FATCA and Offshore Trusts: A Second Bite of the Elephant

By Peter A. Cotorceanu


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In this report, Cotorceanu addresses the FATCA classification of trusts and concludes that most trusts will be foreign financial institutions under the final FATCA regulations and model intergovernmental agreements. That result is not only counterintuitive, but contrary to congressional intent. By trying to wedge trusts into the ill-suited category of FFIs, the IRS and Treasury have created many unanswered questions that will confound offshore trust companies as they try to become FATCA compliant.

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I. Introduction

Trusts. Foreign financial institutions. Square pegs. Round holes.

Think back, if you can, to a world before the Foreign Account Tax Compliance Act.[1] If someone had asked you what a financial institution was, you no doubt would have thought of banks, asset management firms, and similar outfits. I doubt you would have thought of trusts. Yet most trusts are financial institutions under FATCA. Counterintuitive, isn't it?

Still, statutes and regulations often define terms in counterintuitive ways.

Fast forward. FATCA's now been adopted. You're told that FATCA's main goal is finding U.S. persons who hide their money in foreign financial institutions (FFIs), whether in accounts in their own names or in the names of foreign structures they've created. What category would you expect trusts to fall in: FFIs or the structures behind which tax cheats might lurk? The latter, no?

Perish the thought.

Apparently, the drafters of the FATCA regulations believed that Congress wanted trusts to be FFIs. I'm not sure what tea leaves they were reading — there is nothing in the legislative history[2] or the statute itself that supports that view. Indeed, the scant evidence of congressional intent supports precisely the opposite conclusion.

The FATCA legislation addresses personal trusts in one, and only one, context: The legislation defines who is a substantial U.S. owner of a trust.[3] That concept is relevant only to the structures tax dodgers might use to keep prying eyes away, not to FFIs.[4]

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[1]FATCA's provisions were enacted as part of the Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147) on March 18, 2010. FATCA consists of five parts, only the first of which is relevant to this report. That part (Part I — Increased Disclosure of Beneficial Owners) was enacted as sections 1471-1474. As used in this report, FATCA refers to not only that legislation, but also the final Treasury regulations under the statute, published on January 17 (T.D. 9610); additional IRS interpretive guidance; and the various model and country-specific intergovernmental agreements designed to further FATCA's ends.

[2]Joint Committee on Taxation, ''Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act, Under Consideration by the Senate,'' JCX-4-10 (Feb. 23, 2010).

[3]Section 1473(2)(A)(iii).

[4]Technically, FFIs can also have substantial U.S. owners. However, the substantial U.S. owners of an FFI are completely

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In contrast, Congress didn't define what constitutes an ''account'' and who is an account holder in a trust. That's a rather curious omission if Congress wanted trusts to be FFIs. After all, FFIs must report their U.S. account holders and details about their accounts. But trusts don't really have accounts and account holders. If Congress wanted to pretend that they do, you'd have thought it might have given us at least some clue as to what those terms mean for trusts. It didn't. Instead, given the IRS's fixation with most trusts being FFIs, the drafters of the FATCA regulations had to come up with the definitions of those novel concepts.

The truth is that trusts shouldn't have been classified as FFIs under FATCA. The IRS could have received all the information it wants about U.S. persons behind offshore trusts if it had classified trusts as nonfinancial foreign entities (NFFEs). All it had to do was prescribe the specific information it wanted about the substantial U.S. owners of those entities. By wedging the square pegs that are trusts into the round holes that are FFIs, the IRS has raised a host of unanswered questions regarding FATCA's treatment of trusts. This has created unnecessary uncertainty and burdens for the offshore trust industry as it struggles to become FATCA compliant.

Still, there's no point whining. Life's hard; soldier on. Let's do just that.

II. Summary

This is the second in a series of reports about how FATCA treats offshore trusts. The goals of this series are to help foreign trust companies understand their FATCA obligations and to help trust companies implement their FATCA compliance plans.

In the previous report,[5] I likened analyzing FATCA's application to offshore trusts to eating an elephant, a task that can be accomplished only one bite at a time. That report discussed the threshold issue of how foreign trustees should be classified under FATCA.

