FATCA: Trusts under a Model 1 Intergovernmental Agreement (IGA): Jurisdiction X

The Model 1 Intergovernmental Agreement (IGA) is a standard template that facilitates FATCA reporting. It has been adopted widely and, as of mid-August 2014, 35 jurisdictions had formally signed Model 1 IGAs with the US. Over 50 further jurisdictions had reached 'agreements in substance' to adopt Model 1 IGAs but had not yet formally signed an IGA. In addition, the Model 1 IGA template forms the basis of the IGA-style agreement the UK has agreed with the Crown Dependencies and Overseas Territories. It also forms the basis for the OECD Common Reporting Standard being introduced as the global standard for automatic exchange of tax information.

There are two versions of the standard Model 1 agreement. Model 1A agreements contain reciprocal arrangements for automatic information exchange. Model 1B agreements see information flowing only to the US. The standard Model 1 agreement also comes in three parts: the Agreement;[1] Annex 1,[2] outlining due diligence and reporting standards; and Annex 2,[3] outlining various exemptions and deemed compliant institutions. Apart from some standard exemptions such as government entities and central banks, Annex 2 may grant various reliefs to other entities and accounts deemed to present a low risk of being used by US persons to evade US tax categories. These are typically smaller institutions with a purely local client base and vary from jurisdiction to jurisdiction.

Several jurisdictions have published guidance on their IGAs, although some give relatively few details on how the IGA applies to trusts. Many other jurisdictions have as yet not published any guidance. All trustees must nevertheless determine by this autumn if their trust needs to register with the IRS as a Financial Institution (FI) under FATCA. If the trust does need to register, it needs to do so in time to ensure that it is on the list of FIs published by the IRS as of 1 January 2015. There is no clear deadline for FIs to register to be on the published list, but taking a cautious approach, STEP's view (and that of other professional bodies that have looked at this issue) is that it would be prudent for trustees to ensure that trusts that need to register do so by 24 October 2014.

It is important to recognise that FATCA potentially puts obligations on all trusts, whether or not they have any US connections, US assets or US income. Moreover, in signing the IGA, jurisdictions are agreeing to incorporate FATCA reporting requirements into their own tax code and take responsibility for enforcement.

STEP has therefore provided this guidance to assist practitioners in Model 1 jurisdictions that have not yet published their own guidance. Where a local tax authority has produced guidance, this should be consulted in preference. Although the Model 1 IGA is intended to provide a standard template, some jurisdictions have indicated that they are going to implement it in different ways (Canada is, so far, the most notable example of a jurisdiction adopting an approach different to that taken by others). This guidance, however, is based upon what we understand to be the consensus approach being taken to FATCA implementation in most Model 1 jurisdictions. We also focus on the main issues that typically arise for trustees. Inevitably some may have questions that are beyond the scope of this guidance.

[11] http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Reciprocal-Model-1A-Agreement-Preexisting-TIEA-or-DTC-6-6-14.pdf
[2] http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Annex-I-to-Model-1-Agreement-6-6-14.pdf
[3] http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Annex-II-to-Model-1-Agreement-11-4-13.pdf

A. The status of a trust under FATCA

All trusts are deemed to be entities under FATCA.[4]

i. Is the trust subject to IGA reporting?

Trustees must first check two issues. The first issue to consider is: 'is the trust covered by the IGA'? Jurisdiction X's IGA will only cover trusts tax resident in Jurisdiction X. This will normally be determined by trustee residence. If the trust is tax resident elsewhere, it may have to report under another IGA, or if no IGA is in place in its jurisdiction of residence the trust may have to report directly to the US. In cases where the trustees are resident in more than one jurisdiction, trustees must satisfy themselves that the information required on the trust is being reported in at least one relevant jurisdiction.

The second issue to consider is whether Jurisdiction X's Annex 2 Agreement extends 'exempt beneficial owner' status to the trust. The exact terms of Annex 2 will vary from jurisdiction to jurisdiction, but typically, exempt beneficial owner status will only apply to government entities, central banks and some types of pension fund. Some trusts may, however, qualify under Annex 2 as 'deemed compliant Foreign Financial Institutions' (FFIs) – this is covered later.

ii. Is the trust a Financial Institution under FATCA?

