Time for non-US trustee companies and their trusts to prepare for FATCA

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Introduction

It is time for advisers to international families to assess the classifications of the family office, trust company, trusts and holding companies within the family's succession planning structures under the Foreign Account Tax Compliance Act (FATCA) and any relevant intergovernmental agreements, regardless of whether such entities currently have US owners, beneficiaries or investments. The reach of possible FATCA withholding for failure to comply is broad, but this need not result in every entity within the structure being registered with the Internal Revenue Service (IRS). At a minimum, non-US entities will have to provide a certification to the financial institutions with which they deal stating their classification as non-financial foreign entities (NFFEs) with no US owners. Other non-US structures will need to determine which entity within the structure will handle their FATCA due diligence and reporting of US persons, if any.

On July 12 2013 the IRS announced that it will publish Notice 2013-43 on July 29 in order to delay for six months the start of FATCA withholding (to payments made after June 30 2014) and the implementation of new account opening procedures, as well as related requirements to comply with FATCA. The notice will also extend the registration timeline, with the registration portal expected to open on August 19 2013. Even though deadlines are being extended, FATCA assessment should not be delayed.

Background

Much has been written on FATCA and its final regulations and the intergovernmental agreements. This update addresses the application of FATCA to non-US succession planning structures utilising the services of a professional trust company or a private trust company established by the family to serve as trustee. Although many people are unhappy with the worldwide imposition of FATCA, it is not only the United States that is looking to gather information on the offshore financial activities of its citizens. Financial institutions will soon be collecting identifying information on everyone with whom they conduct business. US persons will be reported to the IRS. The UK crown dependencies and overseas territories will report UK persons to Her Majesty's Revenue & Customs (HMRC), and eventually other nations will also require

reporting on their tax residents. The result is that every trustee company – both professional and private – will need to determine its FATCA status. Questions still remain, but a review of the FATCA final regulations, IRS revisions to draft model intergovernmental agreements and draft forms for financial institution registration (Form 8957) and certificate of FATCA status (Form W-8BEN-E), plus HMRC guidance on implementation of the UK Model 1 intergovernmental agreement, indicate that opportunities exist for structures benefitting non-US families to avoid FATCA withholding without registering all entities within the structure.

Relevant FATCA jurisdiction

An entity is considered a US entity only if it was created under the laws of a US state (or the District of Columbia). A trust is considered a US entity only if it meets both the court test and the control test (for details please see the Overview (May 2013)). Any entity or trust that is not a US entity will be 'foreign' for FATCA purposes.

A foreign trustee company must determine whether it is governed by:

- a Model 1 intergovernmental agreement;
- a Model 2 intergovernmental agreement, together with the FATCA final regulations; or
- the FATCA final regulations only.

This determination is important because reporting foreign financial institutions (FFIs) under the FATCA final regulations and under a Model 2 intergovernmental agreement must register and enter into a FATCA agreement with the IRS, whereas under a Model 1 intergovernmental agreement the reporting FFI registers to obtain a global intermediary identification number, but is not required to enter into a FATCA agreement with the IRS.

With a foreign private trustee company, that determination should be fairly straightforward, as the private trustee company is organised under the laws of a particular offshore jurisdiction and is generally considered resident in that jurisdiction for tax purposes. However, consideration must be given to situations where the private trustee company is controlled by a family office in another country. Likewise, a professional trustee company may have an office in an onshore jurisdiction that handles the operations for the trust company organised in an offshore jurisdiction.

The final terms of the particular intergovernmental agreements must be examined in order to determine applicability. This is challenging given that many jurisdictions have not yet finalised their intergovernmental agreements with the United States and guidance has not been issued clarifying the application of one or more intergovernmental agreements in potentially overlapping circumstances. The model intergovernmental agreements (updated May 9 2013) allow a choice in defining a financial institution of the country signing the agreement between one that is "resident in" and one that is "organized under the laws of" the country signing the agreement. Thus far, most intergovernmental agreements define a 'financial institution' as one that is "resident in" the country signing the agreement (although the Swiss intergovernmental agreement defines a 'Swiss financial institution' as one that is organised under the laws of Switzerland). 'Corporate residence' is not defined in the intergovernmental agreements, so its meaning must be determined under local law. The HMRC guidance notes to the UK Model 1 intergovernmental agreement states that HMRC will look to the tax residence of the entity; for a professional trust company, this means a company incorporated in or centrally managed or controlled in the United Kingdom. The intergovernmental agreements are designed to apply on a branch level so that branches of a domestic financial institution located elsewhere are excluded and branches of another country's financial institution operating domestically are included.

