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Your November snapshot

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In this month's FS*taxworld*, we set forth our overview of the OECD Standard for Automatic Exchange of Financial Information in Tax Matters, commonly referred to as CRS.

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The View from Deloitte

On 29 October 2014, a new era of tax transparency began. The signing of a Multilateral Competent Authority Agreement (MCAA) by 51 jurisdictions at the annual Global Forum meeting in Berlin advanced the automatic exchange of information (AEOI) towards ultimate realization. Most of the signatories (known as the 'early adopters') pledged to work towards implementing the recently adopted Organization for Economic Co-operation and Development (OECD) standard on financial account due diligence and reporting (altogether, commonly referred to as the Common Reporting Standard or CRS) by the beginning of 2016 and conclude their first information exchange by September 2017. On 19 November 2014, the Swiss Federal Council approved a declaration on Switzerland joining the MCAA. Similar to many of the 41 jurisdictions that have not yet signed the MCAA but officially committed themselves to adopt the new standard as well, Switzerland will only start exchanging information in 2018. Among the jurisdictions that either signed the MCAA or otherwise committed themselves to the new standard are almost all large financial centers, except for the U.S., which will persist in exchanging information via reciprocal FATCA intergovernmental agreements (IGAs).

Like with Model 1 IGAs, local authorities play a key role in the implementation of the regime. As CRS itself and the OECD commentary thereon lack actual legal character, the requirements must be codified into local law. Consequently, akin to the guidance notes that are currently published in Model 1 IGA jurisdictions, local tax authorities will set out specific directions on the application of the rules in each jurisdiction.

For financial institutions assessing future CRS compliance, three aspects are crucial in this regard.

- First, as a threshold determination, each entity must identify which CRS regimes govern it, the financial institutions where it maintains account and its own accounts holders.

  - The necessity for such a triangulation of dependencies is starkest in the context of professionally managed investment entities (often referred to as type B Investment Entity FIs for FATCA purposes). Unless and until there is an exchange agreement in place between the Investment Entity‘s jurisdiction of residence and the account-keeping financial institution’s jurisdiction of residence, the Investment Entity FI needs to be treated as a passive Non-financial Entity (passive NFE) and its individual controlling persons will be subject to reporting, provided that such controlling persons are resident in a jurisdiction that has an agreement in place with the jurisdiction where the account is maintained. However, once and if an agreement between the jurisdiction of the Investment Entity FI and the location of the financial institution maintaining the account becomes effective, passive NFE treatment discontinues and the account is no longer reported by the financial institution maintaining the account. Instead, the Investment Entity FI reports its own account holders who are resident in a partner jurisdiction of the Investment Entity FI‘s jurisdiction, regardless of whether the residency jurisdictions of those account holders are partner jurisdictions of the account-keeping financial institution.

  - Consequently, the determination of whether a specific account holder of an Investment Entity is reported to his or her home tax authorities and which financial institution involved conducts the reporting pivots on the presence of bilateral agreements between and amongst multiple jurisdictions, a situation which is subject to change.

- Second, CRS grants local authorities the power to decide on country-specific provisions when negotiating bilateral agreements and translating CRS into domestic law. Extrapolating from the experience of FATCA IGAs, presumably one or more jurisdictions will offer different interpretations of certain key requirements. Obviously, such diversity will magnify the challenge faced by financial institutions, especially for those operating in multiple jurisdictions and therefore having to comply with varying CRS requirements.

- Third, enactment of domestic legislation in most countries is a time-consuming process, which may result in uncertainty and delays throughout the implementation phase.

  - Relevant agreements with various partner jurisdictions will, thus, not all enter into force on the same date. Consequently, a financial institution needs to decide whether to re-apply certain procedures such as the review of preexisting accounts whenever a new agreement enters into force or to opt for a wider, “big bang” approach and perform an exhaustive one-time operation. Both approaches comprise merits and drawbacks and the selection of which one to apply needs to be carefully evaluated from an operational perspective, balancing, inter alia, current versus likely future resources. While the operational burden may be spread over time through a staggered implementation, this approach may in turn lead to a duplication of effort and additional complexity, where, for example, an account has different statuses in relation to different partner jurisdictions. These redundancies may be avoided through a comprehensive approach; however, the efforts required will be unprecedented due to

the population of clients potentially concerned.

