NEW ZEALAND LAW SOCIETY

NZLS EST 1869

PRACTICE BRIEFING:

FATCA AND NEW ZEALAND LAW FIRMS

This Practice Briefing does not constitute legal advice.

INTRODUCTION

The FATCA agreement between New Zealand and the United States is directed at reducing tax evasion by US taxpayers. New Zealand law firms with trust accounts are likely to be "financial institutions" and subject to FATCA provisions. Law firms without trust accounts are likely to be active NFFEs (refer below).

FATCA has implications for the way New Zealand law firms with a trust account conduct their practice. This Practice Briefing provides information on the FATCA regime to assist law firms which have a trust account with assessing their particular position and FATCA obligations. Reference in this Practice Briefing to a law firm is to a law firm which has a trust account.

In addition to FATCA, the OECD Common Reporting Standard (CRS) will apply from 1 July 2017. The two regimes have much in common. Lawyers may be aware that the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill has been introduced to Parliament. The Finance and Expenditure Committee are due to report on the Bill on 11 February 2017. The Bill proposes amongst other things to incorporate CRS into New Zealand law, and to impose the same obligations and penalties on persons with regard to FATCA and CRS reporting. Nothing in this practice briefing may be taken as expressing a view by Inland Revenue on, or having reached agreement on, any matter contained in the Bill.

A summary of important requirements is at the end of this briefing, before the Summary of Terms.

What is FATCA?

The United States Foreign Account Tax Compliance Act (FATCA) has the objective of reducing tax evasion by American taxpayers with foreign accounts. FATCA requires foreign financial institutions which are not exempt to report on financial accounts held by US taxpayers or certain foreign entities with controlling persons who are US taxpayers (US reportable accounts).

An inter-governmental agreement (IGA) between the New Zealand and the United States governments in June 2014 was followed by the Double Tax Agreements (United States of America – FATCA) Order 2014 and amendments to the Tax Administration Act 1994 and the Income Tax Act 2007. The result is that FATCA is in force in New Zealand.

Inland Revenue has been consulting with the New Zealand Law Society and the New Zealand Bankers' Association (NZBA) on the application of FATCA to law firms. Inland Revenue has reached an understanding with the Law Society in respect of lawyers' trust accounts where the law firm is an NFFE, i.e. it is not a financial institution. The understanding is set out below. NZLS is working with these organisations to finalise a position on what information law firms will need to collect from their clients. Irrespective of any position taken by NZBA, individual banks may adopt their own FATCA procedures.

Is your law firm an FI or an NFFE?

It is important for law firms to determine their FATCA status. Under FATCA your firm will either be a "financial institution" (**FI**) or a "non-financial foreign entity" (**NFFE**). All non-US entities are classified either as FIs or NFFEs. For the purposes of FATCA, entities include legal persons and legal arrangements such as joint ventures, associations, corporations, partnerships and trusts, but not natural persons.

An FI law firm will have significantly greater obligations under FATCA (registration, due diligence and reporting) than an NFFE law firm.

Law firms as Financial Institutions

The IGA contains a definition of "financial institution" which for present purposes includes depository institutions, custodial institutions and investment entities.

Each law firm (including an incorporated sole practice) will need to determine for itself whether or not it is a financial institution under the definitions. A list of **"financial institution"** definitions is provided at the end of this Practice Briefing.

Inland Revenue's view is that many law firms will be FIs under the IGA. One example is if a law firm "manages" funds by placing clients' funds on interest bearing deposit (IBD).

Determining if a law firm is required to register as a Financial Institution

It seems likely that few, if any, law firms will be obliged to register as FIs for FATCA purposes. This is because

a law firm is unlikely to be a depository institution or a custodial institution, and even if it qualifies as an "investment entity" under the IGA definition of "investment entity" (and would therefore be an FI), a law firm is entitled to adopt the narrower definition of "investment entity" under the US Treasury Regulations.

A law firm is unlikely to be an "investment entity" under the US Treasury Regulations. This is because the US Treasury Regulations definition of "investment entity" refers (broadly) to an entity **primarily** carrying on a business providing investment services. For most law firms this would not apply as their primary business would be providing legal services. Consequently, by electing to adopt the US Treasury Regulations definition of "investment entity", rather than have the IGA definition apply by default, most law firms which are investment entity FIs under the IGA should be able to avoid classification as an FI. Each case will depend on its own circumstances. Some law firms which are FIs under the IGA may prefer that status, but it is difficult to see why any law firm would want that status.