Rather than country of residence in general or country of organisation, the draft Form 8957 FATCA registration specifically asks for the FFI's country of residence for tax purposes and its FATCA classification in its country of tax residence. Every corporate entity is tax resident somewhere – this is the place to start a FATCA analysis. Planning can and should be done even before a jurisdiction has an effective intergovernmental agreement in place.

FATCA classification of trustee companies

Every foreign entity will be classified for FATCA purposes as either an FFI or an NFFE.

Professional trustee companies

Non-US professional trustee companies are FFIs. Under the FATCA final regulations, a professional trustee company is a financial institution because it falls under the definition of an 'investment entity'. Under both the Model 1 and Model 2 intergovernmental agreements, a professional trustee company is also a financial institution, but it is unclear whether this is because it is a custodial institution (an entity that is paid to hold financial assets for the account of others) and/or an investment entity. It is hoped that the IRS or the partner jurisdictions will clarify this point and apply it consistently across the participating jurisdictions. At present, HMRC guidance notes to the UK Model 1 intergovernmental agreement list "trust companies" as an example of a possible custodial institution, but generally the understanding has been that trustee companies are better classified as investment entities.

Regardless of the exact category of FFI, since both model intergovernmental agreements require a financial institution to register with the IRS, professional trustee companies either are currently or should be undertaking due diligence and preparing to register through the IRS portal using Form 8957 (currently in draft form only).

Even professional trust companies that act as trustees only of trusts where no US persons are involved should plan to register in order to comply under their country's intergovernmental agreement, or to avoid FATCA withholding for failure to document that they have no US owners or account holders. In fact, such a trustee company will have no US person to report, but that is irrelevant to the classification as a financial institution or the requirement to register under the intergovernmental agreement. For example, Article 3 of the Swiss Model 2 intergovernmental agreement states that Switzerland shall direct all reporting Swiss financial institutions to register with the IRS by January 1 2014, and to agree to comply with the requirements of an FFI agreement, including with respect to due diligence, reporting and withholding. It is clear that this includes all Swiss institutions, regardless of whether they do business with US persons.

The trustee company, especially a professional trustee company, will usually maintain its own bank and investment accounts to hold the fees that it receives for trustee services. As a registered FFI, it will be easy for the trustee company to provide its financial professionals with Form W-8BEN-E certifying that it is a participating FFI or a reporting Model 1 FFI and thus avoid FATCA withholding.

Private trustee companies

Sometimes a family will create a private trustee company to act as trustee only for trusts benefiting the family. Depending on the particular family structure, it may make sense for the private trustee company to register with the IRS and maintain the due diligence on the family structure, reporting US persons as necessary. On the other hand, for non-US family structures where the private trustee company acts as the trustee of a family trust that holds only the stock of one or more holding companies, which themselves own holding companies or operating companies, it may be preferable to ensure that the structure is non-financial.

Private trustee companies are frequently established in offshore jurisdictions, the vast majority of which appear to be contemplating entering into intergovernmental agreements. Thus far, the British Virgin Islands and the Cayman Islands have indicated that they intend to enter into Model 1 intergovernmental agreements and Bermuda is negotiating a Model 2 intergovernmental agreement. The Bahamas also intends to enter into an intergovernmental agreement, although which model has not yet been announced. Thus, the following analysis is based on a private trustee company in an intergovernmental agreement offshore jurisdiction.

A private trustee company will be an NFFE if it is not an FFI. As an NFFE, the private trustee company must still certify its FATCA status to withholding agents, but it is not subject to FATCA due diligence, reporting and withholding. If the NFFE does in fact have US owners, they will be reported on the Form W-8BEN-E certification. To be classified as an NFFE, the private trustee company must fall outside the definition of a 'financial institution', which includes both a custodial institution and an investment entity. A custodial institution holds, as a substantial portion of its business, financial assets for the account of others. It holds financial assets for the account of others as a substantial portion of its business if its gross income is attributable to the holding of financial assets and related financial services (there is a

percentage test that is irrelevant in most private trustee company situations because the only income comes from the family trusts). An investment entity conducts as a business, for or on behalf of a customer, certain investment activities, including "otherwise investing, administering, or managing funds or money on behalf of other persons".

