Articles

The impact of the Common Reporting Standard on trusts

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Introduction

When the Foreign Account Tax Compliance Act (FATCA) was first introduced by the USA, there was a degree of reluctance among some in the finance industry to engage with it. Heads buried in the sand, they hoped that the compliance monster which has been imposed on them against their will would disappear. However, not only did the FATCA monster not disappear, the Organisation for Economic Co-operation and Development (OECD), together with the G20 countries, decided to create the Common Reporting Standard (CRS), their own compliance monster which has a far wider reach than FATCA.

While under FATCA reporting was only required in respect of US citizens, financial institutions could potentially be reporting in respect of 101 jurisdictions under the CRS, that being the number as at the date of this article which have committed to participate in the CRS. Fifty-five of these jurisdictions are the so called 'early adopters', being the first wave of jurisdictions to have agreed to implement the CRS. In respect of these jurisdictions, the CRS came into effect from 1 January 2016 with the first round of reporting to be completed by June 2017.

This article will provide a brief overview of the CRS, and it will then discuss some of the issues faced by financial institutions when applying the CRS in a private client trust context.

What is the CRS?

The CRS is a standardised model for the automatic exchange of information, which is built on FATCA, to allow participating jurisdictions to exchange information with each other about their tax residents. It is the perception of the OECD that vast amounts of money and gains and income derived from them are kept offshore by taxpayers which are not disclosed to their home jurisdictions. Hence mutual co-operation is required between all the countries to fight against tax evasion in order to protect the integrity of the tax systems. A key aspect of that co-operation is the exchange of information.

As a part of the CRS, the OECD has developed a Model Competent Authority Agreement (the Model CAA) which countries will enter into to participate in the CRS. Countries can enter into the Model CAA as a bilateral reciprocal agreement (in which case information would only be exchanged with the countries which have entered into such agreement) or a multilateral agreement (in which case information would be exchanged with all the jurisdictions that have signed up to the CRS on a multilateral basis).

Once countries have signed the Model CAA, they will implement the standard by incorporating the CRS into domestic law.

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The process for the CRS is based on the Model 1 FATCA Intergovernmental Agreement (FATCA IGA). The process is broadly categorised as follows:

(1) *Classification* – financial institutions are required to obtain the classification of all of their account holders to ascertain whether they are financial institutions, active non-financial entities (active NFEs) or passive non-financial entities (passive NFEs). The due diligence and reporting obligations of each of the financial institutions, active NFEs and passive NFEs are different; therefore, it is important to obtain the correct classification so the account holder can satisfy its obligations under the CRS correctly.

(2) *Due diligence* – financial institutions are obliged to ascertain whether there are any reportable persons or controlling persons within the structures that are classified as financial institutions or passive NFEs, respectively. In the context of a trust which is a financial institution, reportable persons are persons who are debt and equity interest holders and who are also tax residents in a jurisdiction which has committed to participating in the CRS. The concept of a debt and equity interest holder and controlling persons is explained further below.

(3) *Verification* – financial institutions must verify the due diligence information they have obtained against the information they hold on file to determine the reasonableness and accuracy of the due diligence information. Therefore, if the information they have obtained from account holders is different from the information they hold, they must make further enquiries. In respect of certain types of accounts, it is possible for the financial institution to carry out due diligence from the information they hold or publicly available information.

(4) *Reporting* – if there are reportable persons, financial institutions are required to report the same to their local tax authorities pursuant to the requirements of their domestic laws. In respect of passive NFEs, financial institutions are required to hold onto the due diligence information and when requested by other financial institutions, provide such information to them for the purposes of satisfying their reporting obligations.

While the process for the CRS is conceptually the same as FATCA, there are nevertheless many differences in the detail so that financial institutions are not able simply to adopt the same approach for CRS purposes as they do for FATCA. Financial institutions must independently review the systems and procedures they have in place to ensure that they are adequate for CRS purposes. As mentioned above, depending on whether a structure is classified as a financial institution, active NFE or passive NFE, different due diligence and reporting obligations would apply, it is therefore important that the correct classification is adopted for CRS (rather than FATCA) purposes.

By way of example, the CRS definition of 'financial institution' differs from the IGA definition. Therefore, an entity which has been classified as an investment entity (which is a sub-set of the definition of financial institution) for FATCA purposes might not be able to be classified as an investment entity for CRS purposes.

