withersworldwide

FATCA Update: Final Regulations, IGAs and their Impact on Trusts and Trust Companies

June 2013

Background

On March 18, 2010, President Obama signed the 'Hiring Incentives to Restore Employment Act of 2010' into law. Although this legislation was broadly focused on the creation of jobs in the US through tax incentives, it also contained numerous provisions focusing not only on US persons investing outside of the United States but also on persons and entities investing into the United States (the '**Foreign Account Tax Compliance Act**' or '**FATCA**' provisions).

This will result in unprecedented new client identification, disclosure and withholding obligations for virtually all non-US financial institutions (Foreign Financial Institutions) ('**FFIs**') and non-US non-financial entities ('**NFFEs**') that wish to retain access to the US capital markets. While much of the focus has been on non-US banks and investment funds, FATCA will also affect virtually all non-US trust companies and most family trusts and family investment vehicles.

FATCA will impose a new withholding tax of 30% on US source dividends, interest, and various other 'fixed, determinable, annual or periodic' ('**FDAP**') payments as well as gross proceeds from the sale or disposition of assets that generate such payments (such as sales of US stock).

Withholding on US source FDAP payments will begin for payments made after December 31, 2013. However, withholding will not be required on 'foreign passthru payments' or on gross proceeds from sales or dispositions of property (including stock in a US corporation) before January 1, 2017.

Subject to significant exceptions under both the final regulations (the '**Regulations**') and bilateral intergovernmental agreements ('**IGAs**'), this new US withholding tax will apply to payments (i) to FFIs that do not comply with certain identification and information reporting requirements regarding their US accountholders (including certain US settlors, beneficiaries, fiduciaries, and owners of non-US entities such as trusts and companies) either under an agreement with the IRS ('**FFI Agreement**') or under the terms of an applicable IGA, and (ii) to NFFEs unless they provide certain information regarding any 'substantial United States owners' they have directly to withholding agents.

1. Recent Developments

1.1 Intergovernmental Agreements ('IGAs')

In 2012, the US, the UK, France, Germany, Italy, and Spain issued joint statements regarding implementing FATCA through a process of intergovernmental information exchange (the '**Model 1 IGA**'). Statements from Japan and Switzerland soon followed, adopting an alternative approach (the '**Model 2 IGA**').

FFIs in either a Model 1 or Model 2 jurisdiction should not be subject to the new US withholding tax under FATCA provided they meet the requirement of the applicable IGA. FFIs in Model 1 jurisdictions also will not be required to: (i) enter into FFI Agreements with the IRS, (ii) withhold on 'passthru payments' to other FFIs located in 'FATCA Partner' jurisdictions, or (iii) close the accounts of 'recalcitrant' accountholders (*i.e.*, those unwilling to provide information to the FFI or waive applicable bank secrecy laws).

- The UK signed the first Model 1 IGA on September 14, 2012.
- In November of 2012, the US Treasury announced that the US was in various stages of negotiation with more than 50 jurisdictions with respect to the possibility of implementing an IGA, including: Argentina, Australia, Belgium, Bermuda, Brazil, Canada, Cayman, Chile, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Gibraltar, Guernsey, Hungary, India, Israel, Italy, Japan, Jersey, Korea, Lebanon, Liechtenstein, Luxembourg, the Isle of Man, Malaysia, Malta, Mexico, the Netherlands, New Zealand, Norway, Romania, Russia, the Seychelles, Sint Maarten, Singapore, the Slovak Republic, Slovenia, South Africa, Spain, Sweden, and Switzerland.
- Since that time, Model 1 IGAs have been signed with Denmark, Ireland, Mexico and the first Model 2 IGA was signed with Switzerland on February 14, 2013.

Under the Model 1 IGA, certain FATCA Partner countries will implement legislation requiring FFIs located in those jurisdictions to collect and report information regarding their accountholders to the relevant local tax authorities, which will compile and forward this information to the US.

The Model 2 IGA, released in draft form in November of 2012, essentially builds upon the foundation of Model 1 with some significant differences, as discussed below. This model formed the template of the recently signed US agreement with Switzerland and is expected to be the basis for agreements with Japan and certain other countries where there might be domestic legal or administrative impediments to entering into a Model 1 IGA.