If a law firm is an FI, any Lawyers Nominee Company it operates would also be an FI if it is managed by an investment entity law firm – which would normally be the case. For further information, refer to Lawyers' Nominee Companies below.

Obligations for law firms which are Financial Institutions

As an FI, a law firm will need to do the following:

- Register as an FI on the United States IRS website. This is done by using the Foreign Financial Institution Registration Tool at *www.irs.gov/Businesses/Corporations/FATCA-Foreign-Financial-Institution-Registration-Tool*.
- Register on the New Zealand IRD portal.
- Conduct due diligence on its client account holders that hold moneys in the law firm's trust account on IBD. The due diligence is to determine if the client is a US citizen or US tax resident, a US corporation, a US partnership, some US trusts, or the estate of a deceased US citizen or resident (collectively "Specified US persons"), or whether any passive NFFE (company, trust, partnership etc.) has one or more controlling persons who are US citizens or US tax residents.
- Report to New Zealand's Inland Revenue on all accounts identified as being US reportable accounts.

Decision on registering as a Financial Institution

A law firm may prefer to register as an FI on the basis it will not then need to report client information to its bank (as an NFFE law firm needs to do). The FI law firm would report directly to Inland Revenue details of US reportable accounts.

Whether a law firm which is an FI under the IGA prefers to register as an FI or wishes to avoid being an FI (normally by adopting the US Treasury Regulations definition of investment entity), is a decision for each law firm to take. **That decision should be made by law firms as soon as possible.**

Of relevance to the decision is that NFFEs have reduced, but still significant, obligations compared to the obligations of an FI. An NFFE does not have to register with the IRS or Inland Revenue. **Most law firms will want to avoid being FIs if they are able to, and accordingly will want to adopt the US Treasury Regulations definition of "investment entity" if that is the means by which they can avoid being FIs.** As mentioned, the law firm's FI bank will then have the FI obligations of obtaining from the law firm details of US reportable accounts, and reporting those accounts to Inland Revenue.

Adopting the US Treasury Regulations "investment entity" definition

There is no formality to the election to adopt the US Treasury Regulations definition of "investment entity". A law firm could simply resolve "We hereby adopt the US Treasury Regulations definition of "investment entity".

A law firm that elects to adopt the US Treasury Regulations definition of "investment entity" and which does not qualify as a depository institution or custodial institution (see definitions at end), must notify the bank with which it has its trust account and deposits that it has elected to adopt the US Treasury Regulations definition of "investment entity" and that as a consequence of the election, it is an NFFE for FATCA purposes – most likely an active NFFE (see below).

Inland Revenue expects the law firm to do this within a reasonable time after the election. Within 20 working days is likely to be regarded as a reasonable time but there is no reason why it should not be done immediately.

The notification to the bank could be "As a result of our firm having adopted the US Treasury Regulations definition of "investment entity", our firm is an active NFFE.".

Active and passive NFFEs

NFFEs are either active or passive. An NFFE is a passive NFFE if it is not an active NFFE. FATCA is concerned with passive NFFEs, not active NFFEs because active NFFEs do not give rise to US reportable accounts.

For present purposes, an active NFFE means an NFFE where less than 50% of the NFFE's gross income for the preceding calendar year or other reporting period is passive income (under New Zealand tax law) and less than 50% of the assets held during such period produce or are held for the production of passive income.

Passive income covers the types of income that are derived 'passively', as opposed to, for instance, through 'active' trading operations. This would include (but would not be limited to) dividends, interest (and substitute amounts), rents and royalties (other than rents and royalties derived in the active conduct of a trade/business), annuities, and amounts received under cash value insurance contracts.

Passive NFFEs are of interest to the IRS (and therefore the law firm's bank and Inland Revenue) if they have "controlling persons" who are US citizens or tax residents. Controlling persons would be the client if an individual or, for an entity, the natural persons exercising control over the entity.

For example, in the case of a trust client, the controlling persons would include a settlor, trustees, protector, beneficiaries or class of beneficiaries and any other natural person exercising ultimate effective control over the trust.

Except for any law firm whose passive income exceeds its practice income, all NFFE law firms would be active NFFEs.