Under the FATCA IGA, an investment entity is an entity that conducts as a business, or is managed by an entity that conducts as a business, one or more of the following activities, for or on behalf of a customer:

- trading in money market instruments (cheques, bills, certificates of deposit, derivatives etc);
- foreign exchange;
- exchange, interest rate and index instruments;
- transferable securities and commodity futures trading;
- individual and collective portfolio management; and

- otherwise investing, administering or managing funds or money on behalf of other persons.

In the case of a trust where its trustees are in the business of investing, administering and managing funds and money on behalf of other persons, the trust can be classified as an investment entity using the IGA definition. Some of the professional trust company services providers (TCSP) have, relying on this definition, classified all of the structures they manage and administer as financial institutions regardless of the assets held and income earned by such structures.

Under the CRS, an investment entity is:

(1) an entity that primarily conducts as a business one or more of the following activities or operations for or on behalf of a customer: trading in money market instruments etc, individual and collective portfolio management; or otherwise investing, administering, or managing financial assets or money on behalf of other persons; or

(2) the gross income of which is primarily attributable to investing, reinvesting or trading in financial assets, if the entity is managed by another entity that is, amongst others, an investment entity described in (1) above.

The test for determining whether the entity's gross income is primarily attributable to the relevant activities is whether the entity's income for the 3 years ended 31 December of the year preceding the year in which the determination is made or the period since commencement, if shorter equals or exceeds 50% of the entity's gross income. Therefore, the fact that a structure is managed by a TCSP would not be sufficient for the structure to be classified as a financial institution for CRS purposes.

Using a practical example, a trust which is managed by a TSCP and holds as its sole asset a bank account would be classified as an investment entity under FATCA, whereas it would not meet the CRS definition of investment entity because cash is not considered to be a financial asset. Therefore, under the CRS that trust cannot be classified as a financial institution since it cannot generate more than 50% of its income from financial assets.

The CRS and trusts

The CRS does not provide much detail on how trusts should be treated for CRS purposes. However the CRS implementation handbook sheds some light on how CRS is intended to apply to trusts. The CRS will generally apply to trusts in two circumstances: (1) when a trust is a reporting financial institution; and (2) when a trust is an NFE that maintains a financial account with a reporting financial institution.

A trust that is a reporting financial institution

If a trust is a financial institution and it is resident in a participating jurisdiction (being a jurisdiction which participates in the CRS), the financial institution would be treated as a reporting financial institution, unless it qualifies as a non-reporting financial institution (which includes, amongst others, different types of retirement funds).

A trustee will be considered to be resident where the trustee(s) is/are resident. If there is more than one trustee, the trust will be a reporting financial institution in all participating jurisdictions in which a trustee is resident. This means that the trustees will need to report in each of those participating jurisdictions in respect of their reportable accounts.

Once it has been established that a trust is a reporting financial institution, it must identify its financial accounts. In the context of a trust, a financial account is defined as its debt and equity interest.

Debt interest is not defined in the CRS, and therefore what is considered a debt interest will be determined under the local law of each implementing jurisdiction.

The equity interests are 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 (which will at a minimum include the trustees of the trust). Discretionary beneficiaries will only be treated as an account holder in the years in which they receive a distribution from the trust. If a settlor, beneficiary or other person exercising ultimate effective control is an entity, the entity must look through to identify the ultimate natural controlling persons behind the entity.

If any of the debt or equity interests is held by persons who are resident in a reportable jurisdiction, their interest is treated as a reportable account. These persons are referred to in the CRS as 'reportable persons'.

A trust that is an NFE

Trusts which are not classified as financial institutions would be classified as either an active NFE or a passive NFE. If the trust is a passive NFE, it must identify controlling persons that are reportable persons. The controlling persons of a trust are the settlor(s), trustee(s), beneficiary(ies), protector(s) and any other natural persons exercising ultimate effective control over the trust. It is not necessary to enquire as to whether any of these persons can exercise practical control over the trust. Therefore, for example, if the protector only has the power to veto the appointment of new trustees, he would be deemed as a person exercising ultimate effective control over the trust.

Whilst the above position sets out the overall approach of the CRS in a trust context, many questions have been raised by industry in respect of the application of these principles to structures and transactions which are commonly set up or carried out by trust advisers. There are too many such issues to list in this article, but to highlight a few:

(1) 'Settlor' is not defined in the CRS, therefore there was a question mark over who should be considered to be a settlor of a trust; is it the person who is named on the trust deed, or is it the person who has contributed the funds?

