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28 September 2012

The Manager
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Dear Sir/Madam

SUBMISSION ON THE PROPOSED INTERGOVERNMENTAL AGREEMENT TO IMPLEMENT THE FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

We enclose a submission by King & Wood Mallesons on the advantages and disadvantages of the proposed intergovernmental agreement between Australia and the United States to implement the Foreign Account Tax Compliance Act (FATCA).

Thank you for considering this submission.

Yours sincerely

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SUBMISSION ON THE PROPOSED INTERGOVERNMENTAL AGREEMENT TO IMPLEMENT THE FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

1 INTRODUCTION

We set out below the advantages and disadvantages that an intergovernmental agreement ("**IGA**") would have for Australian financial institutions ("**FIs**") based on the Model Intergovernmental Agreement published by the United States Department of the Treasury on 26 July 2012 ("**Model IGA**"), as an alternative to individual agreements between Australian FIs and the U.S. Internal Revenue Service ("**IRS**") under FATCA.

Definitions used in this submission have the meanings ascribed to them in the Model IGA, or the FATCA Proposed Regulations issued by the U.S. Department of the Treasury on 8 February 2012 ("**Proposed Regulations**"), as applicable.

2 ADVANTAGES OF AN IGA

2.1 Privacy and confidentiality law concerns would be addressed

An IGA would allow the Australian Government to resolve the Australian privacy and confidentiality law issues arising under FATCA. This will significantly reduce compliance costs for Australian FIs.

FATCA requires Participating FFIs to report certain information to the IRS about both existing and new customers. However, Australian privacy laws would make it difficult for Australian FIs to report this information. In particular unless a relevant exemption applied, Australian FIs would be prohibited from:

(a) reporting "*personal information*" about an individual to the IRS under National Privacy Principle 2;

(b) transferring "*personal information*" about an individual from the FI in Australia to the IRS in the US under National Privacy Principle 9;

(c) reporting information to the IRS that is not publicly available and has any bearing on an individual's credit history, credit capacity, credit worthiness or credit standing (if the FI is a "*credit provider*" for the purposes of the Part IIIA of the *Privacy Act*); and

(d) reporting "*confidential information*" about an individual or body corporate to the IRS under the banker's duty of confidentiality (and the Code of Banking Practice, if the FI was a signatory).

An exemption that is common to all of these restrictions is consent from the individual or body corporate (or in the case of credit information, written authorisation). However, relying on consent exposes the FI to risk. For example, to obtain consent from existing customers the FI could be forced to rely on implied consent as it is impracticable to obtain express consent from all customers. This exposes the FI to the risk that a customer claims that it did not give consent. Further, even if express consent is sought the risk that customers will not give their consent exposes the Australian FI to risk because the Australian FI may then be forced to close the customer's account which it may not have express power to do. To the extent that credit information is disclosed, written authorisation would be required and is likely to impose significant costs when considered across the whole of the business of an FI.

For these reasons we do not consider that obtaining consent is an appropriate solution.

Compulsion by law is also an exception to each of the restrictions listed above (with the exception of the requirements under National Privacy Principle 9). Although FATCA does compel disclosure by Australian FIs it is not clear that this would provide a sufficient basis for Australian FIs to disclose information to the IRS. This is because most of the case law and relevant commentary suggests that

the entity must be compelled by an Australian law. However an IGA would presumably require the Australian Government to pass an Australian law requiring reporting to the ATO. An IGA would therefore overcome the restrictions referred to above and permit Australian FIs to report to the ATO.

The National Privacy Principle 9 issue would also be resolved because under an IGA, Australian FIs would not be required to transfer personal information offshore. Rather, it is proposed that Australian FIs would provide the prescribed information about U.S. Reportable Accounts to the Australian Tax Office ("**ATO**"), which in turn would report such information to the IRS.

2.2 No obligation to withhold on U.S. Source Withholdable Payments

An IGA would remove the obligation on Australian FIs to withhold on "U.S. Source Withholdable Payments" made to non-participating FFIs, other than where the FI is:

(a) a qualified intermediary that has made an election to assume primary withholding responsibility under chapter 3 of the U.S. Internal Revenue Code ("**Code**");

(b) a partnership that has made an election to act as a withholding foreign partnership for the purposes of sections 1441 and 1471 of the Code; or

(c) a trust that has made an election to act as a withholding foreign trust for the purposes of sections 1441 and 1471 of the Code.[1]

The removal of this obligation would be advantageous for Australian FIs. The withholding creates difficulties for Australian FIs from both a legal and a systems perspective, particularly for pooled vehicles such as trusts and managed investment schemes.

