Implementation of International Tax Compliance (United States of America) Regulations 2013

STEP Response to Draft Guidance and Draft Legislation issued on 18 December 2012

Main Points

- **This submission focuses on the position of trusts under the IGA. While there are many detailed issues which need to be resolved in due course, we highlight four key areas where trustees working to ensure that the trusts for which they are responsible are IGA compliant need further information and guidance as a matter of priority. We would note more broadly, however, that it is essential that the regulations and guidance should be as clear as possible to minimise the risk of inadvertent non-compliance. The draft regulations and guidance in their current form are inadequate in relation to the treatment of trusts and trustees.**

- **Statements from both the UK and US authorities indicate a desire to avoid placing onerous reporting requirements on family trusts. Even so, it seems highly likely on the current approach that large numbers of UK resident trusts will be categorised as Financial Institutions (FIs) and will therefore face significant and unnecessary compliance costs. This problem arises as a result of categorising trusts by reference to the nature of their trustees and the nature of the third party service providers they engage. It would be simpler and more effective if all trusts not set up for commercial purposes were treated as NFFEs. This would be consistent with the declared objectives of FATCA and still ensure that family trusts were fully reported on by their associated FIs.**

- **Unlike most FIs, trusts often hold significant non-financial assets such as real property or chattels. The reporting requirements and associated guidance suggested for trusts categorised as FIs are clearly designed for institutions primarily holding financial assets. Applied to trusts holding non-financial assets they risk imposing costly annual valuation requirements on trustees which will add little to the more readily available information on distributions from the trust.**

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- **There is considerable practitioner uncertainty as to the process for identifying 'controlling persons' and 'specified US persons' in a trust context. In part this relates to the distinction between an interest in the capital of the trust and distributions from the trust.**

- **Family trusts that are deemed to be FIs might well find that the most effective way to fulfil their reporting obligations is by obtaining 'deemed-complaint status', as outlined in the US regulations. Unfortunately, it is not clear that this option is open to them under the IGA.**

Detailed Comments

1. STEP is the worldwide professional association for practitioners dealing with family inheritance and succession planning. STEP helps to improve public understanding of the issues families face in this area and promotes education and high professional standards among its members. STEP has 18,000 members across 80 jurisdictions from a broad range of professional backgrounds, including lawyers, accountants, trust specialists and other practitioners. In the UK STEP has over 6,500 members and it supports an extensive regional network providing training and professional development.

2. As we indicated in our response to the original consultation published in September 2012, STEP welcomes the UK Government's initiative in concluding an Intergovernmental Agreement (IGA) with the US authorities. The UK Government's willingness to address many of the issues highlighted in the initial consultation in terms of shaping the draft guidance and legislation issued in December 2012 is also appreciated. Even under the IGA, however, the compliance burdens imposed on UK practitioners will remain very substantial and it is important to minimise such burdens as far as is consistent with ensuring adequate reporting.

The status of trusts and trustees under the IGA

3. The draft guidance (Paragraph 2.20) argues that "in most cases Trusts will fall to be Non Financial Foreign Entities (NFFEs) as they will not fall within the definition of the four types of Financial Institution". If this aim is fulfilled, this would indeed significantly reduce compliance costs. We have serious concerns, however, that, as currently drafted, the regulations will mean that in practice most UK trusts will be regarded as FIs under the IGA.

4. Similarly the status of trustees under the IGA remains unclear. The draft guidance proposes that "trustees acting on behalf of trusts will be seen as Financial Institutions for the purposes of this legislation, where they are a remunerated independent legal professional or trust company

service provider as defined in the Money Laundering Regulation 2007" (Paragraph 2.20). This is reflected in regulation 7(1) of the draft UK regulations which refers to independent legal professionals (Regulation 3(9) of the Money Laundering Regulations) and trust company service providers (Regulation 3(10) of the Money Laundering Regulations). Both these definitions refer to either firms or sole practitioners involved in the business of providing the relevant services but neither definition refers to the individual partners of a firm. Moreover the independent legal professional definition applies where legal advice has been given by the firm or sole practitioner in relation to the creation, operation or management of trusts – not necessarily where they are acting as trustees. It thus remains unclear what the position of the individual partner of a firm acting as trustee will be, particularly since the IGA Articles 1.1 h-j makes it clear that FIs can only be entities (as do the US regulations), apparently ruling out individual partners being FIs as the guidance suggests they may be. There is also uncertainty regarding the position of other professionals who frequently act as trustees such as accountants and tax advisers. It is assumed, but not entirely certain, that the regulation 3(10) definition is to apply to these professionals. Again, however, it only applies at the firm or sole practitioner level, not to individual partners acting as trustee. There is a risk therefore that the drafting of regulation 7.1 in the UK regulations may distort the market place since it potentially creates differences in the way different professionals acting as trustees are treated and it is not clear what the position of individual partners of professional firms acting as trustees will be.

5. A further ambiguity flowing from the wording of regulation 7 of the draft UK regulations is that the drafting does not make clear whether the regulations apply to the trustees themselves or the trustees in their capacity as trustees of a particular trust (i.e. applies to each individual trust separately).

