action 7—The artificial avoidance of permanent establishment
4. Action 14—Dispute resolution

The modularity of the multilateral instrument that I referenced earlier refers to the provision of multiple options for countries to implement the minimum standards specified in the specific BEPS actions, as well as flexibility in the application of the non-minimum standard elements. For the non-minimum standard elements, the instrument allows countries to specify the treaties to which the instrument applies, and also allows for opt out provisions and/or alternative provisions.

The OECD concluded negotiations on the text of the concisely titled "The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion And Profit Shifting" in late November 2016. The first high level signing ceremony is expected to take place in 2017. At the time of writing, the governments of over 100 of the countries signed up to the BEPS project are in the process of listing treaties that will be covered by the multilateral instrument and selecting which of the modular options to implement.

What Impact Will This Have on Affected Businesses?

The multilateral instrument will amend the tax treaties of many nations, and once ratified in 2017 will come into force fairly quickly. While the multilateral instrument itself does not contain any specific rules that relate to how

businesses operate from a tax perspective, it is a mechanism that will bring swift changes relating to a number of the other BEPS Actions. Affected businesses should monitor the deployment of the multilateral instrument in nations in which they operate commercially. The modular nature of some aspects of the instrument will mean that there are a number of provisions, which governments may opt in or out of that will have an impact on any strategic measures moving forward.

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Impacts of BEPS

The scale of the changes brought about by the BEPS Action Plan is and will be significant, while a number of the outputs represent a fundamental change in the way international taxation is legislated, and in particular, how national tax authorities communicate and share information with each other. Global businesses that have employed structural and operational models for decades have suddenly found that these methodologies will either no longer be legal, or in situations in which they are legal, no longer economically viable.

It is an important point to reaffirm that the practices that the BEPS Action Plan targets were, for the most part, totally legal. Putting aside any discussion of the moral aspects of these types of practice and the impacts that flow from them, there is a fundamental fact at the core of the implementation of these new anti-base erosion practices. Companies that were operating totally legal models yesterday must make dramatic changes to the way they operate to make sure they are still operating legally tomorrow. While that may sound simple to some, the challenge of reorganising a multinational enterprise that operates in dozens of countries across the globe, each with differing standards of BEPS implementation will be massive.

One of the challenges that I have faced in writing this section of the book is the constant need to change between present and future tense when describing the implementation of the BEPS Action outputs. While it is perhaps not the most artistic use of the device, I feel this is an oddly appropriate metaphor for the challenges businesses are currently facing while preparing to meet the demands of present and future regulation that has

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flowed form the BEPS Action Plan. The timeframe for the implementation of the BEPS spans around two years, which by the standards of other global regulatory frameworks isn't particularly long. However, the variety of legal mechanisms (national law, treaties and the multilateral instrument) and requirements (minimum standards, recommendations, best practice) used, mapped to the 100+ nations involved, makes for a messy couple of years.

Companies that operate globally will need to dedicate significant resource to maintain compliance during the phase in of these new regulations across the jurisdictions in which they operate. It is worth mentioning that multinationals will be heavily reliant on the information provided to them by the tax authorities in the jurisdictions they operate. Changes to national law, regulatory changes brought about through the amending of bilateral tax treaties, and through the implementation of the multilateral instrument will all need to be communicated efficiently and effectively to maintain taxpayer compliance. Keeping up with the plethora of changes and their effective staging dates will no-doubt be causing headaches in compliance departments the world over.

The companies that the BEPS Action Plan seeks to target are multinational enterprises. The OECD is keen to point out that the aim of the project is not to increase tax on multinationals, but to create a framework in which profits, and the activities that generate it are aligned. If the project is successful in neutralising schemes such as shell companies, PE abuses and treaty shopping, it therefor follows that the nations that intentionally facilitate such activities will also be impacted by the regulations. At this stage, the nations that have signed up to the BEPS Project represent over 80% of the worlds economy. The takeaway here is that there will be very few multinationals that will not be impacted in some way by BEPS influenced regulations.

While issues like compliance and risk are important considerations when discussing the impacts of BEPS, the reality is that the biggest talking point for many is the potential increase in tax burden. As the project aims to put an end to common mechanisms that are used to avoid taxation, it follows that those businesses that employ such measures will likely see an increase in their effective tax rate as measures are implemented to shut down those strategies. The consequences of burgeoning tax bills will vary from business to business. However, those that operate in nations for the sole purposes of obtaining tax-efficiencies will likely see that these practices become less economically viable.

Further to the possibility that operating certain models may no longer provide sufficient profitability, several of the BEPS Action outputs will rule out the use of what have become fairly common business structures for multinational enterprises. One of the biggest impacts therefore, is the need for

businesses to re-evaluate and in many cases, modify the way they structure their multinational operations.

One of the more unpopular aspects of the BEPS Action Plan is the implementation within Action 13 of rigorous reporting requirements. These new measures will see information about the financial affairs and structures of multinational enterprises facing significantly more scrutiny, both nationally and internationally. The primary goal of Action 13 is to increase transparency, through the use of documentation and reporting mechanisms. The country-by-country reporting template will provide tax authorities with information regarding a companies global allocation of income, assets, taxes paid etc. as well as information about the location of activities between the jurisdictions in which the group operates. Conversely, the transfer pricing documentation (master file and local file) will provide tax authorities information on aspects like intangibles and the allocation of risk. It is easy to understand why the outputs brought forth by Action 13 have been unpopular with businesses. The country-by-country reporting requirement in particular represents an unprecedented step in the transparency requirements for affected businesses. It is still unclear how tax authorities will use the information provided in these reports, however there are legitimate concerns from some quarters that the contents of such a report could provide national tax authorities a road map for auditing purposes.

With the political and social climate so attuned to the tax planning strategies of multinational enterprises, the risk of significant reputational damage should not be underestimated. While many are justifiably focusing on the costs involved in modifying multinational structures, and the likely increase in effective tax rate that multinationals are facing, the greatest threat to many companies may well manifest itself in the form of lost revenue due to reputational issues. The impact from reputational damage has thus far been very minor. Google, for example, have been under the spotlight for their tax planning measures for a few years now. Their company motto, "do the right thing", is completely misaligned from the public perception of their tax practices, yet the reputational damage that they have suffered is minimal. The court of public (and in particular stockholder) opinion is tough to predict, and while we have yet to see a corporate giant slain by the slings and arrows of the unruly mob, there is reasonable justification for concern.

As with the implementation of any new legislative framework, the new BEPS rules will bring an additional compliance burden. While the outputs of many of the actions are not themselves overly burdensome, the package as a whole creates a meaningful challenge from a regulatory compliance perspective. International and intra-national regulations often feature complexi-

ties due to differing or poorly enforced standards between nations. Indeed, it is these types of issues that have given rise to the BEPS problem. While the new rules aim to align national and international rules, there are still many optional rules, recommendations and best practice polices that a nation may or may not elect to apply. It is likely that no two nations will have identical BEPS rules. The impact of this is that multinational enterprises will need to maintain a compliance overview of many similar but not identical rule-sets for the jurisdictions in which they operate. Furthermore, the implementation of these rules over the next couple of years will not be uniform between nations. The compliance burden placed by the new BEPS rules is therefore substantial.

There has been considerable argument from some quarters that the compliance burden placed by the BEPS outputs weighs disproportionately heavily on smaller multinationals, and in particular those that generate income through ideas and creative content. Smaller businesses, it is argued, lack sufficient resources and capabilities to adapt to the demands placed onto them within the timeframe required by the BEPS outputs. This is a common issue with other regulatory frameworks as well—the scale of regulation necessary to cover all eventualities that can crop up with bigger businesses can pose serious problems for smaller entities. The reality for smaller institutions is the need to rely on third party suppliers and consulting subject matter experts to meet their legal obligations.

While the attention and resources needed to remain compliant will be significantly increased as the BEPS outputs come into effect, the scale of the task should not come as a surprise to companies that have been following the progress of the OECDs work. While the compliance responsibilities have become significantly more burdensome, there is an argument (and one that I have considerable time for) that multinationals have it relatively easy compared to the financial services industry in such matters. With the volume of revenue generated by multinationals, and the scale to which tax planning strategies have succeeded, increased transparency and the compliance obligations that come with it were inevitable.

Key Talking Points

The Digital Economy

The rapid development of the digital economy has proven to be problematic for current legislation. While it has provided significant scope for aggressive

tax planning practices, it has also created new forms of intangibles that are well beyond the scope of laws that were developed to regulate such matters.

Changes brought by BEPS Action 1 will have a significant impact on businesses that supply products digitally. To prepare for new BEPS related legislation, businesses should assess and manage the digital elements of their supply chain from a tax perspective. As nations implement the VAT/GST guidelines, electronic systems as well as operational aspects will need the flexibility to adapt. In addition, companies that have a heavy digital presence in other nations will likely see a rise in their effective tax rate.

Hybrid Mismatches

The outputs of Action 2 contain domestic measures to counter Hybrid Mismatch Arrangement. Multinational enterprises should monitor the guidance provided by the domestic regulators / tax authorities in the jurisdictions that they operate. Businesses that find that they are impacted adversely by the new arrangements will need to assess whether reorganisation or elimination of hybrid elements is a practical path.

Treaty Abuse

Much of the legislation that will flow from the Action 6 report on treaty abuse forms part of the multilateral instrument. While the instrument has not been implemented yet it is clear that rules to prevent treaty shopping in particular will be significantly strengthened. Multinational entities that have implemented structures for the purposes of gaining treaty benefits to which they would not otherwise be entitled may find that new anti-abuse rules remove the economic benefit from such arrangement.

Permanent Establishment

Multinationals that currently do not consider themselves to have created a permanent establishment in a jurisdiction in which they operate may find that the new PE rules will have an impact on this status. Activities that would once have qualified for an exception due to being "auxiliary or preparatory in nature" may not now qualify. Furthermore treaty wordings have been updated to close down loopholes that allowed digital products to escape taxation. Businesses that operate multinationally may find that they

no longer meet the requirement for these exceptions, the consequence of this being that they may create new permanent establishments.

Country by Country Reporting

For impacted companies, the country-by-country reporting requirements have not proven popular. Multinationals with a consolidated group revenue above a de-minimis threshold will have to supply an annual country-by-country report for each jurisdiction in which they do business. This document will provide a breakdown of revenue, profit (before and after tax), as well as income paid and accrued. Furthermore the report must include details of the number of employees, capital, retained earnings and assets in each jurisdiction. Multinational enterprises must also identify each entity within the group doing business in each jurisdiction and the business activities each entity engages in.

The disclosure of these details to national tax authorities may increase the risk of triggering an audit, and there is some concern that in such cases this would provide a treasure map of sorts. Furthermore, the risk of public disclosure and the potential for significant reputational damage are cause for concern. Conversely some nations, NGOs and tax advocates have (unsuccessfully) pushed for full disclosure of these reports.

What Should Companies Be Doing?

At the time of writing, the vast majority of nations have indicated their position on the implementation of many of the BEPS measures. While there are still a few unknowns, largely relating to the exact time frame for some aspects of implementation, the picture of what is to come is pretty clear.

Businesses that will see an impact from the implementation of new anti-base erosion rules will generally fall into two categories; multinational enterprises that operate tax-avoidance strategies and those that do not. In the case of the former, the development of the BEPS project and its surrounding conversation will have been closely monitored, as after all, it is these enterprises that the regulations are focused upon. However, it is companies that do not operate international structures and transactions for the purpose of minimising tax liability that may be inadvertently tripped up by new regulation. It is therefore of critical importance to all multinational enterprises to pay close attention to new rules implemented in the wake of the BEPS project, regardless of the company's reasons for operating in a given jurisdiction.

As is typical with the introduction of new legislative measures, the degree to which businesses take proactive steps to comply varies from case to case. Larger multinationals, whom it has to be said are likely to see significant impact, are reported to have moved early on the BEPS issue and are conducting analyses of current structures and implementing plans. It follows then that smaller businesses are reportedly less prepared, being forced to act reactively to BEPS rules as they are introduced. This is an issue that is not unique to BEPS. Indeed we find that the compliance and operational burdens placed by new legislation on smaller organisations is often overwhelming. But therein lies one of the inherent issues of corporate legislation—how does one create a rule set that is comprehensive and far reaching enough to effectively bring the big guys into line without suffocating the smaller players? If you have an answer to this question, please forward your correspondence to: HMRC, IRS, BZSt, ATO etc.

The first action that should be taken by any business that has a nexus with the BEPS outputs is to conduct a thorough analysis of current structures, operational models and transactions. The issues raised earlier in this chapter relating to the potential for increased tax burden, risk and compliance are all major factors that should be considered. Companies will need to assess how their global footprint will affect the wider business going forward under new BEPS rules. Furthermore, current inter-company flows and transactions may be found to be no longer economically viable. Any impact assessment that a company undertakes will need to pay attention to the key differences in implementation between jurisdictions in which the company operates.

Once a business has established how and to what extent new BEPS legislation will have an effect, a transition plan should be formulated. The extent and timing of changes outlined in this plan will be of utmost importance. With the sheer variety of changes and their varied timings, it is critical that businesses monitor what has been agreed upon, recommended and implemented, nationally and internationally, in order to manage the complex implementation period. Also of great importance is to determine to what extent new resources will be required to meet the operational and compliance needs presented by BEPS, and whether these resources are sourced internally or externally.

The new BEPS rules will require systems to be made ready, particularly for the greatly increased levels of data and reporting. As with any new regulation, the appropriateness and preparedness of systems will have a significant impact on operational and compliance aspects of the business. Off the shelf technological solutions are available from a number of the big players in that market that purport to offer integrated reporting solutions as well as BEPS related document and data management.

Beyond the operational issues posed by BEPS, the breadth of the changes speaks to a need to reduce the siloed nature of some organisations. While this is not a need that is unique to BEPS, there is a need for inter-departmental cooperation, particularly relating to aspects such as dispute resolution, financial reporting, tax and compliance. Furthermore, the ever increasing public interest in the financial exploits of multinational enterprises and in particular their tax arrangements, suggests the inclusion of marketing and PR functions in BEPS planning.

An attribute that has become more and more central to strategic matters for multinationals is flexibility. The BEPS project alone represents a set of rules that will be implemented in a non-uniform fashion, over a number of years. During this time there is some level of uncertainty, and businesses that can position themselves to make the best use of the changing environment will have a significant advantage. The BEPS project represents a point in time, not a fixed constant and rules relating to cross border taxation will likely continue to evolve in this area. The advancement of technologies and the digital economy in particular have caught legislators in a state of unpreparedness. And while it is arguable that governments have become quicker at reacting to the challenges faced by these new technologies, the challenges themselves have arguably become more numerous. Moore's law observed that the number of transistors in integrated circuits doubles approximately every two years, which highlights the rate at which computer technologies have advanced. However approaches to the implementation of international regulation have remained fairly static. The problem of course, and the big unknown is what the next disruptive technology will be, and how, when and to what extent legislators will be forced to act. While this may seem a little off topic, it serves to highlight that businesses now, more than ever need to be flexible and proactive in the face of new regulatory challenges.

