

WARNING SIGNAL NUMBER 10! TYPHOON FATCA IS FAST APPROACHING!

FATCA, the Foreign Account Tax Compliance Act, is scheduled for full implementation starting January 1, 2013, with its new withholding tax rules set for enforcement by January 1, 2014. At present, most financial institutions and other designated entities are still struggling with the difficult choices being forced on them by this US extra-territorial legislation. This is a storm bound for a collision course with China - how will China react?

FATCA was enacted in March 2010 in response to what the US government perceives as rampant tax evasion by a minority of American taxpayers through "foreign" (*i.e.*, *non-US*) financial institutions and certain non-financial foreign entities. Targeting the so-called "hidden accounts" and other assets held overseas by these Americans - a class which includes US citizens, green card holders and other deemed US taxpayers - FATCA requires almost all foreign financial institutions and other designated entities to enter into special tax agreements with the US Internal Revenue Service ("IRS"). Under these agreements, foreign entities are required to use enhanced due diligence procedures to identify and disclose their US account holders or substantial US owners, or face a 30 percent withholding tax on their (and their customers') US investment income. This withholding tax also applies to the gross sale proceeds of US securities, including US treasuries, regardless of whether a profit or loss is made on the sale.

Given how US securities and investments are globally-held, FATCA will have a material effect on almost every country and foreign financial institution. US dollar-denominated trade will extend FATCA's reach throughout the globe, and it is not only banks and other financial institutions that are subject to its rules. The FATCA net

catches not only banks but investment funds, brokerage and securities companies, pension funds, and even private trusts. Mandatory provident funds such as those in Hong Kong and Singapore also fall within the scope of FATCA. In addition, FATCA forces non-publicly-traded companies to identify and disclose substantial US owners, which is based on a 10 percent ownership threshold.

At least initially, many foreign financial institutions embraced the position that FATCA would not apply if institutions simply ceased doing business with US clients. However, this consensus has eroded as institutions have come to understand that avoiding FATCA requires a certification that there are in fact no US clients. And this requires that every institution undergo rigorous due diligence on existing and new clients to identify US citizens, green card holders and other deemed US taxpayers. Given this level of mandatory review, simply ceasing US business no longer seems like the easy solution.

Further, actual or perceived non-compliance with FATCA could lead to US counterparties refusing to deal with certain institutions due to the risk of withholding tax liability being imposed on them by the IRS. This is a risk that unrelated parties simply won't take.

More cold water has been thrown on foreign financial institutions by the US government's continued assaults on institutions accused of facilitating US tax evasion, which has involved targeting US assets and financial transactions with US counterparties. In one example, a noted institution had US assets seized and criminal indictments filed against it, leading to its break up

and sale. The US government's willingness to aggressively target almost any financial interaction with US ties has added greater weight to the prevailing view that the US intends to vigorously enforce FATCA.

FATCA has led many countries to begrudgingly, but actively, negotiate with the US for an intergovernmental approach to implementing FATCA or a modified version of FATCA. Some countries have even embraced the FATCA principles as a means of addressing their own perceived issues with taxpayer non-compliance. Earlier in 2012, the US, along with the UK, France, Germany, Italy and Spain announced that these governments had agreed "to intensify their cooperation in combating international tax evasion." In turn, the US also agreed to "reciprocate in collecting and exchanging" information about US accounts held by residents of those countries.

In July, the US and these European countries jointly announced a model information sharing agreement under which a country's financial institutions would not be required to enter into an agreement with the IRS under FATCA if the government enacted laws requiring local institutions to report certain financial information to the local tax authorities. The local tax authorities would in turn pass that information on to the IRS - automatically. In addition, if the US and such country have an existing income tax treaty or tax information exchange agreement and certain confidentiality rules are followed, the IRS would collect certain financial information about that country's citizens and pass that information on to the country's local tax authorities - automatically. Part of the stated purpose of the agreement has been to get around data privacy and bank secrecy issues raised in opposition to FATCA.

This month, the US and the UK signed the first bilateral agreement implementing the principles of the model information sharing agreement. Many countries (not just the initial European countries) are actively engaged in ongoing negotiations with the US, and the US has

announced that more accords are expected to be signed soon. It is expected that future agreements will closely follow the framework of the existing model and the new US-UK agreement.

The US has also agreed to work with Japan and Switzerland on an alternative to the model information sharing agreement and inter-governmental exchange. This alternative framework would allow financial institutions in Japan and Switzerland to report directly to the IRS, yet comply with local secrecy laws by providing information on certain US clients to the local tax authorities who would later provide it to the IRS based on official governmental information requests. Under this approach, Japan and Switzerland would not be required to enact any new information exchange laws. The US has announced that other countries could consider this alternative model for FATCA compliance in their negotiations with the US.

Similar to many European countries, China has data privacy laws that nominally prevent disclosure of the type of information required under FATCA. In widely-reported comments, Li Xinghao, a spokesman for the China Banking Regulatory Commission, said in early 2012 that "unless [FATCA] is modified, the China Banking Regulatory Commission has no right to mandate Chinese banks to disclose account information of US clients to the US taxing authorities." The framework the US has agreed to with Japan and Switzerland could provide a solution to such local law issues.



However, perhaps China's tax authorities will come to consider the US-UK accord and the model information sharing agreement as a better alternative. China has been increasingly enforcing its tax laws, and an agreement that could provide the tax authorities with more information may be quite welcome. It is clear that significant Chinese wealth is being redeployed in the US and elsewhere, and China may want its share of taxes on that wealth. Having effectively unfettered access to US financial information could be a powerful means to that end, and reciprocal exchange of information between equals would appeal to those in China who may feel that FATCA is another example of US hegemony.



So where does this leave China? Despite speculation that financial institutions in China, with or without official government support, may refuse to comply with FATCA, the winds are blowing against them. The global trend is moving rapidly towards compliance - either with the express terms of FATCA or under one of the inter-governmental models. Still, if the Chinese government is willing to put its back to the wind and forcefully resist FATCA, the US may make pro-China compromises. Alternatively, the only result may be additional burdens for US-connected transactions and a negative impact on Chinese and US markets. What is certainly clear is that Typhoon FATCA is bearing down on China and, given the looming 2013 and 2014 deadlines, the next few months should start to reveal how China will prepare for the storm.

This newsletter is contributed by the HKTA/STEP Joint Sub-Committee for China Development. Members include:
Michael Shue (Chairman)
Thomas Lee
Patrice Marceau
Todd Beutler
Ophelia So
Fanny Wong
Alexandra Or
Cathy Pang
Vienne Cheng

Author: TODD BEUTLER