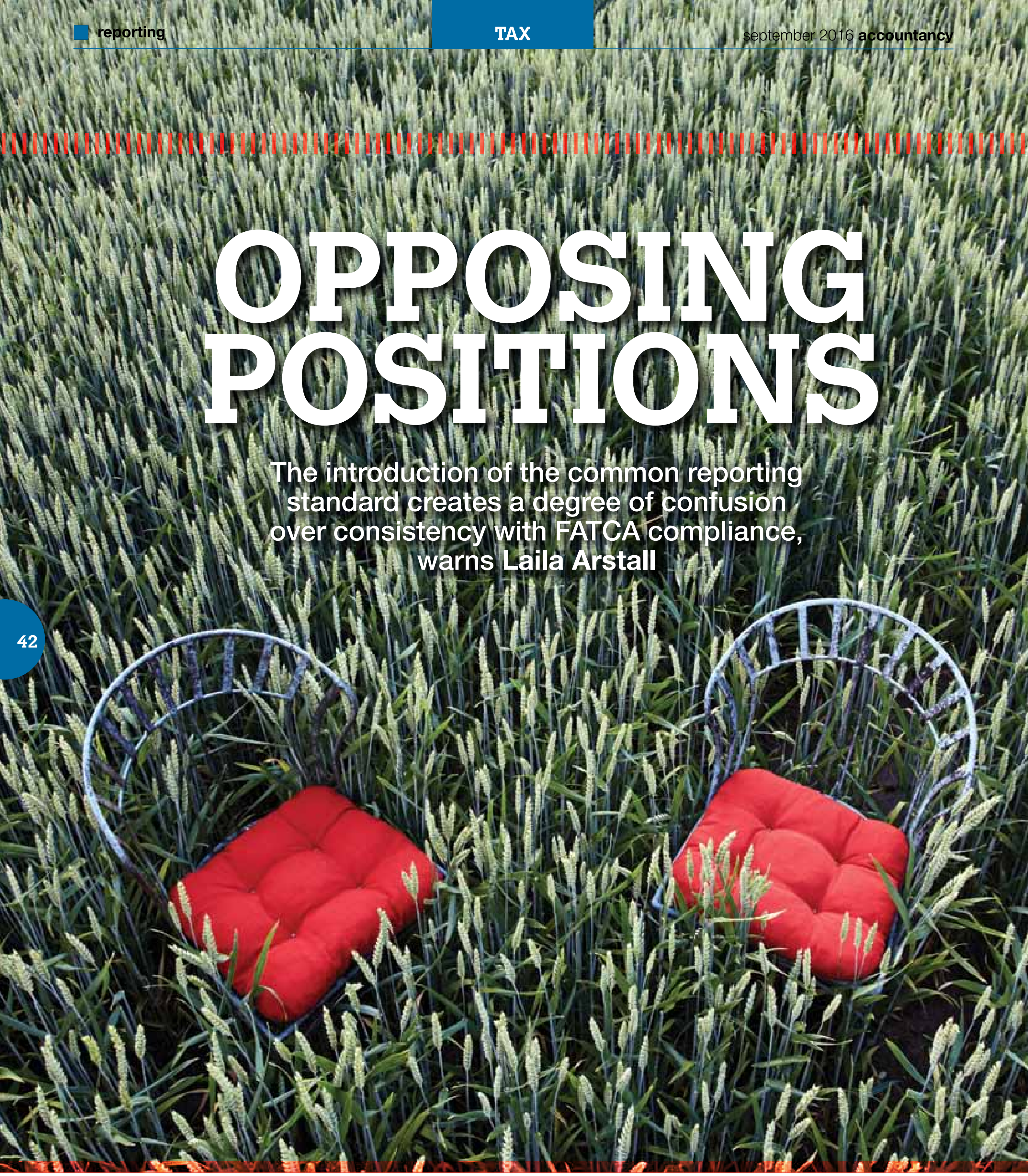

OPPOSING POSITIONS

The introduction of the common reporting standard creates a degree of confusion over consistency with FATCA compliance, warns Laila Arstall

It is nearly a year since tax authorities around the world sent their first sets of Foreign Account Tax Compliance Act (FATCA) reports to the US Internal Revenue Service. These were compiled by financial institutions under the terms of applicable inter-governmental agreements (IGAs) in their respective jurisdictions. Now those same financial institutions are starting to prepare for the common reporting standard (CRS) which, for the 55 early adopter jurisdictions, was introduced with effect from 1 January 2016.

