

# F.A.T.C.A. AND TRUSTS: A PRIMER

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The Foreign Account Tax Compliant Act (“F.A.T.C.A”) requires that “foreign financial institutions” (“F.F.I.’s”) and “non-financial foreign entities” (“N.F.F.E.’s”) identify and disclose their U.S. accounts and substantial U.S. holders or be subject to a 30% withholding on certain U.S. source payments (including gross proceeds) made to a foreign entity.

F.A.T.C.A. affects both:

- U.S. tax residents owning assets outside the U.S.; and
- Non-U.S. tax residents holding assets inside the U.S. provided they are tax residents of a country subject to a Model Intergovernmental Agreement (“I.G.A.”) that provides for reciprocity (*i.e.*, U.S. financial institutions reporting information on non-U.S. tax residents to their non-U.S. home country).

More notably, F.A.T.C.A. withholding may apply to all foreign entities including foreign trusts. However, F.A.T.C.A. withholding will not apply if the entity qualifies for an exemption or complies with specified reporting requirements.

The requirements by which a foreign entity must comply to avoid F.A.T.C.A. withholding differ on whether the entity is classified an F.F.I. or a N.F.F.E.. F.A.T.C.A. generally subjects F.F.I.’s to a higher compliance burden than N.F.F.E.’s. Consequently, it is important for the practitioner to first classify the trust in question as an F.F.I or N.F.F.E. in order to determine its compliance requirements. Similar distinctions apply when an I.G.A. applies.

As mentioned above, the U.S. may sign an I.G.A with different countries that may override the F.A.T.C.A. regulations. There are, in general, two types of I.G.A.’s (“Model 1 I.G.A.” and “Model 2 I.G.A.”), which are then further subdivided depending whether reciprocity is requested or whether there is a preexisting tax information exchange agreement or double tax convention in effect. Depending on which Model is selected, the obligations of the resident F.I.’s will vary.

# CLASSIFICATION OF THE ENTITY

## **Final Regulations**

There are four types of F.F.I.'s: depository institutions, custodial institutions, certain insurance companies, and investment entities. Trusts are most likely to be considered F.F.I.'s under the "professionally managed" prong of the investment entity provision; therefore, other F.F.I. types will not be discussed further.

"Investment entities" can be subdivided into three categories, of which only "Type B" investment entities are relevant with respect to trusts.

To be a Type B investment entity, an entity must meet both of the following requirements:

- The entity's gross income must be "primarily attributable to investing, reinvesting, or trading in financial assets" (the "gross income" test); and
- The entity must be "managed by" a depository institution F.F.I., a custodial institution F.F.I., a specified insurance company F.F.I., or a "Type A" investment entity<sup>4</sup> (the "professionally managed" test).<sup>5</sup>

Under the "gross income" test, an entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets if the entity's gross income attributable to those activities equals or exceeds 50% of its gross income during a three-year look-back window.

Under the "professionally managed" test, a trustee must be an entity and actually act as a money manager. Merely soliciting investment advice or receiving fees from those services, without additional activity, should not cause a trust to be considered F.F.I. status under the investment entity prong of the regulations.<sup>6</sup>

For these purposes, financial assets include: securities, partnership interests, commodities, notional principal contracts, insurance or annuity contracts, or any interest (including a futures or forward contract or option) in a security, partnership interest, commodity, notional principal contract, insurance contract, or annuity contract.<sup>7</sup> However, financial assets do not include direct holdings of real estate.<sup>8</sup>

Entities that are not F.F.I.'s are considered N.F.F.E.'s. A trust may be considered an N.F.F.E. but may still have compliance requirements as outlined below.

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<sup>4</sup> A Type A investment entity is an entity that conducts as a business various activities, such as trading in financial assets or collective portfolio management, for or on behalf of a customer. See Treas. Reg. §1.1471-5(e)(4)(i)(A).

<sup>5</sup> Treas. Reg. §1.1471-5(e)(4)(i).

<sup>6</sup> See Treas. Reg. §1.1471-5(e)(v), Example 1, 5, and 6. You can also read our announcement of this provision [here](#).

<sup>7</sup> Treas. Reg. §1.1471-5(e)(4)(ii).