Lawyers' Nominee Companies (LNC)

An LNC managed by an NFFE law firm would be an active NFFE. The LNC derives no income and the security documents held for the contributors to the mortgage advance produce no income for the LNC.

An LNC managed by an FI law firm would not be a depository institution or a custodial institution. The LNC would not be an "in business" investment entity under either the IGA or the US Treasury Regulations because the LNC is not in business for FATCA purposes. However, it would be a deemed investment entity FI under the IGA if it were managed by an investment entity law firm which manages the investment activities on its behalf. However, the LNC could adopt the U.S. Treasury Regulations definition of "investment entity" under which it would not be a deemed investment entity because it does not derive investment income. In such cases the LNC would be an NFFE.

Understanding with Inland Revenue

The understanding reached between the Law Society and Inland Revenue in respect of FATCA to lawyers' trust accounts is as follows:

1. Money in the general trust account

Inland Revenue takes the view that, consistent with the approach adopted in other jurisdictions (including Australia, the U.K., and Canada) when interpreting FATCA due diligence requirements, a bank is able to take the following approach when carrying out due diligence on a law firm's general trust bank account where funds are not 'designated' in the name of the clients (cf IBD accounts where there is a separate designated account with the bank for the purpose of allocating interest):

The approach is that where:

- the funds of underlying clients of the law firm are held on a pooled basis with a bank
- the only person identified in relation to the bank account is the law firm
- the law firm is not required to disclose or pass their underlying client or clients' information to the bank for the purposes of AML/KYC or other regulatory requirements
- the bank is required to undertake the due diligence procedures only in respect of the law firm.

In practical terms, this means that, under the current regulatory requirements, the bank will need to determine whether the law firm is an active NFFE or other FATCA status (i.e. the bank will request the law firm to certify its status). The bank would not generally be required to go beyond this for FATCA due diligence purposes in respect of the law firm.

2. Money held on IBD

Money held on IBD for a client is held in a 'designated' account for the purpose of allocating interest. IBD accounts are likely to be the primary focus of FATCA (and ultimately CRS) due diligence, collection of information and disclosure, but this will depend on the stance taken by the particular bank. Refer to "Reporting methodology" below for anticipated FATCA requirements in respect of IBD accounts.

3. Exempt accounts

Certain accounts are either exempted under the IGA from the definition of 'Financial Account' and therefore are not treated as US reportable accounts or are otherwise not subject to reporting. These accounts include:

a. money held by a law firm in escrow. Escrow money could include, for example, deposit money held by a vendor's solicitor which are by the terms of the agreement for sale and purchase to be held in escrow. A law firm could hold barristers' fees in escrow. There will be other instances where parties agree that money is to be held in escrow;

b. money held by a law firm for an estate where the law firm holds a copy of the deceased's will or death certificate. This exemption would not extend to testamentary trusts continuing following distribution of an estate;

c. money held by a law firm for a charitable trust registered under the Charities Act 2005, or held for a donee organisation as defined in the Income Tax Act 2007. Pursuant to the Memorandum of Understanding between the US and New Zealand Governments these accounts are agreed to be held by active NFFEs (and are therefore not relevant for FATCA purposes).

As the above accounts are exempt accounts or otherwise not subject to reporting, it follows that money placed on IBD from any such account will not be subject to FATCA reporting requirements. The bank would not be entitled to seek FATCA information in respect of such accounts for reporting purposes.

Bank requirements

When a law firm notifies its bank of an election it has made and that it is not an FI, but an active NFFE, the bank will request the law firm to provide information as to whether the IBD client is a specified US Person (refer Summary of Terms), or whether the IBD client entity, if it is a passive NFFE, has any controlling person who is a US citizen or US tax resident.

Reporting methodology

Final details of the reporting methodology have yet to be confirmed by Inland Revenue and NZBA. However, it is anticipated that the following arrangements will apply for the 2016 FATCA year (ending 31 March 2017) and subsequently. These arrangements may vary depending upon a particular bank's requirements.

In most instances, the law firm will need to provide confirmation of whether the respective IBD account meets

the escrow/other exemption treatments based on the purpose of the funds held in the account (refer Exempt accounts above). Where no exemption applies, the law firm will need to obtain a self-certification and provide this information to the bank. Regardless of this, the law firms themselves will be ultimately responsible for any necessary due diligence, collection of information and monitoring for changes going forward, in order to meet their own service obligations as an intermediary in respect of IBD accounts held with each respective bank.