Private trustee companies that receive no trustee fees from the family trusts may be able to take the position that they are not conducting a business. In that situation, such a trustee might be reimbursed for its expenses pursuant to the terms of the trust. This position is further strengthened if the service agreement between the private trustee company and each of the family trusts states that:

- the trustee company is to act as trustee, but will not take custody of financial assets – in many cases an individual or the transfer agent can hold share certificates and other evidence of any financial assets (under most trust documents, the trustee has the power to appoint agents and delegate powers); and
- the trustee company will not provide investment services, including portfolio management or otherwise investing, administering or managing funds or money on behalf of the trusts, and that it acts solely in its capacity as shareholder of underlying assets, not as an investment adviser.

An investment entity also includes an entity that is managed by an entity that conducts as a business one or more of the specified investment management activities or operations, for or on behalf of a customer. The private trustee company must be a passive entity that is not professionally managed to be classified as an NFFE. In general, a private trustee company's only asset is a deposit account holding a small amount of money to pay expenses. It has no investment assets and therefore no need for an investment account, financial adviser or third-party administrator.

The shares of the private trustee company may be owned by a purpose trust. Although there is currently no guidance on this point, it is hoped that there will be clarification that such a purpose trust is classified for FATCA purposes as a passive non-financial entity, since it has no investable assets and its purpose is to passively hold the trustee company's shares. The trustee of the purpose trust, even if a professional trust company, is not providing investment management services in this context, although it arguably provides some general trust management.

As an NFFE, the private trustee company would not have to register with the IRS and would not fall within the scope of the intergovernmental agreement. If the private trustee company needed to open a checking account with an FFI, it could self-certify to the bank on Form W-8BEN-E that it is an NFFE.

Business opportunities

Trustee companies registered with the IRS will have a business opportunity to provide FATCA due diligence and record keeping for the trusts of which they are trustees. Many families will find this preferable to registering the trust itself. The trustee companies should already have most of the relevant due diligence through their anti-money laundering, anti-terrorism and know-your-client efforts.

Because a trust can use a third-party service provider to meet its obligations under an FFI agreement, family offices will have a business opportunity to provide FATCA services. A FATCA analysis must be performed for the family office itself where the office provides investment advice or oversees portfolio management, or even simply administers all the investment records and carries out instructions from the family's investment officer or committee.

FATCA classification of trusts

Trusts are entities for FATCA purposes and thus will have a FATCA classification. Where its trustee is a professional trustee company and registered as an FFI, the trust will be an FFI as an investment entity that is managed by a financial institution. Where the trustee is a private trustee company that falls into the NFFE classification, the trust can also be an NFFE, if it is not otherwise managed by a financial institution.

It should follow that a trust with an individual trustee or NFFE private trust company as trustee does not jeopardise its own NFFE status merely by opening a financial account to hold trust assets. The HMRC guidance notes to the UK Model 1 intergovernmental agreement state that a trust that simply holds a financial account with a financial institution (eg, a

depository or custodial account), where the financial institution does not participate in the management of the trust or financial assets, would not make the trust an investment entity. It is hoped that this will be clarified with respect to intergovernmental agreements in other jurisdictions, but it is currently uncertain. For simple family trust structures, the foreign trust with an individual or NFFE private trust company as trustee would provide the financial institution with a Form W-8BEN-E showing that the trust is a passive NFFE and certifying that it has no substantial US owners (or providing the name, address and tax identification number of each substantial US owner of the NFFE). The financial institution would then determine whether the account is a US reportable account. The trust's investment director, often a family member, a trusted adviser or a committee consisting of both, would give investment instructions.

Holding company FATCA classification

Often, rather than the trust itself opening the depository or custodial investment account, the trust capitalises one or more foreign holding companies, which then own the trust fund assets. Where a holding company owns only the stock of another holding company or an operating company, it may be classified as an NFFE. However, where the company holds an investment portfolio that is professionally managed or the trust that is its sole stockholder is an FFI, the company may be an FFI.