While many see the imposition of new regulation as a burden, there is also great potential for those that are well prepared to deal with these changes. To use a sporting analogy, and one close to my heart, take the example of Formula One motor racing. The F1 technical regulations read much like government legislation; they are incredibly detailed, prescriptive and, thanks to many years of incremental tweaking they are as convoluted as they are contradictory. Once a team, with adequate resources has found a loophole in these rules, they tend to build a car that dominates the sport for several years. Fearing a decline in viewership, the governing body is forced to react, usually by bringing in hasty, ill prepared new regulations (sound familiar?). The upshot of this is that another team will usually sweep in and build a car that will steal all of the glory for a few years. In almost

every case, the team that comes out on top has strategically targeted these rule changes as an opportunity to make significant gains, and has dedicated significant resources to making sure they make the best of the opportunity. This allegory, while perhaps a thinly veiled excuse to talk about something other than tax for a moment, does serve to highlight an important lesson—the modification of the rules of the game presents both significant challenges and considerable opportunities. Businesses that are well prepared can mitigate the impact of the former and take advantage of the later.

A common feeling that we encounter when assisting companies with their regulatory compliance issues is that of negativity towards incoming legislative frameworks and this is completely understandable - the growing regulatory burden faced by businesses is significant, and it shows no signs of slowing. However, and without wanting to sound too much like some sort of new-age guru, there is little point in expending time and energy being negative about something that you can't influence. Ultimately, businesses have to make changes in the wake of new rules, so why not treat it proactively and take advantage of the opportunity, rather than taking the foot dragging, path of most resistance to compliance?

As hinted in the F1 analogy there are opportunities that present themselves every time the regulatory landscape changes. While that analogy focuses on the idea of stealing a competitive advantage against ones rivals, there are other, potentially less obvious positives that can be found. We live in a world that is much more socially and ethically conscious than it was a few decades ago—we are smart consumers, we think globally and we peek behind the curtain to look at how systems work. While it is forgivable to view the incoming BEPS regulations as burdensome and ultimately costly, there is an argument that this is 'glass half empty' thinking. Consumers value a businesses ethical practices (whether perceived or otherwise) and the marketing value of being able to say "we do not engage in profit shifting methodologies" should not be underrated. At the end of the day, if the changes must be made to remain compliant, why not leverage the positive aspect of these changes as much as possible?

As a footnote to this section, at the time of writing, United Airlines have just had $1bn wiped off of their market value after footage of a paying customer being forcibly removed from one of their flights went viral. In the previous week, Pepsi faced a huge backlash after publishing a video that trivialises the issues of racial tension and the protest movement in the US. Public relations disasters like these are seemingly becoming more frequent and more damaging. In a post BEPS world, in which it is supposed to be more difficult for multinationals to avoid paying taxes, it stands to reason that the risk of reputational damage of doing so will be far greater.

The BEPS Project—Long Term

The lasting impact of the BEPS Project may take some time to become entirely clear. Over the next couple of years national governments will be implementing the measures set forth in the Action Plan and at the same time businesses will have to adapt to the changing regulatory environment. The minimum standard aspects of the BEPS outputs are already being put into place across the globe and change in the short term relating to these aspects will be swift for both governments and businesses.

Many aspects of the Action Plan are to be actioned through the modification of existing tax treaties. The Multilateral Instrument will make quick work of this implementation in the nations that have agreed to its use—thankfully from a compliance perspective, the vast majority of BEPS associates have agreed to the terms of the MLI.

There are a lot of moving parts in the BEPS implementation plan and it is fair to say that governments, tax authorities and businesses all have a roll to play in the coming months and years. The effectiveness and long-term impacts of the project will be substantially impacted by the actions of the major stakeholders. We are still in the early days of the project at this stage, but signals of the project's effectiveness and therefore the lasting impact are becoming more visible.

There has been a considerable shift in political opinion relating to offshore tax avoidance and evasion over the last decade, and global support for the BEPS project is substantial. While in the past, such an issue may have been a passing fancy, or pet project of a small number of politicians, a number of factors have ensured that international tax avoidance/evasion has remained at the forefront of both the public interest and the political agenda of many nations globally. Just a few months after the publication of the BEPS final reports, the Panama Papers story broke, making offshore tax practices front-page news once again.

The relevance of public and political opinion may not seem immediately obvious to the long-term impact of BEPS. At this point in time, most nations have committed to implement a number of the recommendations, however, I feel that it would be naïve to assume that this will be the final standard. The likelihood of another headline grabbing scandal on the scale of the Panama Papers is unknown, but it is probably a fair assumption that it is a question of 'when', rather than 'if'. The current level of BEPS implementation may just be the beginning of an increasing crackdown on what are considered to be abusive tax practices.

Many multinationals have suggested that the BEPS Actions are too restrictive, that they apply an unnecessary compliance burden and dramatically increase the risk of double taxation and disputes. However, other parties have argued that the rules do not go far enough—for example, there are suggestions that the country-by-country reporting should be a more open process if tax-avoidance is to be effectively reduced.

Consistency too is a challenge that many feel has not been properly addressed. The dozens of individual recommendations, applied in a pick'n'mix fashion by BEPS participant nations has created a network of nations that have adopted many of the outputs, but in a non-uniform manner. From a compliance perspective, this can cause headaches, and I have considerable sympathy for this point of view. However, the changes brought into effect by the multilateral instrument will at least create some standardisation in the related elements of the Action Plan outputs.

It is important to acknowledge the elephant in the BEPS room. The big question is 'how effective will the new BEPS measures be at combatting tax avoidance?' The answer of course is not a simple one. There is a feeling in some quarters that the BEPS Actions do not go far enough, and in particular do not fully address issues that arise from the location of ownership of intangibles, transfer pricing and the use of financial instruments and other internal arrangements. The consequence of this is that some tax planning strategies may remain in place with only minor amendments needed. Furthermore, there is always the possibility that new opportunities may present themselves to enterprising businesses that wish to reduce their effective tax rate. Tax accountants are rather adept at seeking out such opportunities, so time will tell to what extent this prediction is correct.

As a counterpoint to the rather negative view presented above, it is important to consider that the fact that the BEPS Project itself exists at all is a big step forward. The OECD/G20 efforts represent the first real global effort to reduce corporate cross-border tax avoidance. It is very easy to view legislative frameworks like BEPS in isolation, ignoring what has come before and what will likely come after as well as parallel legislation that sits alongside. One of the goals of this book is to encourage a broader approach to international tax legislation, encouraging businesses to become more flexible and proactive in their approach to compliance. From this perspective, it would appear that BEPS is a big step forward in plugging a number of long known holes in the regulatory dam.

Perhaps then, a better question to ask would be 'how effective will the new BEPS measures be at combatting what it considers to be the most aggressive tax planning methodologies?' Again, the answer is not a simple

one. Detractors of the project have observed that the measures are weak in certain critical areas, particularly some of the optional measures such as CFC rules. However, the minimum standard outputs, and in particular the country-by-country reporting requirements do seem to have had an impact, with commenters observing that many multinationals have already made efforts to revise their tax planning methodologies.

Ultimately, there is such a large incentive for multinationals to reduce their effective tax rate that businesses will always find a way to do so, and the nature of regulation means that it will always lag behind the inventiveness of tax accounting practices. The BEPS project should be viewed in the context of a wider and longer-term approach to international taxation, rather than a fixed point in time. Just how effective the new measure will be is difficult to predict, however, the scale and scope of the Action Plan ensures that it will have a lasting impact, one way or another.

Part V

The Global Overview

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Introduction

The reader will, by now, have gathered that while tax evasion itself is understandably complex and often impenetrable, (indeed that is often its purpose); the detection and prevention of tax evasion is as complex, if not more so.

In this part of the book, we will try to bring together the many and various threads of previous discussion, with a view to giving the reader a picture of some of the more global issues that GATCA brings to the financial services industry.

These fall broadly under two areas:

- Cyber risk
- Operational challenges

It may sound rather curious that we give such emphasis to cyber risk. However, in bringing together the material for this book, two things have become clear to us. First, that the data being aggregated is of a type that has not heretofore been brought together and is of a particularly sensitive and high value nature to a number of different types of cyber criminal with a variety of motivations. Second, that the weakness of the proposed cross border systems as well as those within countries starting with financial institutions, do not seem to be being addressed in a manner that is proportionate to the risk.

Operational challenges have been individually highlighted in several parts of this book. Indeed these, rather than an exhaustive explanation of each line of each framework, have been the guiding principle of providing value to the reader of this book.

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Cyber Risk

We come now to a critical issue and one on which I have opined several times at conferences and on Twitter—cyber security risk. For authoritative comment in this chapter we spoke to a renowned ethical hacker, Jamie Woodruff, Technical Director at Metrix Cloud who is well known in the financial services industry and is engaged by many financial firms and governments to advise on and test cyber security effectiveness. We interviewed Jamie in April 2017 to obtain his views on the risks associated with the AEoI concept, and his overall view is that the risk is substantial. We have incorporated his opinions from that interview into this chapter.

Location of Risk

Risks are located within the chain of gathering, transmission and receipt as follows and as shown in Fig. 20.1:

- Gathering information
- Storage of information at source
- Modifying the information (packing) at source
- Receiving the information (security of the portals or methods)
- Modifying the information at way point (unpacking and repacking)
- Transmitting the information (in flight interception)
- Storage of information at destination

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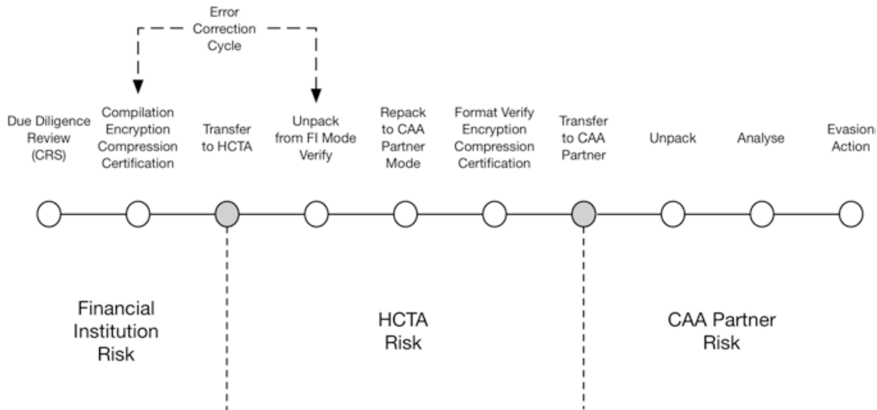

Fig. 20.1 Cyber risk profile of AEoI

The risks are inherent to the fundamental concept of gathering and sharing sensitive information. At present, over a hundred countries are each committed to automatically exchange tax information bilaterally and multilaterally with each other in the AEoI framework. Each, within a reasonably narrow frame of reference, is in the process of by-passing traditional data privacy laws in order to be able to automatically pass sensitive information to another government based on bilateral or multilateral competent authority agreements that are, in turn, supported by domestic legislation. We can also take as read that, for the most part, while data security and transmission methods could be wide and varied as allowed for in the AEoI Standard, in practice they will probably come down to a few core acceptable (and publicly known) operational models covering:

- Formatting data in xml;
- Data encryption;
- Data compression, and;
- Data package certification (digital certificates).

Timing

While each bilateral relationship could activate at a different time of year, most will follow a calendar year reporting model and will thus be actually moving data (i) between financial institutions and their tax authorities in the few months up to September and (ii) between governments in September each year. Transmission methods will be via the internet and most often via

portals designed and built by government departments or purchased and managed by third parties. Each of the financial firms at the base of this process will be using a combination of in-house expertise and third parties to compile, manage and transmit this data.

Value of Data

In this context, private and highly sensitive data about wealthy individuals and entity accounts is going to be automatically shared in at least ten thousand permutations each and every year. This data will include:

- tax ID numbers,
- names of financial institutions where accounts are held,
- names of account holders,
- addresses,
- account numbers,
- details of income and withdrawals to those accounts
- details of gross proceeds (profits) from the sale or purchase of securities

Previous Experience

Since 2013, looking only at banking government and financial sectors i.e. those in which this data is being moved, there have already been notable data breaches including Citigroup, Florida Courts, JPMorgan Chase, the European Central Bank, the IRS, the Australian Immigration department, Wonga, Invest Bank, Tesco Bank, the Privatisation Agency of the Republic of Serbia and many others with a total data loss in terms of records easily exceeding a billion. While the number of reported data breaches has increased since 2010, we must recall that many data breaches have yet to be identified and some of those will probably never be reported. So, the amount of data involved in AEoI will certainly not be a challenge, nor will the seeming alertness of the industry to the risks be a barrier.

The net result is that AEoI represents a highly substantive and significant risk both for the firms mandated to report such data to their tax authorities and also for the governments self-mandated to share it. The risk is both financial and reputational. Financial risk exists because the data alone is not tax evasion, it's merely data being used as part of a tax evasion detection framework. There will be many, if not most data owners, who are not tax

evaders, who have properly disclosed their foreign assets to their home governments. Despite this, their data will be automatically shared effectively on a 'just in case' basis.

There are to our mind several risk points:

- the compilation of data by a financial institution that may be accessed by unauthorised parties prior to transmission;
- the illegal interception of the data while in transit or by breach of security protocols at the point of delivery
- the illegal hacking of the delivery portal

Any of these creates financial and reputational risk at many levels. The legal basis for over-riding data privacy protections in order to meet intergovernmental agreements has yet to be tested. However, considering that the data being moved will, on the whole, represent account holders of substantial financial strength, it is not unimaginable that a data breach whether at the financial firm or at a government function, of an account holder with no demonstrable tax evasion taking place, would potentially create a legal issue of some substance that may in turn bring into question the amount of evaded tax actually being evaded compared to the cost of detecting it and deterring it through AEoI and CRS.

Intent

The second major risk point for me lies in the unpackaging of the data itself at the relevant tax authorities, particularly due to the format it is being transferred in. XML is an easily translated and read format, which opens you up to multiple issues when the data has been transferred away from the financial institution and into the hands of a third party, in this case the Host Country Tax Authority (HCTA). When the data arrives here, it is unpackaged and can be viewed, edited and sent out in its raw format potentially by any number of employees within that tax authority. Now while we might like to think that a tax authority official would never risk their data, the fact is that it can and does happen. Disgruntled employees sell on and give away company data all the time, which makes it a big risk point in its own right. What amplifies that risk is the number of times this data packet is then sent on to other third parties, all of whom have to unpack it, read it, edit it, re-encrypt it and then send it on again. The risk of interception doubles every time that data is sent on, which could be up to 99 times. With that number

of transfers, anyone could get their hands on this incredibly valuable and sensitive data. And with such a large transfer only happening once a year at a pre-scheduled, published time, it would not be difficult for hackers to identify when the transfer is due to happen and be prepared to penetrate it at the key risk points.

This is where we come across our second big security issue with the system—encryption. From studying the AEoI framework in detail, its flaw seems to be that it is not a law or regulation that can set a universal standard for data encryption. Instead, it states that each institution moving data must take steps to ensure it is secure. Now if you're dealing with a bilateral jurisdiction this is not as much of an issue, because you can come to a mutual understanding of encryption standards easily. But when dealing with a multilateral jurisdiction, signing with 99 other countries at once, you run into compatibility problems. It is almost impossible to find an encryption standard that 99 countries could agree on, and the AEoI framework doesn't require them to. So each country will use their own interpretation of 'adequate encryption', which could be wildly different from another country's interpretation. The positive here is that the GDPR (General Data Protection Regulation) that comes into force April 2018 will provide some level of general compliance, as every country that deals with, or is a European country, will have to adhere to this regulation. The GDPR will replace the Data Protection Initiative, and effectively extends the scope of EU data protection law to all companies and institutions processing data of EU citizens. For financial institutions affected by AEoI, this will involve appointing a data processor within the institution who is in charge of ensuring that the storage and transfer of data meets the GDPR requirements. Failure to comply with this regulation will result in strict penalties of up to 4% of worldwide turnover, adding extra incentive to tax authorities and financial institutions to get it right. Within this new regulation are strict guidelines about the processing and storage of EU citizen data, which should help provide a more structured, standardised format for data encryption within AEoI.

