Common Reporting Standard
A work in progress requiring high reactivity

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"I really do think that on the international, on the global level, we have to fight all together against tax evasion". Jean-Claude Juncker's declaration last November at the G20 summit in Brisbane reflects a clear step-up in the global move towards more transparency in tax matters.

Since FATCA in 2010, the momentum for implementing the new automatic exchange of information has grown and the financial industry is increasingly acting as a data facilitator for tax administrations.

New regulations have been issued, new frameworks designed, technical systems have been implemented and financial institutions are often forced to comply in a short order with these new requirements.

Strategic considerations

From FATCA to the Common Reporting Standard

As a matter of principle, FATCA forces financial institutions to disclose their U.S. clients (and clients assumed to be U.S. clients) to the Internal Revenue Service. To ensure a high degree of participation, financial institutions refusing to comply would be categorised as 'Non-Participating Foreign Financial Institutions' and sanctioned with a punitive 30% withholding tax on U.S.-sourced income and gross sales proceeds of assets producing U.S.- sourced income.

Essentially to facilitate compliance with data protection laws, many jurisdictions, including Luxembourg, have negotiated so-called 'Model 1 Intergovernmental Agreements' (Model 1 IGA) with the United States, in order to enable (in most cases, reciprocal) automatic exchange of information through local tax authorities. Local laws transposing such IGA will force financial institutions to comply with FATCA data exchange obligations.

Month after month, the number of countries which have concluded an Intergovernmental Agreement with the United Stares rises steadily (more than 100 agreements had been substantially agreed or signed as at 31 December 2014).

In parallel, in September 2013, the Organisation for Economic Co-operation and Development (OECD) proposed a new framework to automatically exchange information for tax purposes. The Common Reporting Standard (CRS) is a package based on the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters (as amended through a 2010 Protocol), and largely inspired by the FATCA Model 1 IGA mechanics. Implementing the CRS requires partner jurisdictions to enter into multilateral or bilateral conventions. The European Commission quickly leveraged these developments to implement the CRS through an extension of the Directive on administrative cooperation, completing this Directive with CRS-based mandatory automatic exchange of information in tax matters. This lead to Council Directive 2014/107/EU of 9 December 2014 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation (commonly referred to as the DAC2), which in practice will impose CRS reporting throughout the European Union (with a first report due in 2017 for calendar year 2016).

As a result, the EU Commission has already announced it would consider repealing the EU Savings Directive as well as the amended EU Savings Directive on which consensus was reached in 2014 only after many years of political horse trading. Compared to the DAC2, the (amended) EU Savings Directive indeed has a very narrow scope (limited to automatic exchange on certain types of 'interest' income), and consequently become obsolete as soon as the much broader CRS reporting on all types of financial income will apply.

How to deal with new regulatory frameworks?

More than 80 jurisdictions have already signed or announced their participation in the OECD Multilateral Convention on Mutual Administrative Assistance in

Tax Matters, including all EU Member States, but also jurisdictions from all continents such as Argentina, BVI, Cayman Islands, the Channel Islands, China, Ghana, India, Indonesia, Japan, Korea, Nigeria, Russia, Saudi Arabia, Singapore, South-Africa, Switzerland, Turkey, etc. In this respect, we face an unknown factor: when exactly will additional multilateral and bilateral conventions amongst (clusters of) the partner jurisdictions be signed, and to what extent will some of these instruments depart from the standard CRS convention proposed by the OECD? Financial institutions with cross-border clients will need to closely monitor the developments in this area to ensure their reporting systems are adjusted in a timely manner in terms of the country scope and implementation dates, as well as for the management of (hopefully minor) differences in data to be provided to partner jurisdictions.

