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Agreement between the Government of Australia and the Government of the United States of America to Improve International Tax Compliance and Implement FATCA

Introduction

3.1 The *Agreement between the Government of Australia and the Government of the United States of America to Improve International Tax Compliance and Implement FATCA* (the Agreement) is an unusual treaty action in that it has been negotiated to enable the operation of a United States law in Australia. The law in question is the Foreign Account Tax Compliance Act (FATCA).[1]

3.2 For a number of reasons discussed below, and at the request of the Treasurer, the Hon Joe Hockey MP, the Committee tabled a single page Interim Report containing a recommendation on the Agreement, *Report 140*, on 23 June 2014.[2]

3.3 As the Committee has already made a recommendation on this Agreement, this Chapter does not contain a recommendation concerning binding treaty action. Instead, the Chapter contains the Committee's comprehensive views on the Agreement.

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1 National Interest Analysis [2014] ATNIA 9, *Agreement between the Government of Australia and the Government of the United States of America to Improve International Tax Compliance and Implement FATCA,* done at Canberra, 28 April 2014 [2014] ATNIF 5 (hereafter referred to as 'NIA'), para 3.

2 Joint Standing Committee on Treaties (JSCOT), *Report 140*, 23 June 2014.

3.4 While the movement of money between countries is generally legitimate, in some instances, particularly the movement of money to low tax jurisdictions, it can facilitate arrangements designed to evade paying taxes elsewhere.[3]

3.5 Efforts to address this practice began as an initiative by the Organisation for Economic Cooperation and Development (OECD) to improve the transparency of financial flows between countries. The initiative developed into a model tax information exchange bilateral treaty, which enabled signatories to exchange information relevant to determining the taxable income of their citizens.[4]

3.6 A bilateral tax information exchange agreement already exists between Australia and the United States, the *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*.

3.7 The current model for the exchange of information for taxation purposes is the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters*, to which both the United States and Australia are party.

3.8 Representatives of the Treasury have previously described the Multilateral Convention in the following terms:

> One of the benefits of that particular convention is that it provides for more expansive exchange of information; it provides for information on request, as well as automatic exchange of information. It also provides for assistance in the collection of outstanding tax debts and in relation to the service of documents. So it has a broader scope than our bilateral agreements.[5]

3.9 Australia is currently considering the OECD initiated Common Reporting Standard for the automatic exchange of tax information which the G20 endorsed in February 2014.[6] The Treasury explained that the FATCA agreement preceded the G20 Common Reporting Standard but that it would largely comply with the new Standard.[7] However, Treasury told

3 This matter is discussed in more detail in previous Joint Standing Committee on Treaties' Reports. See for example *Report 138*, 26 March 2014, Chapter 3.

4 JSCOT, *Report 138*, 26 March 2014, p. 30.

5 Mr Greg Wood, Manager, Tax Treaties Unit, Tax System Division, The Treasury, *Committee Hansard*, Canberra, 17 March 2014, p. 9.

6 For more information see The Treasury, Common Reporting Standard for the Automatic Exchange of Tax Information, *Discussion Paper*, http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/Common-Reporting-Standard , accessed 7 July 2014.

7 Mr Gerry Antioch, General Manager, Tax System Division, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 7.

the Committee that there are two areas where FATCA differs from the impending Common Reporting Standard: the imposition of a 30 per cent withholding tax for non-compliance and a lack of reciprocity requirements.[8]

Background

3.10 FATCA is an anti-tax evasion measure, the intent of which is to identify United States taxpayers who use 'foreign'[9] financial institutions to conceal income and assets from the United States Inland Revenue Service (the IRS, the United States equivalent of the Australian Taxation Office).[10]

3.11 The Treasury summarised the intent of FATCA in the following terms:

> FATCA aims to identify US persons using offshore financial institutions to conceal untaxed income and assets from the US Internal Revenue Service. It requires foreign financial institutions including Australian financial institutions to agree to identify their customers who are US persons and report their account details to the US Internal Revenue Service. These obligations will commence on 1 July this year.
>
> Financial institutions that do not comply with FATCA will be subject to a 30 per cent US withholding tax on their US source income…[11]

3.12 According to the Treasury, FATCA:

> …stemmed from problems that the US was having with Swiss banks. This was their approach to dealing with that problem. They decided to make it a global solution to that problem.[12]

3.13 The proposed Agreement is best understood as an attempt by the Australian and United States Governments to deal with a number of complicated issues arising from FATCA. The issues fall into the following categories:

- the attempt by the United States to overcome problems with the extraterritorial application of its laws;[13]

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8 Mr Antioch, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 7.

