Trust protectors: reportable under CRS, but not under FATCA

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Introduction

It has become fairly common practice for settlors to name a trust protector when settling a trust, particularly when a commercial trust company is named as trustee. The Organisation for Economic Cooperation and Development (OECD) Common Reporting Standard (CRS) Implementation Handbook describes a protector as enforcing and monitoring the trustee's actions, "such as overseeing investment decisions or authorising a payment to a beneficiary". While some trust instruments bestow wide powers on the protector, many protectors have a much more limited role as regards trust administration. Most commonly, a protector has the power to remove and replace the trust company trustee. This power safeguards the trust property and beneficiaries of a long-term trust from adverse changes in trust company personnel, oversight and communication. A trust protector in most cases is not a family member and is not even a beneficiary of the trust. Historically, it has not been necessary for a trust protector to consider whether he or she might be subject to taxation in his or her country of tax residence with regard to a trust for which he or she serves as protector, because a trust protector generally has no economic interest in the trust and hence no personal tax liability or tax reporting obligation with respect to the trust. The Foreign Account Tax Compliance Act (FATCA) does not require reporting of US protectors who are not otherwise beneficiaries or settlors of the trust. In contrast, under the CRS, protectors will now be reported to their country of tax residence.

FATCA does not require reporting of US protectors

Most jurisdictions with an established trust company business have entered into a FATCA intergovernmental agreement (IGA) with the United States. Trusts formed under the laws of an IGA jurisdiction with a trust company trustee that has registered to be a FATCA reporting financial institution can have a FATCA status of non-reporting IGA foreign financial institution (FFI) as a trustee-documented trust. As such, the trustee will carry out due diligence to determine whether the trust has any equity interests held by US persons. In the case of a trust, an equity interest 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. The IGA does not automatically name the trust protector as an equity interest holder, although a US person in such a position could theoretically have sufficient powers to cause the protector to have ultimate effective control over the trust and hence necessitate reporting under FATCA.

The IGA also provides that in implementing the IGA, the IGA partner jurisdiction may permit its reporting financial institutions to use a definition in the US FATCA regulations in lieu of a corresponding definition in the IGA, provided that such application would not frustrate the purposes of the IGA. The US FATCA regulations specifically provide that in the case of a trust, an equity interest means an interest held by:

- a person who is an owner of all or a portion of the trust under the US grantor trust rules;
- a beneficiary who is entitled to a mandatory distribution from the trust; or
- a beneficiary who may receive a discretionary distribution from the trust, but only if such person receives a distribution in the calendar year.

As is evident, the protector is not *per se* included as an equity interest holder. This is consistent with the fact that a protector is not subject to US tax or reporting merely on the basis of holding this position. Therefore, even if a protector is a US citizen or tax resident, the trustee is not required to file a FATCA report for that protector, provided that the protector is not also a grantor or beneficiary and does not hold sufficiently broad power to be deemed to have ultimate effective control.

Trusts that have no commercial trust company trustees may instead have a FATCA status of passive non-financial foreign entity (NFFE). When such a trust is faced with an entity self-certification form asking for the identification of controlling persons under the IGA, the trustee completing the form should instead choose, as permitted under the IGA, to use the definition of 'substantial US owner' from the US FATCA regulations in lieu of the definition of 'controlling person', and then provide details of any substantial US owners.

The term 'controlling person' under the IGA means:

- 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.

However, under the FATCA regulations the term 'substantial US owner' means, in the case of a trust:

- any specified US person treated as an owner of any portion of the trust under the US grantor trust rules; and
- any specified US person that holds, directly or indirectly, more than 10% of the beneficial interests of the trust.

The regulations further provide that a person holds a beneficial interest in a non-US trust if such person has the right to receive directly or indirectly (eg, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust. The Cayman Islands entity self-certification template, Section 3 of the US FATCA classification, specifically notes that this choice of definitions is available. Not all financial institutions include this information on their self-certification forms, but the choice is available nonetheless.

A US protector has no personal tax liability or tax reporting obligations merely as a result of being named as protector of a non-US trust. Consequently, the United States is not interested in collecting such information under FATCA. If trustees are aware of the FATCA rules with respect to using definitions under the FATCA regulations in lieu of definitions in the IGA, they do not unnecessarily have to gather or disclose personal tax information for a protector.

CRS requires reporting of protectors tax resident in CRS partner jurisdiction

The CRS Implementation Handbook explains that in the case of a trust (and entities equivalent to trusts), the term 'controlling person' is explicitly defined in the CRS to mean "the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust". The entity self-certification forms used by requesting financial institutions all request information for the protector of a trust.

On October 1 2015 the Society of Trusts and Estates Practitioners (STEP) met with representatives of the OECD secretariat team responsible for the handbook. STEP commented in that meeting that it was misleading to state in the handbook that it is the protector who enforces and monitors the trustees' actions. STEP described the role of a trust protector and stressed that protectors have no personal tax liability or tax reporting obligation with respect to the trusts for which they serve. Moreover, the jurisdiction in which the protector is resident has no taxing interest in the trust. STEP concluded that:

> "*On the basis that the exchange of information under the CRS is intended to enable tax authorities to determine whether residents in their jurisdiction have a tax liability by reference to financial accounts they hold, it is difficult to see the justification for providing information about protectors with no control over and no financial interest in the trust.*"

STEP specifically asked whether the better solution would be to provide information only about protectors who are also beneficiaries.

