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FATCA update: planning for compliance within structures for international families

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Introduction

In less than eight months, withholding is scheduled to begin on certain payments of US source income to non-US entities that are not compliant with the Foreign Account Tax Compliance Act (FATCA). Non-US trustee companies and advisers to international families must be aware of the revised compliance deadlines and options to prevent withholding. They

should also consider the deemed compliant category of 'trustee-documented trust' which has been added to the revised model intergovernmental agreements (IGAs), and the exempted non-financial foreign entity (NFFE) category of 'direct reporting NFFE' recently added by Notice 2013-69. Even if a non-US trust structure has no US beneficiaries and no US investments, FATCA will affect how the family and its fiduciaries deal with bankers and investment brokers.

FATCA registration available online and deadlines revised

The Internal Revenue Service (IRS) online registration system is now available for foreign financial institutions (FFIs) to register in order to become FATCA compliant. The website includes registration resources, support information and 'how to' videos. FFIs can sign up and begin entering data. Registration cannot be finalised until after January 1 2014, so the information can be entered and revised over the next few months. FATCA deadlines have been revised as follows:

- April 25 2014 – the last day for FFIs to finalise FATCA registration in order to be included on the IRS's first FFIs list.
- June 2 2014 – the IRS will electronically post the first FFI list, which is to be updated on a monthly basis.
- July 1 2014 – FATCA withholding begins. FATCA due diligence procedures for new accounts must be in place.
- December 31 2014 – FATCA due diligence on pre-existing accounts must be completed.
- March 31 2015 – annual Form 8966 reporting begins with respect of 2014 calendar year.

Professional trustee companies to register under local FATCA agreement

A family's professional trustee company should be preparing to register with the IRS (for further details please see "Time for non-US trustee companies and their trusts to prepare for FATCA"). Asking the trustee about this is important, even if the family has no US members and its trust assets include no US investments. It is the financial institutions and collective investment vehicles with which the trusts and holding companies within the family's structure have accounts that will soon be inquiring as to

each entity's FATCA classification. Every foreign entity has a FATCA classification, regardless of whether there will be any US accounts to report. If a financial institution or hedge fund is itself to be FATCA compliant, its due diligence will include gathering this information.

Many professional trustee companies are located in jurisdictions where the government has or has indicated that it will enter into an IGA with the IRS. The IRS website includes a link to a list of jurisdictions that will be treated as having in effect an IGA, even though that agreement may not have entered into force as of July 1 2014.

Jurisdictions that have completed or indicated their intent to enter into an IGA include the following:

- Model 1 – FFI reports to its own government:
  - United Kingdom – completed September 12 2012;
  - Ireland – completed January 23 2013;
  - Denmark – completed November 19 2012;
  - France - completed November 14 2013;
  - Germany – completed May 31 2013;
  - Mexico – completed November 19 2012;
  - Norway – completed April 15 2013;
  - Spain – completed May 14 2013;
  - Italy;
  - New Zealand;
  - the Bahamas (also indicated that it will enter into UK-FATCA);
  - the Cayman Islands (also indicated that it will enter into UK-FATCA);
  - the British Virgin Islands (also indicated that it will enter into UK-FATCA);
  - Jersey (signed UK-FATCA October 22 2013);
  - Guernsey (signed UK-FATCA October 22 2013); and
  - the Isle of Man (signed UK-FATCA October 10 2013).

- Model 2 – FFI reports directly to the IRS:
  - Switzerland – completed February 14 2013;
  - Japan – completed June 11 2013; and
  - Bermuda (also indicated that it will enter into UK-FATCA).

Professional trustee companies in these jurisdictions will want to comply with their country's IGA. Under both models, this means registering with the IRS. A professional trustee company in a Model 1 jurisdiction will register with the IRS and be issued a global intermediary identification number, but is not required to enter into an FFI agreement with the IRS. That trustee company will gather FATCA due diligence information and report information on US accounts, when relevant, to its own government. Model 1 IGA jurisdictions must advise local financial institutions on how to send their FATCA reports directly to the local tax authorities and provide a secure electronic system to receive and forward the FATCA reports to the IRS. Provided that the IGA is treated as being in effect, entities with a 'reporting Model 1 FFI' FATCA classification will not be subject to withholding, even though service providers may as yet be unable to answer how the mechanics of the local jurisdiction will work.