Building upon the Model 1 IGA template issued by the US to enable jurisdictions to comply with FATCA, the CRS is a separate regime for automatic exchange of information developed by the OECD.

The CRS has a wider global reach than

FATCA given that, as of 9 May 2016, 101 jurisdictions had committed to implement CRS exchanges by 2018 at the latest.

Under the CRS, jurisdiction A will send jurisdiction B information in respect of accounts maintained by financial institutions in jurisdiction A for individuals and entities that are resident in jurisdiction B.

In many cases the exchange is reciprocal but, in some instances, transfers of data take place one-way only, as in the case of the arrangements between, for example, Guernsey and the British Virgin Islands (BVI) and the Cayman Islands, where Guernsey will receive information on financial accounts maintained by financial institutions in the BVI and in the Cayman Islands for Guernsey residents, but not the other way around.

The information to be gathered under CRS is broad in scope across three dimensions:

- the financial information to be reported relates to reportable accounts and includes not only all types of investment income but also account balances and the proceeds of sale of financial assets;
- the financial institutions that are required to report under the CRS include banks, custodians, brokers, certain collective investment vehicles, trust and corporate service providers; and
- reportable accounts include accounts maintained for individuals and entities (which includes partnerships, trusts and foundations) and there is a requirement to look through passive entities to report on the individuals who are seen as ultimately behind these structures.

The CRS sets out due diligence rules to be followed by a financial institution in terms of identifying reportable accounts. This involves reviewing client due diligence gathered for anti-money laundering (AML) and know your client purposes (KYC) on pre-existing account holders and requesting new account holders to complete self-certificates.

Once identified as a reportable account, the data to be reported is gathered from financial statements and other information maintained by the institution on the account and in respect of the relevant account holder, or its controlling person(s). The required data is used to complete a CRS schema which is then filed with the local tax office through an online portal.

Given that, in the main, the steps to review, identify and report on accounts follow the same approach, whether under US FATCA, UK FATCA or CRS.

Financial institutions that have already gone through the process of filing reports under FATCA in 2015 will be well placed to leverage that experience as they take steps to comply with reporting under CRS.

CORE CRS REQUIREMENTS

Jurisdictions around the world will have to comply with the following requirements in order to set up CRS:

1: Translate the reporting and due diligence rules into domestic law, including rules to ensure their effective implementation

2: Select a legal basis for the automatic exchange of information

3: Put in place IT and administrative infrastructure and resources

4: Protect confidentiality and safeguarding

Source: OECD CRS Implementation Handbook

CLASSIFICATION TRAP

But there are traps for the unwary. One such concern arises in the context of the classification of entity account holders. In particular, an entity that is 'managed by' another financial institution could itself be classified as an investment entity under the definition of that term in both the IGA and the CRS.

However, there are subtle differences in the terminology used in each definition and consequently how these terms are interpreted in practice. These differences are now being reflected in guidance published by different jurisdictions, and as a result, the differing approaches are coming to the attention of financial institutions and their advisers as they gear up to collate the appropriate financial data for the reporting period of 2016 in readiness for filing under CRS as early as 2017.

> **While there is no intention to avoid reporting the correct information, the scope of the information can differ**

In both the IGA and the CRS, the definition of investment entity has two limbs; one limb under which entities are classified as investment entities in their own right and the other limb for entities which qualify as such under the 'managed by' test.

In order to determine whether an entity that is managed by a financial institution is an investment entity, the IGA offers the choice of two alternative tests: the test that appears in the US FATCA Regulations or a simpler test that is set out in the IGA itself.