It's now time to take a second bite of the elephant and start digging into the meat of FATCA's application to foreign trusts: FATCA's treatment of offshore trusts themselves. As I pointed out in my last report, the stakes are much higher with FATCA's classification of trusts as opposed to trustees — trusts actually have accounts, as defined under the FATCA regulations,[6] and FATCA's most onerous obligations apply only to FFIs with accounts.[7]

Given that most foreign trusts hold their assets through underlying companies (UCs), my next report will address FATCA's classification of UCs.

For the reasons discussed below, most trusts are so-called Type B investment entity FFIs under the FATCA regs.[8] One exception is trusts that have no UC and derive most of their income from nonfinancial assets, for example, trusts with no UC that hold primarily non-bankable assets such as real estate, art, yachts, and other tangible assets, but also cash, which is a nonfinancial asset for this purpose. Another exception is trusts with both an individual trustee and an individual investment manager. A further example is trusts with private trust companies (PTCs) as trustees when the PTC doesn't charge fees (although perhaps only if the PTC's directors also don't charge for their services) and the asset manager, if any, is an individual. Trusts that qualify for those exceptions generally will be passive NFFEs unless they hold active businesses, whether directly or through a UC, in which case they will be active NFFEs, a subcategory of excepted NFFEs.

Most trusts will also likely be investment entity financial institutions[9] under the FATCA intergovernmental agreements,[10] at least if the IGAs are

irrelevant; FATCA requires no reporting, or anything else for that matter, regarding those persons.

[5]Peter A. Cotorceanu, ''FATCA and Offshore Trusts: The First Nibble,'' *Tax Notes*, Apr. 22, 2013, p. 409.

[6]Reg. sections 1.1471-0 to 1.1474-7 and 301.1474-1.

[7]In future articles, I will explain what an account (including a U.S. account) is, who an account holder is, and what obligations fall on FFIs, including trusts, with U.S. accounts. Technically, offshore trust companies also have accounts, specifically, equity or debt interests in the trust company under reg. section 1.1471-5(b)(1)(iii). However, unless those interests in a trust company are held by U.S. persons, which is rare, those accounts won't be reportable under FATCA. And even then, they won't be reportable unless the value of the U.S. person's interest is determined primarily by reference to assets that could give rise to specified types of U.S.-source income or unless the interest was issued with a principal purpose of avoiding FATCA reporting or withholding. Reg. section 1.1471-5(b)(1)(iii)(C).

[8]*See* Appendix I for a summary of this report's conclusions on FATCA's classification of trusts.

[9]The IGAs drop the term ''foreign'' from ''foreign financial institution'' and refer to just ''financial institutions.'' While the entities covered by an IGA may be foreign to the United States, they are not foreign to IGA partner jurisdictions.

[10]There are two basic model IGAs: Model 1 and Model 2 (all model IGAs and their annexes, and all country-specific IGAs, are *available at* http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx). Under a Model 1 IGA, all FATCA reporting is done to one's home government, which then forwards the information to the United States. Under a Model 2 IGA, FFIs report directly to the IRS.

The Model 1 IGA comes in reciprocal and nonreciprocal versions. Also, there are different versions of each IGA depending on whether the IGA partner country has an existing tax information exchange agreement (TIEA) or double tax treaty (DTC) with the United States. Because there are no differences

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implemented as written. If the United Kingdom implements its IGA in the manner indicated in its FATCA regulations and guidance, and if other countries follow suit, trusts will be classified under those IGAs in essentially the same manner as under the Treasury FATCA regs.

III. The Statute and FATCA Regs

FATCA's reach is truly breathtaking. Every single non-U.S. entity in the world has a FATCA classification. This is as true for a shell company with no assets or activity as it is for the biggest multinational. It is as true for the most informal two-person partnership in the most far-flung country on the planet as it is for the most massive offshore fund. And it is also true for every non-U.S. trust, even though trusts aren't really entities.

More specifically, under FATCA, all non-U.S. entities (including trusts) are either FFIs or NFFEs. And no entity can be both, because the categories are mutually exclusive.