6. It remains unclear what sort of FI trusts with professional trustees might be. The guidance suggests that trust companies might be Custodial Institutions (paragraph 2.11) and the draft UK regulations (7.2) appear to confirm this, stating that "the property (subject to the trust) is to be treated as a custodial account for the purposes of these Regulations". Article 1.1.h of the IGA defines a Custodial Institution as "an entity that holds, as a substantial portion of its business, financial assets for the account of others". The trust fund of many trusts does not include significant financial assets, with the main asset held in many trusts being real property, chattels or interests in private companies. If a trust does indeed hold few or no financial assets it is not at all clear that its trustees could be held to be a Custodial Institution.

7. Paragraph 2.20 of the guidance also suggests that trust managers may be Investment Entities. The IGA definition (Article 1.1.j) of Investment Entity states that these are "any entity that that conducts as a business ….investing, administering or managing funds or money on behalf of other persons". It is again not entirely clear if this definition can include trustees for trusts where the main asset held is real property. The distinction is important, however, since Article

1.1.j of the IGA states that "any entity which is managed" by an Investment Entity is itself an Investment Entity. As a result we would have serious concerns that, in practice, this will make the great majority of UK trusts Investment Entities, not NFFEs, and unintentionally impose burdensome registration and reporting requirements on them to little or no benefit.

8. The final US regulations published in January heighten concerns that in many, indeed probably the majority, of cases UK trusts will in fact be required to register as Investment Entities if the US methodology is applied since their trustees will be deemed to be Investment Entities. Examples 5 and 6 given in Regulation 1.1471-5(e)(4)(v) (page 422) suggest that any trust where trust services are provided by a corporate trustee would be regarded as an Investment Entity (as would the corporate trustees). In the UK context recent years have seen a marked shift towards the use of corporate trustees rather than individual trustees, primarily because this makes it easier when trustees wish to retire or move on for other reasons. If the rules set out in the US regulations were followed in the IGA, therefore, significant numbers of UK family trusts would be deemed to be FIs.

9. Similarly, under the US regulations (Example 5 highlighted above) if an individual trustee hires any entity as third party service provider to perform any of a range of activities then the trust will become an Investment Entity. Thus, for example, if an individual acting as a trustee appoints an FFI (typically an Investment Entity) to act as fund manager and manage the trust portfolio this may mean that the trust itself would be deemed to be an Investment Entity. We cannot see why it is thought necessary to treat a trust in this way simply because of the nature of the third party services that the trustees engage.

10. Both the UK and US authorities have been explicit in stating that there is no intention under FATCA to impose onerous reporting requirements on "family trusts". Both the current IGA and the US regulations, however, are drafted in such as a way as to indicate a lack of understanding about how trusts are structured and used in the UK. Unlike the US, many UK family trusts will have a professional trustee of some sort. Whether this trustee is an individual adviser or a corporate trust service provider will simply reflect the normal procedures of the adviser the family has consulted in creating the trust – it will not reflect the nature of the trust. Treating family trusts differently accordingly to the characteristics of their trustees risks introducing wholly artificial distortions into the market place. Further, such distortions will be introduced with no net gain in terms of reporting since all UK resident trusts with financial assets, whatever the nature of their trustees, will be reported on under the IGA by banks, investment managers and other FIs.

11. The draft guidance (paragraph 2.20) refers to family trusts being those that "generally do not accept deposits, operate as an insurance company or hold financial assets as a substantial part of (their) business for the account of others" and states that unit trusts are not considered to be family trusts. The discussion in the US regulations on Investment Entities (Preamble, VI.E.3),

expresses similar sentiments, suggesting that investment entities primarily conduct "business on behalf of customers" and "function or hold themselves out as mutual funds, hedge funds, or any similar investment vehicle established with an investment strategy of investing, reinvesting or trading in financial assets". The focus on investment businesses investing on behalf of customers appears to be in clear contrast to trusts which hold assets on behalf of a pre-defined group of beneficiaries. An alternative approach would be to explicitly identify family trusts as those where beneficiaries are limited to members of a family or those closely associated with them. This would mimic the approach the US Regulations take to identifying 'sponsored closely held investment vehicles' (1.471-5(f)(2)(iii)) which delineates on the basis of not holding oneself out "as an investment vehicle for unrelated parties".

Trust reporting

12. There remains considerable uncertainty as to what needs to be reported under the IGA, particularly with regard to the reporting of non-financial assets which form part of the trust fund such as holdings of real property, chattels and stakes in private companies. Regulation 7.2 of the draft UK regulations states "the only reportable account in relation to the trust is the property subject to the trust and that property is to be treated as a custodial account for the purposes of these Regulations". Draft UK regulation 10(4)(d) goes on to require an annual valuation of the account. Article 1.1.g the IGA nevertheless defines 'Custodial Institution' in terms of entities that hold "financial assets for the account of others" and Article 1.1.u defines Custodial Account in terms of an account that "holds any financial instrument or contract held for investment". This raises questions over the situation of trusts with significant non-financial assets which are particularly important in practical terms given the cost of obtaining an annual valuation of many non-financial assets. It should be made absolutely clear what assets in the trust fund need to be valued.