9 That is, financial institutions not based in the United States.

10 NIA, para 5.

11 Mr Antioch, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 6.

12 Mr Wood, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 10.

13 NIA, para 5.

- the adverse interaction of the requirements of FATCA with Australian laws, such as the *Privacy Act 1988;*[14]
- the compliance costs to Australian financial institutions resulting from meeting FATCA's requirements;[15] and
- the timing of the application of FATCA to Australian financial institutions.[16]

Extraterritorial application of laws

3.14 A country's laws do not usually have extraterritorial application. In other words, laws made by a country, such as the United States, are considered to only have application in that country.[17]

3.15 The United States cannot use legislation to compel entities in other countries to provide information that would enable the IRS to make decisions about how much tax a United States taxpayer should pay.[18]

3.16 FATCA is an attempt by the United States to encourage entities that are not based in the United States to comply with United States tax law reporting requirements while avoiding the problems associated with the extraterritorial application of laws.

3.17 To overcome the extraterritorial barriers to the application of United States law, FATCA imposes a penalty of a 30 per cent withholding tax on the United States derived income of financial institutions based in other countries, unless those financial institutions report to the IRS specific details on accounts held by United States taxpayers or by foreign entities controlled by United States taxpayers.[19]

3.18 The withholding tax penalty is not related to the income the financial institutions may derive from the accounts in question. [20]

3.19 United States derived income of financial institutions based in other countries may include income derived from: retail services offered in the United States; investment in the United States; listing on United States

14 NIA, para 7.

15 NIA, para 55.

16 NIA, para 51.

17 *Jurist*, "What Exactly is "Extraterritorial Application" of a Statute?", 28 May 2013, <http://jurist.org/forum/2013/05/kenneth-gallant-extraterritorial-application.php> accessed on 6 June 2014.

18 *Jurist*, "What Exactly is "Extraterritorial Application" of a Statute?", 28 May 2013, <http://jurist.org/forum/2013/05/kenneth-gallant-extraterritorial-application.php> accessed on 6 June 2014.

19 NIA, para 6.

20 NIA, para 7.

stock exchanges; United States–based currency transactions; and the purchase or sale of United States Government Bonds.

3.20 According to the NIA, this means that Australian financial institutions will have a strong incentive to comply with the obligations of FATCA 'as non-compliance could expose them to significant economic costs, reputational damage, and a loss of international competitiveness.'[21]

3.21 The NIA makes it clear that FATCA is not extraterritorial. Compliance with FATCA is not mandatory, but the cost of non–compliance will be considerable for any financial institutions deriving income from the United States.[22]

Interaction between FATCA and Australian laws

3.22 The *Privacy Act 1988* prohibits the use or disclosure of personal information for a purpose other than that for which it has been collected unless, amongst other things, disclosure is required or authorised by law.[23]

3.23 This means that the Privacy Act may not extend to permitting the disclosure of information required by FATCA to the IRS.[24]

3.24 In addition, while Commonwealth laws concerning discrimination on the basis of race may not preclude making a distinction based on nationality, such a distinction may be inconsistent with some State and Territory antidiscrimination laws.[25]

3.25 To overcome this, according to the NIA:

> The proposed Agreement establishes a legal framework that will allow [Australian financial institutions] to comply with their FATCA obligations without necessarily breaching Australian anti-discrimination and privacy laws. Without the proposed Agreement, [Australian financial institutions] that perform FATCA obligations would breach these laws.[26]

Compliance costs

3.26 As previously discussed, Australian financial institutions wishing to avoid the 30 per cent withholding tax would have to report to the IRS certain

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21 NIA, para 7.
22 NIA, para 14.
23 NIA, para 19.
24 NIA, para 20.
25 NIA, para 23.
26 NIA, para 17.

information about financial accounts held by US taxpayers or by foreign entities controlled by US taxpayers.[27]

3.27 In addition, compliance with FATCA would require Australian financial institutions to enter into, administer and certify individual agreements with the IRS;[28] and either close or withhold tax from non–compliant financial accounts and prevent any payments to other non–compliant financial institutions.[29]

3.28 The Treasury estimates that compliance with FATCA in the absence of the Agreement would cost Australian financial institutions A$477 million not including any withholding tax incurred by the institutions.[30]

3.29 According to the NIA, the proposed Agreement will reduce compliance costs for financial institutions by removing the requirements to report and enter into individual agreements with the IRS.

