



## TAXATION

## FATCA in a Nutshell for Foreign Trusts, Trustees and Beneficiaries

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The Internal Revenue Code (the Code)<sup>1</sup> generally imposes income tax reporting requirements on all U.S. persons<sup>2</sup> (U.S. persons) and certain foreign persons with sufficient nexus to the United States.<sup>3</sup>

The United States is the only jurisdiction that taxes (at full rates) its citizens and green card holders on income they earn anywhere in the world, regardless of where they reside and whether or not they are subject to tax by their country of residence. Thus, for example, a U.S. citizen residing in London must comply fully with the tax rules of both the United States and the United Kingdom. Although there are certain mechanisms available under the U.S. tax laws to avoid double taxation or reduce the tax burden, U.S. persons must often spend enormous amounts of time, as well as economic resources for tax advisory fees, in order to try to understand the relevant laws, collect relevant financial data, and determine what reporting forms must be filed in any year and how best to complete their U.S. tax returns. It is not surprising that even Albert Einstein once said that "[t]he hardest thing in the world to understand is the income tax."

In addition to complex rules governing U.S. tax obligations generally, the United States imposes special rules addressing the taxation and reporting requirements applicable to U.S. persons in connection with their ownership of certain foreign assets and their activities abroad. For example, if a U.S. person has a financial interest in, or signature or other authority over, any foreign financial accounts having an aggregate value exceeding \$10,000 at any time during a given tax year, he or she must report such accounts on FinCEN Form 114, "Report of Foreign Bank and Financial Accounts" (FBAR).<sup>4</sup> A host of additional information reporting requirements may also apply.<sup>5</sup>



The complexity of reporting obligations multiplies when a foreign trust enters the picture. For example, a U.S. person who establishes, or in any year receives property or money from, a foreign trust must report the transaction on Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts."<sup>6</sup> Reporting on Form 3520 is also required for any tax year in which a U.S. person receives gifts and/or bequests in excess of \$100,000 in the aggregate from one or more nonresident aliens and/or foreign estates.<sup>7</sup> A foreign grantor trust with a U.S. owner must furnish the Internal Revenue Service (IRS) with certain information regarding the trust's identification, income and assets on Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner."<sup>8</sup>

These and other rules, discussed below, are intended to promote compliance by U.S. persons with U.S. tax laws. However, because the rules are often highly technical and burdensome, U.S. persons have struggled to comply with them and the IRS has struggled to enforce them in an increasingly global

economy where money has a global passport. The offshore tax scandals involving U.S. persons stashing property in secret offshore accounts and "sham companies" to avoid U.S. taxes captivated the worldwide audience and gave the IRS a grand stage on which to showcase and strengthen its powerful tools of tax enforcement. Some of these tools have been covered by the worldwide press, including the offshore voluntary disclosure programs for individuals who previously failed to disclose foreign accounts and other financial assets, and, of course, the "Foreign Account Tax Compliance Act" or FATCA.<sup>9</sup>

FATCA has revolutionized the concept of tax enforcement and disclosure of information regarding accounts held by U.S. persons abroad. Its reach is truly colossal as it impacts all entities outside of the United States, whether or not the entity in question has any connections to the United States. FATCA also impacts administrators and beneficiaries of foreign trusts. The purpose of this article is to present a broad overview of FATCA as it relates to foreign trusts, trustees and beneficiaries.

This article is not intended to provide a comprehensive guide on FATCA, but provides an overview of issues that must be considered by U.S. persons connected to foreign trusts. Administrators and beneficiaries of foreign trust structures must carefully analyze their particular facts to determine, together with their tax advisors, if and how FATCA impacts their due diligence and reporting obligations to the IRS, and to devise a proactive strategy to manage their compliance requirements in the most effective manner.

### Purpose of FATCA

FATCA embodies the U.S. government's immense desire to detect, deter, and discourage offshore tax evasion through accounts and vehicles in jurisdictions otherwise beyond the reach of the IRS.<sup>10</sup> There is nothing new about this goal, but what makes FATCA revolutionary is its new concept of deputizing the world beyond the United States to act as de facto agents of the IRS.

