Questions and Answers About FATCA and Foreign Trusts

May 14, 2012

The U.S. Treasury Department recently issued proposed regulations interpreting sections of the Internal Revenue Code (the Code) commonly referred to as the Foreign Account Tax Compliance Act (FATCA). The proposed regulations, which are lengthy and complex, raise reporting and withholding tax issues for trustees of non-U.S. trusts and, indirectly, U.S. citizen and resident beneficiaries of foreign trusts. These questions and answers address some of the most important of these issues. Please visit http://www.mwe.com/info/news/fatca.htm for a general discussion of the proposed regulations.

1. WHAT IS FATCA?

FATCA is U.S. legislation that was enacted in 2010 to prevent U.S. persons from using foreign accounts and foreign entities to evade U.S. tax. FATCA generally requires U.S. persons—including U.S. banks, brokers and companies—and foreign financial institutions that have entered into agreements with the Internal Revenue Service (IRS) to withhold 30 percent of certain payments (described below) made to a foreign entity unless the entity qualifies for an exemption or complies with specified reporting requirements that are designed to disclose U.S. persons holding accounts with or interests in the entity.

Withholding under FATCA is separate and distinct from withholding under other provisions of the Code and affects a broader class of payments. Exceptions from withholding that generally are applicable to U.S. source payments made to foreign persons (e.g., the portfolio debt exception) do not extend to FATCA withholding because FATCA withholding relates to the tax liabilities of U.S. persons.

Withholdable payments for purposes of FATCA generally include (1) payments of U.S. source "fixed or determinable annual or periodic" income, such as dividends and interest; (2) payments of the gross proceeds from a sale or disposition of property that can generate U.S. source interest or dividends; and (3) "passthru payments" made by certain foreign financial institutions.1 The proposed regulations do not define "passthru payments"; further regulations likely will define the term to include foreign source payments that are treated as derived from payments in categories (1) and (2).2

Withholding also can be draconian under FATCA because in some cases a foreign entity may not be entitled to a refund or credit of taxes withheld in excess of the entity's actual liability for the tax.3

The requirements with which a foreign entity must comply to avoid FATCA withholding differ depending on whether the entity is classified for FATCA purposes as a foreign financial institution (FFI) or a non-financial foreign entity (NFFE). FATCA generally subjects FFIs to a higher compliance burden than NFFEs.

2. IS A FOREIGN TRUST AN FFI?

Professional organizations, such as the American College of Trusts and Estates Counsel, have urged that foreign trusts be treated as NFFEs, not FFIs. However, the proposed regulations seem to assume that most foreign trusts will be FFIs.

Based on the proposed regulations, it appears that a foreign trust that earns more than 50 percent of its gross income from investing in stocks, bonds, partnership interests and similar assets will be classified as an FFI rather than as an NFFE, because such a trust is "in the business" of investing, reinvesting and trading financial assets.4 As discussed in Q&A 8, it is possible that a foreign trust that holds its assets through a holding company may be classified as an NFFE.

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[1] Code §§1473(1) and 1471(d)(7); Prop. Treas. Reg. §§1.1473-1(a) and 1.1471-5(h).

[2] Code §1471(d)(7); Prop. Treas. Reg. §1.1471-5(h).

[3] In particular, if a foreign entity that is the beneficial owner of a withholdable payment is not a "participating foreign financial institution" (as described in the text that follows), the entity will not be able to obtain a refund or credit of amounts withheld unless required by an applicable treaty. Code §1474(b)(2); Prop. Treas. Reg. §1.1474-5(a)(2).

[4] Code § 1471(d)(5); Prop. Treas. Reg. §1.1471-5(e).

3. IF A FOREIGN TRUST IS AN FFI, HOW CAN THE TRUST AVOID FATCA WITHHOLDING?

There are three principal ways that a foreign trust that is an FFI can avoid FATCA withholding:

- The trustee can invest only in assets that do not generate payments subject to FATCA withholding, which in general means avoiding U.S.-related investments. But this is not a full solution because while a trustee may be able to invest in a manner that ensures that the trust does not directly receive U.S. source income, as a practical matter it may be difficult for a foreign trustee to control the receipt of passthru payments. If, for example, a foreign trust has an account with a foreign bank or an interest in a foreign investment fund that itself directly or indirectly holds assets that produce U.S. source interest or dividends, the foreign trust is likely to have income from passthru payments.

