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IRS revises FATCA model intergovernmental agreements

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Introduction

The Internal Revenue Service (IRS) recently posted to its website updated model intergovernmental agreements (dated July 18 2013), which it is using to implement the 2010 Foreign Account Tax Compliance Act (FATCA). Changes to the model agreements highlight the IRS's current thinking as implementation moves forward. Most interesting to note with regard to non-US trust structures is a new category of deemed-compliant foreign financial institution - the trustee-documented trust.

Background

Certain foreign financial institutions (FFIs) described in Annex II to the model agreements are classified as non-reporting FATCA partner financial institutions. As such, they are deemed-compliant FFIs for purposes of FATCA and will be treated as having met their FATCA reporting requirements and withholding obligations. Thus, a registered deemed-compliant FFI can certify its FATCA status to any withholding agent on Form W-8BEN-E and avoid the 30% withholding. The IRS recently delayed 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 (for further details please see "Time for non-US trustee companies and their trusts to prepare for FATCA").

Characteristics of trustee-documented trust

The FATCA final regulations do not include the trustee-documented trust option in the deemed-compliant FFI provisions. Nevertheless, as of July 18 2013, the updated Annex II to the FATCA intergovernmental agreement models adds a trustee-documented trust in the deemed-compliant category. To qualify, the trust must:

- be established under the laws of the FATCA partner jurisdiction; and
- have as the trustee:
  - a reporting US financial institution;
  - a reporting Model 1 FFI; or
  - a participating FFI.

That trustee must report all information required to be reported pursuant to the intergovernmental agreement with respect to all US reportable accounts of the trust.

Trust must be investment entity

The trustee-documented trust classification is open to trusts that are financial institutions. Since trusts are entities for FATCA purposes, they will have a FATCA classification. This classification is not necessarily the same for every trust. Where the trustee of a foreign trust is a professional trustee company, the trust itself will be an investment entity because it is managed by a financial institution, and thus classified as an FFI. Where the trustee is

an individual or a private trustee company, the non-US trust may instead be classified as a non-financial foreign entity (NFFE) if it is not otherwise managed by a financial institution (eg, a professional investment manager). As an NFFE, the trust can avoid FATCA withholding by self-certifying to any withholding agent that it is a foreign entity that is not a financial institution and either identify its substantial US owners or certify that it has none.

Although a trust with an individual trustee and a professional investment manager will be classified as an investment entity for FATCA purposes, the trustee-documented trust classification is available only to trusts with financial institution trustees. This means that an FFI trust without a financial institution trustee will need to qualify under a different FATCA classification to avoid withholding (for further details please see "Time for non-US trustee companies and their trusts to prepare for FATCA").

Governing law

In order to take advantage of the trustee-documented trust classification, the trust itself must be established in a jurisdiction with a FATCA intergovernmental agreement that includes this provision in Annex II. Annex II to both the updated Model 1 and Model 2 agreements includes a trustee-documented trust. As discussed below, it would seem reasonable that the existing intergovernmental agreements, such as those with Switzerland (Model 2) and the United Kingdom (Model 1) will be updated to include this classification as well.

FATCA-compliant trustee

It appears to be unnecessary for the trustee to be organised or resident in the same jurisdiction as the trust in order for the trust to qualify for the trustee-documented trust FATCA classification. It also appears that the trustee need not be in a jurisdiction with a FATCA intergovernmental agreement.

The requirement that the trust have as trustee a participating FFI can be met by a trustee company (professional or private) that has registered with the IRS and entered into an FFI agreement pursuant to the terms of the FATCA final regulations. It also can be met by a trustee company in a Model 2 jurisdiction that has registered and entered into an FFI agreement pursuant to the Model 2 intergovernmental agreement or a trustee

company in a Model 1 jurisdiction. At present, reporting Model 1 FFIs would include trustee companies in the United Kingdom, Denmark, Germany, Ireland, Mexico, Norway and Spain. The Bahamas, the British Virgin Islands and the Cayman Islands have also indicated that they will enter into Model 1 intergovernmental agreements. Switzerland and Japan have entered into Model 2 intergovernmental agreements. Jersey, Guernsey and the Isle of Man are each working on finalising an agreement with the IRS similar to the UK agreement (Model 1), which it seems reasonable to assume will include an Annex II with the trustee-documented trust deemed-compliant FFI category. Thus, for example, it appears likely that a Jersey trust with a Swiss trustee company as trustee could be a trustee-documented trust for FATCA purposes.

