

## **FATCA, Foreign Trusts and Estate Planning: Navigating Complex Reporting and Withholding Requirements**

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# FATCA, Foreign Trusts and Estate Planning: Navigating Complex Reporting and Withholding Requirements

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# Agenda

- Overview
- Foreign Financial Institutions (FFIs)
- Trusts
  - FFIs
  - NFFEs
- Inter-Governmental Agreements (IGAs)
- IGA Modifications to FATCA
- Compliance: Reporting and Penalties

# FATCA Overview

- Signed into law on March 18, 2010
  - Part of the Hiring Incentives to Restore Employment Act (“HIRE Act”)
- “Big picture” policy objective is to prevent US taxpayers from avoiding disclosure of offshore assets and income
- Certain foreign entities subject to reporting and record-keeping requirements
- Compliance encouraged by penal withholding tax
- IRS issued first installment of Final Regulations on 17 January 2013

# Overview

- FATCA Withholding:
  - 30% withholding on withholdable payments to foreign financial institutions (“FFIs”) and passive non-financial foreign entities (“NFFEs”).
  - Withholdable Payments
    - Effective July 1, 2014:  
Dividends, interest, rents, annuities, etc.
    - Effective January 1, 2019:  
Gross proceeds from the sale of any property  
than can produce passive investment  
income from US sources  
Foreign passthru payments

# Overview

- No FATCA withholding if:
  - FFI enters into an agreement with the IRS and thereby becomes a “participating FFI” (“PFFI”)
  - FFI is a “deemed-compliant” FFI
    - FFIs under intergovernmental agreements
- PFFIs generally
  - Register with IRS for Global Intermediary Identification Number (“GIIN”)
  - Comply with due diligence procedures required by IRS and obtain information necessary to identify “United States accounts”
    - Financial accounts held by US persons
    - Financial accounts held by “United States owned foreign entity”
  - Report name, address, TIN, account number, account balance and gross receipts/withdrawals
  - Verify compliance on regular basis
  - Withhold on withholdable payments and passthru payments
  - Comply with IRS information requests

# Overview – Recent Updates

- Notice 2014-33
  - Provides for an 18-month enforcement transition period for withholding agents and foreign financial institutions (“FFIs”) that undertake “good faith” efforts to comply with FATCA.
  - 2014 and 2015 will be regarded as a transition period for purposes of IRS enforcement and administration of FATCA.
  - February 20, 2014, the IRS released two packages of regulations under FATCA.
  - Transition-period treatment is granted only to entities that have put forth “good faith” efforts to comply with the requirements of FATCA.

# Entity Classification: FFIs

- Foreign Financial Institution (“FFI”)
  - Any non-US entity that is a:
    - Depository Institution (includes foreign entities that provide trust or fiduciary services)
    - Custodial Institution
    - Investment Entity
    - Specified Insurance Company
    - Designated Holding Company or Treasury Center
  - For any entity resident in a Model 1/Model 2 IGA jurisdiction, as defined in the IGA

# Entity Classification

- Investment Entity
  - Conducts a business of investing, reinvesting or trading in financial assets or otherwise investing, administering or managing funds, money or financial assets for customers (investment entity activities) and regularly received 50% or more of its gross income during the “relevant period” from such investment activities.
  - Is managed by another financial institution and has more than 50% of its gross income during the “relevant period” from investment entity activities.
    - “Managed by” another if the managing entity performs, either directly, or through a third-party service provider, any of the investment entity activities on behalf of the managed entity.