<sup>8</sup> See Treas. Reg. §1.1471-5(e)(v), Example 4.

## **Model I.G.A.s**

The definition of “financial institution” (“F.I.”) for purposes of the I.G.A.’s differ slightly but, in many respects, are practically the same. For example, the Model 1 I.G.A. defines a “Financial Institution” (“F.I.”) as a “Custodial Institution,” a “Depository Institution,” an “Investment Entity,” or a “Specified Insurance Company.”<sup>9</sup> Both the Model 1 and Model 2 I.G.A.’s define the term “Investment Entity” as any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer: (1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.), foreign exchange, exchange, interest rate and index instruments, transferable securities, or commodity futures trading; (2) individual and collective portfolio management; or (3) otherwise investing, administering, or managing funds or money on behalf of other persons. However, both I.G.A.’s also provide that the definition “shall be interpreted in a manner consistent with similar language set forth in the definition of ‘financial institution’ in the Financial Action Task Force Recommendations” (“F.A.T.F.”), and there is some unclarity as to its application.<sup>10</sup> In any event, foreign trusts that are professionally managed will fit within this prong and therefore will be considered an F.I. under the I.G.A.’s similar to the final regulations.

## **OBLIGATIONS AS FINANCIAL ENTITY OR NON-FINANCIAL ENTITY**

### **Final Regulations**

Under the final F.A.T.C.A. regulations, if the trust is classified as an F.F.I., the trust must, in general, register with the I.R.S. as a participating F.F.I. in order to avoid withholding. To register it will have to agree to certain terms, including undertaking due diligence, withholding, and information reporting obligations, particularly with

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<sup>9</sup> Model 1 I.G.A., Article 1, paragraph 1(g).

<sup>10</sup> The F.A.T.F. Recommendations generally define an F.I. as any natural or legal person who conducts as a business one or more of the following activities or operations for or on behalf of a customer: (1) acceptance of deposits and other repayable funds from the public; (2) lending; (3) financial leasing; (4) money or value transfer services; (5) issuing and managing means of payment (e.g., credit and debit cards, cheques, traveller's cheques, money orders and bankers' drafts, electronic money); (6) financial guarantees and commitments; (7) trading in: (a) money market instruments (cheques, bills, certificates of deposit, derivatives etc.); (b) foreign exchange; (c) exchange, interest rate and index instruments; (d) transferable securities; (e) commodity futures trading; (8) participation in securities issues and the provision of financial services related to such issues; (9) individual and collective portfolio management; (10) safekeeping and administration of cash or liquid securities on behalf of other persons; (11) otherwise investing, administering or managing funds or money on behalf of other persons; (12) underwriting and placement of life insurance and other investment related insurance; and (13) money and currency changing. See F.A.T.F. Recommendations available at [http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF\\_Recommendations.pdf](http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf).

respect to its U.S. beneficiaries that are treated as reportable U.S. accounts. Exceptions exist for “sponsored” or “owner-documented” F.F.I.’s, in which case a third party, in general, agrees to take on the trust’s obligations as an F.F.I.

If a foreign trust is treated as an F.F.I., interests in the trust are treated as reportable U.S. accounts (*i.e.*, a “financial account”) for these purposes if the U.S. person satisfies any of the following conditions:

- The U.S. person is treated as the owner of a portion of the trust for income tax purposes under the grantor trust rules;
- The U.S. person is entitled to a mandatory distribution from the trust; or
- The U.S. person receives a discretionary distribution from the trust but only if such person receives a distribution in the calendar year.<sup>11</sup>

Information to be reported includes the name of the U.S. beneficiary, the address, the taxpayer identification number, and the amount of any distributions to the beneficiary.

If a trust is classified as an N.F.F.E., a determination must then be made as to whether the trust has a “substantial U.S. owner.”

An N.F.F.E. has a substantial U.S. owner if:

- A U.S. grantor is treated as the owner of the property under the grantor trust rules;<sup>12</sup> or
- A U.S. person “owns” more than 10% of the trust.

