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DATA PRIVACY AND THE FOREIGN ACCOUNT TAX COMPLIANCE ACT

On 28 January 2013, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued final regulations for implementing the Foreign Account Tax Compliance Act ("FATCA"), which was enacted in 2010 to combat offshore tax evasion by U.S. individuals. Starting 1 January 2014, a 30-percent withholding tax will be imposed on foreign financial institutions ("FFIs") that do not agree to collect and report to the IRS certain financial information about their U.S. customers. Data privacy laws around the world often forbid such disclosures, which could leave FFIs caught between conflicting legal requirements starting next year. Steps are being taken by the U.S. and other governments to resolve this impending legal conflict, but it remains to be seen whether these steps will be adequate or timely. This E-Alert introduces corporate data privacy officers to the requirements of FATCA and tax professionals to FATCA's data privacy implications, and it considers next steps to be taken in the coming months.

BACKGROUND ON FATCA

FATCA was enacted in response to concerns about tax evasion by U.S. citizens with hidden foreign bank accounts. The purpose of FATCA is to require FFIs, as well as certain non-financial foreign entities ("NFFEs") to report income and assets held outside the United States by U.S. tax residents. Significantly, the scope of FFIs covered by FATCA is much broader than "financial institutions" in the traditional sense, such as banks and securities dealers, but also includes insurance companies, private equity partnerships, hedge funds, other similar investment entities. The IRS plans to match U.S. account data against the tax declarations of the individuals in question in order to identify U.S. tax residents who are under-reporting their income or assets.

Under FATCA, FFIs generally must enter into an agreement with the IRS (an "FFI Agreement") to collect information about accounts owned by U.S. tax residents (both directly or indirectly through certain NFFEs) and to report information about such individuals and their accounts annually to the IRS. Starting 1 January 2014, FFIs that do not enter into an FFI Agreement generally will become subject to a 30-percent withholding tax on U.S. source gross investment income (expanded to cover other payments starting in 2017). Certain NFFEs (mainly passive holding companies) will be subject to the tax if they do not disclose any greater-than-10-percent U.S. investors in the NFFE. Under an FFI agreement, FFIs themselves are required to withhold the FATCA tax on the same types of payments when made to FFIs that fail to enter into an FFI agreement, or to account holders that fail to give the FFI enough information to determine whether or not they are U.S. (so-called "recalcitrant" account holders). Finally, if data privacy laws prohibit the FFI from disclosing information to the IRS, then the FFI generally must seek a waiver of those laws or, failing that, close or block the account.

In response to data privacy concerns expressed by many FFIs and their home country governments, Treasury and the IRS have begun to enter into intergovernmental agreements ("IGAs") on FATCA. IGAs are agreements to exchange the information required to be reported under FATCA using a pre-existing tax treaty or information exchange agreement between the FFI's home country and the United States. In exchange, the United States agrees not to impose the FATCA withholding tax on

FFIs in that country. The United States may also agree to provide some types of information from U.S. financial institutions to the other country's taxing authority on a reciprocal basis.

There are two types of reciprocal IGAs currently. Under the first type (commonly-referred to as the "Model 1 IGA"), FFIs report FATCA information to the other government, which in turn reports all of the information to the IRS. Under the second type (commonly-referred to as the "Model 2 IGA"), the FFI reports most of the information directly to the IRS, and the other government steps in to collect and transmit information only on recalcitrant account holders that are U.S. tax residents. Under both types of IGA, local FFIs are not required to withhold the FATCA tax on recalcitrant account holders or to close their accounts, since local law will require their information to be collected and transmitted.

Treasury to date has signed IGAs with the United Kingdom, Denmark, Mexico, Ireland, and Switzerland; and it has announced negotiations with approximately 50 other jurisdictions, some of which have progressed to the point of having initialed draft agreements.

BACKGROUND ON DATA PRIVACY

Under an IGA, the other government agrees to amend its data privacy and other laws in order to accommodate the collection and reporting of information on U.S. tax residents under FATCA. The types of laws implicated include laws governing the collection and processing of "personal data"; laws forbidding the government from collecting personal or financial data on a group basis, rather than on an individual basis with some evidence of wrongdoing; laws forbidding the unauthorized use of customer data; laws protecting an individual's "private sphere"; laws that may disregard a customer's waiver of privacy restrictions; consumer protection laws, such as those prohibiting the unilateral modification of contracts; civil or criminal laws forbidding deductions from a financial account (such as the FATCA withholding tax) unless authorized by local law; laws forbidding discrimination on the basis of national origin; and, in the case of the required closure of accounts, laws protecting the rights of local residents (who may also be U.S. tax residents) to open and maintain a bank account.

As one example of the local-law amendments made to accommodate FATCA, the United Kingdom has released a consultation document on the changes to U.K. law intended to be made to implement its IGA with the United States. According to the consultation documents, these changes are intended to take into account the requirements of the Data Protection Act 1998. Other jurisdictions have yet to propose IGA implementing legislation. It is anticipated that FFIs in an IGA jurisdiction will be able to benefit from the IGA even before implementing legislation is enacted.