- The trustee can enter into an agreement with the IRS on behalf of the trust and cause the trust to become a "participating FFI" (as described in Q&A 4).

- The trustee can cause the trust to be an "owner-documented FFI" (as described in Q&A 5).

A trustee might think that excluding U.S. taxpayers as trust beneficiaries would resolve any FATCA issues. The Code contemplates that FFIs will be deemed compliant with FATCA if they satisfy the IRS that they have no U.S. account holders.[5] The proposed regulations, however, appear to take the position that a foreign trust will be subject to FATCA withholding even if it has no U.S. beneficiaries, although there is no specific provision addressing this point. Therefore, it appears that under the proposed regulations, the trustee of a foreign trust that has no U.S. beneficiaries generally must comply with one of the three approaches identified above to avoid FATCA withholding. If a trust is to be treated as a financial institution, there should be a straightforward way for the many foreign trusts that have no U.S. beneficiaries but that invest in the United States to certify to the IRS that they have no U.S. beneficiaries. Such a certification is possible for NFFEs,[6] and it should be made available to foreign trusts if the final regulations treat them as FFIs.

4. WHAT ARE THE REQUIREMENTS FOR A NON-U.S. TRUST TO BE A "PARTICIPATING FFI"?

The trustee must enter into an agreement with the IRS on behalf of the trust, pursuant to which the trustee agrees to take a number of actions, including following principal items:

- Take steps to identify the beneficiaries of the trust that are U.S. persons and U.S.-owned foreign entities (including other foreign trusts with U.S. beneficiaries).[7]

- Provide an annual report containing information about trust beneficiaries who are U.S. persons and U.S.-owned foreign entities that are not themselves participating FFIs, including each such beneficiary's name, address and taxpayer identification number.[8] The proposed regulations generally require the annual report to include information about any U.S. beneficiary who has a right to receive a distribution or who may receive a distribution in the discretion of the trustee, if such beneficiary has in fact received a distribution.[9] It is not clear whether information must be provided about a U.S. discretionary beneficiary who has not received any distributions from the trust.[10]

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[5] Code §1471(b)(2)(A)(i).
[6] Code §1472(b)(1)(A); Prop. Treas. Reg. §1.1472-1(b)(1)(ii).
[7] Code §§1471(b)(1)(A), 1471(b)(1)(B); Prop. Treas. Reg. §1.1471-4(a)(2).
[8] Code §§1471(b)(1)(C), 1471(c); Prop. Treas. Reg. §§1.1471-4(a)(3), 1.1471-4(d).
[9] Prop. Treas. Reg. §§1.1471-5(a), 1.1471-5(b)(3)(iii), 1.1473-1(b)(3).
[10] As described above in Q&A 3, it does not appear that a foreign trust is excepted from FATCA withholding simply because it has no U.S. beneficiaries. If a foreign trust that has no U.S. beneficiaries becomes a participating FFI, the trustee's annual report to the IRS presumably will indicate that the trust has no U.S. beneficiaries.

- Withhold 30 percent of passthru payments made to beneficiaries that do not provide the trustee with sufficient identifying information and to beneficiaries that are themselves nonparticipating FFIs.[11] A participating FFI must deposit withheld amounts with an authorized financial institution, and annually file a return and pay such amounts to the IRS.[12]

In addition to entering into an agreement with the IRS, for a foreign trust that is a participating FFI to avoid FATCA withholding, the trustee generally must provide information regarding the trust's status as a participating FFI to withholding agents, including U.S. banks, brokers and companies, and to non-U.S. banks, brokers and investment funds that are themselves participating FFIs.[13] In addition, if the withholding agent is a non-U.S. bank, broker or investment fund that itself is a participating FFI, the trustee generally must provide sufficient information about the trust's U.S. beneficiaries to the non-U.S. bank, broker or fund to allow it to satisfy its own FATCA compliance obligations.[14]

5. IS THERE ANY WAY THAT A TRUST CAN SATISFY FATCA DISCLOSURE REQUIREMENTS WITHOUT ENTERING INTO AN AGREEMENT WITH THE IRS?