Having established that the trust is covered by the IGA and is not an exempt beneficial owner, trustees must then decide what sort of entity the trust is under FATCA. There are two options. The trust can either be a non-financial foreign entity (NFFE) or it can be a Financial Institution (FI). The status of the trust as either an NFFE or an FI will be determined by who 'manages' the trust or its assets.

There are three types of FI; Custodial Institutions, Depository Institutions and Investment Entities. If the trust is an FI it will typically be an Investment Entity. The Agreement defines an Investment Entity in the following terms:

> *'The term "Investment Entity" 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:*
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> *(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.'* (Agreement, Article 1.1.j)

On this definition it would appear that where a trust derives less than 50 per cent of its income from financial assets and related activities, but it is managed by a financial institution (such as a corporate trustee, which does derive more than 50 per cent of its income from these sources), the trust would be an Investment Entity. In defining Investment Entity, however, the US Regulations (1.1471-5(e)(4)(i)) additionally add that an entity will only become an investment entity when more than 50 per cent of <u>its</u> income comes from financial assets and it is managed by an FI. This so called 'financial

[4] 'The term "Entity" means a legal person or a legal arrangement such as a trust'(Agreement, Article 1.1. gg).

assets test', which has also been incorporated in the OECD CRS, has been widely copied into the regulations implementing the Model 1 IGA since Article 4.7 of the Agreement explicitly allows jurisdictions to use any definition in the US Regulations in lieu of the definition in the Agreement. Thus, for example, the UK, the Crown Dependencies, Cayman and the BVI have all either adopted, or indicated that they intend to adopt, the financial asset test into their IGA regulations (some jurisdictions, such as Cayman, have also indicated that they will allow entities to choose whether to apply it or not).

The flowchart accompanying this guidance thus assumes the financial assets test applies, although when determining if a trust is an investment entity or not, practitioners should establish if this is the case in their jurisdiction. On this basis, **a family trust will typically be an investment entity if**:

1. **The trust's gross income is primarily attributable to investing, reinvesting, or trading in financial assets (i.e. more than 50 per cent comes from this source), and**
2. **It has a corporate trustee, since the corporate trustee 'manages' the trust and will generally be an FI, or**
3. **The trust appoints a discretionary fund manager, since the discretionary fund manager 'manages' the assets of the trust and will generally be an FI.**

The reporting options for a trust that is an investment entity are covered in Section B.

A trust that is not an investment entity will be a Non Financial Foreign Entity (NFFE). Rather than reporting directly, the trust will typically be reported on by any FI it interacts with. The issues to be considered for NFFEs are examined in Section E.

iii. *The Canadian exception*

The most significant departure from the standard Model 1 interpretation of an Investment Entity is in Canada. The final paragraph of Article 1.1.j in the standard Model 1 agreement is problematic. It indicates that the term 'financial institutions' should be interpreted in a way consistent with Financial Action Task Force (FATF) definitions.[5] However, the FATF definition of a financial institution specifically only applies to a 'natural or legal person' and it does not extend to legal relationships such as trusts. Most jurisdictions take the view that if the trust or its assets are 'managed' by a financial institution (i.e. it has a corporate trustee or a discretionary fund manager), this implies that the trust itself should be regarded as a financial institution. Canada, however, takes the view that an entity will not be considered to be a Canadian financial institution unless it is included in the 13 categories of 'listed financial institutions' in subsection 263(1) of the Canadian *Income Tax Act.*[6] This effectively means that any trust settled with capital provided by a family that is not represented or promoted to the public will be an NFFE regardless of who 'manages' the trust.

This interpretation of the IGA Agreement has proved controversial, particularly since many practitioners have come to the view that in practice it is often desirable for a trust to be an FI under FATCA rather than an NFFE. Article 10.3 of the Agreement commits both parties to review implementation of the IGA 'prior to December 31, 2016' and it is possible the Canadian interpretation could come under pressure at that point. A further issue is that the Canadian interpretation is not shared by the OECD Commentary on the Common Reporting Standard, to be implemented shortly after FATCA.[7]

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[5] http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf
[6] See http://www.cra-arc.gc.ca/tx/nnrsdnts/nhncdrprtng/gdnc-eng.html#Toc390079580, paras 3.12 and 3.19
[7] See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters_9789264216525-en#page1

iv. *Corporate trustees that do not charge*

It is relatively common for corporate trustees to not charge directly for their services, typically because the corporate trustee is part of a wider group that is generating revenues from activities connected to the trust. In these circumstances the corporate trustee is generally still deemed to be a Financial Institution, since part of the revenues of the wider group can be imputed to the corporate trustee, rendering it a Financial Institution.