A professional trustee company in a Model 2 jurisdiction will register, be issued a global intermediary identification number and enter into an FFI agreement with the IRS, pursuant to which it will report information on US accounts directly to the IRS. A draft FATCA report, Form 8966, was released on August 13 2013, and annual reporting will be paperless through the IRS's secure online website. The IRS recently issued Notice 2013-69, providing guidance to FFIs with a 'participating FFI in a Model 2 IGA jurisdiction' FATCA classification on complying with the terms of an FFI agreement, as modified by the IGA.

If a family's structure utilises a private trustee company, it may have other options by which to become FATCA compliant.

Trust itself need not register and trustee can maintain FATCA due diligence

The mere fact that a family's professional trustee company registers with the IRS and is compliant with its country's IGA does not mean that information on family members is being reported to the IRS. In fact, it may

be beneficial to the family's structure to engage the services of a professional trustee company that is FATCA compliant. The reason is that the trust can then have a FATCA classification of 'deemed-compliant' as a non-reporting FFI if it is considered to be a trustee-documented trust or a sponsored trust, and thereby avoid FATCA withholding and be able to present a FATCA classification certificate to any requesting financial institution or collective investment vehicle.

The option of qualifying as a deemed compliant FFI as a trustee-documented trust is available only under an IGA (for further details please see "IRS revises FATCA model intergovernmental agreements"). This category is not available under the FATCA final regulations, but was added to the revised Annex II to the model IGAs (Annex II to the completed UK IGA has since been revised to include the trustee-documented trust classification). It will be a particularly practical and attractive option allowing the professional trustee company to maintain FATCA due diligence on the trust, with the trust itself not needing to be registered with the IRS. The trustee will report only US accounts.

US persons holding equity interests in foreign trusts subject to FATCA reporting

Determining what FATCA reporting takes place at the trust level is complicated, and the language used in the FATCA final regulations and the IGAs does not accurately describe trust interests. Nevertheless, this language must be applied. The trustee must determine whether a trust has any US accounts. A 'US account' means a financial account held by a specified US person. A financial account includes an equity interest in an investment entity. In the case of a trust that is an investment entity (ie, a trust that conducts or is managed by an entity that conducts, as a business, the investing, administering or managing of funds or money on behalf of others), and therefore a financial institution, an 'equity interest' means:

- under the final FATCA regulations and the Model 2 IGA, which refers back to the regulations, an interest held by:
  - a person who is an owner under the grantor trust rules;
  - a beneficiary who is entitled to a mandatory distribution; or

    - a beneficiary who may receive a discretionary distribution from the trust, but only if such person receives a distribution in the calendar year; or

- under the Model 1 IGA, an interest 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.

The definition of an equity interest in a trust under the existing Model 1 IGA (and the IGA concluded with the United Kingdom) appears to be different from that under the final FATCA regulations. However, Her Majesty's Revenue and Customs' (HMRC) guidance on the UK IGA, which echoes that the information to be reported in relation to trusts that are investment entities will be the equity interest in the trust, clarifies that this applies to interests held by:

- a person who is a beneficial owner of all or of a portion of the trust;
- a beneficiary that is entitled to a mandatory distribution (either directly or indirectly) from the trust; or
- a beneficiary that receives a discretionary distribution from the trust in the calendar year.

The HMRC guidance notes thereby revert to the definition in the final regulations.

The interpretation of a US discretionary beneficiary having an equity interest in a trust that is reported to the IRS in the year in which that beneficiary receives a distribution is consistent with the goal of FATCA to provide data that the IRS can use to determine whether the US person has filed the necessary tax forms reporting that distribution.

Example of FATCA classification in common succession planning structure

By way of example, a common succession planning structure is one where a non-US mother establishes a trust with a discretionary beneficiary class that includes her daughter and grandchildren. The trust was established in Bermuda and is governed by Bermuda law. The trustee is a professional Bermuda trustee company. When the trust is settled, no one is a US citizen or tax resident. Pursuant to the Bermuda Model 2 FATCA IGA, the trustee

company is a participating Bermuda financial institution and its due diligence has identifying information on each member of the beneficiary class, the settlor and protector, if any. The trust is considered a foreign non-grantor trust for US tax purposes (for further details please see the Overview (May 2013)).

The Bermuda trustee company registers with the IRS and performs additional FATCA due diligence on the trust settlor and beneficiaries if necessary. As with 'know your customer' and anti-money laundering regulations, that information remains with the trustee company until reporting is otherwise required. The trustee opens an investment account with a non-US investment company and provides a Form W-8BEN-E, ticking the box to identify the trust as a 'non-reporting IGA FFI', certifying that the trust is treated as a trustee-documented trust under the Bermuda IGA and therefore deemed compliant for FATCA purposes. The trust owns US stocks and no FATCA withholding occurs when dividends are paid (the settlor is otherwise protected from US estate tax because she retained no powers over the trust). The trustee makes distributions to the daughter and grandchildren in the trustee's discretion. The trust is not considered to have any US accounts for FATCA reporting purposes.