Whereas, under Model 1, the 'FATCA Partner' government is tasked with collecting information from resident FFIs and reporting this to the IRS, Model 2 instead requires that the FATCA Partner direct resident FFIs to register with the IRS by January 1, 2014 and comply with the requirements of an FFI Agreement with the US. FFIs resident in, or organised under the laws of, Model 2 jurisdictions will be required to request consent from accountholders (where this is required under local law) to report information regarding US accounts and accounts or obligations of non-participating FFIs and, where such consent is granted, report such information as may be required under the FFI Agreement and the Regulations.

Where consent is not granted, FFIs will be required to report aggregate information regarding these non-consenting accountholders and obligations to the IRS, which may then seek to obtain additional information by making group requests to the FATCA Partner government based on the aggregate information reported. The Model 2 FATCA Partner government will then have six months to respond to this information request by the IRS by providing the requested information regarding these accounts and obligations as if it had been reported directly to the IRS by the FFI.

Model 2 defines certain key terms by reference to the Regulations. Model 1 permits FFIs to elect to apply the account identification due diligence procedures under the Regulations rather than those specified in the IGA only if the FATCA Partner permits them to do so. FFIs in Model 2 jurisdictions will automatically be able to elect to do so (although, once they so elect they will be required to continue to apply these procedures consistently).

1.2 Final Regulations

The US Treasury Department released the long-anticipated Regulations on January 17, 2013. These build upon the foundation of the proposed regulations but contain some significant additions and modifications.

(a) Implementation Timeline

The IRS extended certain implementation deadlines under the Regulations to harmonise these with the implementation deadlines under the IGAs.

- All accounts in existence prior to January 1, 2014, will be treated as 'pre-existing accounts,' and withholding agents will have until December 31, 2015, to document accountholders and payees that are not 'prima facie FFIs.'
- The effective date of FFI Agreements entered into with the IRS will be December 31, 2013 for all participating FFIs that apply prior to January 1, 2014. The first information reporting by participating FFIs, with respect to the 2013 and 2014 calendar years, will be due on March 31, 2015.
- Withholding will not be required on 'foreign passthru payments' or on gross proceeds from sales or dispositions of property before January 1, 2017.
- The 'sunset' date for the relief afforded to 'limited' branches and affiliates, by which all members of an expanded affiliated group will be required to be participating FFIs or deemed-compliant FFIs has not been extended, and remains December 31, 2015.

(b) Exemption for 'Grandfathered' Obligations

The Regulations exempt obligations outstanding on January 1, 2014, from FATCA withholding, and exempt certain obligations that may give rise to 'dividend equivalent' or foreign passthru payments under future regulations once issued provided that these obligations are outstanding six months prior to the release of implementing regulations.

(c) Trusts and Family Investment Entities

Certain trusts and family-owned investment entities that primarily hold investment assets (and therefore might potentially have been FFIs under the proposed regulations) generally should instead be categorised as NFFEs provided the trustee and investment advisors are individuals.

This is important as the compliance burden differs significantly depending on whether an entity is an FFI or an NFFE. NFFEs must only either (i) certify to US withholding agents that they have no 'substantial US owners' or (ii) provide the name, address, and US taxpayer identification number of each such substantial US owner. FFIs (subject to a number of exceptions) are required to enter into an FFI agreement with the accompanying enhanced due diligence requirements. The reporting of US account holders though may be limited to the amount of payments or distributions during the year.

Further, a new procedure may assist certain trusts and entities not covered by an IGA and that are still treated as FFIs because they (i) primarily hold investment assets and (ii) are 'professionally managed' -- meaning generally where trust companies (potentially including private trust companies), family offices, and other investment advisors play a role. In these instances, new sponsoring FFI mechanisms may be available under which trusts and underlying entities should be 'deemed compliant' provided that the trust company meets certain 'Sponsoring Entity' requirements.