Law firms will need to collect relevant information (self-certifications) from clients in a form that meets their bank's requirements (sample forms are on the Law Society's website *www.lawsociety.org.nz/for-lawyers/regulatory-requirements/client-care/united-states-foreign-account-tax-compliance-act-fatca*) where money is placed on IBD and pass the information to the bank to enable it to meet its reporting obligations. A bank may insist on use of its own self-certification forms. If a bank is unable to obtain the required information (possibly because the law firm has not been able to obtain it, or has not responded to the bank's request or because the individual client or entity has declined to provide this information to the law firm), the bank would report the particular designated account as a deemed ' US reportable account' under the due diligence requirements of the IGA.

Thresholds may apply in some cases, which may (depending on the bank's threshold elections) remove the need for FATCA reporting of the accounts where aggregated moneys on IBD are below the applicable threshold. This would be subject to the respective banks internal decisions (including the interaction of thresholds as a result of the CRS implementation), and their ability to deal with aggregation of the underlying Account Holders of an IBD account.

Generally, the FATCA threshold for new (on or after 1 July 2014) individual accounts is US$50,000 and for pre-existing (before 1 July 2014) entity accounts it is US$250,000, and accounts over these thresholds are reportable.

However, for entity clients with new (opened on or after 1 July 2014) IBD accounts, there is no threshold, with the result that the bank will need to establish through self-certification forms and processes if the entity is a Specified US Person or is a passive NFFE with one or more controlling persons who are US citizens or US tax residents. This process will need to be used under CRS going forward, although more information will need to be collected on the self-certification. Many banks are combining their FATCA and CRS self-certifications.

It remains to be seen how individual banks will apply thresholds. Further information will be supplied as soon as it is available.

Collecting client information (self-certifications) and consents

To help meet the requirements to certify in respect of clients, law firms (whether FIs or not) may wish to start obtaining information and consents from their clients who have or will have moneys on IBD (as to whether they are Specified US Persons or have one or more controlling persons who are US citizens or US tax residents).

As mentioned, the Law Society has published information and self-certification and consent forms on its website which law firms may wish to use for this purpose. If banks require their own forms completed, the

collected information is likely to be useful. The published forms also seek information on non-US tax residents in light of the coming CRS requirements. This will impose FATCA-like obligations on New Zealand law firms under agreements the New Zealand government will enter into with the governments of many other countries.

Confidential information and the Conduct and Client Care Rules

Law firms need to consider issues of confidentiality regarding client information. While the Law Society does not provide legal advice, law firms may find the comments below helpful in this regard. There will of course be no issue where a client consents to the release of information to Inland Revenue and/or the law firm's bank.

The reporting obligations imposed by FATCA have, at least for now, the potential to be contrary to a lawyer's client confidentiality obligations. While these obligations can be overridden in certain circumstances, the issue arises as to whether the FATCA requirements constitute such a circumstance.

Rule 8.2(d) of the Lawyers and Conveyancers Act (Lawyers: Conduct and Client Care Rules) 2008 requires a law firm to disclose confidential information where disclosure is required by law. However, FATCA directly imposes the reporting obligation only on FIs. Where a law firm is an FI, disclosure will be "required by law".

Where a law firm is an NFFE, the reporting obligation is on the law firm's (FI) bank, but currently there is no direct reporting obligation on the law firm NFFE. Accordingly, it is doubtful that FATCA disclosure by a law firm to a bank is authorised by this rule.

Rule 8.4(f) permits a law firm to disclose information where this "is necessary for the effective operation of a lawyer's practice including arranging insurance cover or collection of professional fees". Depending on the circumstances, it may be contended that this rule would permit disclosure of FATCA information to a law firm's bank and/or Inland Revenue.

Further, Inland Revenue has the capacity under section 17 of the Tax Administration Act 1994 to compel any person to disclose information as requested. If a section 17 order were issued, the law firm would be "required by law" to disclose the confidential client information.

Wherever client moneys are placed on IBD law firms should obtain clients' authority to the disclosure of FATCA information to the law firm's bank and/or Inland Revenue. This can be included in a law firm's letter of engagement. It is important that clients should be made aware of the position.

It should also be noted that clause 24 of the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill proposes to introduce a new s185P into the Tax Administration Act 1994 which would compel law firms (and others) to comply with FATCA and CRS disclosure obligations.

