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A MATTER OF FATCA AND COMPLIANCE UNDER JAPANESE DATA PRIVACY LAWS

On January 17, 2013, the U.S. Treasury Department issued final regulations implementing the U.S. Foreign Account Tax Compliance Act of 2010 ("**FATCA**"), a statute principally designed to reduce offshore tax evasion by "U.S. persons" (a defined term that includes not only citizens or residents of the United States, but a U.S. corporation or partnership, any estate other than a foreign estate, or a trust with a nexus to the United States) by requiring the reporting of various information about U.S. persons to the U.S. Internal Revenue Service.

FATCA will apply to a broad range of companies conducting business in Japan, even companies that do not operate purely in the financial or investment arenas. Given the stringent provisions under Japanese data laws restricting the disclosure of certain information, getting caught in the web of FATCA can significantly increase a company's compliance costs and affect its manner of conducting business. Thus, understanding the interplay of FATCA's extraterritorial requirements with Japanese data privacy laws is essential for companies conducting business in Japan (even those that are subsidiaries of non-Japanese companies) to ensure that penalties are not triggered and Japanese laws are not breached when such companies conduct business with U.S. persons in Japan.

What is FATCA?

In general, FATCA requires a "foreign financial institution" (which includes non-U.S. banks, brokerage houses, hedge funds and private equity funds, trust companies, and insurance companies that offer certain products, hereinafter collectively referred to as an "**FFI**") to either (i) comply with local law requirements that implement an inter-governmental agreement specifically entered into with respect to FATCA between its home country and the United States, or (ii) enter into a reporting and withholding agreement directly with the U.S. Internal Revenue Service. The foregoing reporting and withholding agreement will require an FFI to implement complex customer identification procedures and, if a U.S. person is identified, the FFI will be required to send to the U.S. Internal Revenue Service information regarding such person's name, tax identification number/social security number, account balance, and withdrawal/receipt history.

If there is no relevant inter-governmental agreement in place and an FFI has not entered into an IRS reporting and withholding agreement, then the FFI will be subject to a 30% withholding on certain payments it receives. That is to say, a withholdable payment would be subject to a 30% withholding tax captured by the payor/paying agent before the gross proceeds from the sale of the investment are distributed to the subject FFI, unless otherwise exempted from the FATCA regime. The 30% withholding tax would apply to virtually all amounts invested by an FFI into the United States, whether for its own account or for that of its account holders, regardless of whether or not they are U.S. persons (unless otherwise exempted from the withholding tax). Withholdable payments under FATCA make up a large class, including U.S.-source dividends, interest, rents, salaries, wages, premiums, annuities, the gross proceeds from the sale of any property that could produce U.S. source interest or dividends, and a "foreign pass-thru payment"— essentially a payment to the extent it is attributable to a withholdable payment. For example, both interest income and the gross proceeds from the sale of a U.S. Treasury bond would be considered withholdable payments.

FATCA's reach is very broad, extending to companies conducting business in Japan that are not "pure" financial institutions. For example, a Japan-domiciled insurance company (including a subsidiary of a U.S.-based insurance company) or a holding company that is a member of an expanded affiliated group that includes an insurance company could be subject to the FATCA regime, as could certain retirement funds.

FATCA's withholding tax obligation will be phased in over stages, with the first phase commencing on January 1, 2014.

Balancing Japanese Data Privacy Laws and FATCA Compliance

An FFI operating in Japan needs to balance the disclosure restrictions under Japanese data privacy laws against FATCA's reporting requirements in order to avoid breaching Japanese laws when disclosing customer data to third-persons. Japanese data privacy requirements arise from Japanese legislation and Japanese case law.

Japanese Legislation. Japan's Act on the Protection of Personal Information (the **"Japan Privacy Act")** is the principal Japanese statute that impacts the legality of an FFI disclosing customer information to a third-person. Under the Japan Privacy Act, a "*business operator*" is prohibited from disclosing "*personal information*" to a third-person (which includes a Japanese and a non-Japanese governmental authority) without the prior written consent of the individual to whom the personal information relates (subject to certain exceptions, as explained under "Piercing Japanese Data Privacy Requirements").

Having a clear understanding of the following defined terms is key to comprehending the all-encompassing scope and application of the Japan Privacy Act:

- a "*business operator*" is defined under the Japan Privacy Act as an entity that handles, for its business, one or more

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databases that in the aggregate contains or has contained within the past six months personal information relating to more than 5,000 individuals. As companies normally archive information pursuant to information retention policies and the 5,000 individual threshold relates to any individual (i.e., not only customers, but personal information concerning employees, suppliers, business partners or anyone else who interacts with the subject institution), the 5,000 individual threshold is often easily met by most companies conducting business in Japan.

- "*personal information*" is defined broadly under the Japan Privacy Act to mean information about a living individual that can identify that specific individual by name, date of birth or other similar information. Personal information also includes information that on its face would seem not to specifically identify an individual but could lead to the discovery of personal information about a living individual (e.g., disclosing which zodiac animal in the Chinese traditional calendar applies to a person, or a person's year of graduation from high school or college).

It goes without saying that a customer's name and tax identification number/social security would easily qualify as "*personal information*" covered by the Japan Privacy Act. Absent an exception, an FFI that is also a "*business operator*" in Japan would breach the Japan Privacy Act if it discloses to the U.S. Internal Revenue Service the information stipulated under FATCA.