Besides the above strategic factors that will form the core concept of a CRS implementation and compliance program, other salient differences between the FATCA and the CRS regimes warrant consideration, including:

- While most of the FATCA Model 1 IGAs imply a reciprocal exchange of information, i.e. the U.S. will also provide some information to the partner jurisdictions about their own tax residents, such reciprocity is not identical. In contrast, CRS generally foresees that all jurisdictions exchange the same level of information, unless a jurisdiction does not wish to receive information.

- Further, the FATCA regime wields the threat of a 30% withholding tax to coax financial institutions towards compliance. Under CRS, participation and enforcement derives from local legislation and worldwide political pressure through published progress reports.

- In anticipation of the worldwide application of CRS, financial institutions are not required to register on a central portal. It will be up to each specific jurisdiction's authorities to decide whether and in which form domestic registration is mandatory.

- Similarly, there is no need to nominate an individual who is personally responsible for a financial institution's compliance with the CRS requirements (as per the Responsible Officer concept under FATCA). It is more likely that the participating jurisdictions will incorporate oversight and enforcement requirements into their domestic supervision and audit concepts.

- Unlike in the U.S. residence is the sole determinant of unlimited tax liability in most other jurisdictions. Consequently, CRS is a purely residence-based exchange regime and neither nationality nor the place of birth is directly relevant.

In general, a number of smaller, often highly technical differences between the two regimes emerge from a close reading of the assorted texts. From an operational perspective, however, even such small differences complicate the alignment of requirements and procedures and thus implementation in general.

Far-reaching implications for the financial industry

Consistent with its origin as an outgrowth of FATCA, the CRS regime allocates many enforcement responsibilities to financial institutions. At first sight, it seems that the same entities will be affected in the same fashion. However, CRS grants fewer relief provisions than FATCA. While FATCA offers numerous compliance paths for financial institutions that the U.S. tax authorities perceive as posing lower risk of use by U.S. taxpayers to evade taxes (the deemed-compliant or non-reporting statuses), CRS drastically narrows the possibilities for exemptions from reporting requirements. Under CRS, the classifications that incur a non-reporting privilege are limited to few entity types, such as governmental entities, pension funds, some collective investment vehicles and trustee-documented trusts, excluding popular non-reporting compliance paths such as Local FFIs, investment managers and investment advisors and the sponsoring concept. Moreover, while it was possible to limit the impact of FATCA by simply committing to a 'non-U.S. policy', it will be almost impossible for many financial institutions to avoid reporting under CRS by simply altering the constellation of its client population or products offered, unless it adopts a pure onshore strategy. Overall, CRS will result in reporting obligations for more financial institutions than FATCA, irrespective of which clients they serve and their business model.

With regard to respective scopes for accounts and products, FATCA and CRS definitions are mostly congruent. However, discrete deviations from the FATCA definitions expand the scope for reporting accounts under CRS. For example, unlike FATCA, CRS does not offer an exemption from financial account treatment for equity interests that are regularly traded on an established securities market. Thus, shares in, say, an ETF are subject to due diligence and potentially to reporting. Similarly, the USD 50,000 threshold for certain life insurance contracts (so-called cash value insurance contracts) does not exist for CRS purposes, thereby imposing an additional burden on insurance companies.

Depending on a specific jurisdiction's boldness when interpreting the rules, certain FATCA-based statuses for entities and financial accounts not set forth by the OECD may be re-introduced through domestic implementation, hopefully aligning the rules more tightly with FATCA's, though further divergence is also possible.

Proliferation of complexity and compliance efforts due to worldwide application

Despite certain differences in definitions and concepts, these factors do not drive the complexity for reporting financial institutions under CRS. Rather, its complexity stems from the dependencies inherent in its multilateralism (as set out above) and the sheer amount of data that must be obtained, stored, monitored, and exchanged in order to comply. As mentioned above, AEOI under CRS is based on tax residence. Therefore, financial institutions must potentially report all account holders and controlling persons that are not solely resident in the same jurisdiction as the financial institution. The combination of multilateralism and the adoption of the indicia concept from FATCA will lead to an unprecedented level of information reported to domestic tax authorities. As a consequence, government agencies also need to revamp their systems and procedures in order to process mass amounts of data and transmit them to the correct partner jurisdiction. Finally, the same financial account holder information may need to be exchanged with multiple jurisdictions, for example, if the owners of a joint account are resident in different partner jurisdictions or in the case of dual residency.