The US FATCA Regulations test requires the managed entity's gross income to be primarily attributable to the investing, reinvesting or trading in financial assets in order to be classified as an investment entity. An entity's gross income is said to be 'primarily attributable' to the relevant activity if it is equal to or exceeds 50% of its total gross income from all sources. By contrast, the IGA test makes no reference to financial assets or the need to review the

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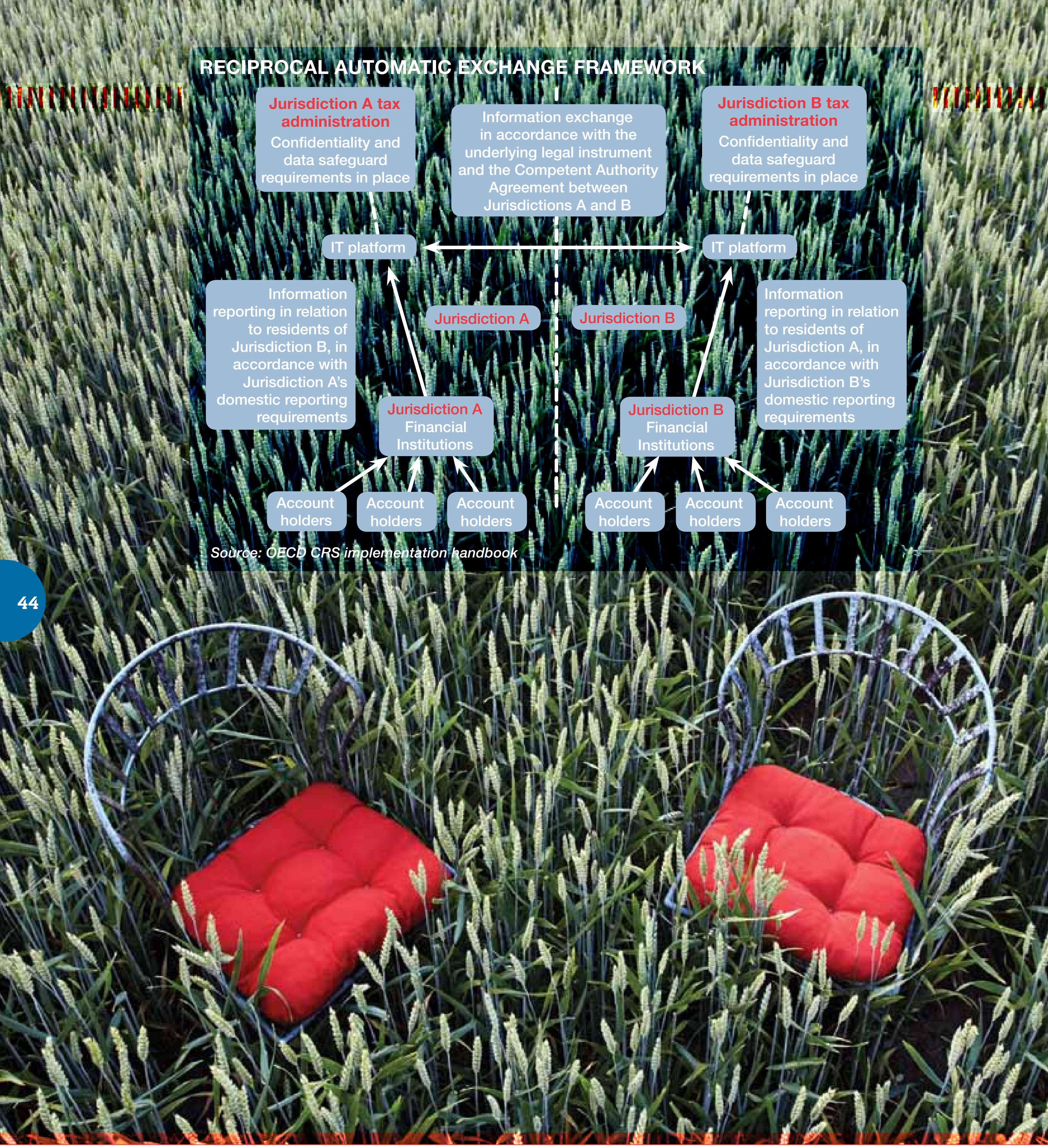

Source: OECD CRS implementation handbook

gross income of the entity concerned in order to qualify as an investment entity.