Japanese Case law. The Supreme Court of Japan ruled in December 2007 that financial institutions conducting business in Japan owe a special duty of confidentiality to their customers with respect to information concerning customer transactions and customer credibility. The Court did not elaborate on the scope of "customer transactions and customer credibility," which makes it difficult to advise on the limits of the Court's holding. Thus, a financial institution in Japan should tread carefully and refrain from disclosing most forms of customer information without obtaining the prior written consent of the customer (subject to certain exceptions, as explained under "Piercing Through Japanese Data Privacy Requirements").

Piercing Japanese Data Privacy Requirements

There are exceptions to the information disclosure barriers under the Japan Privacy Act and Japanese case law, including the following:

Japan Privacy Act. A "business operator" can disclose "personal information" to a third-person without violating the Japan Privacy Act if the disclosure of such information is (i) required under Japanese law, or (ii) necessary for cooperation with a Japanese national or local governmental agency.

Japanese Case law. The Supreme Court of Japan has held that a financial institution can provide a third-person with customer information without violating its duty of confidentiality if it has "good reason" to make such disclosure. It is generally believed that a financial institution has "good reason" if disclosure is (i) required under Japanese law (e.g., disclosure is permitted under the Japan Privacy Act) or (ii) necessary to protect the rights or interests of the financial institution (e.g., when the financial institution is involved in litigation with a customer).

Japan Privacy Act and Japanese Case law. Customer consent and mandated disclosure to a local governmental agency can provide a safe passage through the disclosure barriers under both the Japan Privacy Act and Japanese case law.

Customer consent. If an account holder executes a written consent permitting the processing and transferring of his/her personal data to a third-party or a waiver of his/her Japanese data privacy rights in favor of an FFI, such consent or waiver should be enforceable under Japanese law if it is in writing, stated in clear unequivocal language, and prepared in the native language of the account holder (most likely English under the circumstances). Generally speaking, a single consent or waiver should be sufficient for ongoing/multiple transfers of personal information about an account holder, so long as the document clearly stipulates as such.

While at first blush obtaining an effective customer consent would seem the most prudent way to clear the barriers under the Japan Privacy Act and Japanese case law that prevent the disclosure of a customer's personal information to a third-person, in actuality, this avenue may not be realistic. For those FFIs conducting business with numerous U.S. persons, the consent route is not a panacea as obtaining a customer's consent can be a time consuming and costly effort. The consent approach may not only result in a customer withholding consent to the disclosure, but it could even generate negative feelings from the customer towards the FFI. Thus, an alternative process to sanction disclosure of personal information may be necessary for an FFI to comply with both Japanese data privacy laws and FATCA's disclosure requirements.

Mandated government disclosure. A Japanese legal requirement that an FFI provide a Japanese governmental agency with the personal data of an account holder can serve as an effective route to bypass the personal information disclosure roadblocks under both the Japan Privacy Act and Japanese case law. Once the personal information is disclosed to the Japanese governmental agency, then the data could be transferred overseas by the agency without the consent of the account holder. An inter-government agreement, therefore, between Japan and the United States would need to exist to effect such pass-thru disclosure.

The Makings of an Inter-Governmental Agreement between Japan and the United States

The Japanese and U.S. governments issued a joint statement on June 21, 2012 concerning their pursuit of a FATCA inter-governmental agreement. The joint statement seeks to establish a framework to facilitate the implementation of FATCA by requesting that FFIs in Japan:

- register with the U.S. Internal Revenue Service;
- conduct due diligence on its customer base to identify the

accounts of U.S. persons, and report annually to the U.S. Internal Revenue Service (i) the U.S. account information required for FATCA compliance (e.g., the account holder's name, tax identification number/social security number, account balance, and withdrawal/receipt history) of those U.S. account holders who consent to the reporting, and (ii) the aggregate number and aggregate value of accounts held by U.S. persons who fail to consent or fail to provide the information required for FATCA compliance.

The framework for the inter-governmental agreement envisages that, by requests made by the U.S. authority (most likely the U.S. Internal Revenue Service), the receiving Japanese authority (most likely the National Tax Agency of Japan) would obtain the requested additional information from the identified FFI in Japan and the agency would transfer the information to the requesting U.S. authority pursuant to the U.S.-Japan tax treaty. The framework for the inter-governmental agreement further envisages that FFIs in Japan would not be required to (i) terminate the accounts of account holders who fail to consent or provide the information required for FATCA compliance, or (ii) impose a 30% withholding on pass-thru payments to FFIs in Japan or certain account holders.

Practitioners are carefully watching the development of the FATCA inter-governmental agreement between Japan and the United States. Should FATCA's withholding obligation come into effect before the adoption of an inter-governmental agreement, then an FFI in Japan may find itself in between a rock and a hard place as there would be no Japanese legal grounds for an FFI to close a customer's account or terminate a contractual agreement simply because the customer fails to consent or fails to provide the information needed for the FFI's FATCA compliance.

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While having an understanding of Japanese data privacy laws is critical to properly analyzing the ability of an FFI based in Japan to comply with FATCA's reporting requirements, such knowledge can apply to other areas as well. For example, restrictions under Japanese data privacy laws intersect with a corporation's policies on website data collection, human resource due diligence practices in M&A transactions, Internet browser and mobile phone applications that collect user information, and procedures used by a corporation to complete credit card transactions. Thus, the information about the scope of Japanese data privacy laws in this Newsletter can provide insights in other contexts as well.

It is conceivable that inroads into Japanese data privacy laws made in order for an FFI to comply with FATCA's reporting requirements will eventually be reflected in other personal information regimes that are presently considered to be impenetrable bastions of privacy. It is too early to tell whether the U.S.-Japan inter-governmental agreement ultimately concluded between Japan and the United States will directly or indirectly foil the seal that lids the disclosure of personal information in Japan. We will monitor this area with great interest!