(d) Accounts held by Estates

The Regulations conform the treatment of accounts held by estates with the rules requiring that US persons report certain 'specified foreign financial assets' on the new Form 8938. Therefore, accounts held by estates are generally excluded from the definition of a financial account, and so are not subject to FATCA. However, this is not the case under the US - UK IGA at least currently.

(e) Investment Funds

The Regulations substantially expand the scope of the term 'investment entity' to include entities (i) that primarily engage in the business of trading financial assets for or on behalf of customers, (ii) perform portfolio management services or (iii) invest, administer, or manage financial assets on behalf of customers. Non financial companies such as holding companies used in private equity structures are also caught under a different rule.

In addition, the Regulations treat any entity that holds itself out as a mutual fund, hedge fund, private equity fund, venture capital fund, leveraged buyout fund, or similar investment vehicle as an FFI. Notably, the examples in the Regulations also treat investment advisory companies as FFIs, although it is not entirely clear this would be the result under the Regulations.

The Regulations also clarify that an investment entity will be considered regulated, for the purposes of determining eligibility for treatment as a 'Qualified Collective Investment Vehicle' ('**QCIV**') or a 'Restricted Fund' (and therefore not subject to FATCA withholding), if either: (i) the investment entity is regulated in all countries in which it is registered and operates; or (ii) the investment entity's manager is regulated with respect to the investment entity in all countries in which the investment entity is registered and operates.

(f) Insurance Companies and Insurance Contracts

The Regulations provide a new *de minimis* exception from reporting for cash value insurance contracts valued below US$50,000, and clarify that certain insurance contracts may qualify as having a 'definitive term' by reference to the life expectancy of the insured and therefore may be eligible to be treated as 'grandfathered' obligations.

The Regulations provide that the term 'US Person' does not include insurance companies that have made an election to be taxed as a US insurance company under Section 953(d) unless that company is licensed to do business in a US state. Therefore, non-US insurance companies will generally be FFIs.

(g) Retirement Funds and Retirement/Pension Savings Accounts

The Regulations relax the requirements in the proposed regulations and now exempt certain retirement funds from FATCA withholding even if the fund is not the beneficial owner of the payment. In addition, certain retirement savings accounts are now excluded from the definition of a financial account even where contributions are not limited to employer, employee, or government contributions, including situations where the pension would qualify under a US income tax treaty.

(h) Expanded 'Local FFI' Exception

The 'local bank' exception contained in the proposed regulations and applicable generally to entities that have a customer base primarily consisting of the residents of a single country (or to a certain extent within the EU) has been expanded to apply to insurance companies, credit unions, and investment entities.

These entities are now permitted to maintain a fixed place of business outside their countries of organisation provided that this location is not advertised and provides only back office support functions. Certain forms of print, radio, or television advertising outside the country of organisation are now also permitted, provided that advertising is primarily targeted within the country of organisation and certain other conditions are satisfied. The US - UK IGA permits broad based internet marketing provided that it is not targeted outside the host country.

The Regulations also add, as a condition for qualifying for the Local FFI exception, that an FFI not have policies or practices that discriminate against opening or maintaining accounts for US individuals resident in the local FFI country, underscoring that FFIs cannot simply rely on excluding US customers as a FATCA compliance approach.

1.3 New and Updated Forms

In 2012, the IRS began to release drafts of new and updated withholding tax certification forms, including new forms W-8BEN-E (for entities) and W-8BEN (for individuals), as well as a revised Form W-8IMY (for fiscally transparent entities, including certain trusts), W-8ECI, and W-8EXP. While these new forms have not been finalised, it is clear that they will be significantly more complex than 'pre-FATCA' US withholding tax certification forms, due to the need to provide additional information regarding FATCA withholding status.

The IRS has also released updated drafts of Forms 1042 and 1042-S (for use in reporting income and witholding to the IRS and payment recipients) and a draft of new Form 8957 (FATCA Registration Form).

Although a draft has not yet been released, it is anticipated that the IRS will soon issue a draft of Form 8966, the new FATCA annual reporting form that participating FFIs (and 'sponsoring entities') will need to submit to the IRS to fulfill their annual FATCA reporting obligations.