An FFI is a foreign entity that is a financial institution.[11] An NFFE is a foreign entity that is *not* a financial institution.[12] Thus, every single foreign entity is one or the other. Foreign for these purposes means non-U.S.[13]

The statute doesn't define the term "entity," but the FATCA regs do: An entity means "any person other than an individual."[14] "Person" has the same meaning under FATCA as in section 7701(a)(1),[15] which defines the term as including "an individual, *a trust*, estate, partnership, association, company or corporation" (emphasis added). Yes, fussy U.K. lawyers, you're right: Trusts aren't entities. Got it. They aren't entities under U.S. law either. But they are defined as such under FATCA and the U.S. tax code. Deal with it.[16]

between Model 1 IGAs and Model 2 IGAs that are material to this report or that turn on whether the agreement is reciprocal, nonreciprocal, or for countries with or without TIEAs or DTCs with the United States, references in this report to the model IGAs apply to all versions of those documents unless otherwise indicated. For simplicity's sake, citations in this report to specific provisions of the Model 1 IGAs use the numbering in the reciprocal/preexisting TIEA or DTC version of that agreement, and citations to Model 2 IGAs use the numbering in the preexisting TIEA or DTC Model 2 IGA.

[11]Section 1471(d)(4); reg. section 1.1471-5(d).

[12]Section 1472(d); reg. section 1.1471-1(b)(74). *Compare* the model IGAs, which define an NFFE as a non-U.S. entity that is not an FFI under the regs, including a non-U.S. entity that is not a financial institution under the IGA. Model 1 IGA, Annex I, VI.B.2; Model 2 IGA, Annex I, VI.B.2.

[13]Reg. sections 1.1471-1(b)(48) and 1.1473-1(e).

[14]Reg. section 1.1471-1(b)(35).

[15]Reg. section 1.1471-1(b)(94).

[16]Actually, U.K. lawyers have no grounds to complain that FATCA treats trusts as entities. A prior draft of the United Kingdom's own FATCA guidance treated some individual trustees as entities. Seriously. *See* HM Revenue & Customs, "Implementation of International Tax Compliance (United States of America) Regulations 2013 Guidance Notes" (Dec. 18, 2012), section 2.20, at 24 (trustees will be financial institutions when they are "remunerated independent legal" professionals) (hereinafter "Dec. 2012 U.K. guidance notes"). Thankfully, the final U.K. FATCA guidance contains no such silliness.

(Footnote continued in next column.)

In sum, then, if a trust is foreign, it will be either an FFI or an NFFE.

A trust is foreign if it is not a U.S. trust.[17] To be a U.S. trust, a trust must satisfy both the court test and the control test.[18]

Court test: A court within the United States is able to exercise primary supervision over the administration of the trust.

Control test: One or more U.S. persons have the authority to control all substantial decisions of the trust.[19]

Thus, if at least one non-U.S. person can control at least one substantial decision, the control test won't be met. And if the control test isn't met, the trust will be foreign regardless of whether the court test is met — remember, to be a U.S. trust, both tests must be satisfied.

Substantial decisions are decisions that persons "are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial."[20] Examples include whether, when, and in what amounts to make distributions; whether to terminate the trust; whether to compromise on, arbitrate, or abandon claims of the trust; whether to sue on behalf of the trust or to defend suits against it; and the power to make investment decisions (or the power, if held by a U.S. person, to hire and fire an investment adviser).[21]

The bottom line is that any trust with a sole, non-U.S. trustee will be a foreign trust. That is because a trustee, by its very nature, will be able to make substantial (that is, nonministerial) decisions, whether of the sorts listed above or otherwise.

If the trust has both U.S. and non-U.S. trustees, the control test will be satisfied only if (1) the U.S. trustee(s) can act independently of the non-U.S. trustee(s); (2) the non-U.S. trustee(s) cannot act independently of the U.S. trustee(s); and (3) no other non-U.S. person (for example, a protector or the settlor) can make a substantial decision for the trust.[22]

[17]Section 7701(a)(31)(B).

[18]Section 7701(a)(30)(E).

[19]*Id.*

[20]Reg. section 301.7701-7(d)(ii).

[21]*Id.*

[22]Reg. section 301.7701-7(d)(iii) and (v) (examples).

Assuming the trust is a foreign trust, it will be an FFI under the FATCA regs if it falls within one or more of the categories of FFI defined in that document. If the entity doesn't fall within any of those definitions, it will be an NFFE.

The FATCA regs create five types of FFIs, but only the following three potentially apply to trusts: depository institutions, custodial institutions, and investment entities.[23]

A. Depository Institution FFI

Foreign trusts don't qualify as depository institution FFIs for two reasons. First, they don't accept deposits. Second, they don't provide trust or fiduciary services.

