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FATCA inter-Governmental agreements for Crown Dependencies

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On Tuesday, 9 October 2012 the three Crown Dependencies, Guernsey, Jersey and the Isle of Man, each announced their intention to negotiate an inter-governmental agreement ("IGA") with the US regarding the implementation of the US Foreign Account Tax Compliance Act ("FATCA").

The IGAs will follow the model IGA ("Model IGA") published by the US Government in July this year and are likely to be similar in form to that signed between the UK and the US on 12 September 2012, which has yet to be brought into force in the UK.

Background

The US Hiring Incentives to Restore Employment Act, 2010 introduced FATCA as part of US law with the aim of combatting tax evasion by US persons ("US Account Holders") who have interests in certain foreign accounts ("US Reportable Accounts"). As the US tax system is based on citizenship, US persons do not need to be resident in the US for them to be US Account Holders and for their US Reportable Accounts to fall within the scope of FATCA.

FATCA requires financial institutions outside the US to enter into an agreement (the "FATCA Agreement") with the US Internal Revenue Service ("IRS") by a deadline, currently set at 30 June 2013. Under a FATCA Agreement a financial institution must report certain information on their US Account Holders and their US Reportable Accounts to the IRS. The FATCA Agreement also requires the financial institution to withhold US tax at 30% on certain payments made to non-compliant financial institutions and non-co-operative account holders, referred to as "recalcitrant" account holders. The financial institution is also required to close the account of recalcitrant account holders.

If a foreign financial institution fails to enter into a FATCA Agreement the financial institution is regarded as non-compliant and will suffer the US withholding tax of 30% on certain US source payments made to it.

Given the extra-territorial reach of the FATCA regime beyond the US jurisdiction, the legal and administrative difficulties faced by financial institutions seeking to comply with FATCA and the potential costs involved in doing so, financial institutions around the world recognised that FATCA would significantly impact on their business and governments, in turn, realised that this would reduce the competitiveness of their finance industry.

Purpose of the IGA

The impetus behind the US' willingness to enter into a bi-lateral IGA with a foreign jurisdiction, which then becomes a "FATCA Partner", came about following an approach by the governments of the UK, France, Germany, Italy and Spain (the G5) setting out concerns regarding the operation of FATCA and how, due to legal constraints (e.g. data protection and duties of confidentiality), financial institutions in those jurisdictions would not be able to deliver the information to be reported under US law. In response to that approach, the US published the Model IGA which, once finalised and implemented through domestic legislation in the foreign jurisdiction, would deal with these legal issues for financial institutions in that jurisdiction which would otherwise be required to enter into a FATCA Agreement direct with the IRS. The US published 2 types of Model IGA – a reciprocal and a non-reciprocal agreement. Under the reciprocal Model IGA the US offers to exchange information with the FATCA Partner on a reciprocal basis at an equivalent level. Under the Model

IGA, local financial institutions would report information to their local tax authority under domestic law obligations, rather than direct to the IRS, as is required under the FATCA Agreement. The local tax authority would then transfer that information to the IRS, subject to the confidentiality and other protections provided for under an existing convention or Tax Information Exchange Agreement ("TIEA") between the FATCA Partner and the US.

Advantages of an IGA

It is not clear at this stage whether any proposed Guernsey-US or Jersey-US IGA may include the option for a Guernsey or Jersey based financial institution to enter into a FATCA Agreement direct with the IRS instead of complying with FATCA under the IGA.

From the perspective of a Channel Islands financial institution, there are advantages that come with compliance with FATCA under an IGA, rather than having to comply through a FATCA Agreement with the IRS. For example, under the Model IGA it is anticipated that, for a financial institution which meets its reporting obligations under an IGA:

- US withholding tax of 30% will not be imposed on US source payments received by that financial institution;
- the financial institution will not be required to withhold US tax at 30% on payments that it makes; and
- due diligence requirements will be more closely aligned to existing anti-money laundering procedures undertaken by the financial institution in its own jurisdiction in compliance with international standards recommended by the Financial Action Task Force.

