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FATCA reporting: who and what

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Introduction

The policy statement in the final amendments to the regulations under the Foreign Account Tax Compliance Act (FATCA) asserts that the law was enacted to prevent abuse of the US voluntary tax compliance system and to address the use of offshore accounts to facilitate tax evasion. The vast majority of US taxpayers pay their taxes and report their worldwide income and foreign financial assets. Unfortunately, those US taxpayers who have attempted to evade tax by hiding wealth in offshore accounts and through offshore structures have caused all US taxpayers to wrestle with increased reporting obligations (for further details please see the Overview (May 2014)). The Internal Revenue Service (IRS) hopes that FATCA will strengthen the integrity of the US voluntary tax compliance system by requiring foreign financial institutions, beginning in 2015, to identify and report information regarding their US account holders. US financial institutions have done so for years.

Every non-US entity has FATCA status

International families using non-US structures to hold wealth must analyse each entity within the structure to determine whether the entity is a non-financial foreign entity (NFFE) or a foreign financial institution (FFI). Provided that a non-US entity knows its FATCA status and can provide a certificate – Form W-8BEN-E in the case of a corporation or complex trust or Form W-8IMY in the case of a partnership or grantor trust (for further details please see "Taxation of offshore trusts and impact of new lower tax rates") – its US source investments will not be subject to a FATCA withholding penalty, although the entity will still be subject to US withholding tax on certain types of US source income. As a practical matter, even if an entity has no US source investments and no US persons, it will need the certificate to open accounts and transact business in the world financial community.

An entity's FATCA status defines whether the entity itself is responsible for FATCA due diligence and reporting or whether the financial institutions with which the entity has accounts are responsible for identifying and reporting US persons.

For example, an active NFFE (eg, a company that manufactures and sells bicycles) is not required to undertake FATCA due diligence, but the company's banker must still request the W-8 certificate in order to carry out the bank's FATCA due diligence on its account holder. In the case of an active NFFE, the inquiry ends there. However, in the case of a passive NFFE or FFI, further inquiry is made to determine whether US individuals might have an interest in the entity that should be reported to the IRS or to the local tax authority, which then exchanges the information with the IRS (for further details please see "FATCA reporting: where and how").

Passive NFFEs report substantial US owners

By definition, a 'passive NFFE' is a non-financial entity and so is not subject to the FATCA due diligence and reporting requirements of an FFI. Instead, the W-8 certificate for a passive NFFE includes the names, addresses and tax identification numbers of its substantial US owners, if any. A 'substantial US owner' is defined as a US person who:

- owns, directly or indirectly, more than 10% (by vote or value) of the stock of any foreign corporation;

- owns, directly or indirectly, more than 10% of the profits or capital interests in a foreign partnership;
- is treated as an owner of any portion of a foreign trust under the US grantor trust rules; or
- holds, directly or indirectly, more than a 10% beneficial interest in a trust.

If the W-8 includes substantial US owners, the financial institution requesting the certificate then designates the account as a US reportable account and files an annual FATCA report with regard to the passive NFFE's substantial US owners. If the passive NFFE has no US owners, the account is not a US reportable account and there is nothing for the requesting financial institution to report. An NFFE that provides its FATCA status certificate when requested will not be subject to a FATCA withholding penalty, regardless of whether that certificate reports substantial US owners.

Controlling persons
A requesting financial institution in a jurisdiction that has entered into a FATCA intergovernmental agreement (IGA) with the United States is also required as part of its FATCA due diligence to identify the controlling persons of its passive NFFE account holder. According to the definition in the model IGAs, 'controlling persons' are the natural persons who exercise control over the entity and the term is to be interpreted in a manner consistent with Financial Action Task Force (FATF) recommendations. However, the FATF recommendations do not use the term 'controlling persons'. The Cayman guidance notes to its Model 1 IGA states that the term corresponds to the term 'beneficial owner' as described in FATF Recommendation 10 and its interpretative note. By grafting concepts of beneficial ownership onto the descriptive term 'controlling person', the IGAs appear to be trying to get at something more than a mere company director or trust protector who, if a US person with no ownership interest and no authority over foreign bank accounts, would have no US reporting obligations.