A depository institution FFI is one that ''accepts deposits in the ordinary course of a banking or similar business.''[24] A banking or similar business includes providing ''trust or fiduciary services.''[25]

The FATCA regs don't define the phrase ''accepts deposits'' or even the term ''deposits.'' However, they do define a depository account,[26] which presumably is what an institution would have to offer to be deemed to accept deposits. That definition is aimed squarely at the sorts of accounts that retail banks offer.[27] Trusts fall well outside its ambit.

Further, trusts don't provide trust or fiduciary services. Trust companies do, but trusts don't.

B. Custodial Institution FFI

Offshore trusts shouldn't be classified as custodial institution FFIs either, because they don't earn the sorts of income the FATCA regs require for this category.

A custodial institution FFI is an entity that ''holds, as a substantial portion of its business . . . financial assets for the benefit of one or more other persons.''[28] At first blush, trusts — at least those that hold financial assets — might seem to fall within this definition if one ignores the ''business'' requirement.[29]

However, the test is met only if the entity's gross income ''attributable to holding financial assets and related financial services'' is 20 percent or more of its gross income over a stated period.[30] Income attributable to holding financial assets and related financial services is narrowly defined as the sorts of income only true money managers earn, for example, fees for custody, account maintenance, and transfers; commissions and fees from executing and pricing securities transactions; and income earned on bid-ask spread of financial assets.[31] Traditional offshore trusts don't earn those sorts of income — banks or other financial intermediaries that hold offshore trusts' assets do, but trusts don't.

C. Investment Entity FFI

The only remaining relevant type of FFI, then, is an investment entity FFI.

There are three types of investment entity FFIs: (1) an entity that ''primarily conducts as a business'' specified activities ''for or on behalf of a customer'' (a Type A investment entity)[32]; (2) an entity whose gross income is primarily attributable to specified investment activities and that is managed by a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A

[23]*See* section 1471(d)(4) and 1471(d)(5)(A)-(C); reg. section 1.1471-5(d) and 1.1471-5(e)(1)(i)-(iv). The other two categories of FFIs are (1) specified insurance companies and related holding companies, and (2) treasury centers and some narrowly defined holding companies.

[24]Section 1471(d)(5)(A); reg. section 1.1471-5(e)(1)(i).

[25]Reg. section 1.1471-5(e)(2)(i)(E).

[26]Reg. section 1.1471-5(b)(3)(i).

[27]*Id.* That definition provides that a depository account means any account that is a ''commercial, checking, savings, time, or thrift account, or an account that is evidenced by a certificate of deposit, thrift certificate, investment certificate, passbook, certificate of indebtedness, or any other instrument for placing money in the custody of an entity engaged in a banking or similar business for which such institution is obligated to give credit.'' The only conceivable way a traditional offshore trust could be said to have a depository account under this definition is if it were deemed to have an account evidenced by an instrument for placing money in its custody for which it is obligated to give credit. That interpretation would be stretching the language beyond any reasonable reading, especially given the tenor of the entire provision.

[28]Reg. section 1.1471-5(e)(1)(ii). The definition in the statute is substantively identical, although the word order and wording itself are slightly different. Under the statute, a custodial institution FFI is one that ''as a substantial portion of its business, holds financial assets for the account of others.'' Section 1471(d)(5)(B).

[29]As I note later in this report, under U.S. tax law, trusts cannot, by definition, be in business.

[30]Reg. section 1.1471-5(e)(3)(i)(A). The relevant period is the shorter of (1) the three-year period ending on December 31 of the year preceding the year of determination, or (2) the period during which the entity has been in existence before the determination is made. *Id.* Because the testing period is not static and an entity's income varies over time, an entity could be a custodial institution FFI one year but not the next, and vice versa. The same issue arises with other types of FFIs whose statuses are determined in part by the types of income they earn over a floating period. *See, e.g.*, reg. section 1.1471-5(e)(4)(iv) (testing period for Type B investment entities, discussed later in this report). This raises practical concerns, including the need to monitor a trust's income, an issue addressed in the context of investment entity FFIs. They also include logistical questions such as how an entity de-registers or re-registers with the IRS as a participating FFI or registered deemed-compliant FFI. Hopefully, guidance will be forthcoming on those points.

[31]Reg. section 1.1471-5(e)(3)(ii).

