Reining in tax evasion

The road to FATCA and the Fourth EU Directive — Customer Due Diligence requirements revisited

Offshore tax evasion is widely recognized as a global issue requiring global solutions. Some of the regulation emerging from ongoing discussions on an international level will impact directly upon financial institutions globally as can been seen with the Foreign Account Tax Compliance Act (FATCA), which will come into force on July 1, 2014. Financial institutions are faced with the challenge of aligning their exiting Know Your Customer (KYC) due diligence processes with these new requirements. The article outlines the background and international discussions regarding tax evasion and the ongoing debate to curtail it, and seeks to touch upon the impact it will have in dealing with should be: high-risk clients in regions, which are considered high risk for tax evasion.

Tax evasion — global standards for a global problem

Discussions for changes to international tax rules gained significant momentum following the financial crisis. Demands for greater transparency and efforts to tackle offshore tax evasion to restore fairness and integrity of tax systems and the global financial system more generally were voiced and significant action by governments was undertaken. According to the Organization for Economic Co-operation and Development (OECD), the capacity for cooperation in international tax matters has improved significantly since 2009. More jurisdictions are committed to the *Global Forum on Transparency and Exchange of Information for Tax Purposes* (global forum), the number of exchange of information agreements has grown substantially, and many changes in domestic legislation have been introduced to comply with the standard.

With more and more jurisdictions joining the Convention on Mutual Administrative Assistance in Tax Matters, a clear legal basis for comprehensive automatic exchange with strict safeguards protecting confidentiality exists. Bilateral tax treaties also provide such a legal basis and within the European Union, directives provide a specific legal framework for automatic exchange of information regarding interest income and certain other types of income between its members. As stated by Itai Grinberg, there are four incongruent: initiatives the European Union, the OECD, Switzerland, and the United States, which together represent an emerging international regime in which financial institutions act to facilitate countries' ability to tax their residents' offshore accounts. Although there is a growing consensus that financial institutions should act as "tax intermediaries" in a cross-border context, whether they will act as a withholding agent or an information reporting agent and for which countries varies.

The international framework — Global Forum

The Global Forum on Transparency and Exchange of Information for Tax Purposes has been the multilateral framework within which work in the area of transparency and exchange of information has been carried out by both OECD and non-OECD economies since 2000.[1] Issues addressed at the forum include money laundering, tax evasion, tax havens, offshore financial centres, tax information exchange agreements and Double Taxation Conventions. The forum is established under the auspices of the OECD and Group of Twenty Finance Ministers and Central Bank Governors (G20).

According to the Global Forum's web site, the organization was restructured in September 2009, in response to the G20 call to strengthen the implementation of these standards. The Global Forum now has 120 members on equal footing and is the premier international body for ensuring the implementation of the internationally agreed standards of transparency and exchange of information in the tax area. Through an in-depth peer review process, the restructured Global Forum monitors to ensure that its members fully implement the standard of transparency and exchange of information they have committed to implement. It also works to establish a level playing field, even among countries that have not joined the Global Forum.

The Global Forum's members include OECD and non-OECD members, including China who joined in August 2013.[2] The OECD, as reported in their report published in advance of the G-20 meeting in St. Petersburg in September 2013, have set up three initiatives in the fight against tax evasion.

- Global Forum on Transparency and Exchange of Information for Tax Purposes
- Base Erosion and Profit Shifting (BEPS)
- The Multilateral Convention on Mutual Assistance

FATCA

The most wide-reaching piece of regulation implicating financial institutions as information reporting agents was passed by the United States in an attempt to curtail tax evasion by U.S. nationals and associated entities. FATCA aims to crackdown on offshore tax evasion through increased information reporting and withholding. Through the implementation of inter-governmental agreements negotiated with partner countries, FATCA facilitates the automatic exchange of information between the Internal Revenue Services (IRS) and partner countries or foreign financial institutions.[3]

[1] http://www.oecd.org/tax/transparency/
[2] http://www.oecd.org/tax/transparency/membersoftheglobalforum.htm/

As reported on the web site of the U.S. Department of Treasury, FATCA was enacted in 2010 by Congress to target non-compliance by U.S. taxpayers using foreign accounts. FATCA requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. Links to many documents related to FATCA and its implementation can be found on the web site of the U.S Treasury.[4] Grinberg stated that the FATCA regime requires annual asset reporting as well as income reporting, including assets held by shell entities. This reporting attempts to deter and identify patterns suggestive of the use of offshore accounts to evade tax on domestic income earned by closely held businesses.