Intent

But what would someone want with this data? There are a number of reasons and they are not triggered intrinsically by AEoI. They are out there already and being successful. So, while the AEoI framework has very clear guidelines about what financial institutions and tax authorities should have

as minimum standards for security at all levels, we already know that having the knowledge is not the same as actual protection.

- Theft for fun
- Theft for profit
- Bribery and Extortion
- Reputational damage

Let me give you some examples. Mr High Net Worth is an individual with a large amount of money and assets. He is a French national, with 10 bank accounts in 5 different countries within Europe for investment purposes. He travels extensively in some countries where he has accounts (which may trigger reporting under substantial presence tests). While he is a French national, he also has residential addresses in some other countries where he also has accounts. He also is a controlling person in several corporate accounts that he has in several other countries. In effect, the AEoI reporting package created by the French financial institutions may well be shared with more than one foreign tax authority. Equally, some of those foreign tax authorities may well receive information about him from their financial institutions that will also be shared with the French and others. So, the data about this person very quickly becomes a network map of this person's global financial footprint.

However, like many private millionaires, he keeps himself to himself and avoids the public eye, so he isn't widely known. But because he has reported accounts containing over £50,000 in foreign countries, his details, including a list of bank details and the amount of money held in each account, will be reported under AEoI.

Our cyber criminal has several points at which they can potentially access this data. Once the schedule of reporting is known, the hacker will certainly be able to focus their efforts on the time between gathering and reporting in the home country. As with all cyber security, the first risk is human, not technological. If an employee at a financial institution is corrupt or disgruntled or if an employee is subject to any one of the numerous scams that put their legitimate access rights at risk, then the data itself is immediately at risk, not because the systems were inherently insecure, but because the people who access them were vulnerable.

Now for a hacker who has acquired the data pack from his bank, finding out about Mr High Net Worth is a fantastic opportunity. The hacker can attempt to steal his assets directly, try to recover email addresses to gain access to his details or simply sell the information on for a profit. From his

point of view, it is highly unlikely that Mr High Net Worth will be monitoring every single one of his accounts at the same moment, and may not even notice money going missing until some time has passed. Even if the hacker had no interest in stealing his money directly, there is a cyber black market full of criminals searching for high net worth individuals to target, and willing to pay handsomely for it.

Of course, there is more than one way to make a profit from data. Smuggling money from bank accounts is one thing, but what about a hacker who doesn't want to be so subtle. Imagine that, instead of wanting to steal the information within the data pack, the hacker wanted to intercept and modify it? Digital blackmail is a strong trend in the cybercrime world, both through direct means and software like ransomware. By intercepting these highly sensitive packs of information, a cybercriminal can see the identities of foreign nationals who might be evading tax. Using this information, they could reach out to high net worth individuals and use this knowledge as blackmail. 'I know you've been evading tax with foreign bank accounts. But if you pay me a large sum of money, I can remove you from the reports.' Or they could simply publish the data online as a way of showing off their skills.

This information is therefore highly valuable and very dangerous simply because of what it represents. It could potentially cause corrupt individuals to act rashly, and even be used to cause political instability. While these scenarios might seem a bit far-fetched, they are worryingly possible. State sponsored cyber crime should also not be discounted since publication of information about wealthy account holders of one country by another could lead to media coverage being focused on that latter country or distract law enforcement or legislature. It may even be used to highlight certain countries publicly as supporting tax evasion. The principle of AEoI is that this data is shared between governments and that governments will then take domestic action, but this data in the wrong hands or even the right hands with the wrong intent is a dangerous thing.

The Perpetrators

This distinction between motives brings us on to another important difference to acknowledge. While the media might only focus on the cybercriminals with sinister motives, there are actually 7 different types of hacker, all of whom have different motives for stealing data, and different purpose for using it:

Script Kiddies: Script kiddies don't hack into systems in order to steal things. They hack largely for the fun of cracking systems and encryption, with no real malicious intent at all. At most, script kiddies are responsible for many Denial of Service (DoS) and Distributed Denial of Service (DDoS) attacks, flooding IP's with so much traffic that they collapse under the strain, preventing people from using it. A script kiddie with knowledge of the AEoI framework might be interested just to see if he or she could do it. Typically many script kiddies prove their efforts just by modifying data once they've gained access to it. Adding a zero to an account balance could easily, if undetected, lead to a receiving tax authority believing it has evidence of tax evasion, when in fact this would not be the case.

White Hat Hackers: White hat hackers, also known as ethical hackers, are the good guys of the hacker world. They follow a strict set of rules, laws and code of ethics, and use their abilities to help people and businesses operate more securely. White hat hackers are often employed by corporates and financial institutions to identify weaknesses in their security systems before any other hackers do. However, in order to do their job, white hats need to be aware of new systems or procedures that may need to be investigated for weaknesses. This leads in particular to the financial firms gathering all this data into new data packets, having a procedure in place to identify the new process, and to ask the white hat to test it for vulnerability.

Black Hat Hackers: Black hat hackers, or 'crackers' are the people you often hear about on the news. They hack with malicious intent, finding large corporates and banks with weak security systems to steal credit card information, confidential data or money. These types of hackers would be interested in AEoI for its extortion value directly or indirectly through the sale of hacked information to others.

Grey Hat Hackers: As with everything in the world, nothing is just black and white. Grey hat hackers are hackers with morals—so they might not steal credit cards from people, but only from institutions who can afford to lose them. The morals usually depend on the person, but generally follow similar themes. These hackers make up most of the hacking community, even though the black hats garner most of the media attention. So, a grey hat hacker whose beef was rich people evading taxes might want to steal that information in order to publish it along with their commentary and opinion. A grey hat hacker who thinks that financial institutions are the root of

all our worldly woes might want to steal AEoI information simply to embarrass the financial institutions to show up their security weaknesses.

Green Hat Hackers: Green hat hackers are 'green' in every sense of the world. They are new into the hacking world, mainly using script to learn how to crack systems and fulfil their dreams of being full blown hackers.

Red Hat Hackers: Red hat hackers are the vigilantes of the hacker world. They're like white hats in the sense that they put a stop to black hat attacks, but mainly through funnelling viruses and attacks back at the black hat hacker. While a red hat hacker might be difficult to find in the financial services arena, the systemic risk posed by this particular type of information flow might make a red hat hacker more eager to identify a black hat hacker in order to prevent further leakage of data and system compromises.

Blue Hat Hackers: Finally, you have blue hat hackers. If a script kiddie ever took revenge, he would become a blue hat hacker. Blue hat hackers will seek vengeance on anyone who has made them angry, stealing information or framing them for crimes. In AEoI, this is far more likely to be an ex-employee or disgruntled current employee in a financial institution or a high minded individual in a tax authority.

We should not however believe that AEoI creates or created these individuals, but they do exist and we should not underestimate attractiveness that this type of data aggregation will have to this community.

Each and every one of these hackers can be incredibly dangerous not only to the individuals whose data is held within these files, but the institutions handling them as well. For example, a script kiddie might publish the information online just to prove that they broke the encryption. A grey hat hacker might steal the information of a company listed along with the controlling persons, while a black hat hacker would use or sell all of it. And if a blue hat hacker has been wronged by an individual or company listed, or the financial institutions handling the data, they would target this type of data. The least likely to target AEoI data would be red and green hat hackers, but even they could probably find profit in stealing and selling this valuable data.

The reason for explaining the various motives and uses for this data is simple. The AEoI framework as it stands has some significant weaknesses and risk points, all while handling data that is both directly and indirectly incredibly valuable. While there are some protections in place in terms of encryption protocols, the main risk points lie in the third-party entities

who handle the data at source and once it has left the financial institutions. However, there are ways to reduce this risk.

Our main view is that all financial firms and tax authorities should create a specific team that is wholly dedicated to this data transfer simply because it represents a major differential of value and risk. All personnel involved should be highly trained in not only the financial services industry, but the AEoI and CRS framework as well. They should understand how to receive, handle, package, encrypt and send the data in a secure way as their primary job role, instead of a tacked-on task within another department. Because the thing everyone forgets is that you can spend millions on firewalls, but the single biggest weakness of any cyber defence is the people within it. Just one disgruntled ex-employee, one lazy administrator who leaves paperwork on the printer or open on a screen, is enough to open up your data to cyber-criminals. An organised hacking group doesn't need to try and penetrate your firewall, they just need to use that weak link to get all the information they need.

In conclusion, we think the risk associated with AEoI is much higher than that related to other aspects of financial services. Therefore, a standardised approach, however detailed, may not be sufficient to deter or prevent one or more attacks on the data. The result of any significant data breach in this area, whether at a financial institution or a tax authority, would have significant and wide ranging consequences both for the individuals subject to the breaches and the integrity of the AEoI project itself.

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Challenges of GATCA

In this final chapter we will consider all three global frameworks of the Global Account Tax Compliance Activities (GATCA), namely the US Foreign Account Tax Compliance Act (FATCA), the Organisation for Economic Cooperation and Development (OECD) Automatic Exchange of Information (AEoI) and Common Reporting Standard (CRS) as well as the OECD Base Erosion and profit Shifting framework (BEPS). However, in contrast to the earlier parts of this book, in this chapter we will be focusing on summarising and explaining some of the key operational challenges associated with implementing these frameworks as well as the wider challenged of regulatory compliance. Knowledge of the basic purposes, structures and issues is assumed.

While GATCA itself contains a broad spectrum of inter-related regulatory frameworks, it sits among hundreds of other legislative devices with which financial institutions must comply. Though GATCA does present unique challenges to affected companies, many of the issues that come with implementing and maintaining regulatory compliance are common to many forms of legislation. Furthermore, regulatory compliance is a broad subject area, encompassing elements of governance, risk, structural elements, policy, procedure, training etc. With that in mind, we will look at the challenges of GATCA both broadly, taking into account wider compliance challenges, and those that are more specific to the GATCA frameworks.

At the risk of understating the point, the global financial regulatory landscape is barely recognisable to that of just a decade ago. The 2008 crisis, while perhaps an overused narrative device on such matters, does mark an

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important watershed in the history of regulation of the financial industry. In the wake of the crisis and the massive regulatory reform that followed, financial institutions have seen compliance risk become a much higher priority.

With the cost associated with compliance rising, and the penalties for failing to do so often severe, there is considerable pressure to get it right. Larger institutions have generally changed their approach in this regard. Where once regulatory compliance may have been an extension of the legal wing of the business, often acting in an advisory capacity, it is now much more likely to be a dedicated function of the business, with significant resource and a harmonised strategy. However, in smaller financial institutions regulatory compliance is often a job role, rather than a department, and it has to be said that most financial regulations don't scale well. That is to say that a company 1/10th the size of a major bank does not enjoy 1/10th of the compliance burden.

To borrow one of our favourite phrases, the 'Tsunami of regulation' that has been introduced since the 2008 crisis hit, continues to be a monumental problem for smaller financial institutions. Resources are, as you would expect, a big part of the issue. However, what is often equally problematic is a lack of joined-up thinking about compliance issues that is endemic in some smaller businesses. Such issues often stem from lack of effective management and oversight at the very top of the organisation, which can lead to fragmented and ineffective implementation of regulatory compliance measures throughout the organisation. It has to be said that we often encounter businesses that view compliance as an onerous task, a box ticking exercise, rather than as an important function of the business that is designed to counter risk. This attitude is perhaps understandable, as the cost of regulatory compliance does not scale well with the size of the business either. However, fundamentally, regulatory compliance is an important business function that, when implemented effectively, should analyse and manage risk.

I mentioned earlier that in smaller financial institutions regulatory compliance is often a job title rather than a department name. In reality, such a setup, while made necessary by economic factors, does not provide sufficient resource to fully encompass the vast number of regulatory areas that impact the company in question. What usually follows is that regulatory compliance tasks are left to departmental managers throughout the businesses. While delegating compliance functionality is not in and of itself a bad thing, we have found that this often leads to a situation in which the knowledge of a regulation, as well as the design and implementation of the necessary control functions for that regulation, fall under the responsibility of just one person within the business. The issues that arise from this include a lack of

knowledge of that particular regulation within the entities DNA, an over-reliance on the skill-set and knowledge of one individual and the risk factors that imposes, as well as the often overlooked factor that the compliance functions this person performs are secondary to their day job. Furthermore, the lack of seniority of this figure can lead to issues in effecting necessary change in other parts of the business that may be impacted by the regulatory framework they have taken responsibility for.

At this point it should be mentioned that in many of the cases in which we have encountered the type of setup outlined above, the person within the business that has taken charge of a regulatory area does so willingly and in our experience takes on this work of laudable reasons, despite the heavily increased workload that is part and parcel of such a situation. However, these fragmented structures are inefficient and their effectiveness can be hampered by the reasons that have already been mentioned. When the structure is replicated across dozens of different regulatory frameworks the problems become increasingly clear. Firstly, with compliance functions spread throughout the organisation, how can the businesses management effectively understand and control the business' state of compliance and therefore fully understand the risk factors? Furthermore, isolation of these compliance functions can inhibit the businesses ability to implement business wide policies on risk and other governance issues. Secondly, with similar functions spread between multiple individuals, there is great inefficiency in the model. Moreover, many regulatory frameworks have significant areas of overlap e.g. QI and FATCA, FATCA and CRS/AEoI—the efficiencies that can be achieved by harmonising efforts in these areas should not be overlooked.

The increasing number of regulatory frameworks and the compliance burden that is associated with them has inarguably posed significant challenges to financial institutions. For many, the cost of providing services has increased and at the same time further obstacles are implemented that negatively impact on customer experience. However, these issues can be mitigated, at least to some extent, by a change in approach to regulatory compliance. By proactively implementing targeted changes to the structure and nature of businesses' compliance functions, financial institutions can improve efficiency and diminish compliance risk. If the message has not yet sunk in, one of the key takeaways from this book is that regulation is being implemented at an unprecedented rate. Businesses that are not already doing so need to place more emphasis on their compliance functions to meet the demands of new regulatory obligations. By getting ahead of the curve in this respect, businesses will be able to reduce future risk while combatting inefficiencies and stealing a march on their competitors.

One of the realities of helping businesses with their tax regulatory compliance issues is that you tend to find a number of commonly accepted approaches that have been implemented with the best of intentions and with sound logic, but when viewed through the eyes of a third party no longer hold up.

Something that we frequently find, particularly in tier 2 and 3 financial institutions, is what would best be described as a fragmented approach to international tax frameworks. In institutions that do not have a dedicated tax unit, it is not uncommon to find that compliance in a regulatory framework is the pet project of someone in a completely unrelated job role. This of course may be duplicated across many individuals within an organisation, leaving disparate parties working separately on interconnected issues. We have found that this even occurs where there are significant crossovers between frameworks (such as with the US QI and FATCA regulations). Evidently, this is not an efficient way of doing things, but of greater concern is that it can lead to serious compliance issues being overlooked.