As burdensome as the reporting requirements appear, the due diligence obligations may exceed them. Similar to FATCA, CRS imposes both enhanced on-boarding requirements for new accounts and a requirement to conduct a due diligence review of all preexisting financial accounts (i.e. the accounts opened prior to the introduction of the new on-boarding processes). However, the slight variations and the multilateral context of CRS increase the challenges with which financial institutions will have to cope, as follows:

- Under FATCA, financial institutions in the retail business can limit the due diligence burden with respect to all preexisting and certain new individual accounts through the application of a USD 50,000 de minimis threshold. For CRS purposes, there is no such exemption. Accordingly, the due diligence requirements apply to all individual accounts irrespective of their account balance, and thus accounts that have been out-of-scope from a FATCA perspective will need to be taken into consideration for CRS.

- As partial relief in respect of lower value accounts, financial institutions may apply the so-called residence address test with respect to their preexisting individual accounts with an account balance or value that does not exceed USD 1 million. As such, in lieu of an indicia search, the financial institution may rely on the residence address on file, provided that this piece of information is supported by documentary evidence or other acceptable documentation.

- While for FATCA purposes only U.S. indicia create a reporting obligation, under CRS any indication of residence in any partner jurisdiction needs to be considered. In other words, financial institutions must capture and monitor indicia with respect to many jurisdictions. The likelihood of clients exhibiting indicia for multiple jurisdictions seems

quite high given the freedom of movement and the close proximities within Western Europe, for example. As a result, robust monitoring systems and effective remediation processes to cure indicia need to be in place. Otherwise, the account information needs to be exchanged with any jurisdictions for which an uncured indicium appears.

- Beyond that, even where a financial institution established sufficient policies and procedures to detect and cure conflicting indicia, there may be cases where it is not straightforward for the client to determine his or her tax residence. Similar to FATCA, the determination of whether a person is considered a taxpayer of a specific jurisdiction is governed by the laws of such country. While the 'U.S. person test' is widely known nowadays, financial institutions must develop protocols for situations where clients are unable to determine their own tax residences. In practice, this means that financial institutions likely need to increase the awareness for the domestic standards in the jurisdictions with which their account holders are associated.

- Similarly, obtaining a taxpayer identification number (TIN) from each reportable person is familiar as a concept from FATCA. The TIN collection and management for CRS purposes, nonetheless, presents new forms of challenge to financial institutions. First, many jurisdictions, including Switzerland, do not routinely assign a unique identification number to each taxpayer and therefore call for an alternative, like the social security number. Second, the format of the various TINs will vary considerably but nevertheless the electronic systems of a financial institution must be able to store and process them. Third, there is no expectation of a centralized TIN register by which financial institutions can verify the TINs obtained from their clients (though the OECD reportedly intends to publish a primer on the recognized formats of taxpayer or equivalent identification numbers in different countries).

- Further, the CRS due diligence requirements explicitly refer to the domestic implementation of the Financial Action Task Force (FATF) recommendations on anti-money laundering when it comes to the determination of controlling persons of passive NFEs. Due to considerably varying criteria among jurisdictions, a fragmentation of the standard may be observed.

The necessity for timely action due to tight timeline and anticipated impact

In light of all of the above, AEOI will be one of the high-priority topics in the compliance agenda of numerous financial institutions over the coming months. Any expectation that the implementation of CRS could be a FATCA 2.0 project must be reconsidered. The multilateral dependencies and enormous increase in the number of accounts concerned pose completely new challenges to the financial sector. Above all, the timing of CRS is highly ambitious. The group of early adopters will start reporting in 2017, consequently, financial institutions in those jurisdictions need to be ready to start gathering data by 1 January 2016. Although the standard will become effective in Switzerland one year later, Swiss financial institutions with representation in jurisdictions that have decided to adopt the standard earlier need to accelerate their efforts in line with the tighter timeline. The absence so far of any specifications detailing domestic implementation standards exacerbates the timing problem further. Finally, the implementation of multiple overlapping tax transparency regimes obliges financial institutions to align and coordinate their CRS-related efforts with those undertaken for AML/KYC or FATCA purposes to the best extent possible. Therefore, with a realistic and present sense of urgency, financial institutions ought to develop familiarity with the most important CRS concepts and craft the framework of a compliance program to be filled in with technical details upon the release of relevant local legislation.