In general, ownership is determined for purposes of the 10% test as follows:

- The person receives, directly or indirectly, only discretionary distributions from the trust and the fair market value of the currency or other property distributed, directly or indirectly, from the trust to such person during the prior calendar year exceeds 10% of the value of either all of the distributions made by the trust during that year or all of the assets held by the trust at the end of that year;
- The person is entitled to receive, directly or indirectly, mandatory distributions from the trust and the value of the person's interest in the trust exceeds 10% of the value of all the assets held by the trust as of the end of the prior calendar year; or
- The person is entitled to receive, directly or indirectly, mandatory distributions and may receive, directly or indirectly, discretionary distributions from the trust, and the value of the person's interest in the

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<sup>11</sup> Treas. Reg. §§1.1471-5(a)(2), 1.1471-5(b)(3)(iii)(B).  
<sup>12</sup> Code §§671-679.

trust, determined as the sum of the fair market value of all of the currency or other property distributed from the trust at the discretion of the trustee during the prior calendar year to the person and the value of the person's interest in the trust at the end of that year, exceeds either 10% of the value of all distributions made by such trust during the prior calendar year or 10% of the value of all the assets held by the trust at the end of that year.<sup>13</sup>

The regulations, however, provide a *de minimis* exception. A U.S. person is not treated as an owner if he/she receives less than \$5,000 during the prior calendar year or the value of the mandatory distribution right is less than \$50,000.<sup>14</sup>

An N.F.F.E. complies with F.A.T.C.A. by identifying its substantial U.S. owners including the name, address, and taxpayer identification number of each beneficiary.<sup>15</sup> The N.F.F.E. can also comply with F.A.T.C.A. by certifying to U.S. withholding agents that it has no substantial U.S. owners or to F.F.I.'s with whom it maintains accounts on I.R.S. Form W-8BEN-E.<sup>16</sup>

As an alternative to the foregoing, the N.F.F.E. may elect to be a direct reporting N.F.F.E., in which case it will register with the I.R.S. and report directly the information as required under F.A.T.C.A. including, among other things, the name, address, and taxpayer identification number of each substantial U.S. owner, the total payments made to each substantial U.S. owner, and the value of the interest in the N.F.F.E.<sup>17</sup>

### **Model I.G.A.s**

The Model 1 I.G.A. largely follows but diverges from the final regulations in certain respects. In particular:

- If treated as an F.I., withholding but not information reporting is eliminated unless there is significant non-compliance over an 18-month cure period. However, the F.I. must report information on its reportable U.S. accounts.
- Reportable U.S. accounts include not only e.g., depository and custodial accounts, but also an equity interest in the foreign trust if the trust is treated as an "Investment Entity." The term equity interest 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 U.S. person is treated as being a beneficiary of a foreign trust if such U.S. 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. There is no *de minimis* threshold for these purposes.

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<sup>13</sup> Treas. Reg. §1.1473-1(b)(3).

<sup>14</sup> Treas. Reg. §1.1473-1(b)(4).

<sup>15</sup> See Code §1472(b).

<sup>16</sup> See Part XXV, lines 39 b and c. of Form W-8BEN-E (currently in draft form).

<sup>17</sup> Treas. Reg. §1.1472-1T(c)(3).

- Any F.I. that maintains a financial account, which may, as noted above, include an equity interest in a trust, must report information on U.S. individuals and “Controlling Persons” of entities who hold the “account.” The term “Controlling Persons” means the natural persons who exercise control over an entity. In the case of a trust, the term means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust. The I.G.A.’s provide that the term “Controlling Persons” is interpreted in a manner consistent with the F.A.T.F. Recommendations.
- In general, the information to be reported includes the name of that person, the taxpayer identification number, the value of the “account,” and the amount of payments made to the account holder.

The Model 2 I.G.A. follows the Model 1 I.G.A., including the reference to Controlling Persons, but also the F.A.T.C.A. final regulations in certain instances. Notably, for the Model 2 I.G.A., the definition of “financial account” cross-references the definition of financial account in the final regulations. Therefore, those rules will, in general, apply unless expressly stated otherwise by that I.G.A.<sup>18</sup>

### **Conclusion**

The above discussion is only a short summary of the rules. F.A.T.C.A. is incredibly complex and it is now highly recommended that a taxpayer have a competent tax advisor to assist in any non-U.S. tax planning. We are here to assist.

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<sup>18</sup> An exclusion is provided for accounts listed in Annex II, which include *e.g.*, certain retirement and pension accounts.