From a FATCA strategic viewpoint, most financial institutions decided to continue to accept U.S. Persons as clients, and have invested in setting up FATCA reporting systems. However, some institutions decided to terminate client relationships with persons and entities qualifying as a U.S. Person. This strategy allowed them to avoid an expensive implementation project, and limited the FATCA implementation to procedures which decline U.S. Persons as clients, respectively discontinue the client relationship should a person or entity become a U.S. Person. However, from a CRS strategic viewpoint, not accepting clients who are resident in a partner jurisdiction will, especially in an international centre such as Luxembourg, not be an option: in the first instance this would exclude all clients from another Member State, and in a second stage, an increasing number of clients from more than 80 jurisdictions worldwide. Investing in CRS classification and reporting systems will consequently be a must (and may also lead to revisiting certain FATCA strategic decisions taken in the past).

Key challenges for 2015

Two questions will need to be answered in the coming weeks: how to initiate the CRS implementation project? What is the first step?

Since the financial industry will clearly be forced to implement CRS reporting, the most appropriate timeframe for implementation will need to be determined, as well as the strategic choices, which can be different than the ones made for FATCA.

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For example, as the number of U.S. Persons that are reportable clients for FATCA may be relatively limited, some (especially medium-sized or smaller) institutions may have set up manual FATCA reporting processes. In view of the broad country scope of CRS reporting, which will only grow in the coming years, manual processes will likely not be realistic for CRS reporting (except maybe for financial institutions with essentially local clients). In most cases, due to significantly higher reporting volumes than for FATCA, automation will be key to drive CRS compliance. Depending on the success of your FATCA implementation, it could be relevant to leverage resources (project managers, tax and compliance experts), experiences (strengths and weaknesses highlighted during FATCA implementation), procedures and technical systems to put in place KYC and tax reporting solutions, aligned with the Common Reporting Standard.

Once global strategy has been assessed and key decisions have been made, another challenge will consist in client communication. A number of clients may have been contacted recently to provide documentation in respect of their FATCA status (and/or evidence relating to US indicia detected in their file). Financial institutions may have to contact clients once again very soon, starting now, to request additional information in respect of their CRS classification (and/or to provide evidence relating to certain CRS indicia detected in their file). Some clients may express puzzlement at these requests to provide documentation and/or evidence that was already submitted (and to sign yet another updated version of general conditions and other contractual documentation). Relationship manager training and support with appropriate communication will be two of the key assets of a successful CRS project.

Operational workload must be anticipated

Due to new requirements encompassed by the CRS, additional data will be gathered and communicated by financial institutions to local tax administrations. Reporting processes may have to be updated and extended year after year as additional partner jurisdictions will join, and each country may negotiate a customisation of the standard reporting schema.

While the IRS already declared that the FATCA reporting schema (i.e. Form 8966 and the related XML schema) will be updated in 2016 with the aim to more closely align with the CRS released by the OECD, several Member States also stated that they would like to take advantage of this new initiative to enhance the reporting format by adding some specific local requirements. Consequently, this could have the effect that the CRS schema designed by the OECD may increasingly be tailored to local reporting requirements.

Beyond these technical considerations, operational challenges will also arise. Back offices that currently only have to report U.S. clients for FATCA purposes will experience a significant increase in workload with the CRS. Before filing the electronic report to the local tax administration, several operational tasks must indeed be performed in order to enable data transmission and ensure data consistency. Checking client information, analysing data discrepancies, manage communication with the client to confirm or clarify his CRS classification, and manage tax authorities' questions and feedback could quickly turn into a nightmare without proper organisation for a financial institution with an important cross-border client base.

Moreover, clients may expect to receive from their financial institution a copy of the data transmitted to the authorities. This was (and is) not mandatory under FATCA, but several jurisdictions have signalled a desire to introduce such mandatory reporting for CRS purposes. This would make perfect sense: as a taxpayer, one would probably wish to know what data has been sent to tax authorities, and also to be able to detect and correct any mistakes, to avoid unnecessary questions from tax authorities. Again, due to the significantly higher volume compared to FATCA, the CRS workload in this respect will be much higher. On the other hand, there may be an opportunity for financial institutions which already provide separate tax reports on client portfolios to further enhance these reports by making the link with transmitted CRS data (or for those institutions not yet providing such tax reports to their clients, to use the opportunity of CRS implementation to begin producing such reports).