Summary of important requirements

Law firms should determine their status for FATCA purposes (either as an FI or an NFFE). If the law firm is an FI on the basis of the IGA definition of "investment entity" and is not a depository institution or a custodial institution (which is unlikely), and wishes to avoid being an FI, it will likely be able to avoid being an FI by

electing to adopt the US Treasury Regulations definition of "investment entity". Law firms wishing to avoid being an FI should make the election as soon as possible.

If a law firm does adopt the US Treasury Regulations definition of "investment entity" to avoid being an FI (and is not a depository institution or a custodial institution), it will need to advise the bank which maintains its trust account of its election and that it is an active NFFE.If a law firm is an FI it must register as such on the IRS website and the Inland Revenue portal and meet all the obligations imposed on FIs by the FATCA regime. These obligations include reporting to Inland Revenue details of clients who are Specified US Persons or passive NFFEs with one or more controlling persons who are US citizens or US tax residents.

Each law firm should start collecting information relating to clients whose funds are held or will be held on IBD. This information should be obtained from clients on an ongoing basis whenever moneys are held on IBD. At the same time that this information is gathered, the law firm should obtain appropriate consents to the disclosure of the information.

Banks will require law firms to obtain self-certifications from clients with money on IBD before the money is placed on IBD. The banks may require their own forms of self-certification rather than the forms on the Law Society's website. Further information will be supplied when it is available.

Summary of Terms used

FATCA: Foreign Account Tax Compliance Act.

FI: Financial Institution.

IGA: Inter-Governmental Agreement (between New Zealand and the United States).

IRS: Internal Revenue Service (United States).

NFFE: Non-Financial Foreign Entity.

US Person: means a US citizen or resident individual, a partnership or corporation organised in the United States or under the laws of the United States or any State thereof, a trust if (i) a court within the United States would have authority under applicable law to render orders or judgments concerning substantially all issues regarding administration of the trust; and (ii) one or more US persons have the authority to control all substantial decisions of the trust, or an estate of a decedent that is a citizen or resident of the United States.

Specified US Person means a US Person other than various "low risk" entities such as a company whose shares are regularly traded on an established securities market, any agency of the US, any State of the US or any agency of any State of the US, regulated investment companies, registered securities dealers etc.

FATCA "Financial Institution" definitions

The following definitions compare those used in the IGA and the US Treasury Regulations (US Regs).

Custodial Institution

IGA: means any Entity that holds, as a substantial portion of its business, financial assets for the account of others. An entity holds financial assets for the account of others as a substantial portion of its business if the entity's gross income attributable to the holding of financial assets and related financial services equals or exceeds 20 percent of the entity's gross income during the shorter of: (i) the three-year period that ends on December 31 (or the final day of a non-calendar year accounting period} prior to the year in which the determination is being made; or (ii) the period during which the entity has been in existence.

US Regs: The definition is similar

Depository Institution

IGA: means any entity that accepts deposits in the ordinary course of a banking or similar business.

US Regs*:* The definition is similar.

Specified Insurance Company

IGA: means any entity that is an insurance company (or the holding company of an insurance company) that issues, or is obligated to make payments with respect to, a Cash Value Insurance Contract or an Annuity Contract.

US Regs: The definition is similar.

Investment Entity

IGA: "means any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:

4. trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;

5. individual and collective portfolio management; or

6. otherwise investing, administering or managing funds or money on behalf of other persons.

This subparagraph 1(j) shall be interpreted in a manner consistent with similar language set forth in the definition of "financial institution" in the Financial Action Task Force Recommendations."

US Regs: *(Note – this definition has been shortened and amended for ease of understanding) Investment Entity means any entity that is described below:*

(A) The entity **primarily** conducts as a business one or more of the following activities or operations for or on behalf of a customer-

1. Trading in money market instruments (checks, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity

futures;

2. Individual or collective portfolio management; or

3. Otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons; or

(B) The entity's gross income is **primarily** attributable to investing, reinvesting, or trading in financial assets (as defined [below]) and the entity is managed by a depository institution, custodial institution, certain insurance companies, or an investment entity. For the purposes of this definition an entity is managed by another entity if the managing entity performs, either directly or through another third-party service provider, any of the activities described in (1), (2) or (3) above on behalf of the managed entity; or

(C) The entity functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting or trading in financial assets.

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