[32]Reg. section 1.1471-5(e)(4)(i)(A). The designations ''Type A,'' ''Type B,'' and ''Type C'' investment entity do not appear in the regs; they are used in this report as shorthand.

investment entity (a Type B investment entity)[33]; and (3) a collective investment vehicle or one of several different types of fund (a Type C investment entity).[34]

1. Type C investment entities. Type C investment entities can be eliminated at the outset; the sorts of trusts addressed in this report aren't collective investment vehicles or funds as defined in the FATCA regs.[35]

2. Type A investment entities. Typical offshore trusts are also not Type A investment entities. As discussed above, a Type A investment entity primarily conducts as a business specified activities for or on behalf of a customer. Trusts aren't engaged in business, and they don't have customers.

The U.S. entity classification regulations acknowledge that trusts aren't engaged in business. Those regulations define a trust as ''an arrangement . . . whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries.''[36] Traditional trusts like those stand in contrast to business or commercial trusts, which are created by the beneficiaries simply as a device to carry on a profit-making business.[37] Business and commercial trusts are business entities (that is, depending on the facts, corporations, partnerships, or sole proprietorships), not trusts, for U.S. tax purposes.[38] Thus, even when the trust itself owns a going concern, it is the underlying firm, not the trust, that is engaged in business.

Moreover, the preamble to the FATCA regs implicitly acknowledges that trusts don't have customers. It contains the following statement: ''Comments requested that the definition of 'financial institution' be clarified and more narrowly defined to exclude passive, non-commercial investment vehicles, including trusts. The IGAs adopt this approach by requiring an investment entity to undertake activity on behalf of customers.''[39]

3. Type B investment entities. Because trusts are neither Type A nor Type C investment entities, the only remaining category is a Type B investment entity. Most personal trusts will fall into this category.

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

1. the entity's gross income must be ''primarily attributable to investing, reinvesting, or trading in financial assets'' (the gross income test); and

2. the entity must be ''managed by'' a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A investment entity (the managed by test).[40]

a. 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 percent of its gross income during a stated period.[41] For these purposes, financial assets include shares (whether closely held or publicly traded), bonds, partnership interests, insurance and annuity contracts, and any interest in any of the foregoing.[42]

This definition captures most bankable assets. However, it also covers non-publicly traded shares, so the definition is broader in that sense than bankable assets. And, oddly, it doesn't include cash — to that extent, the definition is narrower than bankable assets.

Nonfinancial assets aren't defined, but by exclusion they would comprise (in addition to cash) tangible property generally, including real estate, art and other collectibles, yachts, airplanes, and jewelry.

When applying the gross income test, it is critical to remember that it is the source of the trust's income, and not the nature of the trust's assets as such, that is determinative. Thus, for example, nonfinancial assets that don't throw off any income

[33]Reg. section 1.1471-5(e)(4)(i)(B).

[34]Reg. section 1.1471-5(e)(4)(i)(C).

[35]A Type C investment entity is one that ''functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.'' *Id.* One might argue that trusts with bankable assets are investment vehicles established with an investment strategy of investing, reinvesting, or trading in financial assets, but that would be stretching the definition beyond its natural meaning. This is especially true given that trusts are not similar to the other types of investment vehicles and funds listed, which they would have to be under the foregoing definition.

[36]Reg. section 301.7701-4(a).

[37]Reg. section 301.7701-4(b).

[38]*Id.*

[39]Preamble to T.D. 9610, at 66. The quote is actually quite misleading. As we will see later when we discuss the IGAs, an investment entity under the model IGAs as written doesn't in fact have to have customers if it is managed by an entity that does.

[40]Reg. section 1.1471-5(e)(4)(i)(B).

[41]The period is the same as that for testing a custodial institution FFI's income, *i.e.*, the shorter of (1) the three-year period ending on December 31 of the year preceding the year in which the determination is made, or (2) the period during which the entity has been in existence. Reg. section 1.1471-5(e)(4)(iv).

[42]Reg. section 1.1471-5(e)(4)(ii), cross-referencing in part section 475(c)(2)'s definition of a security.

won't affect the gross income calculation no matter how valuable they are or how much of the trust's assets they represent.