To successfully deal with these new challenges, the financial industry will need to put in place new solutions, both technical and human. The 2020 outlook is still somewhat foggy, but current developments indicate that governments, regulators and tax authorities will continue to put forward new regulations promoting transparency in tax matters at all levels.

Synergies and focus points

At this stage, leveraging FATCA implementation projects appears to be a valid strategy for initiating CRS implementation projects. The philosophy of both texts is the same (as the CRS is inspired by the FATCA IGA Model 1) and most definitions are very similar. However there are also differences. Additionally, as CRS obligations (the DAC2 and future conventions with other partner jurisdictions) need to be transposed into local law, certain country specificities may have to be dealt with.

Registration

The first important difference between FATCA and the CRS is the absence of a central registration process. Of course, financial institutions may possibly have to register with local authorities to submit their yearly CRS report, but no new global identifier (such as the FATCA GIIN) will be used. In terms of responsibility, each jurisdiction will be in charge of ensuring that financial institutions will comply. Unlike FATCA, there is no concept of a FATCA Responsible Officer.

Withholding

Another major point is the absence of punitive withholding under the CRS (in IGA Model 1 countries, FATCA withholding may have to be applied; however only in exceptional cases). Of course, local laws transposing CRS obligations will contain certain sanctions for non-compliance; in most countries under the form of administrative fines (as is the case with FATCA implementation laws).

Client identification and classification

The main principle of the CRS is to report foreign tax residents to their tax administrations. This is again an important difference with FATCA, which starts from the concept of U.S. Persons, who can be classified based on nationality, place of birth, immigration status, substantial presence, etc.

Obviously, in certain cases, complications with identifying tax residence may arise: some clients may be taxable in several countries during the same year or their files may contain indicia indicating potential tax residence in two or more jurisdictions.

The question arises: how may a financial institution determine a client's tax residence?
For new clients, a systematic self-certification will be required. Each time new clients open a financial account, they will have to provide a document containing their tax residence(s), their Taxpayer Identification Number(s) (TIN(s)), their date of birth and their place of birth. This document will not be harmonised and each country or each financial institution may decide to produce its own template.

For existing clients, the approach will be similar to FATCA, provided that local authorities accept the approach. Local authorities may allow financial institutions to rely on the residence listed in their systems and consider this as the tax residence of the client (note that some countries have already signified that they would rather require a systematic self-certification instead). As within the context of FATCA, when indicia of foreign residency are found, these indicia have to be resolved by a self-certification, and the concept of 'reasons to know' is maintained within the DAC2. Relationship managers will also have a particular role in determining to where a client should be reported.

Reporting

The FATCA XML scheme was used as a blueprint for the CRS reporting scheme. In the beginning of 2014, discussions took place to decide whether both schemas should be combined into a single scheme or not. As developments for FATCA had already begun, it was decided not to merge them but the differences are small. Meanwhile, the IRS announced that they would upgrade the FATCA scheme to align it with the CRS scheme in 2016.

Regarding the content, reported financial data is similar: account balances or values at year-end, as well as income and gross proceeds paid during the calendar year. As opposed to FATCA, there will be no phased-in approach. Considering that in 2017, the full FATCA phase 3 reporting scope will apply (including income & gross sales proceeds), the OECD proposed to start immediately with full CRS reporting. Nevertheless, local authorities may - to a certain extent - decide to implement a phased-in approach to facilitate implementation for financial institutions.

As mentioned above, the main difference will be the significant increase in reporting volumes under the CRS. Additionally, an important difference for entity clients is related to the myth that under the CRS, all investment entities in non-partner jurisdictions are Passive NFE, and consequently, controlling persons of such entities that are tax resident in a partner jurisdiction are reportable. For example, a Panama entity could possibly qualify as a Participating FFI for FATCA purposes, and an account held by such an entity with a Luxembourg bank would not be reportable. However, for CRS purposes, as Panama is not a partner jurisdiction (yet), and assuming the entity is an investment entity under the CRS definitions, the same bank should identify the controlling persons of this entity who are tax resident of a partner jurisdiction, and consequently report these persons.