### Structural Overview

FATCA generally imposes a compliance burden on foreign entities that qualify as "foreign financial institutions" (FFI) or "non-financial foreign institutions" (NFFE) whereby they are required to assist the IRS or face 30 percent withholding on all "withdrawable payments," which generally includes dividends, interest, rents, royalties, and other "fixed determinable annual periodical" (FDAP) income from U.S. sources.<sup>11</sup> Beginning Jan. 1, 2017, the withholding tax will also be imposed on (1) gross proceeds from capital transactions which, unless related to the sale of a U.S. real estate, would not be subject to U.S. tax if earned by a non-citizen/non-resident of the United States, and (2) non-U.S. source payments under certain circumstances.<sup>12</sup> If a foreign FFI or NFFE does not comply with FATCA, it can "lose" 30 percent of its income from U.S. sources, although it may be able to avoid this loss by providing the necessary information and claiming a refund. Even if a foreign entity does not have any U.S. investments, it will nevertheless be impacted by FATCA, because other entities with which it conducts transactions, in order to satisfy their own FATCA obligations, will require a certification from the foreign entity regarding its FATCA status.

Pursuant to authority granted in the Code, the U.S. Treasury Department and IRS have developed extensive regulations to implement and provide guidance on the requirements of FATCA. Additionally, the United States has entered into two model intergovernmental agreements (IGAs), "Model I IGA" and "Model II IGA," which modify the requirements under the regulations on entities resident in countries that are parties to the agreement (partner countries). Thus, as a preliminary matter, it will be important to determine an entity's country of residence for purposes of FATCA.

An entity resident in a non-IGA jurisdiction will be governed solely by the regulations.<sup>13</sup> By contrast, an entity resident in a Model I IGA jurisdiction generally will be governed by that IGA in lieu of the regulations, except that

"in cases prescribed in the Model I IGA, the laws of the partner jurisdiction may allow the resident FFI to elect to apply the regulations instead of the rules otherwise prescribed in the Model I IGA."<sup>14</sup> An entity resident in a Model II IGA jurisdiction will be governed by both that IGA and the regulations, except that in the case of inconsistencies, the Model II IGA will control.<sup>15</sup> In addition, the rules under both IGAs will supersede the regulations in determining whether an entity is an FFI or NFFE.<sup>16</sup>

Unless otherwise exempt, an FFI can avoid the 30 percent withholding by entering into an agreement with the IRS whereby it agrees to ascertain U.S. ownership of its accounts<sup>17</sup> and provide the IRS with information regarding such accounts.<sup>18</sup> Information required to be reported under such an agreement includes the names, addresses, and taxpayer identification numbers of U.S. persons having an account at an FFI, as well as specific details about the accounts, such as account numbers, balances or values, and gross receipts, payments and withdrawals.<sup>19</sup> FFIs must also identify and provide information regarding any substantial U.S. owners (or U.S. "controlling persons" under IGAs<sup>20</sup>) of foreign entities that hold accounts at the FFI.<sup>21</sup>

In the case of an NFFE, the obligations under FATCA are far less complex. An NFFE generally must ascertain whether or not it has substantial U.S. owners (or U.S. controlling persons) and provide to the withholding agent a certification that it has no such person; if there are such persons, the NFFE must obtain information about them and provide that information to the withholding agent.<sup>22</sup>

### Classification as FFI or NFFE

In the world of FATCA, a foreign entity will always be an FFI or an NFFE unless a specific exclusion under the Code, regulations or an applicable IGA applies.

The Code considers a foreign entity an FFI if it falls within three broadly defined categories: depository institutions, custodial institutions, and investment entities.<sup>23</sup> A depository institution is an FFI if it accepts deposits in the ordinary course of a banking or similar business.<sup>24</sup> A custodial institution is an FFI if it holds financial assets for the benefit of one or more other persons as a substantial portion of its business.<sup>25</sup> An investment entity is an FFI if, as a business on behalf of its customers, it primarily engages in: (1) trading in an enumerated list of financial instruments; (2) managing individual or collective portfolios; or (3) otherwise investing, administering, or managing funds, money, or certain financial assets.<sup>26</sup>

### Foreign Trustees and Trusts

A foreign trust will generally be classified as an FFI if it falls within one of the categories described above, or if not, it will be an NFFE. Under regulations and IGAs, a trust is generally subject to FATCA if it is a foreign trust. An individual trustee will not be treated as an FFI or NFFE because an individual is not an "entity",<sup>27</sup> but traditional offshore trust companies are likely to be classified as investment FFIs under regulations.<sup>28</sup> Even if a trustee is not subject to FATCA, the underlying foreign

trust arrangement must always be analyzed to determine its FATCA classification.<sup>29</sup>