The all too common situation described in the previous paragraph points to a system wide issue in the way that such an organisation approaches its governance and oversight roles. These problems can stem from a lack of knowledge of the issues relating to specific regulatory frameworks at the top level, or an unwillingness to adapt to the growing amount and complexity of current tax legislation. What has become apparent is that a lot of businesses would have a much easier time of things if they approached these tax compliance frameworks with a more holistic view. Rather then treating each regulation separately, a common approach undertaken by dedicated staff with adequate resources would go a long way to mitigating the risks associated with compliance failings.

Another issue that we commonly encounter relates to the allocation of resources to GATCA regulatory frameworks. While the preceding paragraphs concentrated on the lack of joined up thinking in organisations when it comes to GATCA issues, we encounter organisations that either can't, or won't, allocate the resources necessary to effectively maintain compliance. In our experience, organisations often see compliance as a burden, and as such often do not prioritise it as a function within the business. It must be said that regulators and national tax authorities do little to dissuade this type of sentiment—rarely making public examples of successful penalties applied to non-compliant businesses.

I have talked previously about the idea that compliance should be worn as a badge of honour, but further to this idea, it is something that can often

be productised. Businesses that are reluctant to commit resources to compliance measures for economic reasons should consider building the costs associated with compliance into the cost of the product. For example, we know of several financial institutions that now apply fees to downstream institutions for processing tax documentation forms for their clients. The regulations have imposed the burden of processing these forms upon them, however, instead of taking the glass half empty approach, they have seen the opportunity to offset their compliance cost with a processing fee. This is just one example, and a simple one at that. The wider point to be made here is that the spectre of regulatory compliance will always haunt financial institutions, but the impact on the organisation can often be mitigated with a change of approach.

A common theme that runs through the GATCA frameworks as well as BEPS is the breadth of the regulations, and in particular that they impact multiple functional areas within an in-scope business. The company wide nature of many of the rules can pose a significant challenge in terms of both implementation and with on-going compliance.

We have, from time to time, encountered organisations that operate with highly insular vertical silos. For those unfamiliar with the terminology, essentially the various departments within these businesses are effectively walled off from each other, causing issues with efficiency, productivity, leadership and information sharing. Moreover, in our experience, organisations that exhibit the silo mentality often suffer from compliance issues that stem from this mentality as well.

Earlier in this chapter I talked about the efficiencies that can be gained by harmonising efforts in interrelated regulatory areas—the example that was used related to QI and FATCA, which make use of the same series of client documentation forms, as well as several key structural similarities. However, we have encountered many companies that have not harmonised their FATCA and QI regimes—in such cases separate departments within the business handle the compliance function for each framework in isolation. There are obvious issues here, most notably with duplicative work efforts and paperwork. However, in organisations with a silo mentality, the overlaps between the two frameworks are not considered at all, which can lead to significant compliance failures. Cooperation on such issues is becoming more and more essential.

Businesses, now more than ever need the flexibility to approach regulatory issues in a harmonised fashion. As the scale and scope of legislation continues to increase, those that will not approach regulatory compliance as a key strategic issue will face significant challenges. Silo thinking encourages local-

ised decision-making and discourages information sharing, both of which can lead to, or exacerbate, compliance problems. The widespread nature of the GATCA frameworks ensure that many different business arms are impacted by the legislation—the need for effective cooperation and joined up thinking is then obvious.

The uncomfortable truth about the silo-mentality is that more often than not, the issues start at the top of the business. However, the point I am trying to make here is not to pour scorn on boards of directors, but is to speak to the need for those with the power to do so, to take ownership of regulatory compliance and incorporate it as a key part of the organisation's strategic goals. Cooperation within and between business units is an important aspect of wider organisational culture, but in the implementation of new and complex rules it has material importance. For companies to truly embrace compliance as part of wider strategic goals there is a need to ensure that compliance professionals have a seat at the table and are a fundamental part of the decision making process, and not a cursory afterthought.

This leads us nicely to one of the more complex challenges posed by GATCA; that the frameworks have significant commonalities in some areas, but also, critically, important detail differences. The similarities between FATCA and AEoI are legion and the influence of the former upon the latter is obvious, while the overlap between the two information exchange frameworks and BEPS is more subtle. However, there are core concepts that are present in all three frameworks that present challenges to impacted businesses.

One concern that is presented by all three frameworks, is that of reputational damage following from information contained within the required reports. The FATCA and AEoI frameworks are of course built on the idea of exchange of taxpayer information, while country-by-country reporting under the BEPS Action Plan requires in scope businesses to divulge unprecedented amounts of sensitive information to national tax authorities. The issues of cyber and human security in this matter were detailed in the previous chapter, but even when the data is totally protected there is potential for problems. In a way it feels strange having to write this, but ultimately, there are companies and individuals that will be exposed by these reports. Many, if not most, will alter their practices to mitigate the issue, but some will be caught in the net so to speak, after all, that's the point!

There is no getting away from the fact that the reporting requirements of the GATCA frameworks are extensive, and the compliance burden placed upon in scope businesses is significant. While the BEPS reporting requirements do a good job of limiting the impact on smaller businesses, AEoI and

FATCA, by their nature are not able to do so. This places a heavy burden on the shoulders of small financial institutions, and I can tell you from personal experience that reporting season is a tense time at this type of business.

One of the key objectives in the OECD frameworks we are discussing is that of harmonisation of tax rules. This laudable, if Herculean objective sits in stark contrast to the US frameworks and FATCA in particular. The merits of standardising the approach to tax legislation across territories globally are obvious, however such ideals do not necessarily reflect the objectives of all participants. Given that AEoI and FATCA are functionally similar it would of course make sense from an international perspective if adoption of the global framework were, in fact, global.

What the FATCA/AEoI issue highlights, is just how problematic it can become if just one major participant implements a similar but not-identical tax framework. The issues for impacted financial institutions have been talked about in detail elsewhere, but to summarise; duplicative efforts, additional compliance burden and therefore risk as well as increased costs are all generated through such an arrangement. One of the major concerns that has arisen from the BEPS project is that a lack of uniformity in application of the Action Plan will result in this type of situation multiplied across over 100 jurisdictions. The reality will likely not manifest in the worst-case scenario highlighted here, however, it can be considered as a strong argument for harmonisation.

While the OECD has made efforts to replicate the FATCA model within its own AEoI regime, it has also implemented elements of other aspects of US tax law within the BEPS actions. One of the core outputs from BEPS Action 6 involves the universal adoption of limitation on benefits rules within tax treaties that are based upon the model used by the United States. Action 6 is part of the minimum standards package that all associate nations must implement, which represents a positive step from the aspect of harmonisation.

The issues that stem from a lack of harmony in the approach that a business takes to achieve and maintain operational compliance are far from insurmountable. The overlapping nature and interconnectivity of some of the GATCA frameworks, alongside other existing international tax legislation, has lead to many financial institutions making structural changes to accommodate the morphing regulatory landscape. The obvious change, for institutions that do not already have one, is to form a tax unit with appropriate personnel and resources—and this is an approach that we have seen a number of businesses take. There are advantages to this approach beyond the obvious efficiencies, not least of all the ability to consolidate the firms

tax compliance program into one harmonised regime that is maintained and updated by those with boots on the ground. It is not simply enough to have a business function that is dedicated to tax. The unit must have sufficient influence to effect change, but more than this it must be able to work with the leadership and influence policy where necessary.

When a rule set is static, it is reasonably simple to maintain compliance once it has been achieved. However, regulatory frameworks rarely remain static, and many of the cases of non-compliance we encounter happen because at some point the rules have been changed and nobody in the business realised. While it is fair to say that it is the job of compliance professionals to keep abreast of regulatory changes, I have a fair amount of sympathy for those that miss the occasional update. Legislative and regulatory bodies on the whole are pretty bad at keeping businesses in the loop. By way of an example, in the last few days of 2016 the IRS issued new QI Agreements and FFI Agreements for the QI and FATCA regulations respectively. These new agreements, which imposed fairly substantial changes for some companies, were due to come into force only a few days later on January 1st. If the lack of time wasn't bad enough, the regulations were issued just as companies shut down for the Christmas break!

Keeping abreast of regulatory changes is a significant task, and one I know fairly well, as a significant part of my day job involves keeping our clients appraised of modified and new rulings that may impact them. I mention this as I do have considerable biases when it comes to this particular subject. We invest considerable time in maintaining and updating a database of regulatory documents and therefore have a good understanding of the costs involved in staying ahead of the curve in this regard. The pace of change is something that has escalated somewhat in recent years and importance of the task of monitoring for regulatory changes should not be downplayed.

Not only does new and modified tax legislation cause challenges for personnel, it has a significant impact on systems as well. The ins and outs of this topic are well beyond the scope of this book, so you will have to excuse my brevity on the subject. Much of what has been said about the need for flexibility and harmonisation in personnel and structures can be applied to systems as well. As the needs of users evolve with the regulatory landscape, systems need to be flexible enough to encompass these changes. This is an area in which hosted solutions are starting to make a big impact in the industry, as the structure allows for almost immediate changes to be implemented while almost entirely removing issues that occur with legacy users. We are starting to see very sophisticated, tax focused software solutions that encompass the GATCA frameworks hitting the market, and this can be seen as a very positive step forward.

One of the words that is most commonly written regarding the implementation of new legislation has to be 'uncertainty'—and to refer to our own example, it is used extensively throughout the BEPS chapters in particular. Change, by its very nature brings uncertainty, and it stands to reason that times of great change bring with them great uncertainty. We have made no secret of the fact that GATCA has imposed significant volumes of regulation on financial institutions around the globe and that businesses are facing significant challenges to prepare themselves. However, perhaps as some sort of cruel trick the universe is playing on us, we are facing significant global uncertainty at the time of writing that promises to compound the problem.

The western world is enjoying the longest period of stability in recorded history, but there are challenges on the horizon that cast a considerable shadow over the future, particularly from a business perspective. It is fair to say that the impact of two global events in particular, Brexit and the election of President Trump are producing considerable uncertainty. You will forgive me for steering clear of the political aspects of this subject area, as there is little of value to add to the discourse that has not already been said, ad nauseam. The financial sector in particular has taken a rather negative view of the political landscape that is evolving in front of us, and that is perhaps understandable—Brexit will have a colossal impact on how businesses are structured and where they are located. Furthermore, uncertainty over how business models will need to evolve is harming institutions' ability to strategise and is generating considerable costs.

Global uncertainty is not itself a challenge that is specific to GATCA, however it will have a considerable impact on the implementation as well as operational aspects of many of the frameworks. Perhaps the biggest impact will manifest within the BEPS camp, where organisations that already have to plan to restructure to more economically sound business models, will have had another spanner thrown in the works by Brexit in particular. What this speaks to is a need for businesses to closely integrate regulatory compliance into their decision making process. The sheer volume of new regulation alongside growing global uncertainty have manufactured a landscape in which institutions can not afford to be ill prepared.

Summary

Some readers however will want some more specific commentary of real challenges. Here are some practical notes.

Awareness

The largest single issue. Both board level and department heads need awareness of what regulation is out there and how it might affect the different parts of an organisation. This may seem trite, but it's true. We still see C levels in many medium and smaller financial firms with no knowledge of the issues let alone the impact. The difficulty this presents is that department heads have more difficulty obtaining budgetary approval for resources because the C levels don't even understand that there's a problem. Even when they do, there may be a different understanding of the priorities and impacts on the business between department level and C level.

Knowledge

Get some subject matter experts, in-house or outside, it doesn't matter. In most firms there is no subject matter expertise. This affects the resourcing process as described above, because there is usually a layer of complexity below the principle level that most C levels don't really want to know, and most functional heads either also don't want to know or who don't have the time to acquire. It's at the subject matter level that many of the cost and risk complexities occur, so both in the compliance assessment phase and the implementation phase, if you don't have that granular connection between the concepts and obligations, and the how it really happens on the ground and what must change—the firm will probably fail in compliance.

Prioritisation

One of the first things we do when we consult or train on these matters in the market, is establish whether the firm has prioritised these issues. To do that of course, you must both be aware of and understand the practical issues involved. In the FATCA and CRS worlds for example, it is important, before deciding to wholly re-design systems and procedures, to understand the scale and scope of the impact on your business of these frameworks. If you have customers that are 90% domestic and of relatively low value, your approach to practical compliance will be different from that of a private banking firm with many high net worth clients from many different jurisdictions. This is called risk-weighted compliance.

That said, prioritisation, for example in FATCA, would be based on whether you accept US persons as part of your business model and if so, what steps you can take to minimise the impact on your operations. We see this in US IRC Chapter 3 where firms typically need to assess the reliance that their business has on the US market. That would be in US$ terms—what value of US securities, income and customers would be affected if the firm simply decided to withdraw from the market because the compliance load costs more than the exposure. Some firms in Europe, Australia and New Zealand have taken this step already.

Approach

Once the awareness has created knowledge, and that knowledge has set a priority, the firm needs to decide its approach. This is a really difficult one and there is no one size fits all solution. However, this issue is typically addressed at the functional level because the practical problems are at that level:

i. Do you use the W-8 for FATCA and if so why? Is it because the W-8, properly validated, removes liability from the firm?
ii. If you do use the W-8 instead of an in-house designed data gathering form for US IRC Chapter 4 status, how do you handle the client relationship management frustrations associated with the extremely complex tax technical W-8.
iii. Do you have robust validation procedures for these statuses? In our experience most firms do not. In fact many firms have no written procedures at all. Those that do are not robust enough to stand up under scrutiny.
iv. Are you leveraging systems enough to reduce risk? The answer to that is almost always no. Most firms have legacy systems with a few bolt-on extras. The lack of prioritisation and approach usually then means that functional heads and staff are reduced to managing data gathering outside of KYC and AML using spreadsheets. These are also commonly used throughout the process and are usually also seen at the reporting end of the cycle too with spreadsheet data, for example, being used to reconcile an upstream form 1042-S from a US Withholding Agent to downstream data.
v. Is the collated data secure? Probably not. The point at which this data will enter a secure environment is when gathered preparatory to reporting, at which point GATCA frameworks all start talking about security of transmission. However, the chances are that this data is being extracted from legacy systems and held in spreadsheets for checking prior to being entered into a secure system.

vi. Who is in charge of monitoring competency? This has several elements. You need resources capable of knowing where to look for changes that might need to be reflected in systems. There are many business oriented social media groups that can help, but view is these are often contradictory and rarely useful in a specific set of circumstances. With FATCA of course, you only need to look at one regulator, the IRS, but even here the number and types of communication are different and some have more force that others. Revenue Procedures are different from Notices and Announcements and Publications. In addition, competency needs to be controlled in terms of specialist knowledge and training. When we conduct interim periodic reviews, we focus a lot of attention on whether there are adequate training programmes in place and whether the human resources function is aware that knowledge about these regulations creates value in individuals. Given that most firms have a very low resource aimed at GATCA frameworks, the retention of these individuals and a plan for replacement as part of compliance continuity, is critical to maintaining corporate memory.

