GLOBAL EXCHANGE OF INFORMATION: HOW DOES THE U.S. FIT INTO THE PUZZLE? MEET THE U.S. FOREIGN TRUST

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U.S. RECIPROCAL REPORTING UNDER F.A.T.C.A.

In 2010, the U.S. enacted the Foreign Account Tax Compliance Act ("F.A.T.C.A.") in an attempt to obtain information about foreign bank and financial accounts held by Americans. Many of these Americans had not been fully U.S. tax compliant and had failed to file information returns or pay tax on the income from these accounts. The new law placed the onus on foreign financial institutions to look for U.S. account holders and U.S. persons who controlled certain non-U.S.-owned accounts and to report specific information relating to such "U.S. accounts."

Generally, the information that the U.S. sought was (i) the names of the U.S. persons, (ii) the account balance on the last day of the year, (iii) the amounts paid during the year, (iv) the dividends and interest earned, and (v) starting in 2017, the gross proceeds from sales of property.

Motivation for foreign financial institutions to comply came in the form of a 30% F.A.T.C.A. withholding tax, applicable to U.S.-source income paid to nonparticipating institutions. However, no matter how strong the motivation was for foreign financial institutions to comply, they could not overcome the fact that reporting this type of information was against the law in most countries.

Thus, foreign governments that chose to cooperate with F.A.T.C.A. first had to enact F.A.T.C.A.-inspired laws to allow for the required disclosures of information. The first step in foreign implementation was the signing of an intergovernmental agreement ("I.G.A.") with the U.S., and to entice participation in the I.G.A. approach to F.A.T.C.A. compliance, the U.S. offered some countries reciprocal agreements.

Notably, not all countries were offered the reciprocal version. Only those with which the U.S. had an income tax treaty allowing for the exchange of information for tax purposes, or those that were a party to an agreement on exchange of information in tax matters ("T.I.E.A."), were offered a reciprocal model 1 I.G.A.

HOW RECIPROCAL ARE THOSE AGREEMENTS? DOES THE U.S. REPORT INFORMATION SIMILAR TO WHAT IT REQUESTS AND RECEIVES?

As it turns out, reciprocal does not mean equal. While the U.S. requires foreign countries to provide all of the above-mentioned information, the U.S., without changing its laws, would offer only the information it already collects, namely, U.S.-source interest income earned on individual depository accounts. With respect to non-cash accounts, the U.S. would report U.S.-source dividends and interest earned. And in

any event, the U.S. would not (and will not) seek to learn or identify the residency of beneficial owners. If an entity custodial account is reported, it is the entity that will be reported.

Additionally, the I.R.S. announced that it will engage only in reciprocal exchange (as reciprocal as that may be), with foreign countries that, among other requirements, meet stringent I.R.S. information safeguard, privacy, and technical standards. The I.R.S. said that before exchanging information the U.S. will conduct a detailed review of the recipient country's laws and infrastructure concerning the use and protection of taxpayer data and cyber-security capabilities, as well as security practices and procedures.[1]

REPORTING UNDER THE COMMON REPORTING STANDARD

In 2014, the G-20 countries, inspired by F.A.T.C.A., requested that the O.E.C.D. draft standards for common reporting of information between jurisdictions. Many refer to this as the Global F.A.T.C.A. – or in short, G.A.T.C.A. – but the formal name is the Standard for Automatic Exchange of Financial Account Information in Tax Matters. In short, it is known as the Common Reporting Standard or C.R.S.

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C.R.S. requires financial institutions to report information similar to that requested under F.A.T.C.A., except it is not limited to U.S. persons. There is no *de minimis* rule under the C.R.S., and the categories of entities for which a look-through rule applies are broader.

As of July 26, 2016 – the last day the O.E.C.D. updated its list of participating jurisdictions – 101 countries have committed to the C.R.S.[2] Of those, 54 countries have committed to an initial exchange as early as 2017. This exchange will correspond to the prior year. The 2017 reports affecting preexisting accounts are expected to only be with respect to high value individual accounts. Entity accounts are expected to begin in 2018, with respect to 2017.

THE C.R.S. LOOK-THROUGH RULE

The C.R.S. requires financial institutions to "look through" passive nonfinancial entities in order to identify "controlling persons." The term controlling person is defined under C.R.S. in relation to the term "beneficial owner" in the Financial Action Task Force ("F.A.T.F.") recommendations. Generally, the term means the natural person(s) who exercises control over the entity, normally, the individual(s) with a controlling ownership interest. While there is no set threshold, in many structures, individuals that hold, directly or indirectly, more than 25% of the voting rights will be

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1 "IRS Announces Key Milestone in FATCA Implementation; U.S. Begins Reciprocal Automatic Exchange of Tax Information under Intergovernmental Agreements," I.R.S., last reviewed or updated September 12, 2016.