Private trust companies, however, often do not charge a fee and are often not part of a wider group. In these circumstances they are not financial institutions since they do not 'conduct as a business' their activities. In these circumstances, and assuming there is no discretionary fund manager, the trust will be an NFFE, although the BVI Guidance, for example, indicates that in these circumstances the private trust company may elect to be treated as a Financial Institution and register, enabling the trust to become a trustee documented trust (see below).

v. *Trusts that own real property*

Many trusts will own real property. Real property will sometimes be held via a corporate structure, but a non-debt, direct interest in real property is generally not regarded as a financial asset for the purposes of establishing if the trust is an investment entity. The Crown Dependencies guidance (3.9.2) usefully adds that 'direct interest in this case means direct-line of ownership i.e. this can include real property that is indirectly held through companies'.

B. Registration and reporting options for trust that are FIs

Trusts that are FIs have a variety of options in terms of fulfilling their registration and reporting obligations under the Model 1 IGA.

i. *Trustee Documented Trust*

Many trusts will be a financial institution because they have an FI as trustee. Where the trust has a reporting FI as a trustee (typically this will be where the trust has a corporate trustee) and the trustee agrees to report all necessary information with respect to the trust, the trust can opt for 'trustee-documented trust status' (Annex 2 Article IV.a). This will qualify the trust to become a 'deemed compliant FI'. As such, the trust itself is not required to register with the IRS or report under the IGA. The trustee will instead register and report on the trust. This is widely seen by practitioners as a relatively attractive option in terms of possible routes for the trust to fulfil its FATCA obligations.

It should be noted that some IGAs, such as the Canadian and – perhaps more surprisingly – the Irish IGAs, do not appear to contain this option. However, Article 7.2 of the Agreement automatically extends 'most favoured nation status' to all IGA signatories, so the fact that it is not mentioned may not prevent trustees taking advantage of the trustee documented trust route after consultation with their domestic authorities.

ii. *Sponsored Investment Entity (Annex 2 Article IV.B)*

This option is primarily intended for those trusts that are investment entities because they have appointed a discretionary fund manager. The sponsoring entity (i.e. typically the fund manager) must be authorised to act on behalf of the trust and must register as a sponsoring entity with the IRS. The sponsoring entity must perform all necessary due diligence and, if there are reportable accounts, the sponsoring entity will need to register the trust. The trust in these circumstances is again regarded as a deemed compliant Financial Institution.

In practice the main issue with this option is that trustees have found it difficult to identify FIs prepared to act as sponsors.

Annex 2 Article IV.C also creates the option of the trust becoming a 'sponsored closely held investment vehicle' if there are fewer than, effectively, 20 beneficial owners. This option is in many respects similar to the sponsored investment entity category. The sponsor must register with the IRS as a sponsor and fulfil all necessary due diligence and reporting obligations on behalf of the trust.

iii. *Owner Documented Financial Institution*

This category is not specifically mentioned in the IGA, but is available under the US Regulations (1471-5(f)(3)) and is highlighted in many guidance notes issued by Model 1 tax authorities. The trust need not register with the IRS but it must appoint a withholding agent, which must be a reporting FI. Owner documented status will apply only to payments received from, and accounts held with, the designated withholding agent. The trust must supply the withholding agent with all necessary information and the withholding agent undertakes to report all necessary information under the IGA.

iv. *The trust registers as an FI with the IRS and reports to its local tax authority under the IGA*

The trust must register with the IRS and obtain a Global Intermediary Identification number (GIIN). This can be done via the IRS Registration Portal.[8] The IRS has published a user guide to assist in this process.[9]

The trust must then perform due diligence to identify any Specified US Person and report as required to the local tax authority under the IGA.