The FATF recommends that financial institutions understand the ownership and control structure of their customers. A controlling ownership interest depends on the ownership structure of the company. The financial

institution may look for a particular ownership threshold (eg, any person owning more than a certain percentage of the company). A controlling ownership interest also includes the natural person on whose behalf a transaction is being conducted and those persons who exercise ultimate effective control by means of control other than direct control. For this purpose, the Cayman guidance notes state – and in relation to NFFEs only – that a 25% ownership threshold applies for companies, partnerships, trusts and foundations. For trusts, this would apply only to beneficiaries, settlors when they are also beneficiaries and protectors where they have the power to change the trustees, thereby influencing the distribution of trust assets. This last reference to a trust protector does not necessarily indicate beneficial ownership, but echoes US estate tax concepts where a beneficiary who serves as protector with the unfettered right to remove and replace the trustee has a general power of appointment over the trust property.

Further guidance is needed, but international families and their trustees and company directors must be prepared to answer questions regarding decision makers who are US persons. The goal of FATCA is to root out the use of offshore accounts to facilitate tax evasion. The IRS believes that the foreign financial institutions are generally in the best position to identify and report with respect to US persons and this means those institutions will be required to ask questions. One challenging example might be an offshore purpose trust or foundation with no named beneficiaries and broad philanthropic purposes, but which is not strictly charitable. The trustee or founder may be a local individual. Close scrutiny might reveal a US individual who is calling the shots with regard to investments and distributions and with unrestricted power to remove and replace the named fiduciaries perhaps as a member of the foundation council or as protector. The identification of such a US controlling person could cause the financial institution to treat the account in the name of the passive NFFE as a US reportable account. US individuals involved with non-US structures should ensure that their US tax filings have been accurate with regard to any gifts made to or ownership interests in non-US entities and any authority over foreign financial accounts.

Direct reporting NFFE

If a family has passive NFFEs within its structures and those NFFEs have substantial US owners, or if the entity's controlling persons are US citizens or residents, the officers of the entity may wish to handle the FATCA reporting themselves. This can be done by utilising the FATCA status of direct reporting NFFE and registering the passive NFFE with the IRS or by engaging a registered sponsoring entity to qualify the entity as a sponsored direct reporting NFFE.

International families are generally keen to comply with relevant tax laws, including those laws that affect family members who have married US individuals and moved to the United States or who may be residing in the United States for work or education reasons. For some time, a US person with an equity interest in a NFFE has had an obligation to report that foreign financial asset to the IRS (Form 8938). Similarly, for years a US controlling person with authority over foreign financial accounts has had US reporting obligations (the foreign bank account report). This is nothing new to the international family. The FATCA report now provides the IRS with the information from the FFI that the IRS needs to confirm that the asset and any income which it produces have been properly reported by the US taxpayer.

Trustee of trust or its sponsoring entity will report US persons

A foreign trust that holds financial assets (as opposed to a trust that holds only real estate) and that has as a trustee a professional trust company will be an investment entity, and thus an FFI. An FFI trust can be FATCA compliant as a reporting FFI, a trustee-documented trust or a sponsored entity. The trustee or sponsor responsible for the trust's due diligence must determine whether the trust has any US reportable accounts.

The trustee or sponsor will carry out due diligence with regard to the trust's settlor, beneficiaries and persons who exercise ultimate effective control over the trust. Each year the trustee or sponsor must determine whether the trust has any US reportable accounts. There has been some confusion on this point, which is not helped by the fact that the financial accounts of a trust will depend on the nature of the trust and the relationship between the trust and those persons interested in or having control over the trust. Based on the FATCA regulations, model IGAs and guidance notes to date,

in practice the following will be treated as having an equity interest in the trust and reporting will apply to those individuals who are identified as US persons:

- a settlor;
- a beneficiary who is entitled to a mandatory distribution (directly or indirectly);
- a beneficiary who received a discretionary distribution (directly or indirectly) from the trust in the calendar year; and
- any person who exercised ultimate effective control over the trust.

Settlor
If the trust's settlor is a US person, the trustee or sponsor will file an annual FATCA report identifying the name, address and tax identification number of the US settlor. This report will correspond to the US settlor's Form 3520 and the trustee's Form 3520-A, which are used to report a US person's transfer of property to a foreign trust and by US taxpayers who are considered the owners of a foreign trust under the US grantor trust rules. In some cases, the value of a settlor's equity interest in the trust can be considered to be nil, but will still be a US reportable account if that settlor is a US person.

Beneficiaries
The trustee or sponsor should maintain due diligence on all trust beneficiaries, including all members of a trust's discretionary beneficiary class, so that the trustee knows their citizenships and tax residences. The trustee or sponsor will file a FATCA report annually for each US beneficiary who is entitled to a mandatory distribution from the trust and each beneficiary will file a Form 3520 to report the receipt of the distribution.