The trustee of a non-U.S. trust may be able to treat the trust as an "owner-documented FFI." This approach effectively shifts the burden of providing information about the trust's U.S. beneficiaries to institutions with which the trust has accounts. However, the approach has limited application because it is available only for accounts held with designated U.S. financial institutions and participating FFIs that have specifically agreed with the IRS to fulfill heightened due diligence and reporting obligations.[15]

Furthermore, foreign trustees may find the owner-documented FFI approach unattractive in view of the extent of information about beneficiaries that generally will be required to be disclosed to institutions with which the trust has accounts. While not entirely clear, it appears that a trust generally may be an owner-documented FFI only if the trustee annually provides institutions with identifying information about both U.S. and non-U.S. trust beneficiaries.[16] (The institutions, in turn, will be required to provide to the IRS information about the trust's U.S. beneficiaries.[17])

As an alternative to annually providing institutions with identifying information about both U.S. and non-U.S. trust beneficiaries, the proposed regulations provide that a trustee may obtain an auditor's letter from an independent accounting firm or legal representative having a location in the United States. The auditor's letter generally will be required to certify that the firm or representative has reviewed the trust's documentation with respect to all of its beneficiaries and that no direct or indirect beneficiary is a nonparticipating FFI, a U.S. person or a passive NFFE with substantial U.S. owners.[18] It likely will be very costly, in general, for a trustee to obtain an auditor's letter that satisfies the requirements of the proposed regulations.

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[11] Code §1471(b)(1)(D); Prop. Treas. Reg. §§1.1471-4(b), 1.1471-2.

[12] Prop. Treas. Reg. §1.1474-1(a), 1-1471-1(b).

[13] Prop. Treas. Reg. §1.1471-3.

[14] Code §§1471(b)(1)(A), 1471(d)(1), 1471(d)(3); Prop. Treas. Reg. §1.1473-1(b). Non-U.S. banks and brokers that are participating FFIs generally will be required to obtain information only about U.S. beneficiaries having greater than 10 percent beneficial interests in the trust (with beneficial interests determined for this purpose as described in footnote 29). Non-U.S. investment funds that are participating FFIs generally must obtain information about U.S. beneficiaries with lesser interests. Prop. Reg. §1.1473-1(b)(5). Non-U.S. banks, brokers and investment funds will not, however, need to provide any information to the IRS about the U.S. beneficiaries of a trust that is itself a participating FFI. Prop. Reg. §1.1471-4(d)(2)(ii).

[15] Prop. Treas. Reg. §1.1471-5(f)(3).

[16] Prop. Treas. Reg. §§1.1471-5(f)(3), 1.1471-3(d)(7) (in particular §1.1471-3(d)(7)(iv)(A)). If further guidance makes it clear that information about non-U.S. beneficiaries does not need to be provided to institutions, the owner-documented FFI approach may become more attractive to the trustee of a foreign trust.

[17] Prop. Treas. Reg. §§1.1471-4(d)(2)(iv), 1.1474-1(i).

[18] Prop. Reg. §1.1471-3(d)(7)(ii).

6. ARE THE FATCA COMPLIANCE RULES DIFFERENT FOR FOREIGN GRANTOR TRUSTS?

While some uncertainty remains, it seems that a foreign grantor trust that is an FFI will be required to comply with FATCA in a manner similar to a foreign non-grantor trust.[19] In other words, for a foreign grantor trust to avoid FATCA withholding on withholdable payments, the trust generally will need to become a participating FFI by satisfying the requirements described in Q&A 4, or an owner-documented FFI by satisfying the requirements described in Q&A 5.[20]

7. IF A FOREIGN TRUST COMPANY HAS ENTERED INTO AN FFI AGREEMENT WITH THE IRS, IS IT NECESSARY FOR EACH TRUST FOR WHICH THE TRUSTEE ACTS TO SEPARATELY COMPLY WITH FATCA?