For those financial institutions that applied the US Regulations' test to classify managed entities in order to comply with FATCA, they would be able to continue to rely on that same criteria for the purposes of CRS. Those that applied the simpler test of the IGA, rather than opting for the US FATCA Regulations test, now find that they have to revisit that classification and, in addition, review the entity's gross income to see if it is primarily attributable to the investing, reinvesting or trading in financial assets.

Apart from the additional resources required to revisit a classification, what are the consequences of this difference in approach for those financial institutions and their managed entities which are affected?

WWW

The OECD CRS Implementation Handbook is available at http://bit.ly/1VMgiel

Where an entity has been classified as an investment entity under the 'managed by' limb of the IGA test for FATCA purposes, the result is that the entity itself is responsible for the reporting of financial information in respect of its own investors. Often the fulfilment of that duty is delegated to the third party service provider which manages the entity. This is permitted under the IGA and CRS.

However, under the 'managed by' limb of the definition of investment entity in the CRS, that same entity could potentially fail to meet the gross income test and as a consequence be classified instead as a passive non-financial entity (passive NFE). In this case, the obligation to collate and report information on financial accounts maintained for the entity passes to the financial institutions at which those financial accounts (if any) are maintained, which could be in a number of jurisdictions.

The reporting of data, therefore, becomes fragmented and is collated by entirely separate institutions. Furthermore, reports would only be triggered if the controlling person behind that entity is identified as being resident in a participating jurisdiction. While there is no intention to avoid reporting the correct information, the scope and nature of the information to be collated and then reported can differ depending upon the classification of the entity itself. This has led to confusion at the coal face.

OECD APPROACH

On the face of it, the CRS is portrayed as a global standard which is compatible with FATCA. Indeed, the OECD states in its Implementation Handbook that 'an explicit objective when designing the standard was to build on FATCA, and more specifically the FATCA IGA, as by maximising consistency with the FATCA IGA governments and financial institutions could leverage on the investment they are already making for FATCA. This was to ensure that a new international standard could be created, which would deliver the most effective tool to tackle cross-border tax evasion, while minimising costs for governments and financial institutions'.

So, this seems to suggest that an approach which allows the IGA definitions to be used interchangeably with the CRS definitions should be acceptable. If this is correct, then the classification of an entity as an investment entity under the 'managed by' test of the IGA would be acceptable for the CRS, and its treatment as an investment entity as far as the reporting of data would be consistent. But is this correct?

The handbook continues by stating: 'While a large proportion of the standard precisely mirrors the FATCA IGA, there are also areas of difference. These differences are due to the removal of US specificities (such as the use of citizenship as an indicia or tax residence and the references to US domestic law found in the FATCA IGA); or where certain approaches are less suited to the multilateral context of the standard, as opposed to the bilateral context of the FATCA IGA.' Here it seems the OECD is warning that where there are differences, this is deliberate and for specific jurisdictional reasons.

The definition of investment entity is referred to in part III of the handbook, which states that 'while the wording of the definition of investment entity may differ between Model 1 IGA and the investment entity in section VIII, A, 6 of the standard, the standard was designed to achieve an equivalent outcome to that achieved through the Model 1 IGA. Jurisdictions should therefore be able to rely on the approach in the standard for purposes of both the standard and the Model 1 IGA'. This suggests that in cases of divergence between the definitions used in the IGA and in the CRS, it is the CRS that should be applied (and not the other way around).

> **Under the 'managed by' limb definition of investment entity in CRS, that same entity could fail to meet gross income test**

DEFINED TERMS

How is it then possible to reconcile consistency with divergence in the case of defined terms?

Perhaps the key lies in the fact that the OECD has confirmed that the CRS 'often incorporates definitions and processes contained in the current US FATCA Regulations'. Accordingly, it is of the view that jurisdictions can adopt a single approach to these areas, both in relation to implementing the CRS and the IGA, provided that, where a choice is given in the IGA to use the definitions of the US FATCA Regulations, its financial institutions have chosen to do so.

Where does this debate leave us? Until the position is clarified, financial institutions which manage entities will continue to call for reassurance so that they can continue their preparations for CRS in the certainty that they are on the right track. But who will provide this clarification? As the OECD's global forum on transparency and exchange of information for tax purposes assesses whether participating jurisdictions are implementing the CRS correctly, the finance industry stands on a ledge between two streams.

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