To do's and timeline

Financial institutions confronted with the DAC2 will need to take urgent action in 2015 to start CRS implementation projects.

A first step likely consists in carrying out an impact analysis, which links up with the FATCA implementation project. The impact analysis should among other things also cover a review of the FATCA strategic decisions in the light of the CRS. For example, investment funds having opted for a deemed complaint status under FATCA may be confronted with the fact that a similar deemed compliant status does not exist under the CRS, and possibly reconsider whether it is worth maintaining this status for FATCA.

Of course, the impact analysis should among other things also assess the implementation costs, and whether the organisation should self-develop its CRS reporting systems, consider an external package to be integrated into the organisation's systems, or consider an outsourcing solution of FATCA and CRS reporting. Taking into account the likelihood of significantly higher reporting volumes, IT solutions will generally need to be more complex and robust than for FATCA reporting. Once the CRS project team is activated (which will likely be the same or a similar team as for FATCA), the implementation roadmap developed during the impact analysis exercise and CRS strategy can be executed to deliver training, develop CRS procedures, modify contractual terms and agreements, set up classification and reporting systems for CRS purposes and achieve data collection readiness as from 1 January 2016. Permanent monitoring will nevertheless be required as the DAC2 is just a first step in CRS implementation. Non-EU countries will indeed follow, with more than 20 early adopters other than the EU Member States intending to implement reporting starting in 2017 for calendar year 2016, and many other countries wanting to implement CRS reporting starting in 2018 for calendar year 2017 (among which Switzerland, likely based on an agreement with the European Union). More countries will follow with CRS implementation after 2018, which means that permanent monitoring for the updating and upgrading of reporting systems and procedures will be needed.

Resources

One aspect that should not be overlooked is building resources. To meet the increase in workload resulting from the DAC2 and further CRS conventions with other countries than the EU Member States in the near future, in particular front offices, back offices, IT and compliance departments will be confronted with an additional workload. Indeed, these departments will be in the front line of managing the internal trainings, collection of additional self-certifications, additional documentation and pieces of evidence in respect of client classification and clarification of indicia, correct communication with the clients, collection of the data to be exchanged, managing changes in client status, identifying possible reasons to know that a client classification may be inaccurate, managing the likely increasingly frequent requests over time issued by foreign tax authorities, executing a compliance programme with regular health checks, etc.
Existing FATCA teams should thus generally be reinforced to cover this increased workload (which could to a certain extent be mitigated through opting for an outsourcing solution for FATCA and CRS reporting).

Conclusion

With the DAC2 being adopted very quickly, the financial sector needs to move rapidly to implement CRS reporting systems in the course of 2015, in order to be ready to collect the necessary data as from 1 January 2016. Building on FATCA experience and implementation, projects will be possible to a large extent from a technical and legal viewpoint, as the CRS is highly inspired by the FATCA IGA Model 1. Nevertheless, there are significant implementation differences to be taken into account as well, and FATCA strategic decisions may even need to be reviewed and possibly changed in light of the CRS. The most significant difference with FATCA is related to the fact that, in particular in international centres like Luxembourg, CRS reporting volumes are expected to grow exponentially, and continue to grow in the coming years, as more and more partner jurisdictions will implement similar CRS reporting obligations. Institutions which have implemented manual or semi-manual reporting solutions for FATCA are likely to have to reconsider their decision in favour of more automated CRS reporting solutions in view of this increased reporting volume. Outsourcing solutions should also be considered, and could to a certain extent mitigate the need for reinforcing teams dealing with CRS reporting within the institution. Finally, this could also be seen as an opportunity to assess and improve existing tax reporting solutions for clients (or consider implementing such solutions), making the link with FATCA and CRS reporting in order to further improve client service standards.