Robert. W. Wood commented on FATCA in his regular *Forbes Column* in early 2012.[5] He noted that foreign banks are required to report U.S. account holders to the IRS. After identifying them, institutions must impose a 30 percent tax on payments or transfers to account holders who refuse to step up. Foreign financial institutions (FFIs) must file IRS reports by September 30, 2014. At first, FFIs must report only:

- Name, address, and U.S. taxpayer identification number of U.S. account holder. For U.S.-owned foreign entities, the name, address, and U.S. Tax Identification Number (TIN) of each substantial U.S. owner is required.
- Account balance as of December 31, 2013.
- Account number.

Withholding, according to Wood, is not required if the payee or beneficial owner provides the withholding agent with a certification that the foreign entity does not have a substantial U.S. owner, or provides the withholding agent with the name, address and TIN of each substantial U.S. owner. Wood highlighted a number of exceptions that apply under FATCA. For example, withholding doesn't apply to any payment beneficially owned by a publicly traded corporation or member of an expanded affiliated group of a publicly traded corporation. He added that there is no withholding on payments the IRS identifies as posing a low risk of U.S. tax evasion. In addition FATCA's Section 6038D requires U.S. taxpayers to report foreign accounts and assets with an aggregate value exceeding $50,000. Required reporting includes:

- Any financial account maintained by an FFI;
- Any stock or security issued by a non-U.S. person;
- Any financial interest or contract held for investment that has a non-U.S. issuer or counterparty; and
- Any interest in a foreign entity. That means taxpayers who purchase foreign real estate through an entity are covered.

FATCA and AML

Although the IRS is providing financial institutions with a two-year window to become FATCA-compliant, institutions must also have FATCA-indicia know your customer processes in place by the time they register, thus the link between FATCA and AML requirements lies also in the regulations due diligence requirements.

In February 2012, the Financial Action Task Force (FATF) issued its revised recommendations on anti-money laundering and expressly listed tax offenses as a predicate for money laundering crimes. FATCA requirements and AML requirements are different not merely because FATCA appears to be more rules-based in its requirements and AML has long moved on to being risk-based, there are differences between FATCA requirements and typical AML standards. When identifying the beneficial owner of an entity for AML purposes, one usually looks for 25 percent direct or indirect ownership, whereas under FATCA a stricter beneficial ownership of 10 percent is required. Nonetheless, the due diligence requirements in particular for high-risk clients that have come to any institution's attention for FATCA related issues could leverage current KYC processes already in place for managing high risk AML/CFT clients. It is however, important to develop a suitable risk matrix which includes the risk factors which might label any one client as high risk.

Fourth EU AML Directive

This is particularly relevant in the lead up to the Fourth EU Anti-Money Laundering Directive,[6] due to come into force in 2015, that will not only expand the list of predicate offenses to include tax offenses but is likely to move away from the concept of simplified due diligence and enhanced due diligence to a 100 percent risk-based approach as well as any adapted requirements for Politically Exposed Persons (PEPs) and beneficial ownership, and could mark an opportunity for institutions to include FATCA requirements for high risk clients into an all-round amended framework that is based on a comprehensive risk-based approach. As reported in an article published by the *Organization for Certified Financial Crime Specialists*, German finance minister Wolfgang Schaeuble and French finance minister Pierre Moscovici urged the EU Commission to augment the beneficial ownership standards in the fourth directive stating that "the fourth directive is an important step toward enabling national authorities to force disclosure of the ultimate beneficiaries of trusts and legal entities, thus increasing the transparency of financial flows."[7] The overlap between AML legislation and tax prevention regimes is becoming more apparent and thus the synergies open to institutions aiming to be compliant.

Conclusion

Given that the upcoming deadline for FATCA in 2014 and other likely amendments for customer due diligence requirements, institutions are in a good position to perform an effective redesign of their KYC procedures. Accommodating for rules-based FATCA requirements and making provisions for risk-based due diligence requirements which will most likely come into force at the latest when the Fourth EU Anti-Money Laundering Directive is enacted is the prominent challenge. If mastered successfully however it has the opportunity to increase efficiencies and improve compliance processes and procedures.

Jennifer Hanley-Giersch, CAMS, managing director, Business Risk Research Limited, Berlin, Germany, Jennifer.hanley@business-risk-research.com

[3] http://wmledger.com/article/a-paradigm-shift-seeking-transparency-in-global-tax-law/
[4] http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx
[5] http://www.forbes.com/sites/robertwood/2012/02/01/will-irs-get-fat-off-fatca/
[6] Proposal for new directive published in 02/2013 - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0045:FIN:EN:PDF
[7] http://www.acfcs.org/fatcas-crucial-sidekick-the-hunt-for-beneficial-owner-pushed-as-g20-nations-senior-us-senators-urge-action/