2.3 No withholding upon or closure of accounts of recalcitrant holders

An IGA would remove the obligation imposed on Australian FIs to close accounts of recalcitrant account holders or to withhold tax under section 1471 or 1472 of the U.S. Internal Revenue Code in respect of recalcitrant account holders, provided that such accounts are reported upon in accordance with the IGA requirements.[2]

This would be beneficial for Australian FIs, particularly as an FI is unlikely to have express authority to unilaterally close accounts and, in any event, will not want to do so from a commercial perspective. The advantages set out in paragraph 2.2 (above) apply equally to the removal of the withholding obligation in this context.[3]

2.4 Alternative to gross proceeds withholding and foreign pass-thru withholding

Under an IGA, the parties agree to develop "a practical and effective alternative approach that achieves the policy objectives of foreign passthru payment and gross proceeds withholding that minimizes burden."[4] Given the proposed breadth of the foreign pass-thru payment rules under FATCA, an IGA would be a significant advantage for Australian FIs in this regard.

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[1] Model IGA, Articles 4(2), 6(2); Proposed Regulations, §1.1471-4(b)(1).

[2] Model IGA, Article 4(2).

[3] Proposed Regulations, §§1.1471-2(a)(1) and 1.1471-5(g)(2).

[4] Article 6(2) of the Model IGA.

2.5 Australian FIs would be treated as FATCA-compliant

Under an IGA, Australian FIs would generally be treated as complying with, and not subject to withholding under, FATCA, without having to enter into a FFI agreement with the IRS. This would be a key advantage for Australian FIs and ensures that Australian FIs are not disadvantaged in competing with non-Australian FIs based in countries which have entered into an IGA with the United States (see also paragraph 2.10 below).

2.6 FIs with offshore branches and related entities

The Proposed Regulations generally provide that an FFI can only be a participating FFI if all of the members of its "expanded affiliate group" are also FATCA-compliant.[5]

Under an IGA, Australian FIs would be specifically permitted to have offshore Related Entities or branches that are non-participating FFIs. For an Australian FI to be eligible for this concession, its offshore Related Entities or branches would need to meet certain conditions prescribed in the IGA, including the requirement that the foreign jurisdictions prevent the Related Entities or branches from becoming a participating FFI or deemed-compliant FFI. The status of such Related Entities and branches would not affect the FATCA status of the Australian FI. This would greatly assist Australian FIs with offshore branches and affiliates.

2.7 Administrative burden on Australian FIs would be reduced

An IGA would reduce the administrative burden on institutions in the following ways:

(a) Australian FIs would not have to conclude separate FFI agreements with the IRS. Direct reporting on U.S. Reportable Accounts to the ATO would allow Australian FIs to make use of their existing reporting channels, which should reduce costs and increase efficiency.

(b) an IGA would not generally require an Australian FI to continuously update due diligence procedures in respect of a financial account, except in discrete circumstances.

(c) an IGA would provide some relief to Australian FIs in respect of the prescribed due diligence procedures in respect of the identification of U.S. Reportable Accounts,[6] by allowing for more reliance on an FI's existing Anti-Money Laundering ("**AML**") and Know-Your-Client ("**KYC**") procedures in order to satisfy the due diligence obligations. This would reduce both administration and compliance costs for Australian FIs.

(d) an IGA would replace the obligation to report on "substantial U.S. owners" (ie U.S. persons who hold more than 10% of the interests in an entity)[7] under the Proposed Regulations with an obligation to report on "Controlling Persons" (ie U.S. persons with ultimate effective control over an entity).[8] The "Controlling Persons" concept would capture fewer persons and is therefore likely to reduce the number of financial accounts on which an Australian FI would need to report.

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[5] Proposed Regulations, §1.1471-(4)(e).

[6] Model IGA, Annex I.

[7] Proposed Regulations, §1.1473-1(b).

[8] Model IGA, Article 1(1)(nn).