The trustee or sponsor will also file a separate FATCA report with respect to each US beneficiary who received a discretionary distribution from the foreign trust. This report will coordinate with the US beneficiary's Form 3520 reporting the receipt of distributions from foreign trusts. If a US beneficiary does not receive a discretionary distribution the following calendar year, there is no FATCA report to be filed for that calendar year with respect to that US person (and similarly no reporting by the US beneficiary). However, it is possible that a regular pattern of discretionary

distributions or a situation where the US individual is in fact the only discretionary beneficiary may cause the US beneficiary to have a reporting obligation in the United States on Form 8966. This may mean that the US beneficiary has an equity interest in the trust and the trustee should file a FATCA report annually.

In situations where the trust has a non-US settlor and non-US beneficiaries, or discretionary US beneficiaries who do not receive distributions and no US beneficiaries who receive mandatory distributions, the trustee or sponsor has no FATCA report to file with respect to US accounts of the trust. Note, however, that some Model 1 jurisdictions such as the Cayman Islands have included in their guidance notes that a reporting IGA FFI with no reportable accounts will nonetheless be required under the local regulations to submit a report to that effect (a 'nil' report) to the local tax information authority.

Persons with ultimate effective control

The trustee or sponsor will also want to consider whether any person that exercises ultimate effective control over the trust is a US person. Similar to passive NFFEs, the IGAs add that a natural person exercising ultimate effective control over the trust may be considered to hold a so-called equity interest in the trust, and thus it must be determined whether such a controlling person is a US person for purposes of FATCA reporting. Keeping in mind when US persons have US reporting obligations and that US tax laws encompass trusts over which taxpayers have retained certain controls may help in this analysis. Engaging US tax counsel and informing US persons before reporting will help to reduce confusion and concern in the event that a FATCA report prompts an audit enquiry.

Trustee reporting

Even before FATCA, trustees of non-US trusts were responsible for supplying information with regards to US settlors and US beneficiaries. US settlors of foreign trusts must arrange for their trustee to file Form 3520-A with the IRS and to avoid adverse tax consequences US beneficiaries require a foreign non-grantor trust beneficiary statement or foreign grantor trust beneficiary statement from the trustee to file with their Form 3520. If US settlors and beneficiaries have not been insisting on such documentation and perhaps not filing as required with the IRS, the trustee's new FATCA report will alert the IRS to this non-compliance.

Other reporting FFIs in structure will carry out FATCA due diligence

A professional trustee company is familiar with compliance issues and has operated under anti-money laundering and know-your-customer regulations for years. But what about the family's private trust company or an investment entity that has registered with the IRS as a reporting IGA FFI?

Registered entities must establish a compliance programme that includes policies, procedures and processes sufficient for the participating FFI to satisfy the FATCA due diligence and reporting requirements. In the case of a bank or other large financial institution with many account holders, compliance is a huge undertaking. But in the situation of a family entity, FATCA compliance is much more straightforward and easily maintained.

For example, take a company established in the Cayman Islands. The family's succession planning structure includes two separate trusts, each set up by the now deceased patriarch for a specified child and that child's issue. Each trust owns 30% of the shares in the Cayman company, which holds investment assets, and the non-US matriarch owns 40% of the shares in her own name. The trusts themselves may have different professional trust companies, perhaps in different jurisdictions such as Bermuda and the British Virgin Islands, and so can be deemed compliant as trustee-documented trusts. The Cayman investment entity is a corporation that has not made a US check-the-box election to be disregarded and so has its own FATCA status. In this example, the Cayman company hired professional investment advisers to manage significant investment holdings and so is an FFI as an investment entity under the Cayman IGA.

The family could have arranged for one of the trust companies – which for this example are also registered as FATCA sponsoring entities – to sponsor the Cayman company and provide FATCA due diligence and reporting. Instead, the family prefers to maintain the independence of the family branches by not involving either trust company at the Cayman company level and so decided to register the Cayman company with the IRS as a reporting Cayman FFI. The company was assigned a global intermediary identification number (GIIN), which it provides to requesting financial institutions and hedge funds on its Form W-8BEN-E.

Pursuant to the Cayman IGA and guidance notes, the Cayman Islands requires that reporting Cayman financial institutions apply the due diligence procedures contained in Annex I of the IGA to identify US reportable accounts and accounts held by non-participating financial institutions. These procedures include identifying the company's account holders which, in the case of an investment entity, are its equity and debt owners. Here, each trust and the matriarch are the account holders of the Cayman company.