2 As of September 14, 2016, with the joining of Pakistan, 104 countries have committed to the C.R.S. O.E.C.D., "Pakistan Becomes the 104th Jurisdiction to Join the Most Powerful Multilateral Instrument Against Offshore Tax Evasion and Avoidance," news release, September 14, 2016.

treated as controlling persons. In the case of a trust, the term controlling persons is explicitly defined in the C.R.S. to mean the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust. If any of the above controlling persons is an entity, the reporting financial institution must identify the controlling persons of such entity in accordance with the applicable definition.

Further, the C.R.S. views investment entities that are managed by financial institutions that are resident in countries not participating in the C.R.S. as passive nonfinancial entities. When the look-through rule applies, the financial institution applying C.R.S. must identify the controlling persons of such investment entity. With respect to trusts, these will be investment entities if their gross income is primarily attributable to investing, reinvesting, or trading in financial assets, and if they are managed by a financial institution. Generally, the only trusts that would not be investment entities are those that have an individual trustee that does not hire any entity as an investment manager, advisor, etc., but those will be subject to the general look-through rule applicable to passive nonfinancial entities.

Under C.R.S. definitions, a trust is considered resident in the country where the trustee is residing, regardless of whether the trust, itself, is considered resident in that country for income tax purposes. Thus, if the trustee is a resident of a country that does not participate in the C.R.S., the financial institution with which an account is held that is subject to C.R.S. reporting obligations will be required to look through the trust to its controlling persons. Controlling persons (*i.e.*, trust beneficiaries as well as settlors, protectors, and trustees) who are residents of C.R.S.-participating countries will be reported to their countries of residence, and any U.S. person will be reported to the U.S. under F.A.T.C.A.

Consequently, trusts that historically have been established in third-party (now participating) jurisdictions for asset protection, privacy, and other reasons may find that the new C.R.S. rules will impose a level of disclosure inconsistent with those objectives.

U.S. PARTICIPATION IN THE C.R.S.

To date, the U.S. has not signed or committed to sign on to the C.R.S. Thus, the U.S. is not part of the O.E.C.D.'s list of participating jurisdictions. However, in a footnote to that list, the O.E.C.D. stated that the U.S.:

> [H]as indicated that it is undertaking automatic information exchanges pursuant to FATCA from 2015 and has entered into intergovernmental agreements (IGAs) with other jurisdictions to do so. The Model 1A IGAs entered into by the United States acknowledge the need for the United States to achieve equivalent levels of reciprocal automatic information exchange with partner jurisdictions. They also include a political commitment to pursue the adoption of regulations and to advocate and support relevant legislation to achieve such equivalent levels of reciprocal automatic exchange.[3]

While the U.S. has committed, in its reciprocal I.G.A.'s, to adopt regulations and

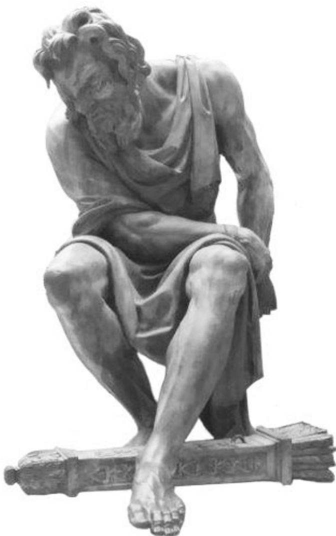
[3] O.E.C.D., *AEOI: Status of Commitments*, (2016).

advocate relevant legislation, to date, no legislative action has been taken. Under these I.G.A.'s the U.S. and partner countries agreed that prior to December 31, 2016 they would consult in good faith to amend the agreements as necessary to reflect progress on the commitment for reciprocity.[4]

WHERE DOES IT LEAVE THE U.S.? WILL U.S. TRUSTS AND FUNDS BE TREATED AS PASSIVE NONFINANCIAL ENTITIES TO WHICH THE C.R.S. LOOK-THROUGH RULE WILL APPLY?

Under the C.R.S., it is expected that each country would have a list of non-reporting financial institutions and that there will be a separate list for domestic institutions and for different participating jurisdictions. It is further expected that each country would make its lists publicly available.

Based on the footnote with respect to the U.S., which the O.E.C.D. included on the list of participating jurisdictions, it appears that each C.R.S. signatory may decide how to treat the U.S. in its local implementing legislation, and financial institutions in that country would be required to follow such a classification. Nevertheless, the O.E.C.D. has provided guidelines for including countries in the participating list. These guidelines basically limit the list to those countries that demonstrate some commitment to the C.R.S.