2.8 Postponed reporting timeframe for 2013 calendar year

The IGA allows FIs additional time before their reporting obligations commence. Reporting in respect of the 2013 calendar year would begin by 30 September 2015, rather than by 30 September 2014 under the Proposed Regulations.[9]

2.9 Australia would have the opportunity to tailor the IGA to Australian circumstances

Through intergovernmental negotiation, the annexes to the IGA could be amended to accommodate specific structures and products applicable to the Australian financial services sector. In particular, the IGA permits categories of FIs to be classified as "deemed compliant financial institutions" and "exempt beneficial owners", as well as for certain accounts and products to be specifically excluded from being "financial accounts".[10]

An IGA specifically contemplates that retirement plans identified in the annex to the IGA will be treated as deemed compliant or exempt.[11] This would clearly be a significant advantage for the Australian superannuation industry, which is generally unable to rely on the existing deemed-compliance exemptions under the Proposed Regulations due to the way in which Australian superannuation funds are structured.

There are a number of structures and products that merit inclusion in the annexes to an Australian IGA. Set out below are three particular instances which apply more generally to some broad categories of Australian products we believe the Australian Government should seek to have included in the annex to an Australian IGA.

(a) Entities listed or quoted on the ASX

Equity and debt interests that are "regularly traded"[12] on an "established securities market"[13] are not considered "financial accounts" for the purposes of FATCA. Consequently, FFIs do not need to report on the U.S. holders of such interests.

Despite presenting a low risk of U.S. tax evasion, many Australian listed investment companies ("**LICs**") and other entities that are listed or quoted on the Australian Stock Exchange ("**ASX**"), such as exchange traded funds, may not meet the "regularly traded" test.

In many cases, whether an entity meets the "regularly traded" test will depend on prevailing market conditions, and an entity will need to continually monitor the trading in its interests to determine whether or not it is "regularly traded". This will be extremely difficult to manage from a practical perspective. LICs are likely to have particular difficulty in meeting the "regularly traded" test due to the medium to long-term investment nature and strategy of Australian LIC investments, which typically result in lower turnover volumes than other listed securities.

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[9] Model IGA, Article 3(3) and (5); Proposed Regulations, §1.1471-4(d)(7)(v)(B).

[10] See Model IGA, Annex II; UK-U.S. Agreement dated 12 September 2012, Annex II.

[11] Model IGA, Article 4(3).

[12] §1.1471-5(b)(3)(iv) of the Proposed Regulations.

[13] §1.1472-1(c)(1)(i)(C) of the Proposed Regulations.

Equity and debt interests in a FI that is described in §1.1471-(5)(e)(1)(iii) of the Proposed Regulations (i.e. an "investing FFI") that are not "regularly traded" are considered financial accounts for the purposes of FATCA.[14] This means that not all FIs whose interests are listed or quoted on the ASX will be treated in the same way for FATCA purposes. Those entities whose interests are "regularly traded" will not need to report on their US shareholders or bondholders. However, those entities whose interests are not "regularly traded" will need to conduct such reporting to comply with FATCA. The Australian government should seek to negotiate an IGA such that all ASX listed or quoted FI entities are treated in the same way.

Entities that are admitted to quotation or trading on the ASX are subject to the spread requirements set out in the ASX Listing Rules or the ASX Operating Rules (as applicable) and are generally widely held across a diverse ownership base. Listing or quotation on the ASX is not a mere "compliance" listing. In addition, an entity's ability to meet the "regularly traded" test may be adversely affected by other factors such as trading halts whilst an entity is negotiating a takeover. For this reason, we recommend that equity and debt interests in ASX-listed or quoted FIs are specifically excluded from the definition of "financial account". Such exclusion would mean that Australian ASX-listed or quoted FIs would not need to monitor their trading status to determine whether they fall within the "regularly traded" exemption.

(b) Local FFIs

On 12 September 2012, the United States and the United Kingdom signed an IGA that is based on the Model IGA ("**UK IGA**"). The UK IGA broadens the deemed compliance category of Local FFI which is contained in the Proposed Regulations. It applies to all FIs that are licensed or regulated in the UK, not only those who are licensed or regulated as a bank (or similar organisation authorised to accept deposits in the ordinary course of its business), securities broker or dealer, financial planner or investment adviser.[15] If appropriately adapted for Australian FIs, this broader exemption may permit more Australian FIs to be considered deemed-compliant.

The deemed-compliant exemption in the UK IGA applies to essentially local FIs; for example, one requirement is that the FI has no fixed place of business outside the United Kingdom.[16] Given the low US tax risk presented by essentially local entities, and given that these entities are separately regulated in Australia, we consider that a deemed-compliant exemption on similar lines to the UK IGA is a reasonable carve-out from FATCA.