Resources

Almost without exception, tier 2 firms and below will take a risk-weighted approach to compliance. This in itself creates risk. However, the main impact is that there is never enough resource to do a good job. We typically see GATCA related resources at between one and five full time employees (FTE). When deadlines come around, this is when we see this resource level under most pressure. It's often a case of 'not my problem' from those in supposedly supportive functions who have 'day jobs'. In other words, for tier 2 firms and below, the most common response to GATCA frameworks is to spread the effort out across several departments, usually tax and client onboarding. This is not an automatic failure but it presents serious risks. Reporting, for example, is often left to whichever individual happens to know enough to sound intelligent, irrespective of the calls on their time from their day job. Smarter firms recognise this risk, and create a cross functional approach that includes a specific team of FTEs dedicated to the issue, with operational support mandated by the board from other departments in a documented way i.e. support for GATCA issues becomes part of their day job not a politically sensitive adjunct to it.

Policy

Most firms we talk to lack some or all of the foregoing elements and we work diligently with them to fill the gaps. However, the challenge is always that those further down the organisation usually have a better idea of what is required than those further up. The downstream staff are concentrated on activity i.e. procedure. It is easy for an operational procedure that is not predicated on a prior policy discussion, to become policy by default. This is where our work is most challenging. This is because most queries come from an operational standpoint—e.g. what happens if we have an indirect client who has a US person as a client? The problem is that this type of question belies the fact that there is no policy guiding the answer, and the circumstances and choices made by the firm can radically affect the response and subsequent procedure. It is therefore very important that those driving compliance in GATCA matters, whoever they may be, the champions of the cause, must raise these questions into a policy domain. We typically aggregate all these kinds of questions into 'policy groups' i.e. the responses to these questions all share a common thread that requires a policy driver. In this way, a C level person can immediately see that a request for policy is not just an 'out of the blue' request, but has been thought through and presented so that the overall picture can be discussed and agreed. In the US FATCA example cited here, the status of the firm as QI or NQI is relevant; their status as P-FFI or NP-FFI is relevant; their policy on indirect account holders is relevant; their policy on risk mitigation for US persons through TIN Matching is highly relevant. So the question sounds simple, but is in fact more complex and requires a base policy. It's actually a bit of a circular discussion because, in order to discuss the policy alternatives, there needs to be an understanding of all the possible impacts of each policy and how they might impact procedures in the business. The US example is, in fact, the simplest to consider. The parallel CRS question would be ten times as difficult to describe.

Procedure

So, a modelling process is actually what takes place in most firms. The base state of the firm is taken as the starting point, and discussions begin with hypothetical questions that join the GATCA issue to the base state in order to test potential policies, their risk profile and their resource load and cost implication. Time is a factor here simply because, in almost all cases, this type of

work has never been done and while the firms usually understand its value, the causative question has usually been triggered because someone somewhere realised that a deadline was approaching. This leads to short term plans and longer term plans—how do we fix the problem now, and what do we do later on. There is a procedural approach we have found to be very useful and it's based on the requirement in FATCA to have a written compliance program that is used to demonstrate effective compliance to an independent reviewer every three years. While CRS and AEoI do not mandate this particular model, leaving compliance monitoring to bilateral discussions, we provide opinion that the FATCA compliance approach is of a high level and can be used across the board in a principle basis with CRS and AEoI as well as BEPS to a more limited extent. The below represents an extract of the topics we cover in procedural terms in compliance programs we develop with our own clients:

1. Static Data & Business Model description
2. Policy Statement with regard to compliance prioritisation (risk weighting) and resources;
3. Policy Statement with regard to control (Responsible Officer)
4. Operations

(a) Sales
  i. Policies on US Persons (FATCA) and non domestic account holders (CRS) as direct account holders—accept or not and if so, subject to what conditions;
  ii. Policies on indirect account holders—accept or not and if so, subject to what policies and control procedures
  iii. Policies on material changes (how identified and how communicated)
  iv. Policies on reason to know and actual knowledge—how applied, how trained;

(b) Onboarding & Material Changes
  i. Policies and procedures for the solicitation, validation and processing of new accounts;

(c) Documentation
  i. Policies and procedures on use of KYC and AML, Use of W-8 and W-9 (FATCA) and ISD (CRS)
  ii. Validation procedures
  iii. Policies and procedures for segmentation of accounts for review and use of indicia—application of thresholds and responsibilities for data extraction and reporting

   iv. Policies and procedures for curing indicia
(d) Withholding/Penalties
   i. Procedures for abatement of penalties
(e) Reporting
   i. Procedures for aggregating data and cyber security
   ii. Policy and procedures for establishing and monitoring reporting methodologies (in-house, outsource, third party solutions)
   iii. Policy and procedures for reconciliation of data to counterparties
   iv. Procedures for test harnesses on report data
(f) Control & Oversight
   i. Statement of legal basis and regulator identification
   ii. Policy on methodology for oversight (internal audit, external audit, frequency, regulator constraints, timing, dependencies)
   iii. Policies on 'four eyes' risk, remediation of risk, notifications of failure, regulator mandated certifications, whistleblower protection
(g) Training
   i. Statement of commitment to adequate resources
   ii. Policy and procedure on competency (establishment of subject matter expertise, retention, training, periodicity of training and updates;
(h) Transparency and Change Management
   i. Policy and procedure on 'raise of concern'
   ii. Policy on protected disclosures
   iii. Procedures for change management on issuance of new forms, new guidance and new reporting methodologies.

The above is an extract of a much larger document. Merely talking through a table of contents like this for a compliance program, we have found to be extremely effective in getting the message across to both functional heads, staff and boards of directors.

It is hopefully clear that we could not have addressed this amount of practical procedure without doubling the size of the book and that any such work would, of necessity, have had to encompass a variety of different possible scenarios for each given variable. But that is also the point—that GATCA frameworks may sound simple in principle—the detection and deterrence of tax evasion. However, the depth of change that this simple principle can create in the industry is massive and complex.

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Conclusions

In this final chapter, we seek to bring together several important threads relating to GATCA frameworks that hopefully will give the reader a broader picture of how GATCA tax evasion frameworks will sit in the future priorities of investors, financial firms, corporations and governments.

Purpose

We have now provided much commentary on the various elements of GATCA. FATCA, which has been in place since 2010 and now AEoI/CRS whose first exchange of information is 2017 with further exchanges annually thereafter and BEPS whose implementation schedule is ongoing at the time of writing. The big questions really are—(i) will all this effort actually work, and (ii) will it all be worth it? In other words, can GATCA frameworks really deliver on their purpose. The answer is probably not, depending on what part of the question you seek to answer.

Detection

Will GATCA frameworks detect tax evasion? Possibly. The problem is that these frameworks are so complex that they suffer from the same fundamental problem that the original tax regulation does—complexity leads to loopholes and it's loopholes that tax evaders typically leverage. So, on the one

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hand, given that the rules of the game are public domain, the tax evaders have ample warning of the new rules and will be among the first to see that their very complexity leads to other 'opportunities'.

Deterrence

Will GATCA frameworks deter tax evasion? Probably not. Tax evasion is a behaviour that is triggered by self interest whether that be of an individual, a corporate or a jurisdiction. If the benefit is large enough and the loophole exists, you will always find someone prepared to go through it. The general trend towards reducing taxes is more likely to make tax evasion, as opposed to tax avoidance, less of an issue, both in absolute monetary amounts and also as a proportion of gross domestic product (GDP). In particular for example, President Trump's policy on taxation is driven by the belief that lowering taxation will increase growth. In combination with his 'America first' policy, this may have the effect of encouraging greater inflows of assets back to the US. It's one thing to be a tax evader. It's quite another to be an unpatriotic tax payer. That said, we must also consider that those jurisdictions that have historically been deemed to be tax havens stand to lose large amounts of inward investment. It is also true that while tax evasion has always been with us, its high profile in recent years has certainly been generated by the financial crash and subsequent volatility. As time goes by, it is perhaps likely that its profile relative to other issues, will drop.

Notwithsanding any of the above, tax authorities and governments have now, more than at any time in history, gained the knowledge that the industry has enormous amounts of data and that they would like to have access to that data.

It is certainly true that GATCA will have some deterrent effect. There will be some proportion of tax evaders who do change their behaviour. The issue, we believe, is that tax evasion is often talked about as a problem that can be solved, while the reality is that it's a behaviour that needs to be changed and it's rare that rules alone will achieve that. If you don't believe us, consider why the rules (and even the penalties) didn't deter you the next time you drive over the speed limit. You made a judgement, even if unconsciously, that the risk of getting caught was relatively low and the penalties were not high enough to offset that risk assessment. The one thing that GATCA does do is to limit the occasions in which evasion can take place without detection. That may certainly change the judgement of evaders where the penalties aren't in GATCA (with the exception of FATCA) but within domestic law and, of course, by media.

The penalty for businesses should their tax planning strategies become exposed, is potentially more severe than it is for individuals, as the cost of reputational damage can be extensive. Because of this, BEPS may stand to act as a stronger deterrent than the other GATCA frameworks.

Prevention

Will GATCA prevent tax evasion? Almost certainly not. Prevention, as we know, is another side of the coin of deterrence. Deterrence relies on the principle that tax evasion behaviours can be modified with rules so that they don't occur in the first place. Prevention on the other hand recognises that rules alone are unlikely to deter these behaviours. In this respect GATCA's benefit is that it encompasses multiple jurisdictions. Therefore, the concept that a tax evader can merely move assets to another jurisdiction, becomes a less workable concept. That said, the potential variability inherent in the multi-jurisdictional interpretations of the frameworks creates 'loophole' opportunities for tax evasion as well as costs for the industry.

Cost Benefit

The difficulties that many readers will perceive is that, notwithstanding the principles underlying the intent of GATCA and whether or not they'll meet their intended purpose, these frameworks all require the industry to pay the cost for the benefit of others. That cost is substantial and may, in the long run, even be higher than any tax repatriation.

The complexity of due diligence and reporting processes creates significant business issues. Operationalising GATCA frameworks requires board level engagement and a cross disciplinary approach that few firms can easily run with. While AEoI leaves much of the substantive material of compliance to the jurisdictions concerned, FATCA, as a similar construct, shows how best practice has been moulded when a regulator is involved directly from top to bottom. The top level of operations requires someone to take overall control—the responsible officer.

The next level down requires a compliance program that is written and that includes both policy and procedures for every aspect of operational compliance. This level also, importantly, includes the need for explicit training, awareness, change management, monitoring, systems adequacy and control across the business. At the sharp end we see firms struggle to append

GATCA processes to existing KYC and AML creating issues of document solicitation, validation, data storage, data refresh, and relationship management. These cycle, in principle, once a year, but in reality, the cycles of each receiving jurisdiction that faces off to each sending jurisdiction can be different and that creates feedback into the operational activities—meaning that while it's an annual cycle, the reality is that this actually becomes a full time activity. We also see a fragmented approach from the IT sector with many of the solutions being proffered actually being extensions to existing systems that, by definition, are less able to handle the fact that these various sets of rules have very different purposes.

These low level operational activities bounce back up the management chain to controls for extracting data, packaging data, securing data and then transmitting data.

Many firms are leveraging their FATCA compliance processes, as best practice, into their GATCA compliance even though this means over-specifying resources in many cases in order to get something that homogenous and practical in place.

Tax authorities do not of course have FATCA experience to draw on and their focus is usually predominantly domestic. They are and will struggle to operationalize the guidance for their financial firms and create systems for receipt of data as well as unpacking, re-packing, security and transmission out to CAA partner tax authorities. All of this in an environment where most tax authorities are under-funded, under resourced and the team handling outbound AEoI transmissions will be unlikely to see any direct benefit of all that activity. The connection between the distribution of exchange information and the identification and prosecution of tax evasion may be many years long and will be unlikely ever to reach the public domain.

Cyber

Is there likely to be a data breach? Yes. We consider it highly likely. This will have ramifications for the regulators and for the financial services industry. The nature of the data being exchanged and its potential value and/or effects present an almost irresistible target for black hats, red hats and grey hats. Remember that, at the point of exchange/report, the data does not represent tax evasion per se. It represents data which, when analysed by a tax authority, may lead to a potential case of tax evasion. Prior to that, it's merely extremely sensitive, valuable information about the richest, non-domestic account holders of each financial institution in each country. A normal

hacker would have to search a bank's entire database to isolate valuable information during which time they would be vulnerable to detection. With GATCA, the financial industry will be preparing that information annually to a public schedule. In the case of BEPS, its information about the activities of major corporations, how they manage their business, exchanged between thousands of multinationals and national tax authorities. The potential scope for data leaks is enormous, and the consequences equally serious.

Ethics and Fairness

We began this book with a chapter entitled Moral Outrage and Righteous Indignation. Urban legend has it that when a certain government were approached by the US for the names of Americans with hidden bank accounts, the government concerned asked the US how much they thought was being evaded. On being given a number, legend again has it that the US were asked if they would take a cheque and 'go away'. The result was FATCA. While almost certainly untrue as an anecdote, it does rather underpin the idea that tax evasion is more about perceptions than monetary value.

The efforts required of financial institutions and corporates to meet the requirements of GATCA frameworks are more about showing that something is being done. Until there are prosecutions brought that are explicitly linked to information gathered under a GATCA framework, it will be difficult for those operating in the industry at onboarding or reporting level, to connect the work that they have done and the money that they have spent, with the intended purpose. That said, post-2008, ethics and fairness in tax matters still remain sensitive topics for financial institutions and large multinational corporates. So, perhaps it is not so surprising after all that these constituencies may view compliance in these areas as a cost worth paying.

Proportionality

Issues of ethics and fairness aside, the reader should, by now, have some sense of the amount of time effort and resource that sits behind every element of the task of detecting, deterring and penalising tax evasion. As we have written this book, and from our own vantage point as subject matter experts to the industry, hence knowing how firms typically react and deploy resources, it becomes increasingly obvious that the amount of money being spent on developing and implementing GATCA frameworks is likely to

far exceed the actual amount of tax being evaded, let alone the amount of evaded tax that can successfully be recovered.

Ironically therefore, the unintended consequence of these frameworks may actually be the positive effect on employment. Investors must take additional tax, legal and investment advice on investment structures and foreign held assets. Businesses must employ more people to assess and address potential effects of international business operating models in BEPS and spend more on public relations and reputational consultants to mitigate the effect of reputational damage. Financial firms must employ more people to meet compliance, operational, systems and training needs. Tax authorities are having to spend more on technology (and in some cases develop into that capability from scratch) not only to receive, unpack, re-pack and send data, but also to be recipients and thus employ more people to analyse the truly enormous amount of data. The advisory community itself must, and is, expanding with subject matter experts to fill the void at all of the aforementioned groups in terms of knowledge and practical experience. Lawyers will also benefit of course from the defence (or prosecution) of detected tax evaders, when found.

It looks more and more like GATCA is really more of a global job creation framework than a global tax evasion model—but that may be just a cynic's approach. It is certainly true that, at some point, someone will need to show the cost benefit analysis both at a jurisdictional level and at the OECD level to, in some way, connect the activity with the expected result.