The proposed regulations take the view that each foreign trust is an entity that must comply with FATCA.[21] The rules apply to the trust itself, not to the trustee. Unless the proposed regulations are clarified, foreign trust companies and foreign trusts should separately comply with FATCA to avoid withholding.[22] Foreign trust companies will be FFIs as companies providing fiduciary services, not as trustees of each separate trust for which they may act.

For a foreign trust company to become a participating FFI, the company must enter into an agreement with the IRS similar to the agreement described in Q&A 4.[23] While the obligations of a foreign trust company under such an agreement are not entirely clear, the company likely will be required to take the following actions:

- Take steps to identify any trusts with U.S. beneficiaries for which the trust company provides fiduciary services.[24]
- Provide an annual report to the IRS containing information about those trusts with U.S. beneficiaries for which the trust company provides fiduciary services, other than trusts that are themselves participating FFIs.[25]
- Withhold 30 percent of withholdable payments made to foreign trusts that are not themselves participating FFIs.[26]

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[19] Prop. Treas. Reg. §1.1471-3(a)(3)(ii).

[20] It is not clear whether the trustee of a foreign grantor trust that is a participating FFI must annually provide information to the IRS about the trust's U.S. beneficiaries (as described in Q&A 4) if the trustee provides information about any U.S. deemed owner of the trust. Similarly, it is not clear whether the trustee of a foreign grantor trust that is an owner-documented FFI must annually provide information about U.S. and non-U.S. beneficiaries to institutions with which the trust has accounts (as described in Q&A 5) if the trustee provides information about the trust's deemed owners, U.S. and foreign. Prop. Treas. Reg. §1.1471-5(b)(3)(iii). Pending the issuance of further guidance, trustees of foreign grantor trusts should be prepared to provide information about both grantors and beneficiaries. Guidance is needed in the final regulations on the treatment of foreign trusts that are "owned" by foreign grantors for U.S. tax purposes.

[21] Prop. Treas. Reg. §§1.1471-1(b)(17); 1.1471-1(b)(36); 1.1471-5(d) 1.1471-5(e).

[22] A foreign entity that provides trust or fiduciary services is itself an FFI. Prop. Treas. Reg. §1.1471-5(e)(2)(i)(E).

[23] Code §1471(b)(1); Prop. Treas. Reg. §1.1471-4.

[24] Code §§1471(b)(1)(A), 1471(b)(1)(B); Prop. Treas. Reg. §1.1471-4(a)(2).

[25] Code §§1471(b)(1)(C), 1471(c); Prop. Treas. Reg. §§1.1471-4(a)(3), 1.1471-4(d).

[26] Code §1471(b)(1)(D); Prop. Treas. Reg. §§1.1471-4(b). Any withheld amounts must be deposited with an authorized financial institution and annually remitted to the IRS. Prop. Treas. Reg. §§1.1471-2, 1.1474-1(a), 1.1471-1(b). Presumably withholding will not be required on payments that already have been subject to withholding by the payor because of the trust's status as a non-participating FFI.

8. ARE A FOREIGN TRUST'S FATCA COMPLIANCE OBLIGATIONS ALTERED IF THE TRUST'S INVESTMENTS ARE MADE ENTIRELY THROUGH ONE OR MORE HOLDING COMPANIES?

If a foreign trust holds its investments through a holding company that is a disregarded entity for U.S. tax purposes, the foreign trust's FATCA compliance obligations will be the same as if the foreign trust held the investments directly.[27] If, however, a foreign trust holds its investments through a holding company that is a corporation for U.S. tax purposes, it is possible that the existence of the corporation may cause the trust to be treated as an NFFE rather than an FFI.[28]

As described in Q&A 1, NFFEs generally are subject to less stringent FATCA compliance obligations than FFIs. A trust that is an NFFE generally will be able to avoid FATCA withholding simply by providing withholding agents (including U.S. banks, brokers and companies, as well as foreign financial institutions that have entered into an agreement with the IRS) with information about U.S. beneficiaries having substantial interests in the trust.[29]