US reportable accounts of trust

As a non-reporting FATCA partner financial institution, the trust itself will not be required to register with the IRS. Its trustee, which will be registered with the IRS, will report all information required with regard to the US reportable accounts of the trust. A 'US reportable account' means a financial account held by one or more specified US persons or by a non-US entity with one or more controlling persons who is a specified US person.

Under the Model 2 intergovernmental agreement, the term 'financial account' has the meaning set out in the FATCA final regulations. Under those regulations, a financial account includes an equity or debt interest in an investment entity. In the case of a trust, an equity interest in a trust 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 pursuant to the terms of the trust;
- a beneficiary who may receive a discretionary distribution from the trust at the discretion of the trustee or a person with a limited power of appointment, but only if such person receives a distribution in the calendar year.

Under the Model 1 intergovernmental agreement, the meaning of an equity interest in a trust is different. As in the FATCA final regulations, under the Model 1 agreement, a financial account includes, in the case of an entity that is a financial institution solely because it is an investment entity (as is the case with a non-US trust that has a professional trustee company as trustee), any equity or debt interest in that financial institution (ie, the trust). However, under the Model 1 agreement, 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.

A specified US person is treated under the Model 1 agreement as being a beneficiary of a trust if such person "has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution *or may receive*, directly or indirectly, a discretionary distribution from the trust" (emphasis added). The wording 'may receive' applied to a discretionary distribution, without the clause 'but only if such person receives a distribution in the calendar year', seems to result in the reporting of all US discretionary beneficiaries, regardless of whether they receive a distribution. In general, US beneficiaries of foreign trusts are required to report to the IRS only distributions received and known interests in foreign trusts if their specified foreign financial assets meet certain reporting thresholds (for further details please see "New guidance and forms to report foreign accounts and use of trust property" and "IRS releases new form to report specified foreign financial assets").

The regulations to the UK Model 1 FATCA intergovernmental agreement repeat the definition of 'equity interest' with the 'may receive' language. However, Her Majesty's Revenue & Customs (HMRC) guidance notes to the agreement state that the information to be reported in relation to trusts that are investment entities will be the equity interest in the trust and this applies to interests held by "a beneficiary that *receives* a discretionary distribution from the trust in the calendar year". The guidance further provides that payments to be reported are the total gross amounts paid or credited to "beneficiaries who receive mandatory or discretionary distributions during the calendar year" and a specified US person shall be

treated as being a beneficiary of a trust if such person has the "right to receive directly, or indirectly a mandatory or discretionary distribution" from the trust. Arguably, a US discretionary beneficiary who has not received a distribution does not have a "right to receive" a discretionary distribution.

The HMRC guidance notes conform the UK Model 1 language with that of the FATCA final regulations and the Model 2 intergovernmental agreements. This is the correct approach and it is hoped that the IRS will clarify that only US discretionary beneficiaries receiving distributions from trustee-documented trusts need be reported to the IRS by the trustee.

Information to be reported pursuant to intergovernmental agreement

It appears that the information to be reported with respect to a trustee-documented trust is that which is required pursuant to the intergovernmental agreement of the jurisdiction where the trust is established. The information required under the model agreements and the final regulations is substantially the same.

The trustee is required to report the following information with respect to an equity interest in a trust held by a US person:

- the name, address and US tax identification number of the US person;
- the value of the equity interest;
- the gross amounts paid or credited to the US person during the calendar year; and
- such other information as may be required by Form 8966, FATCA report (not yet released).

Application to existing intergovernmental agreements

All the intergovernmental agreements concluded to date provide that, in certain circumstances, a partner jurisdiction is entitled to the benefit of any more favourable provision to which the United States agrees in a comparable agreement with another partner jurisdiction (typically referred to as a 'most favoured nation' clause). Some also include a coordinating provision providing that a partner jurisdiction may permit its FFIs to use a definition in the relevant FATCA final regulations in lieu of a corresponding definition in the intergovernmental agreement, provided that such

application would not frustrate the purposes of the agreement. Hopefully, as a result of these provisions, or the agreement of the parties to amend existing intergovernmental agreements, the trustee-documented trust will be available to trusts with FFI trustees in all FATCA partner jurisdictions.

Comment

The inclusion of a trustee-documented trust as a deemed-compliant FFI is a positive development. It is still cumbersome to apply the FATCA rules designed for custodial and depository institutions with their straightforward accountholders to trusts, beneficiaries and trustee companies, but the trustee-documented trust will allow international families to place the trust's FATCA compliance in the hands of their professional trustee company, which already maintains 'know your client' and anti-money laundering due diligence, and thus avoid the 30% FATCA withholding on the trust's US investments.

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