No Benefit

Regulation, or at least rules, laws or regulation that firms are required to follow, usually have some benefit for those that are regulated. For financial services, especially since 2008, that benefit is often better or more controlled behaviour that in some way protects the market and/or the firm from risk. In the case of GATCA however, those who must follow the rules gain no benefit whatsoever. The beneficiaries, at least in principle, are the tax authorities, who have a greater ability to detect and prosecute tax evaders. If this becomes a trend, it will be extremely worrying for the industry. The industry complains at regulation, but to a large extent can connect the dots between the causal reason for the regulation and the regulated activity that reduces risk. GATCA represents a change in scope as well as a change in scale. KYC and AML clearly have a larger role to play, but the industry recognises that operational adherence has benefits for the industry and the firm itself in

terms of a better understanding of their customers, their needs and the consequent impact on their business. GATCA frameworks also have a larger role to play, but one that is more shrouded. There are no real direct operational benefits to firms affected by GATCA frameworks.

Perhaps the most we can hope for with GATCA frameworks is that the industry will do a reasonable job of compliance, that regulators will do a reasonable job of providing usable guidance and using the information to identify and deter tax evasion. That those of criminal intent—whether they be tax evaders or cyber criminals, are ultimately unsuccessful, and that those of us tasked with making GATCA happen are given the resources to support those objectives and are ultimately successful.

Appendix A: List of Abbreviations and Acronyms

General

AUP	Agreed Upon Procedure
AML	Anti Money Laundering
CIV	Collective Investment Vehicle
CSD	Central Securities Depository
EU	European Union
FI	Financial Institution
GATCA	Global Account Tax Compliance Activities
IRS	US Internal Revenue Service
IRC	US Internal Revenue Code
KYC	Know Your Customer
LOB	Limitation of Benefits
NGO	Non Governmental Organisation
OECD	Organisation for Economic Cooperation and Development
OTC	Over the Counter
REIT	Real Estate Investment Trust
SaaS	Software as a Service
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TIN	Tax Identification Number
1042	US Tax Return for non-US Financial Institutions
1042-S	US Information Reports for non-US Recipients

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IRC Chapter 3 (QI Regulations Referencing FATCA)

EFTPS US Electronic Federal Tax Payment System
EIN Employer Identification Number
FDAP Fixed, Determinable, Annual or Periodic income
FIRE Filing Information Returns Electronically
FWS Full Withholding Statement
IPR Interim Periodic Review
IRC Internal Revenue Code
ITIN Individual Taxpayer Identification Number
NQI Non Qualified Intermediary
NRA Non-Resident Alien
NWFP Non Withholding Foreign Partnership
NWQI Non Withholding Qualified Intermediary
PAI Private Arrangement Intermediary
POA Power of Attorney
PR Periodic Review
QDD Qualified Derivatives Dealer
QI Qualified Intermediary
QI-EIN Qualified intermediary EIN
QSL Qualified Securities Lender
RA Repurchase Agreement
RO Responsible Officer
SSN Social Security Number
SSNA Social Security Numbering Agency
TCC Transmitter Control Code
TIN Tax Identification Number
USWA United States Withholding Agent
WFP Withholding Foreign Partnership
WFT Withholding Foreign Trust
WQI Withholding Qualified Intermediary
WRPS Withholding Rate Pool Statement

US IRC Chapter 4 (FATCA)

A-NFFE Active NFFE
BO Beneficial Owner
C-DCFFI Certified Deemed Compliant FFI
DC-FFI Deemed Compliant FFI

EAG	Expanded Affiliate Group
EoI	Exchange of Information
FATCA	Foreign Account Tax Compliance Act *(misnomer)*
FFI	Foreign Financial Institution
GIIN	Global Intermediary Identification Number
HIRE	Hiring Incentives to Restore Employment Act (2010)
IDES	International Data Exchange System
IGA	Inter Government Agreement
NFFE	Non Financial Foreign Entity
P-NFFE	Passive NFFE
NP-FFI	Non-Participating FFI
PFFI	Participating FFI
R-DCFFI	Registered Deemed Compliant FFI

OECD

AEoI	Automatic Exchange of Information
APA	Advanced Pricing Arangements
BEPS	Base Erosion and Profit Shifting
BIAC	Business Industry Advisory Committee
CbCR	Country by Country Reporting
CFC	Controlled Foreign Company
CRS	Common Reporting Standard
CFA	Committee on Fiscal Affairs
FATF	Financial Action Task Force
FHTP	Forum on Harmful Tax Practices
G20	Group of governments and central banks from 20 major economies
HCTA	Host Country Tax Authority
HMA	Hybrid Mismatch Arrangement
ICG	Informal Consultative Group
IP	Implementation Protocol
ISD	Investor Self Declaration
MAP	Mutual Agreement Procedure
MCAA	Model Competent Authority Agreement
MLI	Multilateral Instrument
MTC	Model Tax Convention
NFE	Non Financial Entity
OECD	Organisation for Economic Cooperation and Development

PE	Permanent Establishment
PPT	Principal Purpose Test
TIEA	Tax Information Exchange Agreement
TP	Transfer Pricing
TRACE	Tax Relief and Compliance Enhancement

EU

EU	European Union
EEA	European Economic Area
FISCO	Fiscal Compliance Experts Group
GDPR	General Data Protection Regulation
T-BAG	Tax Barriers Business Advisory Group

Appendix B: US Model 1 Reciprocal IGA Template

Author's Commentary

We have included the text of the US Model 1A Inter Governmental Agreement (IGA) of the US for several reasons. First, it is a quick guide to the main characteristics and general structure of the IGA. Second, it demonstrates at the same time, the efforts to simplify the arrangements that would otherwise flow directly up to the HIRE Act (2010) as well as the complexities that flow from trying to address, in a single document, the definitional, exemption and exception issues associated with a complex financial services industry. Third, while OECD competent authority agreements (CAAs) are different documents, they do show great similarity of structure and also topic headings addressed. Once the reader has a feel for the US IGA, this will be of great benefit when OECD CAAs are reviewed.

The authors note here, as elsewhere, that there are several types of IGA of which this is only one, and represents an IGA where there is reciprocity and a pre-existing tax information exchange agreement. Other models reflect reciprocity options as well as language options related to whether there is a double tax treaty (DTT) and/or Tax Information Exchange Agreement (TIEA) already in place when the IGA is being executed. As the reader will quickly surmise, there are several parts of the model IGA that are also variable within a given IGA template and that would be specific to the markets concerned—and are shown in square brackets. Therefore, the text provided in this appendix is presented for general review of structure, scale and scope

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and should not be used in any specific set of circumstances to assess any particular market.

With respect to the IGA contained in this appendix, we observe the following. The IGA is split into ten sections or articles. Each addresses a different purpose:

1. **Definitions**—sets out the definitions of terms relating to the governmental counterparties as well as terms relating to accounts, account holders, reportability and types of financial institution, non financial institution and individual.
2. **Obligation to obtain and exchange information**—sets out the information to be reported between the two governments. Note that this does not mention responsibilities of each jurisdiction's financial institutions. This is dealt with by Article 4.
3. **Time and manner of exchange**—sets out the schedules for exchange and expectations with regards to security and safeguards. Note that while the US has two systems for transfer and management of these reports (IDES and ICMM), neither is specifically mentioned in the IGAs.
4. **Application to financial institutions**—sets out the due diligence framework in which financial institutions of each jurisdiction must act and coordinator aspects with other US regulations such as IRC Chapter 3 and 61. In particular for FATCA, this article sets out the rules for suspension of penalty withholding on recalcitrant accounts and the presumption on which that suspension is permitted.
5. **Compliance and enforcement**—sets out the intent that, other than FATCA penalty withholding, compliance and enforcement is effectively delegated to each jurisdiction's domestic regulator and legal framework. This article also provides authority for financial institutions to outsource elements of their obligations.
6. **Mutual commitment to enhance effectiveness**—addresses any areas where definitive decisions have yet to be made. In particular these include the treatment of passthru payments and expectations of collaboration with respect to reciprocity.
7. **Consistency of application**—sets out the 'most favoured nation' provision that has led to the issuance of 'Partner Letters'. This causes significant risk for financial firms because, in essence, it means that if the US provides better terms to one country in its IGA it must automatically extend the same benefit to other IGA countries. Inevitably this means that firms that have established policy and procedure under the

original IGA will need to have a monitoring and change management programme ready to review and assess partner letters. In our experience, most firms are not even aware of the concept of partner letters, let alone their potential impact.

8. **Consultation and amendments**—sets out an expectation of further collaborative efforts whenever requested.
9. **Annexes**—are separate documents that are however included within the framework of the IGA. In this respect they most commonly set out detailed due diligence processes agreed between the countries and specific exemptions and exceptions to the standard rules such as the treatment of collective investment vehicles.
10. **Term**—ironically does not set out a term in the normal sense of an end date or period of effect. Instead this article establishes the date on which the IGA is deemed to come into force and also provides for termination twelve months after notice is give from one party to the other.

Agreement Between the Government of the United States of America and the Government of [FATCA Partner] to Improve International Tax Compliance and to Implement FATCA

Whereas, the Government of the United States of America and the Government of [FATCA Partner] (each, a "Party," and together, the "Parties") desire to conclude an agreement to improve international tax compliance through mutual assistance in tax matters based on an effective infrastructure for the automatic exchange of information;

Whereas, [Article [] of the Income Tax Convention between the United States and [FATCA Partner]/[the Convention on Mutual Administrative Assistance in Tax Matters] (the "Convention")]/[Article [] of the Tax Information Exchange Agreement between the United States and [FATCA Partner] (the "TIEA")], done at [__] on [__][1] authorizes the exchange of information for tax purposes, including on an automatic basis;

Whereas, the United States of America enacted provisions commonly known as the Foreign Account Tax Compliance Act ("FATCA"), which introduce a reporting regime for financial institutions with respect to certain accounts;

Whereas, the Government of [FATCA Partner] is supportive of the underlying policy goal of FATCA to improve tax compliance;

Whereas, FATCA has raised a number of issues, including that [FATCA Partner] financial institutions may not be able to comply with certain aspects of FATCA due to domestic legal impediments;

Whereas, the Government of the United States of America collects information regarding certain accounts maintained by U.S. financial institutions held by residents of [FATCA Partner] and is committed to exchanging such information with the Government of [FATCA Partner] and pursuing equivalent levels of exchange, provided that the appropriate safeguards and infrastructure for an effective exchange relationship are in place;

Whereas, the Parties are committed to working together over the longer term towards achieving common reporting and due diligence standards for financial institutions;

Whereas, the Government of the United States of America acknowledges the need to coordinate the reporting obligations under FATCA with other U.S. tax reporting obligations of [FATCA Partner] financial institutions to avoid duplicative reporting;

Whereas, an intergovernmental approach to FATCA implementation would address legal impediments and reduce burdens for [FATCA Partner] financial institutions;

Whereas, the Parties desire to conclude an agreement to improve international tax compliance and provide for the implementation of FATCA based on domestic reporting and reciprocal automatic exchange pursuant to the [Convention/TIEA], and subject to the confidentiality and other protections provided for therein, including the provisions limiting the use of the information exchanged under the [Convention/TIEA];

Now, therefore, the Parties have agreed as follows:

Article 1

Definitions

1. For purposes of this agreement and any annexes thereto ("Agreement"), the following terms shall have the meanings set forth below:

   (a) The term **"United States"** means the United States of America, including the States thereof, but does not include the U.S. Territories. Any reference to a **"State"** of the United States includes the District of Columbia.[2]

(b) The term **"U.S. Territory"** means American Samoa, the Commonwealth of the Northern Mariana Islands, Guam, the Commonwealth of Puerto Rico, or the U.S. Virgin Islands.

(c) The term **"IRS"** means the U.S. Internal Revenue Service.

(d) The term **"[FATCA Partner]"** means [full name of FATCA Partner][, including ____][, but not including ____][3]

(e) The term **"Partner Jurisdiction"** means a jurisdiction that has in effect an agreement with the United States to facilitate the implementation of FATCA. The IRS shall publish a list identifying all Partner Jurisdictions.

(f) The term **"Competent Authority"** means:

1. in the case of the United States, the Secretary of the Treasury or his delegate; and
2. in the case of [FATCA Partner], [][4]

(g) The term **"Financial Institution"** means a Custodial Institution, a Depository Institution, an Investment Entity, or a Specified Insurance Company.

(h) The term **"Custodial Institution"** means any Entity that holds, as a substantial portion of its business, financial assets for the account of others. An entity holds financial assets for the account of others as a substantial portion of its business if the entity's gross income attributable to the holding of financial assets and related financial services equals or exceeds 20% of the entity's gross income during the shorter of: (i) the three-year period that ends on December 31 (or the final day of a non-calendar year accounting period) prior to the year in which the determination is being made; or (ii) the period during which the entity has been in existence.

(i) The term **"Depository Institution"** means any Entity that accepts deposits in the ordinary course of a banking or similar business.

(j) The term **"Investment Entity"** means 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:

1. trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;

2. individual and collective portfolio management; or
3. otherwise investing, administering, or managing funds or money on behalf of other persons. This subparagraph 1(j) shall be interpreted in a manner consistent with similar language set forth in the definition of "financial institution" in the Financial Action Task Force Recommendations.

(k) The term **"Specified Insurance Company"** means 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, a Cash Value Insurance Contract or an Annuity Contract.

(l) The term **"[FATCA Partner] Financial Institution"** means (i) any Financial Institution [resident in]/[organized under the laws of][5] [FATCA Partner], but excluding any branch of such Financial Institution that is located outside [FATCA Partner], and (ii) any branch of a Financial Institution not [resident in]/[organized under the laws of] [FATCA Partner], if such branch is located in [FATCA Partner].

(m) The term **"Partner Jurisdiction Financial Institution"** means (i) any Financial Institution established in a Partner Jurisdiction, but excluding any branch of such Financial Institution that is located outside the Partner Jurisdiction, and (ii) any branch of a Financial Institution not established in the Partner Jurisdiction, if such branch is located in the Partner Jurisdiction.

(n) The term **"Reporting Financial Institution"** means a Reporting [FATCA Partner] Financial Institution or a Reporting U.S. Financial Institution, as the context requires.

(o) The term **"Reporting [FATCA Partner] Financial Institution"** means any [FATCA Partner] Financial Institution that is not a Non-Reporting [FATCA Partner] Financial Institution.

(p) The term **"Reporting U.S. Financial Institution"** means (i) any Financial Institution that is resident in the United States, but excluding any branch of such Financial Institution that is located outside the United States, and (ii) any branch of a Financial Institution not resident in the United States, if such branch is located in the United States, provided that the Financial Institution or branch has control, receipt, or custody of income with respect to which information is required to be exchanged under subparagraph (2)(b) of Article 2 of this Agreement.

(q) The term **"Non-Reporting [FATCA Partner] Financial Institution"** means any [FATCA Partner] Financial Institution, or other Entity resident in [FATCA Partner], that is described in Annex II as a Non-Reporting [FATCA Partner] Financial Institution or that otherwise qualifies as a deemed-compliant FFI or an exempt beneficial owner under relevant U.S. Treasury Regulations [in effect on the date of signature of this Agreement].[6]

(r) The term **"Nonparticipating Financial Institution"** means a nonparticipating FFI, as that term is defined in relevant U.S. Treasury Regulations, but does not include a [FATCA Partner] Financial Institution or other Partner Jurisdiction Financial Institution other than a Financial Institution treated as a Nonparticipating Financial Institution pursuant to subparagraph 2(b) of Article 5 of this Agreement or the corresponding provision in an agreement between the United States and a Partner Jurisdiction.