The OECD secretariat responded that it did not want to provide for a protector to be identified by reference to the powers held or whether the protector is a beneficiary. It confirmed that it is necessary to disclose information about any person who is simply named a protector. The secretariat acknowledged that if a person who is not identified as a protector has power over the trust it may mean that information about such other person is not disclosed. The secretariat said to STEP that it is up to the reporting financial institution, where that financial institution has information on the type of controlling person the account holder is, to include such information in the report. The secretariat believes that doing so will enable the tax administration receiving the information to make appropriate use of the information in tax compliance actions.

In its CRS-related frequently asked questions (FAQs) dated June 2016, the OECD responded to the question: "Are protectors of a trust that is a Reporting Financial Institution considered to be Account Holders of the trust in all instances or only in circumstances where their powers are such that they could be regarded as exercising control over the trust?" The response says, in no uncertain terms: "The protector must be treated as an Account Holder irrespective of whether it has effective control over the trust." As a result, although a trustee-documented trust is technically a non-reporting financial institution, the safer approach is for the trustee to report protectors who are tax resident in a CRS partner jurisdiction.

Protector committee does not eliminate CRS reporting

Given the breadth of the OECD secretariat's view, it is difficult under the CRS to take the position that several individuals serving as a protector committee would not have to be reported simply because no single individual can control the decisions of the protector, while a single protector would have to be reported. The CRS Implementation Handbook uses the term 'protector(s)', which seems to reference all persons serving as protectors. STEP appears to have the same understanding since it pointed out to the OECD secretariat that many trusts have not just one protector but a number of protectors forming a committee, "requiring information about the trust having to be provided to each jurisdiction where a protector is resident", which will result in substantial disclosure to jurisdictions that have no taxing interest.

Tax identification number not required if protector not tax resident in CRS partner jurisdiction

In another of the June 2016 FAQs the OECD stated that if a controlling person is not a reportable jurisdiction person, meaning that the individual is not tax resident in a CRS partner jurisdiction, the tax identification number need not be collected from such controlling person. This is particularly relevant where the protector is a US person. As mentioned above, in the FATCA section of the entity self-certification, a trustee can choose to use the 'substantial US owner' definition in lieu of the 'controlling person' definition under the IGA and not disclose a US protector. However, in the CRS section of the entity self-certification, when the trust is classified as a passive NFFE or treated as a passive NFFE because it is tax resident in the United States, information on the protector must be provided. A US individual's tax identification number is that person's social security number. The US Social Security Administration keeps all records confidential and warns US individuals to be careful about sharing the number, even when asked for it. Providing this number, together with a protector's address and date of birth, results in an increased risk of identity theft.

Options going forward

Since many existing trusts have a protector, there is little that can be done with respect to the 2016 reporting year, which will be the first year of information to be reported by many CRS partner jurisdictions in 2017. Protectors, who may not even be tax resident in the same country as the trust's settlor and beneficiaries, will be reported under the CRS. The OECD secretariat confirmed to STEP that protectors should be included in Table 7 of the CRS Implementation Handbook when the trust is a financial institution, as they are in Table 8 when the trust is a passive NFE. Thus, the total account value or balance will be reported to the protector's country of tax residence, even though the protector will have no personal tax liability as regards the trust. Hopefully, as the CRS partner jurisdictions begin to bring their reporting portals online, they will include fields that allow for information on the type of controlling person being reported. The family's advisers and trustees should discuss the CRS reporting obligations with the family's trust protectors, and offer support in the hopefully unlikely event that such a report triggers an inquiry by the tax authorities.

Going forward, it may be possible to draft trust instruments with a 'power holder', not called a protector, who holds a non-controlling, non-fiduciary power to remove and replace a trustee. However, the OECD secretariat noted to STEP that if the use of power holders not identified as the protector results in people finding ways to get around the disclosure obligations, the CRS rules may be updated to include such other power holders. As an alternative, rather than including the power to remove and replace a trustee in the trust instrument itself, commercial trust companies could provide in their services contract for a designated individual who can remove and replace the trustee pursuant to the terms of the contract. In such a situation, instead of involving a person who exercises control over the trust, the trustee would agree contractually to step aside if instructed to do so by a party to the services agreement.

It may also be possible to use a carefully crafted entity protector, keeping in mind that the trustee of a trustee-documented trust will need to identify the controlling persons of that entity to see whether they are tax resident in a CRS partner jurisdiction.

An analysis comparing the legal work required to establish and maintain an arrangement different from the traditional protector appointed in the trust instrument with disclosure to a jurisdiction that has no taxing interest in the protector, will have to be weighed in each family's particular circumstances.

Comment

It is unfortunate that the CRS requires disclosure of trust protectors who contributed no money to the trust, have no beneficial interest in the trust (the terms of which may even expressly prohibit the protector from benefiting) and have no effective control over the trust. CRS reporting may discourage individuals from accepting the role of protector, to the detriment of families creating modern, healthy governance structures for the trusts they create. Perhaps the taxing authorities receiving the information will merely note that they have no taxing interest in the protector and file that information away. Alternatively, time and resources may be wasted making useless inquiries based on the CRS report. Perhaps more troubling, there is also a risk that corrupt government employees may attempt to use or disclose confidential information gained in the course of their employment for personal financial gain. In its introduction to the CRS, the OECD remarked that countries have a shared interest in maintaining the integrity of their tax systems. Hopefully, countries receiving information under CRS take this admonition seriously. Collecting information on protectors who have no personal tax liability or tax reporting obligations with respect to the trust assets they have agreed to safeguard does nothing to further the fight against tax evasion or strengthen the integrity of tax systems. But it appears that this information collection is here to stay.

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