Laws governing the release of personal data may exist at the supra-national level as well. The EU Data Protection Directive, which has been implemented in all EU Member States, generally requires FFIs to notify account holders if their account information will be processed and transferred internationally, as well as to ensure that any transfers comply with cross-border data transfer controls. Unless the Member State creates a clear legal basis for the FFI to report the account information, the FFI may be prohibited from reporting it to the IRS. Historically, European data protection authorities have been opposed to disclosures of data to foreign regulatory authorities, particularly those in the United States. The Data Protection Directive also gives account holders the right to a copy of the information sent, the right to correct any erroneous information, and the right to claim compensation from the FFI if they have suffered damage as a result of a breach of local privacy legislation.

IMPLICATIONS AND NEXT STEPS

When FATCA becomes effective at the start of 2014, it now appears very likely to catch many FFIs between two conflicting legal regimes. Unless they agree to transmit data on U.S. accounts, FFIs will become subject to a 30-percent withholding tax on their U.S. investments. If they do agree to collect and transmit the data, however, then in addition to the often exorbitant costs of changing their internal systems and procedures to do so, they risk violating the data privacy rules outlined above, some of which may be criminal-law violations. FFIs may need to decide to enter into an FFI agreement well in advance of this issue being resolved, even though actual reporting may not be due to the IRS until 2015. For affected FFIs, their stakeholders and governments, the implementation of FATCA requires immediate action.

We recommend that FFIs and FATCA stakeholders consult with their government representatives as soon as possible on the entry into an IGA and on the changes to privacy laws needed to protect them as they comply with FATCA. There are several benefits to an IGA, including the following:

- FFIs in IGA jurisdictions are generally exempted from the FATCA tax as long as they comply with the due diligence requirements to identify U.S. customers and provide the required information to their government (or, in the case of FFIs in Model 2 IGA countries, to the IRS in the manner provided in the IGA). Data privacy laws routinely allow local tax authorities to gather tax information from FFIs (or will be amended to do so as part of implementing the IGA), and FFIs would be able to rely on those exceptions to avoid data privacy violations.

- If amendments to data privacy laws are necessary to enable the transfer of information, an IGA obligates the other government to enact those amendments. While the changes to local laws are pending, FFIs in an IGA jurisdiction are exempt from the FATCA withholding tax.

- An IGA is also advantageous to the other government because, in addition to protecting its FFIs from a withholding tax, the IGA may also impose an obligation on the United States to provide tax information on a reciprocal basis. The final regulations provide no such reciprocity.

- Each IGA includes a country-specific annex that lists specific types of local accounts and entities, such as state-sponsored pension funds, which the IRS agrees will be exempt from FATCA reporting. FFIs in non-IGA countries must instead rely on general rules in the final regulations.

- Because IGAs eliminate barriers to reporting on account holders, they typically excuse FFIs from closing accounts and from withholding on recalcitrant account holders. This provision reduces the risk of violating data privacy laws prohibiting such actions and may reduce the scope of the legislative amendments necessary to accommodate FATCA.

- IGAs contain a variety of technical benefits relative to the final regulations. For example, IGAs may permit FFIs to use data already collected for AML/KYC purposes by raising the threshold for ownership-reporting to 25 percent. The final regulations use the 10-percent threshold included in the original FATCA legislation.

For these reasons and others, we recommend that FATCA stakeholders engage with their government on the possibility of negotiating an IGA, on the contents of the country-specific annex, and on the changes to data privacy and related laws necessary to permit local FFIs to comply with FATCA. Engagement with Treasury and the IRS also may help to facilitate discussions of an IGA and a resolution of technical issues that have arisen with the final regulations, which are lengthy and detailed. Now that the those regulations have been issued, Treasury and the IRS are expected to turn their primary attention to concluding IGAs. Treasury and the IRS are also expected to amend the final regulations as needed, and opportunities still exist to make a case for changes or clarifications to those rules.

Local law permitting, it also would be prudent to consider explicit consent or waiver provisions in account-opening documentation to transmit information pursuant to FATCA to provide a legal basis for disclosing information to U.S. authorities. In the event that local data protection laws prohibit the disclosure, FFI's may wish to have local data protection authorities confirm that view, which can then be shared with U.S. regulators.

Certain other strategies are often discussed for dealing with FATCA, but in our view they do not offer a satisfactory solution. Some FFIs have responded to FATCA by announcing that they are closing all U.S. accounts. Thus, the FFI can agree with the IRS to comply with FATCA by transmitting U.S. account data because there is no such data to transmit. This approach, however, is not a complete solution for many FFIs, such as those with significant U.S. investors or those who may be required by law to permit local residents to open an account, even if they are also U.S. tax residents. FFIs that attempt to close all U.S. accounts also may discover they have overlooked some U.S. customers or that existing customers have later changed their tax residence to the U.S. without informing the FFI.

Another approach an FFI could take is to refuse to comply with FATCA and to dispose of all investments that produce or could produce U.S. source investment income (*e.g.*, U.S. stocks and bonds, IP covering the U.S. market, etc.). This approach may not be realistic. First, it may interfere with investment mandates. Second, the FATCA withholding tax may be expanded in 2017 to cover certain *non*-U.S.-source investment income. Third, FATCA withholding is now being added to deal documentation, and the market practice is to impose the risk of FATCA withholding on the FFI receiving payments. Even if the payments received by a non-compliant FFI are not subject to FATCA withholding, refusing to comply with FATCA may affect their dealings with FATCA-compliant financial institutions.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our tax or data privacy practice groups:

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