(2) Where the trust is classified as a financial institution, does the protector hold an equity interest in the trust or is it only when the protector has exercised ultimate effective control should he be considered to have an equity interest?

(3) Where a trust (trust 1) makes a distribution to another trust (trust 2), should the settlor of trust 1 also be considered to be a settlor of trust 2?

As a result of much consultation between the Society of Trust and Estates Practitioners (STEP) UK branch and the OECD, STEP UK has recently published further guidance notes on the CRS and trusts (STEP Guidance Notes) which shed further light on the application of CRS principles to trusts.

For example, the STEP Guidance Notes have clarified that:

(1) a settlor should be the person who has provided assets to the trust. However, Her Majesty's Revenue & Customs also expects nominal settlors (including those who are named on the trust deed but who have provided a nominal amount on trust) to be treated as a settlor for CRS purposes. In each case, if the settlor is a reportable person, the full value of the trust assets would be reported in respect of him;

(2) protectors should be reported in respect of the full value of the trust fund regardless of whether they actually exercises effective control;

(3) it is to be expected that the settlor of trust 1 would be treated as the settlor of trust 2, unless there is a break in the chain by way of a distribution.

Although the STEP Guidance Notes have provided further guidance on how some of the practical issues arising from day-to-day trust activities should be dealt with, there are still a lot of unanswered questions.

CRS implications for day-to-day trust activities

While much attention has been focused on complying with the obligations arising from the CRS, the TSCP have sometimes not appreciated the implications which the CRS has for other aspects of trust administration.

Appointment and retirement of trustees

Under the CRS it is possible for the trust itself to be treated as a non-reporting financial institution provided that the trustee of the trust assumes the reporting obligations. This is known as a trustee-documented trust. According to the CRS commentary (at para 56), in respect of a trustee-documented trust the responsibility is transferred by the trust to its trustee. Therefore, as with FATCA, the trustee becomes personally liable to carry out its obligations. Where there is a change of trustees, it does not automatically follow that the CRS obligations should transfer to the new trustee and in the author's view, it would be prudent for the retiring trustee to agree with the new trustee that the new trustee will satisfy the reporting obligations going forward. In the event that the retiring trustee wishes to carry out reporting in respect of the period in which it acted as trustee, it may wish to consider retaining some funds to meet the costs of reporting. (The rationale is that, for example, if a trustee retires in June 2017, it will not complete its CRS reporting in respect of the 2017 reporting year until June 2018, by which time it will no longer hold the trust fund from which it can meet its expenses and fees. Therefore, the retiring trustee, before handing over the trust may wish to consider retaining some funds to meet the costs of reporting that it is likely to incur in 2018 or negotiate a wider form of indemnity.)

Scheme design

As mentioned above, equity interests and controlling persons in respect of reportable persons would be reportable. Therefore, when establishing trusts and when trustees are making distributions, they should take steps to educate their clients about the reporting position arising from such events to ensure that the clients understand the consequences. If necessary, clients should be given sufficient time to seek advice.

Data protection

Most TCSP's terms of business include provisions which allow the TSCP to handle personal data in order to carry out its functions. However, the terms of business are usually the result of a contractual arrangement entered into between the settlor and the trustee and the TSCP. Beneficiaries and protectors are almost always not parties to such arrangement. This means that when handling personal information in respect of the beneficiaries and protectors, the trustee must have careful regard to its obligations under the data protection legislation and whether additional express consent should be obtained from such persons before processing their data. This issue is most acute where the trustee is looking to outsource its due diligence or reporting functions to third parties.

Conclusion

The CRS is an important aspect of the establishment and ongoing administration of trusts. It should not be viewed as a standalone compliance burden. Rather, trustees, settlors and advisers should consider the CRS implications in all aspects of scheme establishment and administration to ensure that all those who have an involvement in the trust have a full understanding of their roles and obligations.

There is still a lot of uncertainty in relation to how CRS principles apply in the context of trusts. It is hoped that as issues are raised with the OECD Secretariat, they will provide further guidance on how CRS principles should be applied. Further, it is also hoped that as further guidance is published, financial institutions will have sufficient lead-in time to seek advice and consider the implications of the further guidance on their structures.

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