Trusts with mostly bankable assets (other than cash) or closely held shares will generally meet the gross income test because most of their income will come from investing, reinvesting, and trading in financial assets. However, given that the relevant testing period looks back over the prior three calendar years (or, if shorter, the period during which the entity has been in existence), it resets every January 1. Thus, a trust might be an FFI in some years and an NFFE in others, potentially flipping back and forth between the two classifications more than once depending on whether the trust derived most of its income in the testing period from financial or nonfinancial assets.

Take, for example, a trust that from its inception holds commercial real estate, a nonfinancial asset, and assume for present purposes that there is no UC. As long as most of the trust's income comes from the real estate, the trust will not meet the gross income test and will not be a Type B investment entity (or, as explained above, any other type of FFI). Thus, the trust would be an NFFE. However, if the trust sells the property and invests the proceeds in, say, shares and bonds, it will become a Type B investment entity in any year in which most of its income in that year and the prior two years (or since the trust's inception if shorter) comes from those assets (provided, of course, that the managed by test is also met).

And, of course, if the same trust later reinvests all the financial assets in nonfinancial assets, the trust might flip back to being an NFFE at some point, especially in the third and subsequent years after the sale. The only way to be sure is to crunch the numbers each year.

To take a more concrete example, assume a trust with only financial assets (worth, say, $100 million) earns income from those assets. No matter how much or little income the trust earns, the trust meets the gross income test because more than 50 percent (here, 100 percent) of its income is from financial assets, the only assets it owns. In year 10, the trust sells all its assets and invests everything in an art collection held for personal enjoyment or long-term investment. It earns no income in subsequent years. Even though in years 11 and 12, the trust earns no income, it will still satisfy the gross income test for those years given the three-year testing period (which will include year 10, when financial assets were still producing all the trust's income and were sold). In year 13, however, the trust will not meet the gross income test so it will become an NFFE.[43]

Now assume instead that when it buys the art in year 10, the trustee retains a small amount of the financial assets (say, $100,000) to cover carrying costs such as trustee fees and insurance. The art is retained and the investment account is kept in place during all subsequent years. The trust won't become an NFFE, even though the value of the art collection dwarfs the value of the investment account — the income from the financial assets is 100 percent of the trust's overall income. If, however, instead of investing in financial assets as defined in the FATCA regs, the trustee put aside $100,000 cash in an interest-bearing account, all of the trust's income (the interest) would come from a nonfinancial asset (cash), the trust would not meet the gross income test, and the trust would therefore be an NFFE.

Thus, the gross income test makes a trust's FATCA classification a moving target and requires yearly monitoring of a trust's income sources.[44] The good news is that trusts with UCs should be able to dispense with that monitoring, at least if the UC makes regular payments to the trust. Unfortunately, trusts without UCs are not in that enviable position.

Annual monitoring of any sort is an administrative headache. It is doubly so for trust companies with hundreds or thousands of structures, especially when monitoring requires number crunching, as under the gross income test.

To avoid annual monitoring, trust companies may be tempted to cut corners, that is, to classify their structures only once at the outset and leave it at that. Trust companies may also be tempted to fudge even the initial classifications by treating their structures as either all FFIs or all NFFEs so that they have to deal with only one FATCA compliance path for all entities. This is especially true given that an entity's correct FATCA classification is not always entirely certain.

All of this begs the question: Just how careful do trust companies need to be when classifying their entities under FATCA?

There are two schools of thought on this issue. The conservative approach is that one must apply

[43]This assumes that some income must be received for the gross income test to be met. Technically, zero income received is at least 50 percent (it's 100 percent) of zero total income. However, it doesn't make sense that an income-based test would be satisfied if no income at all were received during the relevant period.

[44]As discussed further below, annual monitoring of trusts with individual trustees is also required under the managed by test because the trust's investment manager might change from time to time.

the law scrupulously as written — close enough isn't good enough. Not only is this the right thing to do, but the potential consequences of getting FATCA entity classification wrong are simply too painful to ignore: 30 percent withholding on most U.S.-source investment income and (in 2017 and beyond) on gross sales proceeds of some U.S. assets and foreign passthrough payments — not to mention incurring the IRS's wrath.

The other view takes a more pragmatic approach, rejecting slavish adherence to technical minutiae. Under that approach, companies should be free to choose an entity classification that while perhaps not technically correct, will result in no less disclosure to the IRS than the correct classification. After all, what does the IRS care as long as it gets at least as much information as it's entitled to? No harm, no foul. Because FFIs generally report more information than NFFEs must disclose, this approach would simply treat all entities as FFIs and be done with it.