1.4 Online Registration Portal

As of August 2012, the IRS had outlined on its website certain features of the online registration process through which FFIs may either apply to enter into an FFI Agreement or apply for a certification and register with the IRS as a deemed-compliant entity that should be available shortly. See http://www.irs.gov/Individuals/International-Taxpayers/Details-on-the-FATCA-Registration-Process-for-Foreign-Financial-Institutions-(FFIs)*. The portal should be available by 15 July 2013 and the IRS is encouraging FFIs to register online instead of via the paper Form 8957.

2. Application to Trusts and Holding Companies

2.1 Classification of Trusts as FFIs or NFFEs

The compliance burden differs significantly depending on whether an entity is classified as an FFI or an NFFE.

NFFEs must generally only either certify to US withholding agents that they have no substantial US owners or provide the name, address, and US taxpayer identification number of each such substantial US owner

FFIs (unless they are covered by a Model 1 IGA) must generally enter into an FFI Agreement and, whether or not covered by an IGA, must comply with extensive due diligence and verification requirements and provide substantial additional information to the IRS.

Classification as an FFI or an NFFE is based on a number of factors, as discussed below.

(a) Based on Status of Trustee and Investment Managers

Under the Regulations, trust companies and entities acting as a professional investment manager will generally be FFIs because they are deemed to conduct, as a business, activities including 'investing, administering, or managing funds, money, or financial assets on behalf of other persons.'

Family managed trusts and family-owned investment entities generally should be NFFEs regardless of whether the trust or entity primarily holds certain 'financial assets' (and therefore might potentially have been FFIs) provided that the trustee and investment managers are all individuals.

Trusts and underlying companies that are managed by an entity that is itself considered to be an investment entity—such as a trust company or family office—will generally be FFIs unless the trust in question primarily holds assets that are non-financial in nature (such as real estate).

(b) Based on Nature of Assets

Under the Regulations, trusts and companies will be classified as an 'investment entity' (and therefore an FFI), if they are both 'managed' by an investment entity and the gross income is 'primarily attributable to investing, reinvesting, or trading in financial assets.'

The category of 'financial assets' includes securities, and would generally encompass assets held within a non-US bank or brokerage account. Therefore, trusts and holding companies that directly hold tangible assets (*e.g.*, real estate, art, airplanes and yachts) should escape classification as FFIs under the Regulations even if they are managed by a trust company or an entity acting as investment manager; however, trusts and companies that primarily invest in securities, funds, commodities, derivatives, and other passive investment assets will generally be FFIs if the trustee is a trust company (as opposed to an individual trustee) or if an entity is acting as the investment manager (*e.g.,* a bank).

Even where a trust primarily holds tangible assets, if these are held through an underlying holding company or partnership, rather than directly, the trust might primarily hold financial assets (*e.g.,* stock and partnership interests) and therefore would potentially be an FFI if professionally managed, unless the trust has substantial income (*i.e.*, more than 50% of income) attributable to tangible assets and/or directly held business income other than passive investment income.

(c) IGA Overlay and Key Differences

Trusts, holding companies, and family investment entities covered by an IGA, where the definition of the term 'investment entity' is determined consistently with the FATCA Partner's interpretation of the FATF guidelines, may potentially be categorised as NFFEs under a different (and in some respects broader) test than under the Regulations.

The draft guidance published to accompany the UK legislation suggests that most family trusts and family investment entities will escape classification as 'investment entities,' so as to be treated as NFFEs regardless of whether they are managed by a trust company or an entity acting as an investment manager. Commentators do not necessarily agree with the statements made in the Guidance. On a strict interpretation of the legislation even 'family' trusts managed by a professional trustee would appear to fall within the definition of 'investment entity' and accordingly could be construed to be a financial institution under the terms of the US - UK IGA. In addition, the professional trustee will be financial institution for the purposes of the rules, although the Guidance indicates that if the trustee fulfils the due diligence requirements imposed by the rules no other financial institution (including the trust) will be required to do so.