Before considering the residence of a trust for purposes of FATCA, one must first determine whether the entity in question is in fact a "trust" under U.S. tax law. For purposes of the U.S. federal income tax, a "trust" is an arrangement by which title to property is held by a person or persons with the fiduciary responsibility to conserve or protect the property for the benefit of another person or persons.<sup>30</sup> Certain trust-like arrangements are not treated as trusts because instead of merely holding and conserving the assets for the beneficiaries, they actively engage in the operation of a business and, therefore, behave more like business entities. Such arrangements are referred to as "business trusts" and classified as corporations or partnerships for U.S. federal tax purposes.<sup>31</sup> In addition, certain "investment trusts" are not classified as trusts.<sup>32</sup>

If an entity qualifies as a "trust" under the above criteria, the next step should be to determine if the trust is "foreign." For purposes of FATCA, the term "foreign" means any person who is not a "U.S. person" for purposes of U.S. taxes.<sup>33</sup> For these purposes, the term "U.S. person" generally includes all citizens and residents of the United States, domestic partnerships and corporations, and domestic trusts and estates.<sup>34</sup> A trust is domestic only if (1) a court within the United States is able to exercise "primary supervision" over the administration of the trust, and (2) one or more U.S. persons has the authority to control *all* "substantial decisions" of the trust.<sup>35</sup> A trust not meeting both tests is treated as a foreign person,<sup>36</sup> in which case it must be an FFI or NFFE, subject to the FATCA requirements as required under regulations and/or IGAs.

### Other Related Provisions

In addition to FATCA, the HIRE Act<sup>37</sup> introduced several other significant provisions that impact U.S. beneficiaries of trusts. For example, the HIRE Act added to the Code §6038D, which, beginning in tax year 2011, established new requirements for including information reporting of "foreign financial assets" on U.S. income tax returns. Section 6038D requires certain individuals<sup>38</sup> who, during any taxable year, hold any interest in a "specified foreign financial asset" to file Form 8938 with his or her U.S. federal income tax return for any year in which the aggregate value of such assets exceeds a certain threshold (e.g., \$50,000 for single filer).<sup>39</sup> A "specified foreign financial asset" is a broader category than that applicable to assets required to be reported on the FBAR, and includes depository or custodial accounts at any FFI, as well as any stocks or securities issued by foreign persons, any other financial instrument or contract held for investment that is issued by or has a counterparty that is a non-U.S. person, and any interest in any foreign entity. The value of assets in a foreign grantor trust are included for purposes of determining whether the U.S. person grantor exceeds the relevant Form 8938 annual threshold filing requirement.<sup>40</sup> The values of foreign non-grantor trust assets are

reportable by a U.S. beneficiary to the extent he or she has reason to know of his or her beneficial interest in that trust.<sup>41</sup>

The HIRE Act also made significant changes to §679, which generally provides that a foreign trust funded by a U.S. person that has or may have U.S. beneficiaries is considered to be a grantor trust, even if the grantor retained no interests in or powers over the trust.<sup>42</sup> Additionally, the HIRE Act added a presumption that a foreign trust with a U.S. grantor is deemed to have a U.S. beneficiary. This presumption can be rebutted by demonstrating that no income can be paid to or for the benefit of a U.S. person in the tax year in question, and, if the trust terminated in the tax year, no part of the income or corpus could be paid to or for the benefit of a U.S. person.<sup>43</sup> The HIRE Act also made further amendments to §679, including treating the uncompensated use of trust property by a U.S. person as a distribution to such person from the trust.<sup>44</sup>

Finally, the HIRE Act also added new paragraph (f) to §1298, requiring any U.S. person that is a shareholder of a "passive foreign investment company" (PFIC) to file an annual report with the IRS on Form 8621. A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year is "passive income"; or (2) 50 percent or more of its assets, by value, consists of property held for the production of passive income.<sup>45</sup> "Passive income," for purposes of the PFIC taxing regime, generally includes dividends and gains from the sale of stock.<sup>46</sup> Prior to this change, reporting on Form 8621 was required only when there was a reportable event, e.g., the receipt of a distribution from a PFIC or the sale of an interest in a PFIC.