Given the already significant burdens FATCA imposes, some offshore trust companies will be tempted to take the latter approach. They should resist that temptation at all costs.

First, sometimes NFFE trusts have to disclose more information than FFI trusts. Even when they don't, the IRS nevertheless will sometimes receive more information about the entire structure than if the trust were an FFI. Second, a grantor and beneficiaries are unlikely to be happy if a trustee wrongly classifies their trust, and as a result, the IRS does in fact receive information it wasn't entitled to (not to mention the trust being hit with 30 percent FATCA withholding for its trouble).

Compliance obligations generally, and reporting obligations in particular, are beyond the scope of this report. Suffice it to say for present purposes that (1) if a trust is an NFFE, it will report any substantial U.S. owners (under the FATCA regs) or any U.S. controlling persons (under an IGA) to its withholding agent, which will report that information to the IRS or to the home government (in a Model 1 IGA country); whereas (2) if a trust is an FFI, it must report its U.S. accounts and detailed information about those accounts to the IRS or home government, as the case may be. After FATCA has been fully phased in, the reportable account information will include the account number, account balance or value, and gross receipts, payments, and withdrawals.

Thus, it is true that in many cases NFFEs will disclose less information than FFIs. For example, a U.S. beneficiary is not a substantial U.S. owner of an NFFE trust (and therefore does not have to be disclosed), unless he has a more than 10 percent beneficial interest in the trust.[45] Accordingly, U.S. beneficiaries with 10 percent or smaller beneficial interests in NFFE trusts don't have to be reported under FATCA. They also don't have to be reported if, in the year in question, they receive less than $5,000 in distributions and their mandatory distribution rights, if any, are worth less than $50,000.[46] However, if the same trust were classified (fingers crossed, no harm no foul) as an FFI and a U.S. beneficiary received a small discretionary distribution, that U.S. beneficiary would have to be reported — there is no comparable de minimis rule for non-depository accounts at FFIs.

But the opposite result would obtain in other cases. For example, for purposes of determining whether a U.S. person has a more than 10 percent interest in an NFFE trust (and is thus a substantial U.S. owner who must be disclosed), the person must aggregate ownership of beneficial interests in the trust held by related persons.[47] Thus, if a close relative of a U.S. person receives a discretionary distribution from an NFFE trust of which that U.S. person is also a beneficiary, that distribution must be added to the U.S. person's own beneficial interest in the trust to determine whether he has exceeded the 10 percent substantial U.S. owner reporting threshold. No similar aggregation rule applies to ''accounts'' in FFI trusts held by U.S. persons. Also, if a trust is wholly owned by a U.S.-person grantor under the grantor trust rules, no other U.S.-person beneficiary need be treated as a substantial U.S. owner.[48] However, an FFI trust with a U.S. grantor must treat both its U.S. grantor and relevant U.S. beneficiaries as account holders in the trust.[49]

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[45]Reg. section 1.1473-1(b)(1)(iii)(B). The regs contain a curious provision lowering the substantial U.S. owner threshold for investment entity FFI trusts from a ''more than 10 percent'' beneficial interest to a ''more than 0 percent'' beneficial interest. Reg. section 1.1473-1(b)(5). However, this provision is a dead letter. As already mentioned, FFIs have no reporting or other obligations for their substantial U.S. owners. Neither do they have any reporting or other obligations for the substantial U.S. owners of other FFIs. *See, e.g.*, reg. section 1.1471-4(d)(3) (participating FFIs must report substantial U.S. owners of accounts held by NFFEs).

[46]Reg. section 1.1473-1(b)(4)(i).

[47]Reg. section 1.1473-1(b)(2)(v).

[48]Reg. section 1.1471-1(b)(4)(ii).

[49]A detailed explanation of the definitions of account and account holder in a trust is beyond the scope of this report. Suffice it to say for present purposes that for discretionary trusts, U.S. beneficiaries are account holders in a trust under the regs only if they actually receive distributions in the year in question. Reg. section 1.1471-5(b)(3)(iii)(B)(3). Moreover, all U.S. mandatory beneficiaries are account holders under the regs even if their distributions may not take place for many years. Reg. section 1.1471-5(b)(3)(iii)(B)(2). (The definitions of account and account holder are considerably different under the IGAs.)