(d) Active vs. Passive NFFE Status

A non-US trust or company that is not an FFI will automatically be classified as an NFFE. Generally, unless an NFFE is a publicly-traded corporation, an affiliate of a publicly-traded corporation, an 'active' NFFE (*e.g.,* a company engaged in an active trade or business or certain holding companies and special purposes entities connected with the same) or one of a few categories of 'excepted NFFE' (including certain non-profit organizations), it will need to perform due diligence with respect to its owners and provide appropriate certifications to withholding agents, or be subject to withholding under FATCA.

Therefore, if a trust or company is not an FFI it is important to determine if the trust or company qualifies as an 'active' or 'excepted' NFFE that might fall within an applicable exemption, or whether it is a 'passive' NFFE subject to the reporting requirements generally applicable to NFFEs.

2.2 Determining 'Ownership'

(a) NFFEs versus FFIs

Under the Regulations, a 'substantial US owner' of a trust or an underlying company classified as an NFFE, includes US persons treated as the grantor and any beneficiary treated as owning a 10% or greater interest in the trust (applying certain attribution rules).

Subject to certain *de minimis* exceptions, this includes (i) a US beneficiary of a discretionary trust who receives distributions the value of which exceeds 10% of either the trust's income or assets, (ii) a US beneficiary entitled to receive mandatory distributions where the actuarial value of their interest in the trust exceeds 10% of the trust's assets, and (iii) a US beneficiary who receives both mandatory and discretionary distributions where the 10% ownership threshold is met under a combined test.

However, if a trust is classified as an 'investment entity' (and therefore an FFI), any beneficial interest in the trust in excess of either US$5,000 (if determined on the basis of the fair market value of discretionary distributions) or US$50,000 (if determined as an actuarial interest resulting from a mandatory distribution interest) will result in the US Beneficiaries being deemed to be reportable as US owners of the trust.

(b) Beneficial Interest Types

Contingent and remainder beneficiaries who are not currently receiving distributions are not viewed as having a present interest in the trust and their interests are not counted for the purposes of the above ownership attribution tests. Beneficiaries that do not have a mandatory distribution interest, but may only receive a distribution in the discretion of the trustees or under a limited power of appointment, will be deemed to have an interest in the trust only to the extent that they actually receive a distribution in a given calendar year.

(c) US Grantors

Under the Regulations, US individuals who are treated as the grantor of a non-US trust will always be reportable as the US owner of a trust, regardless of whether it is classified as an FFI or an NFFE. Where a US person is reported as the grantor this may potentially result in reduced reporting requirements with respect to other US persons who are beneficiaries. Under the US - UK IGA, reporting is focused on controlling persons under the FATF definitions.

(d) IGA Overlay and Key Differences

Depending on the FATCA Partner's interpretation of the FATF guidelines, in the case of determining whether a US beneficiary is a substantial US owner of a trust, a 25% beneficial ownership threshold may apply, whereas the Regulations impose a 10% (or potentially a 0%) beneficial ownership threshold.

IGAs also significantly deviate from the approach under the Regulations by introducing a new concept of 'controlling persons' (defined to mean natural persons who exercise control over an entity), into the test for determining whether an account should be categorised as having US owners. This may lead to additional reporting obligations in certain IGA jurisdictions with respect to certain US beneficiaries or fiduciaries who have certain powers over the trust even where such persons do not have a beneficial interest in the trust.

In the case of a trust, the category of controlling persons can include US individuals who are settlors, trustees, protectors and beneficiaries (to be interpreted consistently with the FATCA Partner country's interpretation of the FATF recommendations and therefore varying depending both on the nature of retained powers and potentially from one IGA jurisdiction to another).

3. FATCA Compliance Alternatives and Reporting Obligations

3.1 FFI Agreement

Trusts and holding companies that are FFIs will, one way or another, be subject to due diligence, verification, reporting and withholding requirements under the Regulations or an IGA.

In most cases, the beneficiaries or owners of such entities will constitute the 'accountholders' of trusts and companies that are participating FFIs, and those entities will be subject to due diligence, reporting and withholding obligations with respect to those beneficiaries or owners.