Certifying FATCA status and avoiding withholding

As mentioned above, a registered FFI (eg, a professional trustee company) can easily provide Form W-8BEN-E with its global intermediary identification number when requested. If the family does not wish to register the underlying trust or companies, and if those entities are classified as FFIs, the entities need to consider the options for becoming "deemed compliant".

Sponsored deemed-compliant

Under the existing rules, the straightforward sponsored deemed-compliant FFI classification still requires registration of the sponsored entity (although this registration by the sponsor is delayed initially). Where the trust has US beneficiaries, this may be fine, as the trust itself is being reported to the IRS on Form 3520 whenever US beneficiaries receive a distribution (for details please see the Overview (May 2013)). If the registered FFI trustee company also registers as a sponsoring entity then, with respect to any entity of which that trustee company can manage and enter into contracts, the trustee company can act as the entity's FATCA sponsor and agree to collect all due diligence, maintain the records and report US persons as necessary. Although the initial registration as a sponsor does not call for a list of the entities that the registrant is sponsoring, eventually the sponsor will be required to register all its sponsored entities with the IRS. An exception is that the Bahamas has negotiated for its trustee companies the ability to sponsor its trusts without having to register them. It is possible that other jurisdictions currently negotiating with the IRS may broker a similar arrangement.

Trustee documented FFI

As with the Bahamas exception, it appears that the UK Model 1 intergovernmental agreement will have a trustee documented FFI classification for trusts where the trustee is a reporting Model 1 FFI, a participating FFI or a reporting US financial institution. Pursuant to the HMRC guidance notes, in such cases the trustee will not have to register each trust. The trust will be classified as a non-reporting UK financial institution and thus compliant under the UK intergovernmental agreement. It is hoped that this will be applied to other intergovernmental agreement jurisdictions.

Sponsored closely held investment vehicle

Although this is a sponsored classification, it does not require the sponsor to register the sponsored entity. It is not yet certain how this will be applied to trusts, but it should be available based on the description in the FATCA final regulations.

Owner-documented FFI

Especially for structures with straightforward investment portfolios, the trust or holding company that is classified as an FFI can avoid registration if it is deemed compliant as an owner-documented FFI as to each of the financial institutions with which it has accounts. The relevant financial entity must agree to act as a specified withholding agent and report any

US persons. This classification also requires the trust or holding company to provide the financial institution with information on its US and non-US equity owners. Alternatively, it will be possible to provide information only on US persons along with a letter from an auditor or an attorney that is licensed in the United States or whose firm has a location in the United States certifying that the trust or company meets the owner-documented requirements. While some commentators hold the view that this letter will be expensive to provide, attorneys with deep knowledge regarding FATCA and significant experience in the area of offshore trust planning should be able to provide such documentation in a cost-effective manner.

For a simple structure where an FFI trust company is a trustee of a trust holding only the stock of a foreign holding company, where no payments come into the trust from other sources, and both the trustee and the trust wish to comply with their local intergovernmental agreement, the trust may be able to be owner documented as to the FFI trustee company, provided that the registered FFI trustee agrees to act as specified withholding agent for the trust. Guidance is still needed to confirm and clarify the steps for accomplishing owner documentation in these circumstances.

Comment

There is no one solution when it comes to FATCA and non-US trust structures. Advisers to international families creating and maintaining these succession planning solutions must begin now to determine how each entity in the structure will become compliant under the relevant local FATCA intergovernmental agreement and be able to complete Form W-8BEN-E accurately certifying its FATCA status. While much initial hand-wringing concerning FATCA focused on its undeniable breadth and the expense associated with understanding and complying with its provisions, on more thoughtful reflection and consideration of the positions taken by HMRC and revised drafts of the IRS forms and models, it is clear that there are options for many typical planning structures that will not require registration with the IRS of every entity in the structure in situations where those structures do not yet include US beneficiaries.

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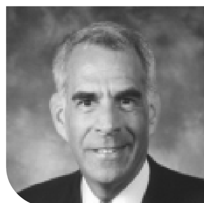
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