(s) The term **"Financial Account"** means an account maintained by a Financial Institution, and includes:

1. in the case of an Entity that is a Financial Institution solely because it is an Investment Entity, any equity or debt interest (other than interests that are regularly traded on an established securities market) in the Financial Institution;
2. in the case of a Financial Institution not described in subparagraph 1(s)(1) of this Article, any equity or debt interest in the Financial Institution (other than interests that are regularly traded on an established securities market), if (i) the value of the debt or equity interest is determined, directly or indirectly, primarily by reference to assets that give rise to U.S. Source Withholdable Payments, and (ii) the class of interests was established with a purpose of avoiding reporting in accordance with this Agreement; and
3. any Cash Value Insurance Contract and any Annuity Contract issued or maintained by a Financial Institution, other than a noninvestment- linked, nontransferable immediate life annuity that is issued to an individual and monetizes a pension or disability benefit provided under an account that is excluded from the definition of Financial Account in Annex II.

Notwithstanding the foregoing, the term "Financial Account" does not include any account that is excluded from the definition of Financial Account in Annex II. For purposes of this Agreement, interests are "regularly traded" if there is a meaningful volume of trading with respect to

the interests on an ongoing basis, and an "established securities market" means an exchange that is officially recognized and supervised by a governmental authority in which the market is located and that has a meaningful annual value of shares traded on the exchange. For purposes of this subparagraph 1(s), an interest in a Financial Institution is not "regularly traded" and shall be treated as a Financial Account if the holder of the interest (other than a Financial Institution acting as an intermediary) is registered on the books of such Financial Institution. The preceding sentence will not apply to interests first registered on the books of such Financial Institution prior to July 1, 2014, and with respect to interests first registered on the books of such Financial Institution on or after July 1, 2014, a Financial Institution is not required to apply the preceding sentence prior to January 1, 2016.

(t) The term **"Depository Account"** includes any commercial, checking, savings, time, or thrift account, or an account that is evidenced by a certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, or other similar instrument maintained by a Financial Institution in the ordinary course of a banking or similar business. A Depository Account also includes an amount held by an insurance company pursuant to a guaranteed investment contract or similar agreement to pay or credit interest thereon.

(u) The term **"Custodial Account"** means an account (other than an Insurance Contract or Annuity Contract) for the benefit of another person that holds any financial instrument or contract held for investment (including, but not limited to, a share or stock in a corporation, a note, bond, debenture, or other evidence of indebtedness, a currency or commodity transaction, a credit default swap, a swap based upon a nonfinancial index, a notional principal contract, an Insurance Contract or Annuity Contract, and any option or other derivative instrument).

(v) The term **"Equity Interest"** means, in the case of a partnership that is a Financial Institution, either a capital or profits interest in the partnership. In the case of a trust that is a Financial Institution, an Equity Interest is considered to be held by any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust. A Specified U.S. Person shall be treated as being a beneficiary of a foreign trust if such Specified U.S. Person has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust.

(w) The term **"Insurance Contract"** means a contract (other than an Annuity Contract) under which the issuer agrees to pay an amount upon the occurrence of a specified contingency involving mortality, morbidity, accident, liability, or property risk.

(x) The term **"Annuity Contract"** means a contract under which the issuer agrees to make payments for a period of time determined in whole or in part by reference to the life expectancy of one or more individuals. The term also includes a contract that is considered to be an Annuity Contract in accordance with the law, regulation, or practice of the jurisdiction in which the contract was issued, and under which the issuer agrees to make payments for a term of years.

(y) The term **"Cash Value Insurance Contract"** means an Insurance Contract (other than an indemnity reinsurance contract between two insurance companies) that has a Cash Value greater than $50,000.

(z) The term **"Cash Value"** means the greater of (i) the amount that the policyholder is entitled to receive upon surrender or termination of the contract (determined without reduction for any surrender charge or policy loan), and (ii) the amount the policyholder can borrow under or with regard to the contract. Notwithstanding the foregoing, the term "Cash Value" does not include an amount payable under an Insurance Contract as:

1. a personal injury or sickness benefit or other benefit providing indemnification of an economic loss incurred upon the occurrence of the event insured against;
2. a refund to the policyholder of a previously paid premium under an Insurance Contract (other than under a life insurance contract) due to policy cancellation or termination, decrease in risk exposure during the effective period of the Insurance Contract, or arising from a redetermination of the premium due to correction of posting or other similar error; or
3. a policyholder dividend based upon the underwriting experience of the contract or group involved.

(aa) The term **"Reportable Account"** means a U.S. Reportable Account or a [FATCA Partner] Reportable Account, as the context requires.

(bb) The term **"[FATCA Partner] Reportable Account"** means a Financial Account maintained by a Reporting U.S. Financial Institution if: (i) in the case of a Depository Account, the account

is held by an individual resident in [FATCA Partner] and more than $10 of interest is paid to such account in any given calendar year; or (ii) in the case of a Financial Account other than a Depository Account, the Account Holder is a resident of [FATCA Partner], including an Entity that certifies that it is resident in [FATCA Partner] for tax purposes, with respect to which U.S. source income that is subject to reporting under chapter 3 of subtitle A or chapter 61 of subtitle F of the U.S. Internal Revenue Code is paid or credited.

(cc) The term **"U.S. Reportable Account"** means a Financial Account maintained by a Reporting [FATCA Partner] Financial Institution and held by one or more Specified U.S. Persons or by a Non-U.S. Entity with one or more Controlling Persons that is a Specified U.S. Person. Notwithstanding the foregoing, an account shall not be treated as a U.S. Reportable Account if such account is not identified as a U.S. Reportable Account after application of the due diligence procedures in Annex I.

(dd) The term **"Account Holder"** means the person listed or identified as the holder of a Financial Account by the Financial Institution that maintains the account. A person, other than a Financial Institution, holding a Financial Account for the benefit or account of another person as agent, custodian, nominee, signatory, investment advisor, or intermediary, is not treated as holding the account for purposes of this Agreement, and such other person is treated as holding the account. For purposes of the immediately preceding sentence, the term "Financial Institution" does not include a Financial Institution organized or incorporated in a U.S. Territory. In the case of a Cash Value Insurance Contract or an Annuity Contract, the Account Holder is any person entitled to access the Cash Value or change the beneficiary of the contract. If no person can access the Cash Value or change the beneficiary, the Account Holder is any person named as the owner in the contract and any person with a vested entitlement to payment under the terms of the contract. Upon the maturity of a Cash Value Insurance Contract or an Annuity Contract, each person entitled to receive a payment under the contract is treated as an Account Holder.

(ee) The term **"U.S. Person"** means a U.S. citizen or resident individual, a partnership or corporation organized in the United States or under the laws of the United States or any State thereof, a trust if (i) a court within the United States would have authority under

applicable law to render orders or judgments concerning substantially all issues regarding administration of the trust, and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust, or an estate of a decedent that is a citizen or resident of the United States. This subparagraph 1(ee) shall be interpreted in accordance with the U.S. Internal Revenue Code.

(ff) The term **"Specified U.S. Person"** means a U.S. Person, other than: (i) a corporation the stock of which is regularly traded on one or more established securities markets; (ii) any corporation that is a member of the same expanded affiliated group, as defined in section 1471(e)(2) of the U.S. Internal Revenue Code, as a corporation described in clause (i); (iii) the United States or any wholly owned agency or instrumentality thereof; (iv) any State of the United States, any U.S. Territory, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing; (v) any organization exempt from taxation under section 501(a) of the U.S. Internal Revenue Code or an individual retirement plan as defined in section 7701(a)(37) of the U.S. Internal Revenue Code; (vi) any bank as defined in section 581 of the U.S. Internal Revenue Code; (vii) any real estate investment trust as defined in section 856 of the U.S. Internal Revenue Code; (viii) any regulated investment company as defined in section 851 of the U.S. Internal Revenue Code or any entity registered with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-64); (ix) any common trust fund as defined in section 584(a) of the U.S. Internal Revenue Code; (x) any trust that is exempt from tax under section 664(c) of the U.S. Internal Revenue Code or that is described in section 4947(a)(1) of the U.S. Internal Revenue Code; (xi) a dealer in securities, commodities, or derivative financial instruments (including notional principal contracts, futures, forwards, and options) that is registered as such under the laws of the United States or any State; (xii) a broker as defined in section 6045(c) of the U.S. Internal Revenue Code; or (xiii) any tax-exempt trust under a plan that is described in section 403(b) or section 457(g) of the U.S. Internal Revenue Code.

(gg) The term **"Entity"** means a legal person or a legal arrangement such as a trust.

(hh) The term **"Non-U.S. Entity"** means an Entity that is not a U.S. Person.

(ii) The term **"U.S. Source Withholdable Payment"** means any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States. Notwithstanding the foregoing, a U.S. Source Withholdable Payment does not include any payment that is not treated as a withholdable payment in relevant U.S. Treasury Regulations.

(jj) An Entity is a **"Related Entity"** of another Entity if either Entity controls the other Entity, or the two Entities are under common control. For this purpose control includes direct or indirect ownership of more than 50% of the vote or value in an Entity. Notwithstanding the foregoing, [FATCA Partner] may treat an Entity as not a Related Entity of another Entity if the two Entities are not members of the same expanded affiliated group as defined in section 1471(e)(2) of the U.S. Internal Revenue Code.

(kk) The term **"U.S. TIN"** means a U.S. federal taxpayer identifying number.

(ll) The term **"[FATCA Partner] TIN"** means a [FATCA Partner] taxpayer identifying number.

(mm) The term **"Controlling Persons"** means the natural persons who exercise control over an Entity. In the case of a trust, such term means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions. The term "Controlling Persons" shall be interpreted in a manner consistent with the Financial Action Task Force Recommendations.

2. Any term not otherwise defined in this Agreement shall, unless the context otherwise requires or the Competent Authorities agree to a common meaning (as permitted by domestic law), have the meaning that it has at that time under the law of the Party applying this Agreement, any meaning under the applicable tax laws of that Party prevailing over a meaning given to the term under other laws of that Party.

Article 2

Obligations to Obtain and Exchange Information with Respect to Reportable Accounts

1. Subject to the provisions of Article 3 of this Agreement, each Party shall obtain the information specified in paragraph 2 of this Article with respect to all Reportable Accounts and shall annually exchange this information with the other Party on an automatic basis pursuant to the provisions of Article [][7] of the [Convention/TIEA].
2. The information to be obtained and exchanged is:
   (a) In the case of [FATCA Partner] with respect to each U.S. Reportable Account of each Reporting [FATCA Partner] Financial Institution:
      1. the name, address, and U.S. TIN of each Specified U.S. Person that is an Account Holder of such account and, in the case of a Non-U.S. Entity that, after application of the due diligence procedures set forth in Annex I, is identified as having one or more Controlling Persons that is a Specified U.S. Person, the name, address, and U.S. TIN (if any) of such entity and each such Specified U.S. Person;
      2. the account number (or functional equivalent in the absence of an account number);
      3. the name and identifying number of the Reporting [FATCA Partner] Financial Institution;
      4. 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;
      5. in the case of any Custodial Account:
         (A) 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
         (B) 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 [FATCA Partner] Financial Institution acted as

a custodian, broker, nominee, or otherwise as an agent for the Account Holder;

6. 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
7. in the case of any account not described in subparagraph 2(a)(5) or 2(a)(6) of this Article, 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 [FATCA Partner] 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.

(b) In the case of the United States, with respect to each [FATCA Partner] Reportable Account of each Reporting U.S. Financial Institution:

1. the name, address, and [FATCA Partner] TIN of any person that is a resident of [FATCA Partner] and is an Account Holder of the account;
2. the account number (or the functional equivalent in the absence of an account number);
3. the name and identifying number of the Reporting U.S. Financial Institution;
4. the gross amount of interest paid on a Depository Account;
5. the gross amount of U.S. source dividends paid or credited to the account; and
6. the gross amount of other U.S. source income paid or credited to the account, to the extent subject to reporting under chapter 3 of subtitle A or chapter 61 of subtitle F of the U.S. Internal Revenue Code.

Article 3

Time and Manner of Exchange of Information

1. For purposes of the exchange obligation in Article 2 of this Agreement, the amount and characterization of payments made with respect to a U.S. Reportable Account may be determined in accordance with the principles of the tax laws of [FATCA Partner], and the amount and characterization of payments made with respect to a [FATCA Partner]

Reportable Account may be determined in accordance with principles of U.S. federal income tax law.

2. For purposes of the exchange obligation in Article 2 of this Agreement, the information exchanged shall identify the currency in which each relevant amount is denominated.
3. With respect to paragraph 2 of Article 2 of this Agreement, information is to be obtained and exchanged with respect to 2014 and all subsequent years, except that:
   (a) In the case of [FATCA Partner]:
      1. the information to be obtained and exchanged with respect to 2014 is only the information described in subparagraphs 2(a)(1) through 2(a)(4) of Article 2 of this Agreement;
      2. the information to be obtained and exchanged with respect to 2015 is the information described in subparagraphs 2(a)(1) through 2(a)(7) of Article 2 of this Agreement, except for gross proceeds described in subparagraph 2(a)(5)(B) of Article 2 of this Agreement; and
      3. the information to be obtained and exchanged with respect to 2016 and subsequent years is the information described in subparagraphs 2(a)(1) through 2(a)(7) of Article 2 of this Agreement;

   (b) In the case of the United States, the information to be obtained and exchanged with respect to 2014 and subsequent years is all of the information identified in subparagraph 2(b) of Article 2 of this Agreement.
4. Notwithstanding paragraph 3 of this Article, with respect to each Reportable Account that is maintained by a Reporting Financial Institution as of June 30, 2014, and subject to paragraph 4 of Article 6 of this Agreement, the Parties are not required to obtain and include in the exchanged information the [FATCA Partner] TIN or the U.S. TIN, as applicable, of any relevant person if such taxpayer identifying number is not in the records of the Reporting Financial Institution. In such a case, the Parties shall obtain and include in the exchanged information the date of birth of the relevant person, if the Reporting Financial Institution has such date of birth in its records.
5. Subject to paragraphs 3 and 4 of this Article, the information described in Article 2 of this Agreement shall be exchanged within nine months after the end of the calendar year to which the information relates.
6. The Competent Authorities of [FATCA Partner] and the United States shall enter into an agreement or arrangement under the mutual agreement procedure provided for in Article [][8] of the [Convention/TIEA], which shall:

(a) establish the procedures for the automatic exchange obligations described in Article 2 of this Agreement;
(b) prescribe rules and procedures as may be necessary to implement Article 5 of this Agreement; and
(c) establish as necessary procedures for the exchange of the information reported under subparagraph 1(b) of Article 4 of this Agreement.