## Conclusions

FATCA has effectively revolutionized concepts of information exchange and bank secrecy with rippling effects around the world. Because of FATCA, countries are rallying together to erode traditional concepts of bank secrecy and promote increased transparency among nations regarding financial data. The United Kingdom has enacted its own version of FATCA, which requires financial institutions in the Channel Islands and the Overseas Territories (e.g., Anguilla, Bermuda, the British Virgin Islands, and the Cayman Islands) to provide information relating to the financial affairs of U.K. residents. In addition, the Organization of Economic Cooperation and Development (OECD) released the "Standard for Automatic Exchange of Financial Account Information in Tax Matters," calling on governments to obtain detailed account information from their financial institutions and exchange that information automatically with other jurisdictions on an annual basis. In October 2014, 51 OECD countries signed a multilateral competent authority agreement by which the party countries will automatically exchange information. These efforts indicate the emergence of a global consensus that decoding of "secret" bank data is warranted not just to protect against more heinous crimes

such as terrorism, narcotics, money laundering and financial fraud, but more simply to promote the tax and fiscal interests of such countries. Thus, as colossal as the provisions of FATCA appear to be, the true power of FATCA may be the transformation of tax enforcement efforts around the world and the global impact on how banks and financial institutions conduct their businesses around the world.

## Endnotes:

1. Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

2. For purposes of U.S. taxes, the term "U.S. persons" generally includes citizens, green card holders and other residents of the United States, domestic partnerships and corporations, and domestic trusts and estates. I.R.C. §7701(a)(30).

3. I.R.C. §6012.

4. 31 U.S.C. §5314; see also Instructions for FinCEN Form 114. Such U.S. persons must note on Schedule B of Form 1040 that they have such foreign account filing requirement and report the income from these accounts.

5. For example, Form 5471 is used to report certain direct, indirect or constructive ownership over a "controlled foreign corporation," Form 8621 to report interests in "passive foreign investment companies," and Form 926 to report transfers of property to a foreign corporation (including a cash transfer of \$100,000 or more).

6. I.R.C. §6048(c).

7. I.R.C. §6039F(a).

8. I.R.C. §6048(b).

9. On March 18, 2010, President Barack Obama signed into law the "Hiring Incentive to Restore Employment" (HIRE) Act, P.L. 111-47. The HIRE Act introduced several new reporting provisions related to certain foreign entities and assets, which were originally introduced in 2009 as "FATCA." FATCA added to the Code new §§1471-1474 and 6038D, and amended Code §§679, 1291, 1298 and 6501.

10. Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310," the Hiring Incentive to Restore Employment Act, Under Consideration by the Senate," JCX-4-10 (Feb. 23, 2010).

11. I.R.C. §§1471(a) & 1473(1); Treas. §§1.1471-2(a)(1) & 1.1471-4(b)(4).

12. This is the so-called concept of "passthru payments," defined at Treas. Reg. §1.1471-5(h), which effectively imposes the 30 percent withholding tax on *any* payments (including foreign source components) with respect to a "recalcitrant account holder," i.e., an account holder who refuses to cooperate with information disclosure or does not agree to waive foreign law limitations on information disclosure. I.R.C. §1471(b)(1)(D); Treas. Reg. §1.1471-4(g).

13. See Preamble to Treas. Reg. §1.1471-1 to -7, T.D. 9610. One potential challenge is determining the jurisdiction in which a foreign entity is considered to be "resident," since the regulations and model agreements differ in their criteria for residency. Moreover, it is possible for multiple FATCA regimes to apply to a single structure. While a detailed discussion of these issues is beyond the scope of this article, tax advisors must carefully assess which FATCA regime or regimes should apply to a foreign entity.

14. See Preamble to Treas. Reg. §1.1471-1 to -7. Note that the only provision of the Model I IGA that allows this exception pertains to the determination whether an account is a U.S. reportable account or an account of a non-participating foreign financial institution. See Model I IGA, Annex I, Article 1(C).

15. See Preamble to Treas. Reg. §1.1471-1 to -7.

16. Treas. Reg. §1.1471-5(d).

17. For purposes of FATCA, a financial account is also broadly defined to include depository accounts, custodial accounts, and any equity or debt interest in a financial institution unless that interest is regularly traded. Certain deposit accounts that are held by individuals and have less than \$50,000 may be excluded. Treas. Reg. §1.1471-5(b).

18. An FFI that registers on the "FATCA Registration Website," upon approval will receive a Global Intermediary Identification Number (GIIN) from the IRS. FFIs in Model I IGA countries should register as "Registered Deemed-Compliant Foreign Financial Institutions," while FFIs in Model II IGA countries should register as "Participating Foreign Financial Institutions."