(c) Financial Institutions with no Financial Accounts

We recommend that Australian FIs that do not have any "financial accounts" are specifically characterised as "deemed-compliant" entities under an IGA.

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[14] Note that equity and debt interests in an FFI that is described in §1.1471-5(e)(i),(ii) or (iv) of the Proposed Regulations will also be considered financial accounts if they are not regularly traded on an established securities market, provided that the value of such interest is determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments (§1.1471-5(b)(1)(iii)).

[15] Annex II, Article II(2) of the Agreement between the United Kingdom and the United States to Improve International Tax Compliance and to Implement FATCA, opened for signature 12 September 2012 (not yet in force) ("**UK IGA**").

[16] UK IGA, Annex II, Article II(2)(b).

2.10 Australia would not be "left behind"

It is reported that, to date, at least 40 countries have indicated their interest in entering into IGAs as a means of mitigating the burden of the Proposed Regulations on their FIs.[17] If Australia does not enter into an IGA, Australian FIs could suffer a competitive disadvantage. Conversely, Australian FIs would gain a competitive advantage over businesses operating in countries that have to comply with the Proposed Regulations. Signing an IGA could be seen as an important step both politically and practically in furthering Australia's objective of becoming a financial services hub for the Asia-Pacific region.

2.11 Reciprocity would strengthen ATO powers to ensure tax compliance

A reciprocal IGA would require the United States to report information held by U.S. FFIs on accounts of Australian taxpayers.[18] This would enhance the ATO's tax enforcement reach by providing it with information about Australians hiding Australian taxable income in the US.

3 DISADVANTAGES OF AN IGA

3.1 ATO would need to dedicate substantial resources

An IGA would require a substantial commitment of resources by the Australian Government in respect of the collection of information from Australian FIs in accordance with the provisions of an IGA, the exchange of information with the IRS and the ongoing collaboration with the U.S. that an IGA requires.

We note that Switzerland and Japan have also announced that they will enter into intergovernmental agreements with the U.S. This "Model II" IGA (which has yet to be released) is intended to retain the requirement for FFIs in Model II IGA jurisdictions to conclude separate agreements directly with the IRS, but for reporting to be supplemented by information exchange on an inter-governmental basis.

We note that Treasury has not sought comments on whether a Model II IGA may be more advantageous to Australian FIs than a Model I IGA.

3.2 Domestic legislation required

An IGA requires the Australian Government to pass implementation legislation, including to require Australian FIs to report information to the ATO. Australian FIs would therefore be dependent on the Australian Government passing the requisite legislation within the requisite timeframes.

3.3 IGA will only apply to FIs located in Australia

An IGA will only benefit FIs that are located in Australia. Consequently, Australian FIs that have branches or affiliates offshore may face increased costs and compliance and administrative burdens, as their offshore affiliates and branches may be subject to the Proposed Regulations, to the Model II IGA, or to the Model I IGA which treats different entities and accounts as deemed-compliant or exempt.

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[17] Reuters, "U.S. overseas tax dragnet refocuses on country partnerships", 18 September 2012, available at <http://uk.finance.yahoo.com/news/u-overseas-tax-dragnet-refocuses-184750246.html> (accessed 21/9/12).

[18] Model IGA, Article 2(2)(b).

3.4 Pushing withholding obligation upstream creates issues for pooled vehicles

An advantage of the IGA for Australian FIs is that it would generally not require them to deduct FATCA withholding in respect of payments made to non-participating FFIs (see paragraph 2.2, above). However, the requirement to report this information and for the withholding to be deducted further up the payment chain will create difficulties for Australian pooled vehicles such as managed funds.

If there is a non-participating FFI investor in an Australian managed fund, then the trustee of the fund will be required to report information about such investor's unitholding to the payor of the relevant withholdable payment. The payor will be required to make the requisite deductions from the distribution payable to such unitholder. It is generally unlikely that Australian trust constitutions will permit such a deduction at source to be allocable to a particular unitholder.

4 CONCLUSION

For a series of practical, legal and competitive neutrality reasons, we strongly endorse the entry into an intergovernmental agreement with the United States based on the Model IGA, despite some identified disadvantages.

We believe that an appropriate result for Australian FFIs can be achieved if acceptable outcomes are reached on the matter to be dealt with in Annex II.