7. All information exchanged shall be subject to the confidentiality and other protections provided for in the [Convention/TIEA], including the provisions limiting the use of the information exchanged.
8. Following entry into force of this Agreement, each Competent Authority shall provide written notification to the other Competent Authority when it is satisfied that the jurisdiction of the other Competent Authority has in place (i) appropriate safeguards to ensure that the information received pursuant to this Agreement shall remain confidential and be used solely for tax purposes, and (ii) the infrastructure for an effective exchange relationship (including established processes for ensuring timely, accurate, and confidential information exchanges, effective and reliable communications, and demonstrated capabilities to promptly resolve questions and concerns about exchanges or requests for exchanges and to administer the provisions of Article 5 of this Agreement). The Competent Authorities shall endeavor in good faith to meet, prior to September 2015, to establish that each jurisdiction has such safeguards and infrastructure in place.
9. The obligations of the Parties to obtain and exchange information under Article 2 of this Agreement shall take effect on the date of the later of the written notifications described in paragraph 8 of this Article. Notwithstanding the foregoing, if the [FATCA Partner] Competent Authority is satisfied that the United States has the safeguards and infrastructure described in paragraph 8 of this Article in place, but additional time is necessary for the U.S. Competent Authority to establish that [FATCA Partner] has such safeguards and infrastructure in place, the obligation of [FATCA Partner] to obtain and exchange information under Article 2 of this Agreement shall take effect on the date of the written notification provided by the [FATCA Partner] Competent Authority to the U.S. Competent Authority pursuant to paragraph 8 of this Article.
10. This Agreement shall terminate on September 30, 2015, if Article 2 of this Agreement is not in effect for either Party pursuant to paragraph 9 of this Article by that date.

Article 4

Application of FATCA to [FATCA Partner] Financial Institutions

1. **Treatment of Reporting [FATCA Partner] Financial Institutions.** Each Reporting [FATCA Partner] Financial Institution shall be treated as complying with, and not subject to withholding under, section 1471 of the U.S. Internal Revenue Code if [FATCA Partner] complies with its obligations under Articles 2 and 3 of this Agreement with respect to such Reporting [FATCA Partner] Financial Institution, and the Reporting [FATCA Partner] Financial Institution:
   (a) identifies U.S. Reportable Accounts and reports annually to the [FATCA Partner] Competent Authority the information required to be reported in subparagraph 2(a) of Article 2 of this Agreement in the time and manner described in Article 3 of this Agreement;
   (b) for each of 2015 and 2016, reports annually to the [FATCA Partner] Competent Authority the name of each Nonparticipating Financial Institution to which it has made payments and the aggregate amount of such payments;
   (c) complies with the applicable registration requirements on the IRS FATCA registration website;
   (d) to the extent that a Reporting [FATCA Partner] Financial Institution is (i) acting as a qualified intermediary (for purposes of section 1441 of the U.S. Internal Revenue Code) that has elected to assume primary withholding responsibility under chapter 3 of subtitle A of the U.S. Internal Revenue Code, (ii) a foreign partnership that has elected to act as a withholding foreign partnership (for purposes of both sections 1441 and 1471 of the U.S. Internal Revenue Code), or (iii) a foreign trust that has elected to act as a withholding foreign trust (for purposes of both sections 1441 and 1471 of the U.S. Internal Revenue Code), withholds 30% of any U.S. Source Withholdable Payment to any Nonparticipating Financial Institution; and
   (e) in the case of a Reporting [FATCA Partner] Financial Institution that is not described in subparagraph 1(d) of this Article and that makes a payment of, or acts as an intermediary with respect to, a U.S. Source Withholdable Payment to any Nonparticipating Financial Institution, the Reporting [FATCA Partner] Financial Institution provides to any immediate payor of such U.S. Source Withholdable Payment the information required for withholding and reporting to occur with respect to such payment.

Notwithstanding the foregoing, a Reporting [FATCA Partner] Financial Institution with respect to which the conditions of this paragraph 1 are not satisfied shall not be subject to withholding under section 1471 of the U.S. Internal Revenue Code unless such Reporting [FATCA Partner] Financial Institution is treated by the IRS as a Nonparticipating Financial Institution pursuant to subparagraph 2(b) of Article 5 of this Agreement.

2. **Suspension of Rules Relating to Recalcitrant Accounts**. The United States shall not require a Reporting [FATCA Partner] Financial Institution to withhold tax under section 1471 or 1472 of the U.S. Internal Revenue Code with respect to an account held by a recalcitrant account holder (as defined in section 1471(d)(6) of the U.S. Internal Revenue Code), or to close such account, if the U.S. Competent Authority receives the information set forth in subparagraph 2(a) of Article 2 of this Agreement, subject to the provisions of Article 3 of this Agreement, with respect to such account.
3. **Specific Treatment of [FATCA Partner] Retirement Plans**. The United States shall treat as deemed-compliant FFIs or exempt beneficial owners, as appropriate, for purposes of sections 1471 and 1472 of the U.S. Internal Revenue Code, [FATCA Partner] retirement plans described in Annex II. For this purpose, a [FATCA Partner] retirement plan includes an Entity established or located in, and regulated by, [FATCA Partner], or a predetermined contractual or legal arrangement, operated to provide pension or retirement benefits or earn income for providing such benefits under the laws of [FATCA Partner] and regulated with respect to contributions, distributions, reporting, sponsorship, and taxation.
4. **Identification and Treatment of Other Deemed-Compliant FFIs and Exempt Beneficial Owners**. The United States shall treat each Non-Reporting [FATCA Partner] Financial Institution as a deemed-compliant FFI or as an exempt beneficial owner, as appropriate, for purposes of section 1471 of the U.S. Internal Revenue Code.
5. **Special Rules Regarding Related Entities and Branches That Are Nonparticipating Financial Institutions**. If a [FATCA Partner] Financial Institution, that otherwise meets the requirements described in paragraph 1 of this Article or is described in paragraph 3 or 4 of this Article, has a Related Entity or branch that operates in a jurisdiction that prevents such Related Entity or branch from fulfilling the requirements of a participating FFI or deemed-compliant FFI for purposes of section 1471 of the U.S. Internal Revenue Code or has a Related Entity or branch that is treated as a Nonparticipating Financial Institution solely due to the

expiration of the transitional rule for limited FFIs and limited branches under relevant U.S. Treasury Regulations, such [FATCA Partner] Financial Institution shall continue to be in compliance with the terms of this Agreement and shall continue to be treated as a deemed-compliant FFI or exempt beneficial owner, as appropriate, for purposes of section 1471 of the U.S. Internal Revenue Code, provided that:

(a) the [FATCA Partner] Financial Institution treats each such Related Entity or branch as a separate Nonparticipating Financial Institution for purposes of all the reporting and withholding requirements of this Agreement and each such Related Entity or branch identifies itself to withholding agents as a Nonparticipating Financial Institution;
(b) each such Related Entity or branch identifies its U.S. accounts and reports the information with respect to those accounts as required under section 1471 of the U.S. Internal Revenue Code to the extent permitted under the relevant laws pertaining to the Related Entity or branch; and
(c) such Related Entity or branch does not specifically solicit U.S. accounts held by persons that are not resident in the jurisdiction where such Related Entity or branch is located or accounts held by Nonparticipating Financial Institutions that are not established in the jurisdiction where such Related Entity or branch is located, and such Related Entity or branch is not used by the [FATCA Partner] Financial Institution or any other Related Entity to circumvent the obligations under this Agreement or under section 1471 of the U.S. Internal Revenue Code, as appropriate.

6. **Coordination of Timing**. Notwithstanding paragraphs 3 and 5 of Article 3 of this Agreement:
   (a) [FATCA Partner] shall not be obligated to obtain and exchange information with respect to a calendar year that is prior to the calendar year with respect to which similar information is required to be reported to the IRS by participating FFIs pursuant to relevant U.S. Treasury Regulations;
   (b) [FATCA Partner] shall not be obligated to begin exchanging information prior to the date by which participating FFIs are required to report similar information to the IRS under relevant U.S. Treasury Regulations;
   (c) the United States shall not be obligated to obtain and exchange information with respect to a calendar year that is prior to the first calendar year with respect to which [FATCA Partner] is required to obtain and exchange information; and
   (d) the United States shall not be obligated to begin exchanging information prior to the date by which [FATCA Partner] is required to begin exchanging information.

7. **Coordination of Definitions with U.S. Treasury Regulations**. Notwithstanding Article 1 of this Agreement and the definitions provided in the Annexes to this Agreement, in implementing this Agreement, [FATCA Partner] may use, and may permit [FATCA Partner] Financial Institutions to use, a definition in relevant U.S. Treasury Regulations in lieu of a corresponding definition in this Agreement, provided that such application would not frustrate the purposes of this Agreement.

Article 5

Collaboration on Compliance and Enforcement

1. **Minor and Administrative Errors**. A Competent Authority shall notify the Competent Authority of the other Party when the first-mentioned Competent Authority has reason to believe that administrative errors or other minor errors may have led to incorrect or incomplete information reporting or resulted in other infringements of this Agreement. The Competent Authority of such other Party shall apply its domestic law (including applicable penalties) to obtain corrected and/or complete information or to resolve other infringements of this Agreement.
2. **Significant Non-Compliance**.
   (a) A Competent Authority shall notify the Competent Authority of the other Party when the first-mentioned Competent Authority has determined that there is significant non-compliance with the obligations under this Agreement with respect to a Reporting Financial Institution in the other jurisdiction. The Competent Authority of such other Party shall apply its domestic law (including applicable penalties) to address the significant non-compliance described in the notice.
   (b) If, in the case of a Reporting [FATCA Partner] Financial Institution, such enforcement actions do not resolve the non-compliance within a period of 18 months after notification of significant non-compliance is first provided, the United States shall treat the Reporting [FATCA Partner] Financial Institution as a Nonparticipating Financial Institution pursuant to this subparagraph 2(b).
3. **Reliance on Third Party Service Providers**. Each Party may allow Reporting Financial Institutions to use third party service providers to fulfill the obligations imposed on such Reporting Financial Institutions by a Party, as contemplated in this Agreement, but these obligations shall remain the responsibility of the Reporting Financial Institutions.

4. **Prevention of Avoidance**. The Parties shall implement as necessary requirements to prevent Financial Institutions from adopting practices intended to circumvent the reporting required under this Agreement.

Article 6

Mutual Commitment to Continue to Enhance the Effectiveness of Information Exchange and Transparency

1. **Reciprocity**. The Government of the United States acknowledges the need to achieve equivalent levels of reciprocal automatic information exchange with [FATCA Partner]. The Government of the United States is committed to further improve transparency and enhance the exchange relationship with [FATCA Partner] by pursuing the adoption of regulations and advocating and supporting relevant legislation to achieve such equivalent levels of reciprocal automatic information exchange.
2. **Treatment of Passthru Payments and Gross Proceeds**. The Parties are committed to work together, along with Partner Jurisdictions, to develop a practical and effective alternative approach to achieve the policy objectives of foreign passthru payment and gross proceeds withholding that minimizes burden.
3. **Development of Common Reporting and Exchange Model**. The Parties are committed to working with Partner Jurisdictions, the Organisation for Economic Co-operation and Development, [and the European Union,][9] on adapting the terms of this Agreement and other agreements between the United States and Partner Jurisdictions to a common model for automatic exchange of information, including the development of reporting and due diligence standards for financial institutions.
4. **Documentation of Accounts Maintained as of June 30, 2014**. With respect to Reportable Accounts maintained by a Reporting Financial Institution as of June 30, 2014:
   (a) The United States commits to establish, by January 1, 2017, for reporting with respect to 2017 and subsequent years, rules requiring Reporting U.S. Financial Institutions to obtain and report the [FATCA Partner] TIN of each Account Holder of a [FATCA Partner] Reportable Account as required pursuant to subparagraph 2(b)(1) of Article 2 of this Agreement; and
   (b) [FATCA Partner] commits to establish, by January 1, 2017, for reporting with respect to 2017 and subsequent years, rules requiring

Reporting [FATCA Partner] Financial Institutions to obtain the U.S. TIN of each Specified U.S. Person as required pursuant to subparagraph 2(a)(1) of Article 2 of this

Article 7

Consistency in the Application of FATCA to Partner Jurisdictions

1. [FATCA Partner] shall be granted the benefit of any more favorable terms under Article 4 or Annex I of this Agreement relating to the application of FATCA to [FATCA Partner] Financial Institutions afforded to another Partner Jurisdiction under a signed bilateral agreement pursuant to which the other Partner Jurisdiction commits to undertake the same obligations as [FATCA Partner] described in Articles 2 and 3 of this Agreement, and subject to the same terms and conditions as described therein and in Articles 5 through 9 of this Agreement.
2. The United States shall notify [FATCA Partner] of any such more favorable terms, and such more favorable terms shall apply automatically under this Agreement as if such terms were specified in this Agreement and effective as of the date of the entry into force of the agreement incorporating the more favorable terms, unless [FATCA Partner] declines the application thereof.

Article 8

Consultations and Amendments

1. In case any difficulties in the implementation of this Agreement arise, either Party may request consultations to develop appropriate measures to ensure the fulfillment of this Agreement.
2. This Agreement may be amended by written mutual agreement of the Parties. Unless otherwise agreed upon, such an amendment shall enter into force through the same procedures as set forth in paragraph 1 of Article 10 of this Agreement.

Article 9

Annexes

The Annexes form an integral part of this Agreement.

Article 10

Term of Agreement

1. This Agreement shall enter into force on the date of [FATCA Partner]'s written notification to the United States that [FATCA Partner] has completed its necessary internal procedures for entry into force of this Agreement.
2. Either Party may terminate this Agreement by giving notice of termination in writing to the other Party. Such termination shall become effective on the first day of the month following the expiration of a period of 12 months after the date of the notice of termination.
3. The Parties shall, prior to December 31, 2016, consult in good faith to amend this Agreement as necessary to reflect progress on the commitments set forth in Article 6 of this Agreement.

In witness whereof, the undersigned, being duly authorized thereto by their respective Governments, have signed this Agreement.

Done at [_____], in duplicate, in the English and [FATCA Partner] languages,[10] both texts being equally authentic, this [__] day of [_____], 20[__].

FOR THE GOVERNMENT OFTHE UNITED STATES OF AMERICA:

FOR THE GOVERNMENT OF [FATCA PARTNER]:

[97163]

Notes

1. [Select the appropriate instrument to serve a legal basis for the exchange of information. Instruments that are not in force generally cannot be referenced as the legal basis for the exchange of information. Note that only the Convention on Mutual Administrative Assistance in Tax Matters done at Strasbourg on 25 January 1988 is currently in force in the United States. The Protocol amending the Convention on Mutual Administrative Assistance in Tax Matters done at Paris on May 27, 2010 is not yet in force in the United States and thus cannot serve a legal basis for the exchange of information.]
2. [The United States prefers not to include a geographic description of the parties as this is unnecessary.]

3. [The United States prefers not to include a geographic description of the parties as this is unnecessary; an example of a political definition is "Mexico means the United Mexican States."]
4. [Include the FATCA Partner Competent Authority.]
5. [Select the appropriate classification for Financial Institutions to be treated as FATCA Partner Financial Institutions, either based on their place of residence or place of organization. This decision is usually made based on the appropriate concept under FATCA Partner's tax laws, and where there is no such concept, the legal organization test is generally chosen.]
6. [Some of our partner jurisdictions have expressed the need for a static definition of Non-Reporting FATCA Partner Financial Institution, even though we believe that a dynamic approach is preferred to provide flexibility. The bracketed language has been included to accommodate jurisdictions that have a need for a static definition.]
7. [Include the appropriate Article of the applicable Convention or TIEA.]
8. [Include the appropriate Article of the applicable Convention or TIEA.]
9. [The bracketed language would only be included where FATCA Partner is a Member State of the European Union.]
10. [Note that it is possible to sign in English, with an official FATCA Partner language version agreed at a later date. This permits signature at an earlier date and was the approach taken by Switzerland.]

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