# Entity Classification

- Professionally managed for purposes of an “investment entity”
  - Trust managed by individual v. entity
    - Ex 5: Foreign non-grantor trust managed by Trustee, an individual. Assets are financial assets, and income derived entirely from these assets. Because the Trustee is an individual and does not hire a third-party service provider, the trust is not an investment entity, or an FFI.
    - Ex 6: Same facts, however the Trustee hires a third-party service provider (an entity that is classified as an FFI) to manage and administer the trust. Under these facts, the trust is classified as an FFI.
      - ❖ Treas. Reg. 1.1471-5(e)(4)(v)

# Application of FATCA to non-U.S. Trusts and non-U.S. Trust Structures

- A non-U.S. trust (as well as any underlying non-U.S. corporation held by the trust) will be classified as either an FFI or an NFFE (unless it is subject to an exemption)
- The “investment entity” category of FFIs meets the classification requirements of many non-U.S. trusts with trust company trustees or financial institutions as managers
- Individual trustees do not meet the definition of an FFI

# Application of FATCA to non-U.S. Trusts and non-U.S. Trust Structures

- Practitioners' Comments:
  - An offshore trust structure typically involves the establishment of a non-U.S. trust with one or more wholly owned underlying corporation to hold the assets.
  - In each case, the practitioner must analyze the classification and reporting requirements at each entity level (i.e., trustees, trust(s), underlying corporation(s)) in the relevant jurisdiction.

# Application of FATCA to non-U.S. Trusts and non-U.S. Trust Structures: FFIs

- Where a non-U.S. trust's gross income is primarily attributable to its investment assets and is managed by a financial institution, the trust is classified as an FFI.
- Where a non-U.S. trust is managed by another, if the managing entity performs investment entity activities, either directly or indirectly through a third-party service provider, the trust is classified as an FFI.
  - Ex: A foreign trust with a trust company serving as trustee is classified as an FFI.
- Contrast: where all trustees and investment managers of a foreign trust are individuals, the trust will not be considered to be managed by an entity and is thus not classified as an FFI.

# Determining Equity Interest in Foreign Trusts

- A person has an “equity interest” in a trust that is classified as an FFI, if the person:
  - Is treated as owning any portion of the trust under IRC Sections 671-679; or
  - Has received a discretionary distribution during the year or is entitled to a mandatory distribution during the year from the trust; or
    - Note: a trust beneficiary who does not in fact receive (but is eligible to) a discretionary distribution will not be considered as holding an equity interest in the trust
  - Has the right to receive (directly or indirectly) a mandatory distribution
    - Certain rules apply with respect to determining the value of the beneficial interest under IRC 7520
    - De minimis amount exception

# Entity Classification: NFFEs

- A NFFE is any foreign entity that is not an FFI
- Further divided into two categories:
  - Excepted NFFEs
    - Includes publicly-traded entities and their subsidiaries
    - Includes direct reporting NFFEs
    - Includes active NFFEs
      - Less than 50% passive income
      - Less than 50% passive assets
  - Passive NFFEs
    - Any NFFE that is not an excepted NFFE
    - Must certify as to substantial U.S. owners (any U.S. person owning 10% or more in the non-U.S. entity)

# Substantial U.S. Owner(s): Determining Beneficial Interest in Foreign Trusts

- FATCA requires a determination as to whether any specified U.S. person has a beneficial interest in a foreign trust
  - Practitioners' Comments:
    - Initial burden on trustees to make adequate review and determination
    - Trustees are required to identify, name and report to the IRS, US accounts (including an equity interest) in the foreign trust

# FATCA – Inter Governmental Agreements (IGAs)

- Meant to streamline implementation of FATCA and reduce compliance burden for FFIs in partner jurisdictions
- Model 1
  - Technically FFIs in Model 1 jurisdictions do not have to comply with FATCA – reporting obligations arise under domestic legislation
  - Model 1 FFIs not required to withhold on payments to non-compliant account holders unless they otherwise are withholding agents
- Model 2
  - FFIs remain under obligation to report directly to the IRS
    - Strict adherence to U.S. Treasury Regulations

# IGAs

- Model 1 IGAs in effect:

- Australia
- Bahamas
- Barbados
- Belgium
- Brazil
- Bulgaria
- BVI
- Canada
- Cayman Islands
- Colombia
- Costa Rica
- Croatia
- Curacao
- Cyprus
- Czech Republic
- Denmark
- Estonia
- Finland
- France
- Georgia
- Germany
- Gibraltar
- Guernsey
- Holy See
- Honduras
- Hungary
- Iceland
- India
- Ireland
- Isle of Man
- Israel
- Italy
- Jamaica
- Jersey
- Kosovo
- Kuwait
- Latvia
- Liechtenstein
- Lithuania
- Luxembourg
- Malta
- Mauritius
- Mexico
- Netherlands
- New Zealand
- Norway
- Philippines
- Poland
- Qatar
- Romania
- St. Kitts & Nevis
- St. Vincent & Grenadines
- Singapore
- Slovak Republic
- Slovenia
- Spain
- South Africa
- South Korea
- Sweden

- Model 2 IGAs in effect:

- Austria
- Bermuda
- Chile
- Hong Kong
- Japan
- Moldova
- Switzerland

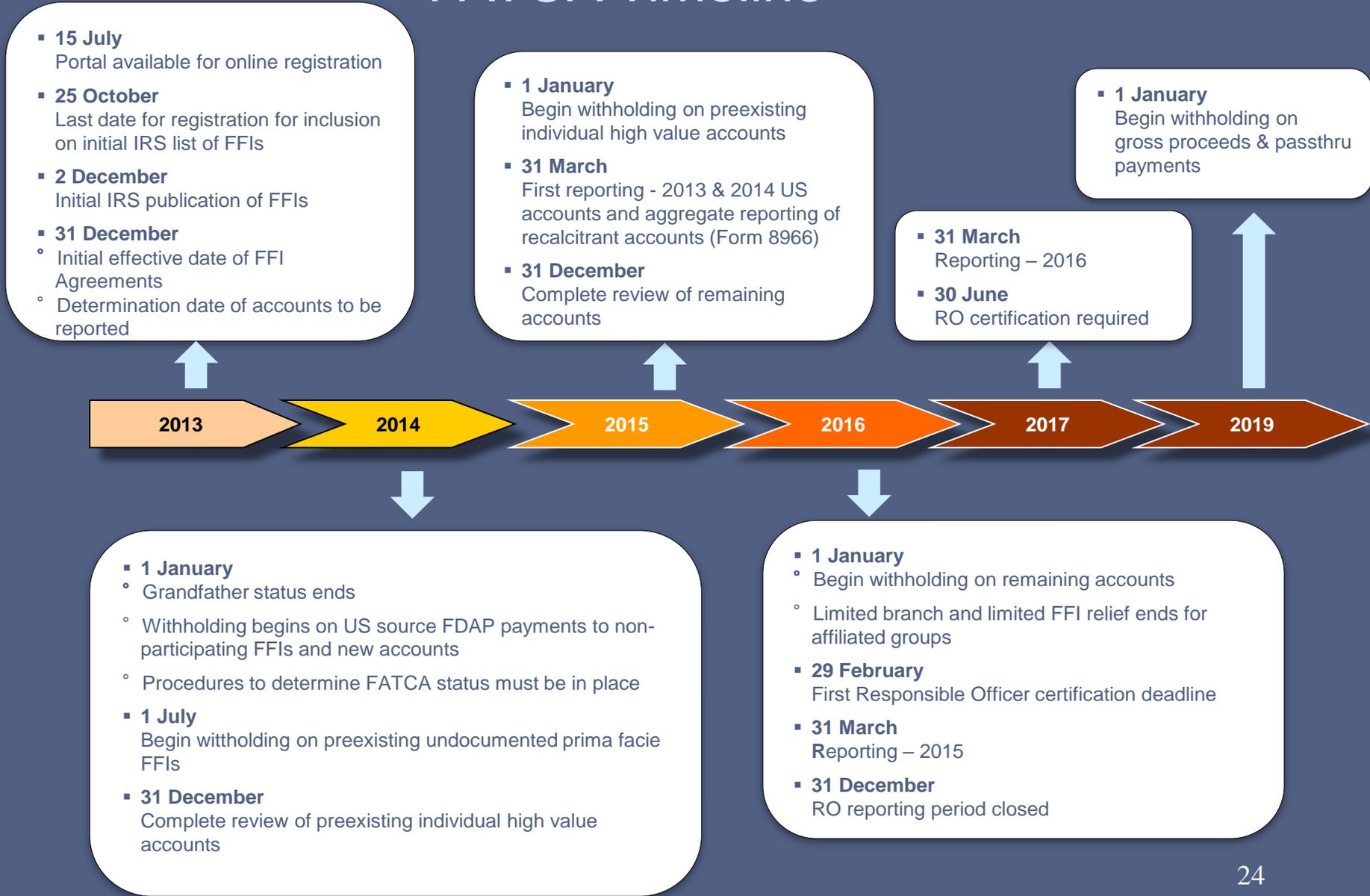
# IGAs Modifying FATCA

- An entity that conducts as a business or “is managed by” an entity that conducts as a business 1 or more activities including “otherwise investing, administering, or managing” funds or money on behalf of other persons
- The definition of an investment entity under the IGAs is generally broader, and includes a catch-all sentence stating that the definition “*shall be interpreted in a manner consistent with similar language set forth in the definition of a ‘financial institution’ in the Financial Action Task Force (FATF).*”
- Controlling U.S. Persons
  - IGAs replace the concept of “Substantial U.S. owners” under the U.S. Treasury Regulations with “Controlling U.S. Persons” according to the FATF recommendations
    - Ownership threshold generally 25% or more
      - ❖ Practitioners’ Comment: In cases where the ownership determination is ambiguous or difficult to assess, it is recommended for the threshold to fall back to 10% (to meet the U.S. Treasury Regulations standard of substantial U.S. owners).

# IGAs – Application to Trusts

- Trustee-Documented Trusts
  - Model 1 (and Model 2) IGAs provide for a category of deemed-compliant FFIs created specifically for trusts
    - ❖ applies to any foreign trust that is classified as an FFI where the trustee is a PFFI or reporting FFI and the trustee reports the information under the IGA