In addition, Annex II of the Model IGA for each FATCA Partner is intended to identify specific entities and products which are exempt from, or are deemed compliant with, FATCA. Since Annex II is country specific, there is potential scope for negotiating a list which is appropriate for Guernsey's or Jersey's finance industry so that entities and products which would otherwise fall within the scope of FATCA might benefit from specific exemptions. However, the criteria for inclusion in Annex II is that these entities and products are seen (by the US) as low risk in terms of not being able to be used to facilitate tax leakage from the US. Annex II is therefore likely to focus on financial institutions which have a local customer base, or are part of the public sector, and on products which have limitations on their availability or use which, in the eyes of the US, prevent those products from being used for US tax evasion. Whilst the criteria for inclusion in Annex II are limited in scope, this is an area where input from industry would be helpful.

Timing

The announcement issued by the Chief Minister of Guernsey explains that formal negotiations will now take place with a view to concluding the IGA between the US and the Crown Dependencies. Once signed at governmental level, they will need to be ratified by the parliaments of each Island. In Guernsey this would be by Ordinance to bring the IGA into effect as part of Guernsey's domestic law. In Jersey, specific legislation would also be passed in order to implement the agreement. This process needs to be completed by 30 June 2013 because, in the absence of an IGA, Guernsey or Jersey based financial institutions which fall within the scope of FATCA will need to have entered into a FATCA Agreement with the IRS by then. Timing is therefore tight!

The precise terms of the proposed Guernsey-US and Jersey-US IGAs have yet to be negotiated/published. Both governments have stated in separate announcements made on 9 October 2012 that the IGAs "will be similar in form to the agreement between the United Kingdom and the USA signed on 12 September 2012". It would therefore be helpful, at this stage, to look at the UK-US IGA to get a sense of how FATCA is likely to be implemented in the UK by HMRC. Below is a summary of the UK-US IGA (which is yet to be brought into effect under domestic law in the UK).

Anatomy of UK-US IGA

The UK-US IGA is divided into 4 sections:

- A preamble.
- 10 articles of substantive provisions.
- Annex I – due diligence obligations.
- Annex II – country specific non-reporting financial institutions and exempt products.

Below is a brief summary of these components.

Preamble

The preamble provides the context in which the IGA is being entered into. In particular, it acknowledges the intention of both governments (each referred to as a "Party") to assist each other in tax matters and improve international tax compliance. The preamble identifies an existing convention or TIEA which already authorises the exchange of information between the two Parties. In the case of the UK, it is the Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains (the "Convention"). The preamble goes on to state that the IGA seeks to address legal impediments and reduce burdens for the FATCA Partner's financial institutions when fulfilling their FATCA reporting obligations. The US confirms its commitment to exchange information with the FATCA Partner on an equivalent basis and both Parties acknowledge that information exchanged would be subject to the confidentiality and other protections provided for in the Convention already in place between the two Parties.

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Article 1

Article 1 sets out definitions of terms used in the IGA and its Annexes. Helpfully, Article 1.2 states that, in general, any term not otherwise defined should be interpreted in accordance with the domestic law of the Party applying the IGA. In practice, this means that, where appropriate, English law is to be used in the interpretation and application of the IGA for UK based financial institutions, rather than US law. This "home rule" approach is echoed later in the IGA at Article 3.

Article 2

Article 2 sets out the information which a UK financial institution would need to report to HMRC, who would then transfer that information to the US under the framework of the Convention. The information set out in Article 2 is essentially the same as that required by FATCA pursuant to a FATCA Agreement.

Article 3

Article 3 sets out the time and manner of exchange of information between the UK and the US. Echoing the "home rule" approach of Article 1.2, Article 3.1 makes it clear that the amount and characterisation of payments made in respect of Reportable US Accounts may be determined in accordance with English tax laws.