If trusts and holding companies do choose to enter into FFI Agreements, they will be required to examine their records to determine whether there are indicia that their 'accountholders' (*i.e.*, the beneficiaries or equity owners) are US citizens, green card holders or tax residents, or entities substantially owned by US persons and to report this information to the IRS.

In general, this would require that these trusts and companies (i) undertake due diligence obligations with respect to new and pre-existing accounts, (ii) identify and provide an annual report to the IRS (on Form 8966) listing and providing information with respect to its US accounts and (iii) agree to satisfy US withholding tax obligations with respect to certain US source payments and potentially also indirect payments from other participating FFIs (once the Regulations governing 'passthru payments' are finalised).

3.2 The 'Sponsoring/Sponsored FFI' Framework

The Regulations now provide a mechanism through which a participating FFI may agree to undertake reporting on behalf of other FFIs ('**Sponsored FFIs**').

The ‘Sponsoring Entity,’ (*e.g.*, a trust company) could register with the IRS and obtain a FATCA identification number (Global Intermediary Identification Number) (‘**GIIN**’*)* for its identified sponsored trusts or underlying holding companies as entities for which it wishes to perform FATCA reporting. The Sponsoring Entity would then be subject to the same due diligence, verification, and reporting obligations that the trust or company would have been subject to had the trust or company itself entered into an FFI Agreement with the IRS (as discussed above).

The trust or holding company would then provide withholding agents and other FFIs with which it maintains an account with a Form W-8BEN-E identifying itself as a ‘Sponsored FFI’ and its GIIN.

There are two categories of ‘Sponsored’ status that would potentially be available: (i) registered deemed compliant sponsored status and (ii) certified deemed compliant status as a ‘closely held investment vehicle.’ The latter requires significantly less reporting and compliance by the trust itself; however, to qualify certain additional conditions must be met (*e.g.,* a limitation that the entity must be held only by twenty or fewer *individuals*).

Therefore, only trusts having 20 or fewer individuals as beneficiaries are eligible for the less restrictive ‘closely held investment vehicle category’ under the ‘Sponsoring/Sponsored FFI’ approach. If this condition cannot be met, the trust or company could still be sponsored, but in such case it would remain subject to certain registration and certification requirements. These obligations would be undertaken by its sponsor but the trust or holding company would remain liable for any non-compliance.

3.3 ‘Owner-Documented’ FFI Status

Trusts and holding companies that are FFIs may be treated as ‘Owner-Documented FFIs’ with respect to payments received from certain ‘designated withholding agents,’ meaning US financial institutions, participating FFIs, or reporting Model 1 FFIs that agree to collect a Form W-8BEN identifying the trust or holding company as an Owner-Documented FFI that is not acting as an intermediary along with an ‘FFI owner reporting statement’ and valid documentation with respect to each person identified on this owner reporting statement.

As an alternative, in lieu of providing an FFI owner reporting statement and documentation with respect to the persons identified thereon, the trust or holding company may provide a Form W-8BEN along with a letter from a qualified auditor or attorney licensed in the US (or whose firm has a location in the US) signed no more than four years prior to the date of the payment certifying that the firm has reviewed the payee’s documentation with respect to its owners and debt holders and that the trust or company in question meets the applicable requirements.

The designated withholding agent must agree to report to the IRS annually on IRS Form 8966 (i) the name of the trust or company that holds the account, (ii) the account number of the account held by that trust or company, (iii) the account balance or value of the account, (iv) the name, address, and TIN of each specified US person that holds an interest in the trust or company and (v) the amount of payments made with respect to the account to the trust or company during that calendar year.

For further information in relation to anything covered by this Stop Press, please speak to your primary contact or to:

Michael Parets	michael.parets@withersworldwide.com	+41 44 488 8803
Jay Rubinstein	jay.rubinstein@withersworldwide.com	+41 44 488 8801
Aaron Schumacher	aaron.schumacher@withersworldwide.com	+41 22 593 7705

withersworldwide

16, Old Bailey, London EC4M 7EG

Withers LLP London Withers Hong Kong · BVI · Geneva · Zurich Studio Legale Associato con Withers LLP · Milan Withers Bergman LLP New York · Greenwich · New Haven
www.withersworldwide.com