      - ❖ Benefit: streamlined compliance for trustees to satisfy FATCA reporting requirements on behalf of the trusts it administers without the burden of having to register each trust with the IRS or obtain a GIIN.
- Registered Sponsored FFIs
- Certified Sponsored FFIs
- Owner-documented FFIs

# FATCA Timeline



# Reporting Obligations & Penalties for Non-Compliance

- The reporting requirements of trusts and trust beneficiaries under FATCA varies depending on whether a trust:
  - (1) is governed by the law of the U.S. Treasury Regulations or an applicable IGA; and
  - (2) meets the corresponding definitions and thus classification of an FFI or an NFFE under the relevant rules.

# Reporting Obligations & Penalties for Non-Compliance

- As stated above, FATCA classifies foreign entities into FFIs and NFFEs
- A withholding agent must withhold 30% of any withholdable payment to an FFI unless that FFI has entered into an FFI agreement with the IRS and agrees to:
  - Identify which of its accounts are U.S. accounts
  - Report information with respect to its U.S. accounts to the IRS
  - Withhold any “passthru payments” (payments that are attributable to withholdable payments the FFI has received) that is made to an account that does not provide the FFI with information required to establish whether the account is a U.S. account (i.e., a “recalcitrant account”)
- A withholding agent must withhold 30% of any withholdable payments to certain NFFEs unless the NFFE either:
  - Certifies that it has no substantial (i.e., 10% or more) U.S. owners (or controlling U.S. persons under a relevant IGA); or
  - Provides the withholding agent information about each of the NFFE’s substantial U.S. owners (or controlling U.S. persons)

# Reporting Obligations & Penalties for Non-Compliance (cont..)

- Foreign Trusts as FFIs

- Reporting requirement: Identify and report all U.S. account holders

Under the U.S. Treasury Regulations, any U.S. account holder of a foreign trust classified as an FFI with a 0% ownership is required to be identified and reported to the IRS

- Exception: If a grantor trust is wholly owned by U.S. persons, it is not required to treat any of its beneficiaries as substantial U.S. owners.