Effect of US individual as a member of discretionary class

A time comes when the trustee is informed that a grandchild has applied for and received a US green card or passport and so is now considered a US tax resident. Common scenarios that may cause a family to raise a flag with its trustee include when a grandchild becomes romantically involved with a US person or attends a university in the United States and is considering job opportunities in the United States following graduation. A common reaction is to remove the grandchild from the beneficiary class, but is this really necessary? In such a situation the family and its advisers should give consideration to the following:

- What are the settlor's wishes? Would the settlor have wanted her grandchild to be excluded from benefiting from the trust because he or she fell in love or pursued a business opportunity?
- Does the US grandchild need distributions? Perhaps he or she has other sources of wealth. In that case, is it necessary to exclude the grandchild from the discretionary beneficiary class? The trust will still

be classified as a trustee documented trust and deemed compliant for FATCA withholding purposes. Therefore, the fact that a discretionary beneficiary has become US tax resident does not cause FATCA withholding on US source dividends and interest. The trustee will ask for documentation of the grandchild's US tax status. The mere fact that the beneficiary's tax status has changed does not trigger reporting, absent distributions.

- What US reporting is required when a distribution is made to the US beneficiary? Regardless of any FATCA considerations, the US beneficiary will be required to report the distribution on the following US tax forms:
  - US income tax return (Form 1040) – the US beneficiary will report the amount of the distribution and its tax character, for example, dividend income, interest or capital gain earned in the same year in which the distribution was made, or income that had been accumulated in a previous year, or trust corpus.
  - Report of distribution from a foreign trust (Form 3520) – the US beneficiary will report the amount of the distribution, the name of the trust, jurisdiction and trustee. The beneficiary will want to get from a trustee a foreign non-grantor trust beneficiary statement.
  - Statement of specified foreign financial assets (Form 8938) – a US beneficiary who knows or has reason to know, based on readily accessible information, that he or she has an interest in a foreign trust may be required to report the interest as a specified foreign financial asset on Form 8938. Because the value of the interest that must be reported is zero until the US beneficiary receives a distribution, a discretionary US beneficiary of a foreign trust who has not received distributions, but has knowledge of his or her interest, reports that interest on Form 8938 only if the US beneficiary has other specified foreign financial assets that trigger the reporting requirement (for further details please see "IRS releases new form to report specified foreign financial assets").
  - Report of foreign bank and financial accounts (Form TD F 90-22.1) – a US person who has a greater than 50% present

beneficial interest in the assets of a foreign trust or who receives more than 50% of the current income of the foreign trust has a financial interest in any foreign financial account for which the trust is the owner of record and may be required to file Form TD F 90-22.1 (commonly known as a foreign bank account report). This analysis is distinct from the question of whether the US person has signature authority with respect to any such account (for further details please see "New guidance and forms to report foreign accounts and use of trust property").

The trustee will be required to report the distribution to the IRS on Form 8966, FATCA Report, which is currently still in draft form. In addition, and separate from the FATCA reporting, the trustee will want to provide the beneficiary with a foreign non-grantor trust beneficiary statement, as this will allow the beneficiary to report accurately the income and not pay more tax than necessary.

Underlying holding companies and family's US directors and protectors

Trusts will often own offshore holding companies that hold underlying investments. This is particularly important when a foreign grantor trust structure is used in order to protect the settlor from possible US estate tax on the value of US situs assets in the trust at the settlor's death, although following the settlor's death there are possible adverse tax consequences of such a structure to a beneficiary who becomes a US person. Regardless, the holding company will also have a FATCA classification.

In the situation of a trustee-documented trust in an IGA jurisdiction, the most attractive option to avoid FATCA withholding on assets owned by the holding company may be the sponsored, closely held investment vehicle classification. It is not uncommon for the holding company to be an entity established in a different jurisdiction (eg, the British Virgin Islands) than the jurisdiction in which the trust is established (Bermuda, in the example above). Pursuant to Annex II of the model IGA, the classification of sponsored, closely held investment vehicle is available only when the sponsoring entity is a reporting US financial institution, reporting Model 1 FFI or participating FFI (which includes a reporting Model 2 FFI). Thus, it appears that the reporting Bermuda trustee company in the example above could act as sponsoring entity for the trust's BVI holding company. In

addition, the holding company must be considered owned by 20 or fewer individuals, which the authors believe will be determined by applying a facts and circumstances test looking through the trust to the beneficiaries.