3.30 Instead, the Australian Taxation Office (ATO) will report to the IRS on behalf of Australian financial institutions using existing reporting mechanisms contained in the *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*.[31]

3.31 Further, Australian financial institutions will be exempt from the requirements to close or withhold tax from non–compliant financial accounts or prevent payments to non–compliant financial institutions.[32]

3.32 In addition, the proposed Agreement will exempt certain Australian financial institutions, such as superannuation funds, from having to comply with FATCA.[33]

3.33 Nonetheless, the remaining costs to Australian financial institutions arising from administering the requirements of this Agreement are expected to be significant. The NIA estimates that the minimum up-front cost for Australian financial institutions to implement the Agreement will be approximately A$255 million, with an ongoing annual cost of A$22.72 million.[34]

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27 NIA, para 10.
28 NIA, para 63.
29 NIA, para 16.
30 Mr Wood, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 9.
31 NIA, para 63.
32 NIA, para 16.
33 NIA, para 39.
34 NIA, para 55.

3.34 Discussions between Australian Government officials and Australian financial institutions did not canvass the issue of how such compliance costs are to be met,[35] but the Committee has no doubt that at least some of the compliance costs will be passed on to the customers of Australian financial institutions.

3.35 The cost to the ATO, estimated to be in the vicinity of A$1 million over three or four years, is expected to be met out of its existing budget allocation.[36]

Timing

3.36 FATCA commenced on 1 July 2014.[37] Consequently, the Australian Government brought the proposed Agreement into force by 1 July 2014.[38]

3.37 Had the Agreement not been in place by that time, Australian financial institutions would either have had to introduce expensive interim arrangements in order to avoid paying the 30 per cent withholding tax on United States derived profits; or simply defer to the necessity of paying the tax until the Agreement came into effect.

3.38 To assist the Government in bringing the Agreement into force by 1 July 2014, the Treasurer, the Hon Joe Hockey MP, wrote to the Committee to request that consideration of the proposed Agreement be expedited so the inquiry could be completed before that date.

3.39 The Committee, recognising the benefit to Australian financial institutions of a timely response in this instance, tabled an Interim Report, *Report 140*, on 23 June 2014. The Report noted that, while the Committee had a number of reservations about the Agreement, the Committee appreciated that it made the best of a less than satisfactory situation, and recommended that binding treaty action be taken.[39]

Overview and national interest summary

3.40 According to the Treasury, the Agreement is one of a number of intergovernmental agreements entered into by the United States with other jurisdictions based on a common model.[40] At the time of the public

35 Mr Wood and Mr Antioch, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 10.

36 NIA, para 54.

37 NIA, para 10.

38 NIA, para 3.

39 Joint Standing Committee on Treaties (JSCOT), *Report 140*, 23 June 2014.

40 NIA, para 15.

hearing on 16 June 2014, 31 countries, including Australia, had signed Agreements of this sort, and a further 25 countries were in negotiations with the United States to make such Agreements.[41]

3.41 The Agreement and its related legislation are intended to reduce the overall burden of FATCA in Australia. The Agreement:

- addresses impediments to compliance in Australian privacy and antidiscrimination law by providing a lawful basis for the provision of information;
- enables information handling within the Australian legal framework, exempting Australian institutions from having to reach individual agreements with the IRS;
- implements less onerous tests for Australian financial institutions to identify accounts and transactions that need to be reported under FATCA;
- allows information to be collected, handled and provided to the IRS by the ATO in accordance with existing tax treaty rules;
- ensures that Australian financial institutions will not be required to close or withhold tax from non-complying financial accounts and financial institutions;
- exempts certain Australian financial institutions from having to comply with FATCA; and
- allows Australia to obtain from the United States the same information it is required to collect for FATCA.[42]

Obligations

3.42 The Agreement consists of the three elements:

- the provisions of the Agreement;
- an Annex detailing the tests Australian financial institutions are to undertake to identify accounts and transactions that need to be reported under FATCA (called the 'due diligence test'); and
- an Annex listing exempt Australian financial institutions.[43]

41 Mr Wood, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 7.

42 Mr Antioch, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 6.

43 NIA, para 31.

3.43 The Agreement will require Australia to obtain and exchange information with the United States on accounts that are deemed reportable by the proposed Agreement's due diligence test, contained in Annex I.[44]

The Agreement

3.44 **Article 2** of the Agreement obliges Australian financial institutions to provide prescribed information to the ATO. The Article also imposes a reciprocal obligation on the United States to provide similar information on Australian taxpayers held by United States financial institutions.[45]

3.45 The Treasury confirmed that, while compliance with FATCA is a matter of 'choice' for financial institutions that are not based in the United States, the Agreement makes compliance with its less rigorous arrangements compulsory. In other words, Australian financial institutions that may have chosen not to comply with FATCA do not now have this choice.[46]

3.46 The cost of failing to comply with FATCA means that for the bulk of Australian financial institutions, the choice is moot. Nevertheless, it is not inconceivable that for a small number of Australian financial institutions, such as those with little exposure to the Unites States, it may have been cheaper to pay the withholding tax, if any, than to meet the compliance costs they are now required to bear.