Luxembourg and the B.V.I., as well as one or two other jurisdictions, initially included the U.S. on their lists of participating jurisdictions, based on the U.S. commitment under F.A.T.C.A. However, shortly after publication, these jurisdictions removed the U.S. from their lists, indicating that the U.S. does not meet the requirements. It seems, therefore, that if the U.S. remains a non-signatory, it would be prudent to assume other countries may not agree to view the U.S. commitment to exchange information under F.A.T.C.A. as satisfactory under the C.R.S.

This may mean that U.S. funds and U.S. trusts that are managed by financial institutions (*i.e.*, U.S. trust companies) will be looked through outside the U.S. if they maintain accounts in a C.R.S.-participating country. This does not mean, however, that the C.R.S. rules will apply to a U.S. entity whose assets are invested in the U.S.

COULD THE U.S. BE THE ANSWER?

It is possible to establish a U.S. trust under the laws of a state such as Delaware, South Dakota, or New York with U.S. trustees, yet which is treated as a foreign trust for income tax purposes. Consequently, this "hybrid" trust will be a foreign trust for U.S. income tax purposes and a U.S. trust for C.R.S. reporting purposes (as the trustees are U.S. persons and the trust, therefore, is resident in the U.S.). This is sometimes referred to as a "U.S. foreign trust."

For a trust to be treated as a U.S. domestic trust for income tax purposes, two tests must be met: (i) a "court test," which looks for a U.S. court to have exclusive jurisdiction over the trust (generally met in the case of a trust established under the laws

[4] Model 1 I.G.A., Article 6 and Article 10(3).

of a state), and (ii) a "control test," which requires U.S. persons to hold the power to make all substantial decisions with respect to the trust. A trust will be a U.S. foreign trust for income tax purposes if, for example, a foreign individual serves as protector and has the power to control the decision to terminate the trust or to distribute trust assets.

A U.S. foreign trust for income tax purposes, is taxed in the U.S. as a nonresident, noncitizen individual that is not present in the U.S. at any time. This means that U.S.-source passive income, such as rents,[5] dividends, interests, and royalties, will be subject to 30% withholding on a gross basis. Some types of interest may be exempt from U.S. tax if the debt for which they are paid meets the requirements for treatment as "portfolio debt."[6] Publicly traded debt instruments issued by U.S. corporations and U.S. Treasury debt instruments typically meet those requirements. Also exempt are (i) bank deposit interest that is not considered to be effectively connected income;[7] (ii) short-term, original issue discount income;[8] and (iii) original issue discount of tax exempt municipal bonds.[9] Effectively connected income is subject to tax at graduated rates of up to 39.6% and the tax base can be reduced by deductions for operating expenses.[10]

Capital gains from U.S. sources generally will not be subject to U.S. tax. However, exceptions to that treatment exist for capital gains from real property[11] and gains from the sale of intangible property to the extent such gain is contingent on productivity, use, or disposition of the intangible property.[12] Real property capital gains will be treated as effectively connected income and as such the net gain will be taxed at 20% if the property is held for more than 12 months. Contingent gain from the sale of intangible property is subject to 30% withholding tax imposed on the gross amount paid. State tax may also apply to certain income allocated to state property.

Accounts maintained by a U.S. foreign trust in a foreign participating jurisdiction may result in C.R.S. look-through reporting in that jurisdiction, unless the U.S. is treated as a participating country under local C.R.S. laws. Those accounts should be avoided until further clarification.

CONCLUSION

The U.S. position on the C.R.S. is likely to be influenced by the outcome of the next election. Whatever happens, planning to use the hybrid trust structure should prove beneficial. As long as the U.S. is not part of the C.R.S., privacy is enhanced,

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[5] Other than rents for which an election is made to have the rents treated as effectively connected income. See Code §871(d). Such rents are subject to graduated tax rates and deductions for operating expenses and depreciation reduce the tax base.

[6] Code §871(h).

[7] Code §871(i)(2)(A).

[8] Code §871(g)(1)(B)(i)

[9] Code §871(g)(1)(B)(ii)

[10] Code §871(b)(1).

[11] Code § 897.

[12] Code §871(a)(1)(D).

and even if the U.S. becomes a participating C.R.S. jurisdiction, the structure can be retained as there is no other jurisdiction that offers privacy and has as stable a financial industry as the U.S. Enjoy the privacy while it lasts, and know that the U.S. will likely be the last jurisdiction to sign on – if it ever does. Even then, the U.S. is unlikely to provide information that will not be kept confidential by the receiving country.

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