Article 3.7 makes it clear that information exchanged will be subject to suitable safeguards and restrictions on the use of that information. It is hoped that the protections and limitations currently set out in the existing Guernsey-US TIEA and the Jersey-US TIEA would be available to safeguard the confidentiality and limit the use of information exchanged for the purposes of FATCA compliance through any proposed Guernsey-US IGA or Jersey-US IGA, as appropriate.

Article 4

Article 4.1 states that if the UK financial institution meets its obligations under the IGA then that institution will be treated as complying with FATCA and will not be subject to US withholding tax on US source payments made to them nor will they have to apply US withholding tax on payments made by them.

Article 4.2 also provides that a financial institution which meets its obligations under the IGA is not subject to the duty to withhold US tax on an account held by a recalcitrant account holder or to close such an account.

Article 4.3 and 4.4 provides that institutions and products identified in Annex II are treated as either deemed-compliant financial institutions or exempt for purposes of compliance with FATCA.

Article 4.5 sets out the position of UK financial institutions which have related entities and/or branches unable to enter into FATCA Agreements with the US due to legal impediments in the jurisdiction in which they operate or where that jurisdiction has not signed an IGA with the US in respect of FATCA. If certain conditions are met, the UK financial institution will continue to be treated as complying with FATCA under the IGA, notwithstanding the non-compliance of a related entity or branch in another jurisdiction.

Article 5

Article 5 sets out the basis on which the competent authorities of both the US and UK would operate and enforce the obligations under the IGA.

Article 5.2 provides that domestic law, including applicable penalties, should be used locally to address issues of significant non-compliance under the IGA.

Article 5.3 expressly permits financial institutions to use third party service providers to fulfil reporting obligations but these obligations will remain the responsibility of the financial institution concerned.

Article 6

Article 6 provides that both Parties acknowledge the need to exchange information on an equivalent level of reciprocity. In this context, it is worth remembering that the present Guernsey-US and Jersey-US TIEAs are based on exchange of information on request rather than automatically, whereas FATCA and the Model IGA require automatic disclosure of information.

Article 7

Article 7 contains what is generally referred to as the "most favoured nation provision". This means that if another FATCA Partner jurisdiction obtains more favourable terms in their IGA than those included in the UK-US IGA, then the UK can also benefit from those terms.

Article 7.2 requires the US to notify the UK of any such more favourable term and shall apply such more favourable term automatically under the UK-US IGA. The IRS is required to publish a list identifying all Partner jurisdictions.

Crucially Article 7 does not appear in the Model IGA but it is hoped that it will be included in any proposed Guernsey-US IGA or Jersey-US IGA that may be concluded.

Articles 8, 9 and 10

These Articles cover consultations and amendments, incorporate the Annexes as an integral part of the IGA and deal with the entry into force of the IGA and how it may be terminated.

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Annex I

Annex I sets out the processes and procedures to identify US Reportable Accounts.

Annex II

Annex II is country specific and identifies entities and products which are seen as low risk for US tax leakage and therefore exempts or treats as deemed-compliant the products/entities set out in Annex II.

Concluding comments

The announcements made by Guernsey's Chief Minister Deputy Peter Harwood and Jersey's Chief Minister Senator Ian Gorst are to be welcomed, as is the level of co-operation and common approach displayed by the governments of Guernsey, Jersey and Isle of Man. Whilst the scope of agreeing specific provisions that are in a particular island's interest may be limited due to the confines of the Model IGA, it is hoped that the US will be willing to consider measures that enable financial institutions in all 3 Crown Dependencies to meet US expectations for the reporting of information under FATCA in an efficient and practical manner, bearing in mind the importance of maintaining proportionality. It is heartening that the Channel Islands are able to draw upon their long history of international co-operation as active participants in global efforts to improve tax compliance and combat tax evasion.

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