To take advantage of this classification, the family's professional trustee company would also need to register with the IRS as a sponsoring entity. IRS Notice 2013-69 confirms that this is a separate registration from that of participating FFIs. The trustee company as sponsor will enter into an agreement with the holding company to handle its FATCA due diligence and reporting obligations. It is unclear at this time whether the Bermuda trustee company in the example above would report directly to the IRS pursuant to its FFI agreement, or whether the BVI will provide some way for it to report to the BVI tax authorities, as the holding company would be required to do if it were a reporting BVI financial institution.

As a sponsored, closely held investment vehicle, the holding company will be deemed compliant for FATCA purposes, ticking the box for 'non-reporting IGA FFI' on its W-8BEN-E form, so that no withholding will occur when its US investments make withholdable payments. It appears that the sponsored, closely held investment vehicle is identified in all reporting completed by the trustee company sponsor on behalf of the holding company, but need not be registered with the IRS and be assigned a global intermediary identification number, as is the case with a sponsored investment entity – another non-reporting IGA FFI classification. In the case of the sponsored investment entity, the sponsoring entity is not required also to be a reporting US financial institution, reporting Model 1 FFI or participating FFI.

Problem with NFFEs and IGAs

It is possible that a trust, holding company or private trustee company will be classified not as a financial institution, but as an NFFE for FATCA purposes. An NFFE will also be asked for a W-8BEN-E form when dealing with financial institutions. Operating companies tick the box on Form W-8BEN-E indicating that they are active NFFEs and are exempt from FATCA withholding. A payment of US source interest and dividends made to a passive NFFE will be subject to FATCA withholding, unless the NFFE is categorised as an excepted NFFE or certifies to the payor that it does not have any US substantial owners (which under the final FATCA regulations

generally includes a US person that owns more than 10% of the entity directly or indirectly) or provides required information of each substantial US owner to the payor.

Recently, the IRS announced in Notice 2013-69 that it intends to issue regulations to provide that a passive NFFE will not include an NFFE that is a 'direct reporting NFFE' or 'sponsored direct reporting NFFE'. A 'direct reporting NFFE' will be an NFFE that elects to report directly to the IRS certain information about its direct or indirect substantial US owners, in lieu of providing such information to withholding agents or participating FFIs with which the NFFE holds a financial account. The new classification is curious, as it removes the reporting of US accounts by an independent third-party financial institution.

The Model 1 IGA replaces the regulation's requirement that financial institutions report substantial US owners of NFFEs with a requirement that they report US persons who are in 'control' of those entities. This appears to be wide enough to include US directors and US protectors who are not owners or beneficiaries. However, the Model 1 IGA specifically provides that 'controlling persons' is to be interpreted in a manner consistent with recommendations of the Financial Action Task Force for international standards on combating money laundering and the financing of terrorism and proliferation. These Financial Action Task Force recommendations provide no bright-line test in determining 'control'. They state that "a controlling ownership interest depends on the ownership structure of the company" and that "[i]t may be based on a threshold, e.g., any person owning more than a certain percentage of the company (e.g. 25%)".

This change is confusing. The final FATCA regulations require the NFFE to report its 'substantial US owners', and the IGA says the NFFE is to report its 'US controlling persons'. Given that the goal of FATCA is to provide the IRS with information on US persons who should be filing to report distributions from foreign trusts and assets owned in foreign accounts, it makes no sense to widen the reporting to mere board members or protectors with no ownership interest; but the term 'controlling person' seems to mean something more than ownership until it is looked at in the context of the Financial Action Task Force recommendations, which again refer to ownership. Hopefully, the IRS will provide guidance to clarify this anomaly in the near future.

Comment

While many families and trustee companies wish to disengage from any US contact in response to FATCA and remove beneficiaries from succession planning structures if they become US tax resident, the reality is that countries other than the United States are also asking financial institutions and governments to report on accounts held by their tax residents. French law now requires trustees to report distributions to French tax residents and certain French assets held in trust. Reciprocal IGAs will require the United States to report the accounts of, for example, UK tax residents to HMRC. The United Kingdom is concluding separate FATCA-like reporting agreements with its crown dependencies. The goal now is for international families and their trustee companies to review succession planning structures to determine where FATCA withholding could take place and then take steps to secure the FATCA classification that will prevent it. The alternative - recovering from government tax coffers money that has been withheld - will prove time consuming and costly, and in some cases impossible.

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