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The Foreign Account Tax Compliance Act explained

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Gareth James, technical marketing manager, AJ Bell, asks how the FATCA will affect UK investors.

Most will be familiar with the phrase “better the devil you know, than the devil you don’t”. We all know it is often wiser, and easier, to deal with something you are familiar with, and problems you know about, than step into the unknown.

The investment industry sits in a landscape that is heavily regulated by the UK government. Those regulations are subject to frequent change, and this can sometimes be time-consuming and frustrating. In spite of our frustrations, the regulatory framework is at least a devil we know. Developments from the US mean we may be forced to deal with a ‘devil we don’t’.

The Foreign Account Tax Compliance Act of 2009 (FATCA) was introduced to both the House of Representatives and Senate in October 2009. It was passed by the House of Representatives in December 2009 and in March 2010 President Obama signed the act into law. The act has strong political support in the US because it is seen as an attack on tax evasion following the UBS Swiss tax avoidance scandal in 2008, and because it is anticipated the act will raise up to \$10bn in additional tax revenue every year.

Guidance is still being written that will refine some of the details, including possible exemptions from the requirements for low-risk institutions.

How will FATCA affect UK investors?

The biggest impact will be felt by those foreign financial institutions (FFIs) that must comply with the reporting requirements relating to ‘US accounts’.

The definition of US accounts is not limited to US citizens but broadly applies to any individual who is subject to US tax and so would include, for instance, green card holders or those who meet a substantial presence test. For example the purchase of, and extended residence in, a Florida holiday home could be sufficient for a UK citizen to be treated as a US account.

The range of this definition means many FFIs will face a significant information gathering exercise in respect of existing clients and may need to establish processes to monitor the status of their client base on an ongoing basis.

What are the requirements?

The act requires the FFIs to identify US accounts and report annually to the US Internal Revenue Service (IRS) on the account ownership, balances, and amounts moving into and out of those accounts.

The legislation gives the US Treasury virtually unrestricted powers to extend the definition of FFI as it sees fit. As we speak this means that just about any financial institution could end up being defined as an FFI, meaning FATCA could potentially affect direct investment in funds, or investment through tax wrappers such as ISAs and pension schemes. The legislation already contains a definition for an FFI which, subject to any US Treasury extension, is broadly an entity that:

- Accepts deposits;
- Is in the business of holding financial assets for others; or
- Is engaged in the business of investing in securities.

The act does take into consideration the fact that FFIs may not be able to identify all US accounts by allowing FFIs to comply with the reporting requirements by undertaking to withhold payments from “recalcitrant account holders”. So if an investor refuses to provide information about their tax status upon request, or refuses permission for the FFI to disclose their information, they will see face a 30% deduction on income from US investments.

FFIs will not be required to obtain specific confirmation from their clients as to their tax status but will be able to rely on general “know your client” account holder information which they hold.

Some FFIs will be exempt from fulfilling the reporting requirements if they are classified by the IRS as low risk. The IRS has already confirmed some pension schemes will be exempted from the requirements, but the current exemption does

not extend to SIPPs, a popular vehicle through which UK investors may invest in US securities. Intensive lobbying is under way from industry bodies in the UK to extend these exemptions to a wide range of FFIs.

The only other option currently in place that will exempt FFIs from fulfilling the reporting requirements is a declaration that they do not hold any US accounts. Some FFIs will choose to close all US accounts to enable them to withdraw from the reporting requirements.

What happens if the reporting requirements are not met?

Failure to comply with the reporting requirements will result in tax of 30% being charged on all “withholdable payments”. This includes interest, dividends, and the proceeds from the sale of assets that could produce interest or dividends. The withholding tax of 30% would be applied to all payments on US investments to the FFI, not just those made in respect of US accounts.

When does this all come into effect?

The act was originally intended to take effect in relation to all payments made after 31 December 2010. This has already been pushed back to 31 December 2012 however the extent of the work that needs to be undertaken by FFIs means that many are already changing procedures and/or eligibility conditions to ensure that they will be able to comply with the rules.

It is hoped the lobbying currently being carried out will be successful and that the IRS recognises the low risk of tax evasion posed by investment in the UK. Tax wrappers such as registered pension schemes and ISAs are already heavily regulated with strict limits on both the amount that can be paid in and the amount that can be withdrawn without tax penalties. If the lobbying is unsuccessful, it will be a devil's job to deal with the outcome.

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Please note this document is intended for trade and national press individuals.

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