Even if a foreign trust that holds all of its assets through a foreign corporation is classified as an NFFE, the holding company itself generally will be an FFI.[30] This means that the holding company will be subject to the more stringent FATCA compliance obligations applicable to FFIs and generally will be able to avoid FATCA withholding only by following one of the approaches identified in Q&A 3.[31]

9. WHAT IS THE TIMELINE FOR THE IMPLEMENTATION OF FATCA?

Withholding on payments of U.S. source "fixed or determinable annual or periodic" income will begin on January 1, 2014.[32] For an FFI to be considered a participating FFI on January 1, 2014, the FFI must enter into an FFI agreement with the IRS by June 30, 2013.[33] Withholding on gross proceeds will begin on January 1, 2015,[34] and withholding on foreign passthru payments will begin on January 1, 2017 (pending the issuance of further guidance).[35]

10. HOW MIGHT INTERGOVERNMENTAL AGREEMENTS ALTER FATCA COMPLIANCE BURDENS?

On February 8, 2012, the United States issued a joint statement with France, Germany, Italy, Spain and the United Kingdom, expressing an intent to collaborate on the implementation of FATCA. The joint statement outlines a possible framework for a partner country to collect the information required by FATCA from FFIs in that country and share this information with the United States. In exchange, the United States would not require FFIs in the partner country to enter into FFI agreements with the IRS and would eliminate FATCA withholding on payments to FFIs in these jurisdictions. The United States may also enter into

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27 Prop. Treas. Reg. §1.1471-3(a)(3)(v).

28 If all of the investments of the foreign trust are done through a wholly owned corporation, it is possible that the foreign trust will not be considered to be "in the business" of investing, reinvesting and trading financial assets, as described in Q&A 1.

29 Code §1472(b); Prop. Treas. Reg. §1.1472-1(b). For this purpose, a beneficiary will be considered to have a substantial interest in a trust if (1) the beneficiary has a right to receive distributions having a value equal to more than 10 percent of the trust fund on an actuarial basis, or (2) in the prior year, the beneficiary actually received distributions having a value greater than 10 percent of the value of all distributions made from the trust in that year. Prop. Treas. Reg. §1.1473-1(b).

30 Code § 1471(d)(5); Prop. Treas. Reg. §1.1471-5(e).

31 If the holding company complies with FATCA by becoming a participating FFI, the terms of the agreement that the company will enter into with the IRS likely will require the company to annually disclose information about any U.S. beneficiary of the trust that has a right to receive a distribution or who may receive a distribution in the discretion of the trustee, if such person actually has received a distribution. It is not clear whether information must be disclosed about a U.S. discretionary beneficiary who has not actually received any distributions from the trust.

32 Code §1474(d).

33 Notice 2011-53, 2011-32 IRB 124, 07/14/ 2011.

34 Prop. Treas. Reg. §1.1473-1(a)(2).

35 Preamble to Prop Treas. Reg. §1.1471-0 *et. seq*. 02/15/2012. Fed. Reg. Vol. 77, No. 31, p. 9022, 9044.

intergovernmental agreements similar to those described in the February 8, 2012, joint statement with other countries. The joint statement suggests that such an intergovernmental agreement will provide that in return for disclosure of U.S. accounts through foreign governmental cooperation, the United States will collect information on income earned from U.S. sources by foreign persons, including interest on bank accounts that is exempt from U.S. withholding tax, and will make that information available to the taxpayer's home jurisdiction.[36]

On April 19, 2012, the U.S. Treasury Department released final regulations regarding the reporting of interest paid by U.S. offices of certain financial institutions to nonresident alien individuals resident in countries with which the United States has information exchange agreements in effect.[37] The new interest reporting requirements will facilitate intergovernmental cooperation to implement FATCA by enabling the IRS to provide information to partner countries.

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[36] To date, Congress has resisted this course of conduct by the U.S. Treasury, by blocking the implementation of Prop. Treas. Reg. §1.6049-8.

[37] T.D. 9584 (April 19, 2012).