Regards,

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Report from the FATCA Frontlines – The ODFFI Compliance Gap

FATCA brings substantial burdens to many of the entities it attends, but some types of entities are finding that FATCA's lack of attention may be more onerous. Trusts with individual trustees, underlying companies thereof and standalone companies (i.e. Personal Investment Companies (PICs) or other closely-held investment vehicles) with individual directors are typically entitled to passive Non-financial Foreign Entity (passive NFFE) status, but the presence of an asset manager, including discretionary portfolio management by a bank where it maintains assets, converts that passive NFFE into an FFI. Unlike their brethren administered by corporate trustees and corporate directors, these FFI trusts and companies lack a sufficiently connected entity that is eligible and willing to sponsor them. The option of full compliance as a participating FFI or Reporting Model 1 or 2 FI is also unavailable as these structures lack any employees or other infrastructure to handle compliance activities and, prior to FATCA, never had to. Deprived of other viable compliance path options, these structures must resort to the compliance path category rejected by most trust companies and corporate directors: Owner-documented FFI (ODFFI) status.

Negative aspects of ODFFI status are plain, such as:

- The requirement to obtain the consent from any financial institution where the ODFFI maintains an account, thereby subjecting the ODFFI to potential extra fees and the financial institution to potential extra scrutiny from the IRS due to the remuneration;

- The obligation to disclose on the owner reporting statement, which must accompany any self-certification claiming ODFFI status, and document, *inter alia*:
  - All individual owners, both U.S. and non-U.S.; and
  - Any indirect owners of the structure (unless held through a U.S. entity);

- Even though the financial institution will only report:
  - Specified U.S. Persons owning direct interest in the structure; and
  - Specified U.S. Persons owning indirect interests in the structure unless held through designated types of compliant entities; and thus

- The incongruity between disclosure and reporting obligations will result in a surplus disclosure of information on the part of the ODFFI and thus an overabundance of information for the bank to digest in order to identify whom to report and therefore the fair possibility of confusion resulting in the reporting of excess, unwarranted or duplicative information to the IRS.

In sum, the ODFFI status forces these trusts and companies to pay for the privilege of a FATCA status they do not want, to a bank that does not want to assume the cost for monitoring the status, the end outcome of which may well be the reporting of unwanted or extraneous information to the IRS. As such, the ODFFI compliance path will foreseeably yield an unhappy result for the parties involved, but the risk may be mitigated by a pact of common sense amongst the structures who, as noted at the onset, have little alternative other than to resort to the ODFFI compliance path, and those financial institutions willing to provide the service to these clients:

- Only structures with no viable alternative should pursue ODFFI status;

- Such ODFFIs will need to accept an intrusion into their ownership structures by their banks in exchange for their consent to ODFFI treatment; and

- Strictly banks with the technical wherewithal, compliance resources and willingness to overcome the ODFFI disclosure-reporting incongruity ought to offer this category and, even then, only if their customer base needs it.

The ODFFI compliance path fills a gap in FATCA compliance for a certain set of entities, but proper and effective compliance looks grueling for the parties involved.

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Deloitte GIIN Validation Tool

With a range of different options available for FFIs to validate GIINs of clients and counterparties, Deloitte is preparing a fully automated software solution to improve upon the manual, decentralized process (e.g. typing GIINs and entity names on the IRS portal) currently in use by many Financial Institutions. Deloitte's GIIN Validation Tool will be a Deloitte-managed service via a secure Swiss cloud and allow each user to set a certain confidence level in order to avoid false positives.

Example solution features that will significantly expedite the GIIN validation process include:

- Archive function with respect to superseded IRS FFI lists;
- Statistical information (additions, deletions, EAG information, country distribution, etc.);
- Search and upload functionality for client FFI list (txt, xls, xml, csv, etc.);
- Automated comparison of the client FFI list with the official IRS FFI list (including branches that cannot be identified by name but only through the main office entry as the branch entry in the IRS FFI list is only "branch");
- Insightful presentation of results from "perfect match" to "no match at all" considering possible abbreviations, language differences or transposed characters; and
- Printing or exporting of results.

For further information on the Deloitte GIIN Validation Tool or a live demonstration, please contact **James Frei**.

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