# Reporting Obligations & Penalties for Non-Compliance (cont..)

- **Indirect Substantial Ownership**
  - Look-through rules for certain entities
    - Stock of a foreign corporation owned directly or indirectly by a corporation, partnership or trust considered owned proportionately (as determined by the entity's shareholders, partners, or trust owners (provided grantor trust) and beneficiaries.
    - Entity ownership of the capital or profits interest in a foreign partnership or ownership of a beneficial interest in a foreign trust treated as owned by the entity's shareholders, partners, or trust owners (if grantor trust) and beneficiaries.
    - US holder of the option to purchase stock in a foreign corporation, capital or profit interests in a foreign partnership, or an ownership or beneficial interest in a foreign trust is treated as owning underlying interest.
    - IRC attribution rules for related persons apply to determination of indirect ownership

# Reporting Obligations & Penalties for Non-Compliance (cont..)

- FFIs must enter into an FFI Agreement with the IRS unless they are considered as either “registered deemed-compliant” or “certified deemed-compliant”
  - Registered deemed-compliant FFIs retain certain reporting obligations under FATCA;
  - certified deemed-compliant FFIs are generally exempt from FATCA withholding provided they properly certify their status to a withholding agent
- Certain categories of FFIs may be deemed-compliant without entering into an agreement with the IRS
  - These are generally FFIs with attributes that the IRS deems as posing a lower risk of being used for U.S. tax evasion

# Reporting Obligations & Penalties for Non-Compliance (cont..)

- **Registered-Deemed Compliant FFIs:**

- Must register with the IRS, and include:
  - Local FFIs: entities that operate solely in the local jurisdiction
  - Non-reporting members of participating FFI groups
  - Qualified collective investment vehicles: funds that have as direct owners only participating FFIs, registered deemed-compliant FFIs, U.S. persons, and certain institutional investors
  - Restricted funds: funds that exclude U.S. investors
  - Credit card issuers (with a threshold amount of deposit not to exceed \$50,000)
  - Sponsored FFIs: one entity sponsors other entities in a consolidated compliance approach

- **Certified-Deemed Compliant FFIs:**

- Must not register with the IRS; rather self certification to withholding agent
- Categories include:
  - Non-registering local banks
  - Sponsored closely held investment vehicles

# Reporting Obligations & Penalties for Non-Compliance (cont..)

- FFIs that are exempt from FATCA include:
  - Exempt beneficial owners
    - Foreign governments
      - Integral parts, controlled entities, and political subdivisions
    - Foreign central banks
    - US territories
    - International organizations
  - Retirement plans
  - Entities wholly owned by exempt beneficial owners

# Reporting Obligations & IRS Form W-8BENs (In general...)

- IRS Form W-8BEN-E
  - Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)
  - <http://www.irs.gov/pub/irs-pdf/fw8bene.pdf>
- Instructions to IRS Form W-8BEN-E
  - <http://www.irs.gov/pub/irs-pdf/iw8bene.pdf>
- Caveat Emptor: Each entity must be classified separately to determine the correct reporting documentation under the U.S. Treasury Regulations or a valid IGA

# OECD Standard for the Automatic Exchange of Financial Account Information in Tax Matters

- Standardized model for automatic exchange of information between countries pursuant to a “Common Reporting Standard” (“CRS”)
- Reporting Financial Institutions automatically exchange information relation to Reportable Accounts
  - Reporting Financial Institution
    - Financial Institution in a Participating Jurisdiction
      - Definition of Financial Institution similar to FATCA
    - Look to where the entity is resident for tax purposes
    - In the case of a trust look to residence of trustees

# OECD Standard for the Automatic Exchange of Financial Account Information in Tax Matters

- Reporting Financial Institutions automatically exchange information relation to Reportable Accounts
  - Reportable Account
    - Account Holder is Reportable Jurisdiction Person
      - In the case of trust, creditors, controlling persons and beneficiary – but in case of discretionary beneficiary only year of distribution
    - Account Holder is Passive NFE with a “Reportable Controlling Person”
      - Natural person or legal entity that has 25% control over entity
      - In the case of a trust, each settlor, trustee, protector or beneficiary who exercises control