19. I.R.C. §1471(c); Treas. Reg. §1.1471-4(d)(3); Model I IGA, Article 2(2); Model II IGA, Article 2(1).

20. Model I IGA, Article 1(1); Model II IGA, Article 1(1).

21. I.R.C. §1471(c); Treas. Reg. §1.1471-4(d)(3); Model I IGA, Article 2(2); Model II IGA, Article 2(1).

22. A "substantial U.S. owner" is generally a U.S. person owning at least 10 percent of the vote or value of a corporation, 10 percent or more of the profits or capital interests of a partnership, or 10 percent or more of a beneficial interest in a non-grantor trust. Any U.S. person treated as a "grantor" of a trust is also treated as a "substantial U.S. owner." I.R.C. §1473(2); Treas. Reg. §1.1473-1(b)(1).

23. I.R.C. §§1471(d)(4) & (d)(5); Treas. Reg. §1.1471-5(d) & (e). Regulations add two more categories of FFI, which are certain insurance companies and certain holding companies. There are certain exceptions, as well as a limited class of FFIs which will be treated as "deemed compliant" with far fewer requirements.

24. I.R.C. §1471(d)(5)(A); Treas. Reg. §1.1471-5(e)(1)(i).

25. I.R.C. §1471(d)(5)(B); Treas. Reg. §1.1471-5(e)(1)(ii).

26. I.R.C. §1471(d)(5)(C); Treas. Reg. §1.1471-5(e)(1)(iii) & (e)(3).

27. To be subject to FATCA, there must be an "entity."

I.R.C. §§1471(d)(4) & (5) & 1472(d); Treas. Reg. §§1.1471-1(b)(56), 1.1471-5(d) & (e)(4)(v), Ex. 5; Model I IGA, Article 1.1; Model II IGA, Article 1.1. For purposes of FATCA, an "entity" is "any person other than an individual." Treas. Reg. §1.1471-1(b)(39).

28. Treas. Reg. §1.1471-5(e)(4)(v), Ex. 6.

29. See examples under Treas. Reg. §1.1471-5(e)(4)(v).

30. Treas. Reg. §301.7701-4(a).

31. Treas. Reg. §301.7701-4(b).

32. Treas. Reg. §301.7701-4(c). An investment trust is classified as a business trust if either (i) the trust agreement confers on the trustees a power to vary the investment of the certificate holders or (ii) subject to certain limited exceptions, the trust has multiple classes of ownership interests. Id.

33. Treas. Reg. §1.1471-1(b)(56).

34. I.R.C. §7701(a)(30).

35. I.R.C. §7701(a)(30)(E).

36. I.R.C. §7701(a)(31).

37. See supra note 9.

38. Individuals subject to Form 8938 filing are U.S. persons (including individuals who elect to be treated as a U.S. resident), and nonresident aliens who are bona fide residents of American Samoa or Puerto Rico. Treas. Reg. §1.6038D-1T(a).

39. Thresholds vary depending on whether the individual lives in the United States or abroad and whether the individual is married filing jointly, married filing separately, or single.

40. However, because of certain rules established to provide exceptions for duplicate reporting, a taxpayer is not required to provide a specific description of the foreign grantor trust interest on Form 8938 if timely filing of Forms 3520 and 3520-A has been completed for the taxable year. Treas. Reg. §1.6038D-7T. If so, it is sufficient to indicate on Form 8938 those Forms on which the foreign grantor trust interest was reported.

41. See Instructions for Form 8938 (Rev. December 2014).

42. I.R.C. §679(a)(1). In addition, a foreign trust established by a non-U.S. person who becomes a U.S. person within five years of directly or indirectly transferring property to the trust will be a grantor trust if the trust has a U.S. beneficiary on the date on which the change in the grantor's residence occurs. I.R.C. §679(a)(4).

43. I.R.C. §§679(c)(1) & (d).

44. I.R.C. §679(c)(5).

45. I.R.C. §1297(a).

46. I.R.C. §1297(b)(1), referencing I.R.C. §954(c). A PFIC is essentially a non-U.S. mutual fund, and can be organized as a corporation or unit trust. As with U.S. mutual funds marketed by Vanguard or Fidelity, a PFIC's name frequently identifies its investment objective, e.g., "Emerging Market Fund," "Asian Growth Fund," "European Equities Fund," "Long Term Bond Fund," "Capital Appreciation Fund," "Growth and Income Fund," and so forth. PFIC's are generally marketed by large foreign financial institutions, including banks and money managers.