13. Further questions arise about the need to report annual valuations because Article 1.1.v of the IGA suggests that a 'Specified US Person' should be treated as the beneficiary of a foreign trust "if such Specified US person has the to the right to receive… a mandatory distribution or…. a discretionary distribution from the trust". This seems to suggest that the main point of interest for the US authorities is distributions rather than capital sums held in the trust.

14. The position of trusts regarded as an Investment Entities is similarly ambiguous where they hold significant non-financial assets. An Investment Entity is defined as "investing, administering or managing funds or money on behalf of other persons" under the IGA (Article 1.1.j.2). The US draft regulations extend this slightly by adding "financial assets" (1.471-5(e)(4)(i)(A)(3)), but given that the definition of Investment Entity does not appear to include non-financial assets it remains open to question whether a trust deemed to be an Investment Entity should include such assets when making an annual report of "account balance or value" under Article 2.2.a.4 of the IGA. Clearly it would substantially ease reporting costs if they did not.

Identification of Controlling Persons and Specified US Persons

15. If the trust is an NFFE it will be necessary to identify any Controlling Person that is a Specified US Person (Article 2.2.a.1. of the IGA). Annex 1.4.a of the IGA notes that for the purposes of identifying a Controlling Person, an FI "may rely on information collected and maintained pursuant to AML/KYC procedures" and the UK Guidance (Paragraph 7.20) adds that "Controlling Persons shall be interpreted in a manner consistent with the Recommendations of the Financial Action Task Force". The FATF Recommendations, however, only use the term 'controlling shareholders' and that is in the context of Recommendation 24 (legal persons), where a reference is made to an illustrative 25% threshold. We understand that it is intended that a 25% threshold should be applied under the IGA in line with the definition of 'beneficial owners' given in Regulation 6(2)(a) of the Money Laundering Regulations 2007. This has not been made adequately clear in the draft Guidance and it would be helpful if explicit reference were made to the relevant section of the 2007 Act in identifying Controlling Persons. Moreover, we would note the US regulations seem to be drawn more narrowly than the IGA in as much as the focus for (non-grantor) trusts that are NNFEs, as in the case of trust which are FIs, is purely on beneficiaries in receipt of distributions (see below) rather than the much wider group of 'beneficial owners' used in the UK for AML purposes.

16. If the trust is an FI it is required to identify each "Specified US Person that is an account holder" (IGA Article 2.2.a.1). In the case of trusts that are to be treated as Investment Entities, the IGA (Article 1.1.v) states that an 'equity interest' is considered to be held by a settlor or beneficiary of "all or a portion of the trust", or any other natural person "exercising ultimate effective control". This appears to refer to capital. Article 1.1.v goes on to note, however, that a specified US person shall be treated as a beneficiary if they have the right to receive mandatory or discretionary distributions from the trust. This raises questions over how to report US citizens who might have, for example, an equity interest in the trust via a right to capital in the trust but not to distributions. Moreover the IGA again appears to be drawn more widely than the US regulations (1.1471-5(b)(iii)) which indicate that beneficiaries need to be disclosed only if they receive a distribution from the trust.

17. The US regulations (1.1473-1(b)(3)) lay out complex aggregation procedures for beneficial interests in foreign trusts that are NFFEs. The US regulations also impose a *de minimis* limit for a reportable specified US person's interest in a trust ($5,000 distribution or $50,000 'beneficial interest' i.e. capital) but deem all US owners to be 'substantial US owners' if the trust is deemed to be an Investment Entity. The UK guidance gives some guidance on aggregation procedures in the case of bank accounts (paragraph 4.6) but remains silent on many of the issues that can arise in the trust context. The IGA also gives *de minimis* limits in terms of "account value" (we assume capital) but makes no indication regarding any *de minimis* limit for trust distributions.

Deemed-Compliant Status

18. Trusts that are deemed to be FIs under the IGA may find that it would help to reduce the likely very substantial compliance costs if the IGA permitted them to obtain deemed-compliant status as found in the US Regulations. Trustees, for example, who are partners of professional firms may find it convenient and cost effective if the trusts they are trustees of could have an equivalent status to 'sponsored closely held investment vehicles' (Regulation 1471-5(f)(2)(iii)), with their professional firm acting as the sponsoring entity for the trust and performing necessary compliance functions. Other trustees have indicated that trusts might well be interested in becoming an equivalent of owner-documented FFIs (Regulation 1471-5(f)(3)) for similar reasons. The US regulations already make reference to Model 1 IGA withholding agents for owner documented FFIs and withholding agents for such owner documented FFIs reporting via Model 1 partner tax authorities. Practitioners would therefore welcome an extension of the IGA regulations and guidance to include these categories of deemed-compliant FIs.

STEP

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