NEW ZEALAND LAW SOCIETY

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PRACTICE BRIEFING:

FATCA AND NEW ZEALAND LAW FIRMS

This Practice Briefing does not constitute legal advice

INTRODUCTION

The FATCA agreement between New Zealand and United States is directed at reducing tax evasion by US taxpayers. New Zealand law firms with trust accounts may possibly be defined as "financial institutions" and could be subject to FATCA provisions.

FATCA has implications for the way New Zealand law firms with trust account conduct their practice. Law firms should consider whether the agreement applies to them and what action they will need to take. This Practice Briefing provides information on the regime to assist law firms with assessing their particular position and FATCA obligations.

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 foreign entities in which US taxpayers hold a substantial ownership interest.

An inter-governmental agreement between 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 Department guidance

At mid-April 2015 the Inland Revenue Department was consulting with the New Zealand Law Society and the New Zealand Bankers' Association. This will assist IRD with finalising guidance on the application of FATCA to law firms, lawyers' trust account relationship entities and lawyers' nominee companies. A trust arises whenever a law firm (trustee) holds money for the benefit of a client (beneficiary). The IRD classifies the trust

relationship arising from the holding of client funds in a lawyer's trust account as a "trust account relationship entity".

The guidance is expected to be released before mid-2015. Law firms may wish to wait for the release of the IRD's guidance before they make any final FATCA decisions. This Practice Briefing will be updated when the guidance is available. This classification is under review by the IRD, but whether the trust account is viewed as a "trust account relationship entity", or representing a multiplicity of trusts, there is likely to be little practical difference from a law firm's perspective.

Are you an FI or an NFFE?

Under FATCA your firm will either be a "financial institution" (**FI**) or a "non-financial foreign entity" (**NFFE**). All non-US entitles 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.

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

Law firms as Financial Institutions

The inter-governmental agreement (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.

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. 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 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 the IGA definition, most law firms which are FIs under the IGA should be able to avoid classification as an FI. Each case will depend on its own circumstances. However, some law firms which

are FIs under the IGA may prefer that status.

If a law firm is an FI, its trust account relationship entity and any Lawyers Nominee Company it operates, would also be FIs if they are managed by an investment entity law firm - which would normally be the case.

The FI law firm would have greater obligations (registration, due diligence and reporting) than a law firm which is not an FI.

New Zealand law firms that are not FIs are classified as NFFEs (non-financial foreign entities).

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 as at a specified date (see "Bank requirements" below) and later, whenever moneys are held. 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 if the client is a non-US entity with one or more controlling persons that is a Specified US person
- Report to New Zealand's IRD on all accounts identified as being US reportable accounts.

Decisions 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, which is a requirement that will apply if the law firm is not an FI (ie, it is an NFFE). The FI law firm would report directly to the IRD 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 (by adopting the US Treasury Regulations definition of investment entity, if it enables such avoidance) is a decision for each law firm to take. Law firms may want to wait for the release of the IRD's guidance before making their decision in this regard.

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 the IRD. It seems likely that many 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 the IRD.

Adopting US Treasury Regulations investment entity definition

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, 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".

The IRD 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.

The law firm must also advise the bank that, as a consequence of the election, it is an NFFE for FATCA purposes - most likely an active NFFE.

As a matter of convenience, the law firm should also advise its bank that having elected to adopt the US Treasury Regulations definition of "investment entity", its "trust account relationship entity" is a passive 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 NFFEs are of interest to the IRS (and therefore the law firm's bank and the IRD) 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.

An NFFE law firm's "trust account relationship entity" is likely to be a passive NFFE because none of the criteria for an active NFFE is likely to apply. This will be a question of fact in each case. If clients' funds are held on interest bearing deposit, all income is likely to be passive income and it is likely that the clients' funds would be assets that produce or are held for the production of passive income. Likewise if moneys are not placed on interest bearing deposit then it is likely that none of the criteria for an active NFFE would apply - with the result that the trust account relationship entity will be a passive NFFE.

Bank requirements

When a law firm notifies its bank of an election it has made and that it is not an FI, but an NFFE, and that its trust account relationship entity is a passive NFFE, its bank will request the law firm to provide

a self-certification. This is to be made by the law firm or controlling persons and must state whether the controlling persons of the passive NFFE "trust account relationship entity" are US citizens or US tax residents. Effectively the information required is whether the client is a US citizen or US tax resident, or whether the client entity 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 the IRD and the Bankers' Association. It is likely that this information will be required by the bank, at least initially, only in respect of those clients who have moneys in the trust account on the date of the bank's request to provide a self-certification (the "**snapshot date**"). If the value of all funds in the law firm's trust account did not exceed NZ$285,453 (the NZ$ equivalent of US$250,000) as at 30 June 2014, no such review of controlling persons would be required unless the value of funds in the trust account exceeds the NZ$ equivalent of US$1 million as at 31 December 2015 or any subsequent 31 March.

Going forward from the snapshot date, the bank will require the above information annually from the law firm in respect of every client which has moneys in the trust account after the snapshot date - no matter how short a period such funds are held in the trust account.

Collecting client information and consents

The Law Society recommends that to help meet the requirements to certify in respect of clients, law firms (whether FIs or not) start obtaining information and consents from their clients (as to whether they are US citizens or US tax residents) either when a new matter arises (which will lead or is likely to lead to the law firm holding funds for the client) or at the latest before funds are lodged in the trust account. Where funds are held in the trust account on the snapshot date the relevant information will still need to be obtained.

The Law Society has published information and **consent forms** on its website which law firms may wish to use for this purpose. The forms also seek information on non-US tax residents in light of coming requirements for the OECD's Common Reporting Standard. This will impose FATCA-like obligations on New Zealand law firms under agreements the New Zealand Government may 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 the IRD and/or the law firm's bank.

The reporting obligations imposed by FATCA have 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 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 IRD.

Further, the IRD 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 possible in all circumstances law firms should obtain clients' authority to the disclosure of FATCA information to the law firm's bank and/or IRD. This can be included in a law firm's letter of engagement. It is important that clients should be made aware of the position.

Summary of important requirements

Law firms should consider 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, and wishes to avoid being an FI, it may be able to avoid being an FI by electing to adopt the US Treasury Regulations definition of "investment entity". Law firms may wish to wait for the release of the IRD's guidance before making any FATCA decisions.

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 and/or deposits of its election and that it is an NFFE. This advice to the bank should be accompanied with advice that its trust account relationship entity is a passive NFFE. This will trigger a process of the law firm being requested to report information to the bank on US controlling persons.

If a law firm is an FI it must register as such on the IRS website and the IRD portal and meet all the obligations imposed on FIs by the FATCA regime. These obligations include reporting to the IRD details of clients who are Specified US persons.

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

Summary of abbreviations used

FATCA: Foreign Account Tax Compliance Act.

FI: Financial Institution.

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

IRS: Inland Revenue Service (United States).

NFFE: Non-Financial Foreign Entity.

FATCA "Financial Institution" definitions

The following definitions compare those used in the Inter-Governmental Agreement (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:

1. 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;

2. individual and collective portfolio management; or

3. 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) 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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New Zealand Law Society
Law Society Building
26 Waring Taylor Street
Wellington 6011

PO Box 5041
Lambton Quay
Wellington 6145

04 472 7837