3.47 The Committee has not had sufficient time during this inquiry to explore this aspect of the Agreement, and so cannot make a meaningful assessment of whether some Australian financial institutions may have found it more cost effective to choose not to comply. However, the Committee notes that it is possible that for some Australian financial institutions, this Agreement does not represent the best outcome.

3.48 **Article 3** concerns the timing and manner of information exchange. This Article permits the amount and character of payments into and out of reportable accounts to be determined under Australian law rather than in accordance with FATCA.[47]

3.49 **Article 4** requires that Australian financial institutions be considered generally FATCA compliant by the United States, and therefore exempt from the 30 per cent withholding tax, provided Australia meets its obligations under the proposed Agreement.[48]

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44 NIA, para 35.

45 NIA, para 35.

46 Ms Lyn Redman, Senior Advisor, Tax Treaties Unit, Treasury *Committee Hansard*, Canberra, 16 June 2014, p. 10.

47 NIA, para 36.

48 NIA, para 37.

3.50 Further, the Article will suspend the application of the FATCA on recalcitrant accounts for Australian financial institutions provided they apply the Agreement's due diligence measures to ascertain whether an account is a 'US reportable account', and if so, provide the relevant information to the ATO.[49]

3.51 This Article also expressly exempts Australian superannuation funds from FATCA, as well as other Australian financial institutions listed in Annex II.[50]

3.52 **Article 5** provides a framework for dealing with non–compliance by an Australian financial institution. Both the ATO and the IRS will collaborate to enforce compliance with the Agreement. Non–compliant Australian financial institutions will be dealt with using domestic (Australian) legal sanctions.[51]

3.53 This Article also provides Australian financial institutions with the opportunity to use third party service providers to fulfil their obligations under the Agreement.[52]

3.54 The proposed Agreement comes with an attached Memorandum of Understanding that will provide guidance on interpreting which financial institutions and financial accounts are reportable and, crucially, will confirm that Australian financial institutions are compliant with FATCA.[53]

Annex I

3.55 According to the NIA:

> Annex I requires [Australian financial institutions] to conduct due diligence to identify reportable accounts and payments made to certain non-participating financial institutions. These procedures are generally simpler than the equivalent provisions in the US FATCA regulations and would be adapted to the Australian context in relevant implementing legislation.[54]

3.56 Specifically, the due diligence obligations relate to:

- pre–existing and new individual accounts; and
- pre–existing and new entity accounts.[55]

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49 NIA, para 38.
50 NIA, para 39.
51 NIA, para 41.
52 NIA, para 43.
53 NIA, para 33.
54 NIA, para 46.
55 NIA, para 47.

3.57 The NIA states that the financial services industry has indicated it is generally satisfied with these obligations and that the obligations can be met.[56]

Conclusion

3.58 As foreshadowed in *Report 140*, the Committee has a number of reservations about this Agreement.

3.59 The intent of FATCA is to identify United States taxpayers who use foreign financial institutions to conceal income and assets from the United States IRS. In the Committee's view, the nature of the Australian taxation system, and that of many of the United States' allies and friends, means that these countries are highly unlikely to be used by United States taxpayers to conceal income.

3.60 This is a point on which the Treasury agrees with the Committee, stating:

> We do not think Australia is a particular risk for the US or its residents to hide their money in. We would consider Australia to be fairly low risk…[57]

3.61 Further, the Committee notes that a number of mechanisms already exist for the IRS to obtain the substantial bulk of the information it is seeking through FATCA from Australia, including, as previously noted, the *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* and the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters*.

3.62 The Committee also notes that the existing mechanisms will be strengthened by the Common Reporting Standard for the automatic exchange of tax information which have been initiated by the OECD and endorsed by the G20. The interaction between these various agreements will need to be closely monitored.

3.63 The compliance cost of the Agreement, while half that which might apply to Australian financial institutions in the absence of the Agreement, is still very significant. Establishing the compliance regime will cost A$255 million, and ongoing costs will continue to be significant.

3.64 The Committee believes that FATCA represents a disproportionate response, and notes the view expressed by Treasury that:

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56 NIA, para 48.

57 Mr Wood, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 6.

> …Everybody acknowledges it is a weapon.[58]

3.65 Notwithstanding the apparent difficulties of FATCA, the Committee understands that the Agreement represents the best possible accommodation to a difficult situation. Under the circumstances, the Agreement is in Australia's best interests.

58 Mr Antioch, Treasury, *Committee Hansard*, Canberra, 16 June 2014, p. 9.