C. Who gets reported?

Where the trust is an investment entity, those responsible for reporting must report on 'controlling persons' who are 'specified US persons'. (Agreement, Article 1.1.cc)

'Controlling persons' in the case of a trust are 'the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries and any other natural person exercising ultimate effective control over the trust' (Agreement, Article 1.1.mm). The Agreement then goes on to note that 'controlling persons' should be interpreted 'in manner consistent with Financial Action Task Force recommendations'. In reality, the FATF does not define controlling persons, but the definition of controlling persons in the agreement matches the definition of 'beneficial owner' used by the FATF. The FATF generally defines a controlling interest relative to a threshold, such as a 25 per cent stake, and the same thresholds as used for normal AML purposes in each jurisdiction can generally be used for IGA purposes (note that the US FATCA regulations (1.1473-1(b)(3)) take a 10 per cent threshold). Similarly, information collected via normal AML purposes can be used in identifying controlling purposes.

'Specified US Persons' are US citizens or residents (Agreement, Article 1.1.ee). Annex 1 gives details of the due diligence requirements required to establish if a controlling person is a specified US person. These vary according to the value of the 'account' and whether the account is a pre-existing or a new account.

[8] http://www.irs.gov/Businesses/Corporations/FATCA-Foreign-Financial-Institution-Registration-Tool
[9] http://www.irs.gov/file_source/pub/irs-pdf/p5118.pdf

D. What gets reported?

In the case of a trust that is an investment entity, for reportable persons it is necessary to provide identity information (name, address and TIN), account numbers (or equivalent), name and GIIN of the reporting financial institution, payments that reporting period and their 'equity interest' (the equivalent of an account, see Agreement, Article 1.s.1). An equity interest in a trust is considered to be held by 'any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust' (Agreement, Article 1.v) and it covers all property that is subject to the trusts, including underlying companies and other assets owned by the trusts. It is not confined to financial assets owned by the trust. In assessing the due diligence required, trustees must aggregate the equity interests and financial accounts held for the same person by other entities in the same group, e.g. other trusts held by the same specified person managed by the same FI.

The equity interest to be attributed to the settlor is determined in the FATCA regulations (1.1471-5(b)(3)(iii)), which, in turn, refer back to the IRS Code. In practice, for the settlor of a settlor interested trust or where the settlor has powers to revoke the trust or powers of appointment, etc, then the settlor's equity interest is the whole value of the trust. Where the settlor is a US specified person but has no such links with the trust, the settlor's equity interest is deemed to be nil, but it still constitutes a reportable account and it should be reported.

For a beneficiary entitled to a mandatory distribution, the equity interest is the net present value of the amounts payable, while for discretionary beneficiaries it is the value of the distribution in the relevant reporting year. Discretionary beneficiaries who do not receive a payment thus do not need to be reported (the same argument applies to contingent beneficiaries).

Where a trust has no US specified persons, some Model 1 jurisdictions, most notably the UK, require a nil return, but most do not.

E. Trusts that are NFFEs

A trust that is not an Investment Entity will be a Non-Financial Foreign Entity (NFFE) (Annex 1, Article IV.B.2). It does not need to register or report to the IRS, but depending on its status, active NFFE or passive NFFE, it may need to be reported on by any Financial Institution it holds accounts with. Trustees must therefore determine if the trust is an active NFFE or passive NFFE.

A trust might be an active NFFE for a variety of reasons (listed in Annex 1, Article IV.B .4), most notably because the trust is a not-for-profit entity meeting a variety of strict criteria or because less than 50 per cent of trust income is passive income and less than 50 per cent of its assets give rise to passive income. Accounts held with FIs by active NFFEs are not reportable accounts.

Trusts that are not active NFFEs are passive NFFEs (Annex 1, Article IV.B.3) and most family trusts that are not Investment Entities are likely to be passive NFFEs. FIs are required to perform due diligence on accounts held for passive NFFE's accounts if they meet certain threshold requirements. The FI must determine both who are the controlling persons of the NFFE and if there are any specified US persons among the controlling persons. This may require self-certification from the controlling persons. The FI will then need to report both the account value and any payments to the US specified persons.

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