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FATCA reporting – are trusts and trustees caught in the net?

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The US Congress enacted the Foreign Account Tax Compliance Act (FATCA) shortly after the first so-called 'voluntary disclosure program' had begun to reveal the unanticipated extent of US persons' undisclosed non-US financial holdings. Congress sought a way to catch even the most obscure unreported financial account. Enter FATCA. When first enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, private practitioners, banks, and other deposit institutions were slow to understand the potential extent of FATCA's reach. The statute, which seeks to coerce beneficial owner disclosure on penalty of a 30 percent withholding tax on certain US-source payments, appeared impossible to implement, and many practitioners (and even some in government) doubted whether FATCA could ever come to fruition. However, the Internal Revenue Service (IRS) and Department of Treasury (Treasury) have worked tirelessly (and some would say ruthlessly) to ensure that FATCA reporting begins in some form by 2014 (which is the current date for initial implementation, although it could again slide, as it has before).

In January 2013, the IRS published the much anticipated final regulations to the Internal Revenue Code that will govern the US implementation of FATCA. In spite of their length (nearly

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500 pages), the final regulations have been widely criticised as lacking clear guidance on key points, including, in particular, the classification of non-US trusts and their trustees for purposes of the disclosure and withholding regime (unless otherwise indicated, this article uses 'trustee' to mean 'corporate trustee' or 'trust company'). On the international front, Treasury, realising there was much to gain and little to lose by getting its principal trading partners to join the disclosure effort, has begun to negotiate two types of 'Inter-Governmental Agreements' (IGAs), which offer a way to either circumvent the regulations entirely (Model I IGAs), or at least trump them when conflict exists (Model II IGAs). Though the terms of the model IGAs are only marginally more 'user friendly' than the regulations, some countries see them as an opportunity for obtaining greater clarity and, in some cases, achieving reciprocity of potential tax avoidance disclosure reporting from the United States. To date, five countries have entered into an IGA with the United States, and numerous other countries are in the midst of negotiations. This article chiefly addresses FATCA reporting pursuant to the regulations, although it notes a few instances where conflict between the regulations and the IGAs appears to exist.

As stated, at its core, FATCA seeks to induce compliance by threatening a penalty-like withholding regime. The statute imposes 30 percent withholding on certain US source payments (including gross proceeds, so it is not correct to call the impost a 'tax') to foreign financial institutions (FFIs) that fail to enter into an agreement with the IRS to report certain required information. Certain non-financial foreign entities (NFFEs) (i.e., effectively any foreign entity that is not an FFI) may also be subject to withholding if they fail to satisfy certain generally lower reporting obligations.

The FATCA regulations classify a non-US entity (generally defined by the regulations to exclude an individual, but an IGA may include an individual in limited instances; the United Kingdom would include an individual acting in a professional legal capacity, e.g., a solicitor acting as a trustee) as an FFI in three principal situations: (i) where the entity accepts deposits in the ordinary course of a banking or similar business; (ii) where the entity holds financial assets for the accounts of others, in a custodial capacity, as a substantial portion of its business; or (iii) where the entity engages in investment transactions (broadly defined) for its customers. A corporate trustee generally does not accept deposits or similar investments from its 'customers', so it is not likely to be considered a depositary FFI. Prior to the final regulations, both private practitioners and the IRS believed that trust companies would qualify as FFIs under the custodial institution provision. However, the final regulations clarify that income derived as fees for providing fiduciary services is not considered income "attributable to holding financial assets". Thus, a trustee must actually act as a money manager to become an FFI under the custodial institution provision, which is clearly not what trustees do.

Accordingly, the IRS will consider a trustee to be an FFI under the investment entity provision, and did so, without explanation, in an example in the regulations. An investment entity is one that engages primarily in trading, portfolio management, or investing, administering, or managing funds on behalf of its 'customers'. Whether one must stretch the definition of "investing, administering, or managing funds" to include the fiduciary services of a trustee is immaterial. The IRS clearly wishes to define trustees as FFIs, and only the definition of an investment entity can realistically capture them. Thus, unless a trustee earns at least 50 percent of its gross income from other sources, it will be treated as an investment entity FFI.

One must also consider whether a trust itself constitutes an FFI or an NFFE. This enquiry applies primarily to trusts considered 'non-grantor trusts', for US tax purposes. The regulations imply, though do not specifically state, that a grantor trust 'owned' for US tax purposes by an individual is an account, not an FFI or NFFE. For grantor trusts considered owned by entities, as well as for non-grantor trusts, it is necessary to ascertain whether the trustee is an entity or an individual to determine whether the trust is an FFI or an

NFFE. As noted above, only an 'entity' may qualify as an FFI under the regulations. If an individual trustee manages the assets of a trust, the trust will be considered an NFFE. The trust becomes an FFI only if its assets are managed by a trustee that is an investment entity, unless the trust holds assets that are primarily non-financial in nature, such as real estate or art.

To avoid FATCA's 30 percent withholding penalty, an FFI must enter into an agreement with the IRS whereby it agrees to provide detailed identifying reports on its US account holders, close accounts of holders who refuse to provide identifying information to the FFI, and ultimately withhold on certain 'passthru payments' (which is not due to be required until 2017). In limited circumstances, alternatives to a full FFI agreement exist. For example, in the case of smaller trusts, the regulations permit certain trustees to comply with the FFI obligations of its FFI trusts. The trustee does so by registering as a 'sponsoring FFI' and obtaining an independent identification number for FATCA reporting purposes. Also, in limited instances, a trust may obtain classification as an 'owner documented FFI' and avoid identifying its non-US beneficiaries.

Unlike an FFI, a passive NFFE (all trust NFFEs are by definition passive) does not enter into a formal agreement with the IRS. Instead, a NFFE complies with FATCA by certifying to US withholding agents or FFIs with whom it maintains accounts (on IRS forms yet to be released) that less than 10 percent of its interests are owned directly or indirectly by US persons. Otherwise, the NFFE must identify its substantial US owners in considerable detail. If a NFFE is partly owned by a grantor trust, it looks to the identity of the trust's 'owner' for purposes of certification, if the owner is a US person. If that is not the case, the NFFE must identify whether the trust's beneficiaries are US persons for certification purposes. A discretionary beneficiary who has received distributions amounting to less than 10 percent of the value of all distributions by the trust in a taxable year will not be considered to hold more than 10 percent of the trust for that year. Thus, an NFFE's substantial US owners may change each year.

In summary, despite their voluminous detail, the final FATCA regulations remain open to interpretation, particularly as they apply to trustees and trusts. Thus, further guidance can be expected as the FATCA regime is implemented in the ensuing years. ■