The Cayman company must also determine whether each account is a US reportable account – that is, whether the account holder is a US citizen or resident, a US corporation or US domestic trust or a passive NFFE with one or more controlling persons who are US persons. If the account holder is an FFI, the Cayman company must determine whether that entity is a non-participating financial institution. A Form W-8BEN-E from the trustee of each trust confirms that each trust account holder is a foreign trust with a FATCA status of non-reporting IGA FFI as a trustee-documented trust under either the Bermuda IGA or the BVI IGA. A Form W-8BEN from the matriarch confirms that she is not a US citizen and is not tax resident in the United States.

The Cayman company has no US reportable accounts and no passive NFFE account holders. As with all good corporate governance practices, the FATCA responsible officer should obtain signed copies of the certificates for the company's records, even though he is a family member and knows the details of all involved. Business can proceed as usual. The Cayman company can continue to make investments with funds and institutions around the world. The Cayman company provides requesting financial institutions and funds with its GIIN and will not be subject to FATCA withholding (which is not to be confused with the US withholding tax on certain US source income payments made to non-US investors). Locally, the Cayman company will file a report with the tax information authority certifying that it has no reportable accounts.

Reporting when US account holders are identified

Suppose, instead, that the matriarch becomes a US tax resident in 2015. A Form W-9 is obtained for the Cayman company's FATCA records and the company now has a US reportable account. Pursuant to the Cayman IGA

guidance notes, the company must report to the Cayman tax information authority by May 31 2016 (for calendar year 2015) the following information regarding the specified US person:

- name;
- address;
- US tax identification number;
- account number or functional equivalent;
- name and identifying number of the reporting financial institution; and
- account balance or value.

Similarly, imagine that one of the trusts has in its discretionary beneficiary class a US grandchild and in 2015 the BVI trustee makes a distribution to that grandchild. Pursuant to the BVI IGA and draft guidance notes, the trustee will report to the BVI international tax authority the following information regarding the US beneficiary:

- name, address and tax identification number;
- account number or functional equivalent;
- name and GIIN of the reporting financial institution;
- equity interest (balance or value) in the trust at the end of the calendar year or other appropriate reporting period; and
- total gross amount paid or credited to the specified person during the calendar year or other appropriate reporting period.

The Cayman Islands and the British Virgin Islands – both Model 1 IGA jurisdictions – will annually exchange the reported information with the United States on an automatic basis pursuant to the respective tax information exchange agreement (TIEA) between the two countries. All information exchanged will be subject to the confidentiality and other protections provided by the TIEA, including the provisions limiting the use of the information exchanged.

Enforcement

In the case of the US resident matriarch, the IRS will now know that she should file for tax year 2015 a Form 8938 reporting her interest in the Cayman company and that her US income tax return should include any dividends which she received (setting aside additional reporting required of US taxpayers owning stock in a passive foreign investment company). The IRS will also know that the US grandchild should file a Form 3520 reporting the receipt of the distribution from the foreign trust. If either US person fails to file the appropriate forms, the IRS may begin an audit of that taxpayer and his or her returns. The taxpayer can correct the mistake and pay any taxes, interest and penalties that may be due. In egregious situations, the IRS criminal investigation division will look into allegations regarding violations of the Internal Revenue Code, the Bank Secrecy Act and various money laundering statutes. The findings of these investigations may be referred to the Department of Justice for potential prosecution.

The reporting Cayman company or the BVI trustee may be asked for substantiating documentation and could be served with a subpoena or summons requiring them to provide such documentation. However, in the absence of egregious institutional misconduct where the company is assisting the taxpayer with evading US taxes and reporting, the target of the investigation is the individual wrongdoer (the non-compliant US person), although the reporting IGA FFI will be the recipient of and will be required to deal with the request for FATCA-related documents.

Comment

Countries other than the United States are also interested in receiving information with respect to their taxpayers. At present, the United States is gathering, and will exchange with certain countries (including the United Kingdom and Canada), information on interest in excess of $10 paid on US accounts held by non-resident aliens and US source income subject to withholding tax. FATCA due diligence and reporting will become standard business practice before long, just as have know-your-customer and anti-money-laundering due diligence and suspicious activity reporting. The list of governments exchanging information will grow as the Organisation for Economic Cooperation and Development implements its common

reporting standards. US family members who have not been compliant with their US tax reporting obligations would be well advised to speak with their family advisers and tax professionals.

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