(Footnote continued on next page.)

Moreover, one cannot consider in isolation the information that NFFE and FFI trusts themselves must disclose. Sure enough, an NFFE trust must disclose to its upstream withholding agent only whether it has substantial U.S. owners and, if so, some identifying information about them. However, an NFFE with a substantial U.S. owner is a U.S.-owned foreign entity,[50] and accounts held by U.S.-owned foreign entities are reportable U.S. accounts.[51] Thus, the NFFE's withholding agent will report the value of the entire account, that is, the value of all of the trust's assets it holds — not just the U.S. person's interest, which might be small — to the IRS or its home country's government. This will reveal much more information about the trust than if the trust were an FFI obliged to report only the U.S. person's ''accounts'' in the trust.

In short, don't be fooled into thinking that no one will care if a trust company takes a broad brush approach and treats all its trusts as FFIs. U.S. beneficiaries of trusts that are really NFFEs have every right to be upset if confidential information about their supposed accounts is reported to the IRS when it shouldn't have been. And the IRS will rightly care if a trust that is really an NFFE reports as an FFI, resulting in less disclosure than the IRS was lawfully entitled to (for example, information about the entire trust value). Thus, while administrative convenience certainly commends a one-size-fits-all FATCA entity classification for trusts and related structures, that approach is fraught with peril. Don't go there.

This will mean that trust companies not only must get their entity classifications right from the get-go but (sadly) must also monitor annually the sources of their trust's income to see whether the gross income test has been satisfied, at least if the trust has no UC.

How, then, does having a UC affect the gross income test? The answer depends on whether one looks through the UC to the underlying assets.

A UC's shares are unquestionably financial assets as defined in the relevant FATCA regulation.[52] Therefore, any income the trust receives from the UC will be attributable to ''investing . . . in financial assets.''[53] If all the trust's income comes from payments from the UC, which would be the case if the trust owned no other assets directly, the gross income test would be met.

As pointed out in my previous report, it's certainly debatable as a policy matter whether the status of a trust as an FFI or an NFFE should turn on something as formalistic as whether it holds its

Also, as already mentioned, the concepts of accounts and account holders in trusts are artificial constructs unique to FATCA. They are not to be confused with real accounts and account holders in financial institutions such as banks. Thus, for a trust's bank or other true financial account, the trust itself is the account holder unless the trust is a grantor trust, in which case the grantor is the account holder. Reg. section 1.1471-5(a)(3)(i) and (ii). Neither mandatory nor discretionary beneficiaries as such are deemed to be account holders of the trust's own accounts in other financial institutions.

[50]Reg. section 1.1471-5(c).

[51]Reg. section 1.1471-5(a)(2).

[52]Reg. section 1.1471-5(e)(4)(ii). The following discussion assumes that the UC has not elected under the check-the-box

(Footnote continued in next column.)

rules to be disregarded for U.S. tax purposes as an entity separate from its owner under section 7701(a)(1) and the related regulations or, if it has, that it is not wholly owned by the trust. A wholly owned company that has elected to be disregarded is not a person under the regs (reg. section 1.1471-1(b)(94)) and, subject to limited exceptions, is ignored for U.S. tax purposes. Therefore, presumably the company's shares should not count as financial assets, and the UC should be looked through for purposes of the gross income test. Rather curiously, however, the most recent draft Form W-8BEN-E, ''Certificate of Status of Beneficial Owner for United States Withholding and Reporting (Entities)'' (published May 22), asks in Part II (line 11) for the FATCA status of disregarded entities and gives the following four possibilities: nonparticipating FFI, participating FFI, reporting Model 1 IGA FFI, and participating FFI in a Model 2 IGA jurisdiction.

Entities covered by a Model 1 IGA aren't governed by the regs but by the IGAs and local law. Thus, entities that are disregarded solely because of check-the-box elections aren't ignored in Model 1 IGA countries — as far as the Model 1 partner country is concerned, a UC that is disregarded for U.S. tax purposes because it has made a check-the-box election is still very much an entity. Indeed, the U.K. FATCA guidance notes interpreting the U.K. Model 1 IGA state plainly that ''entity Classification Elections (known as check the box elections), made to the IRS, are irrelevant for determining whether an entity is in scope for the Agreement.'' HMRC, ''Implementation of International Tax Compliance (United States of America) Regulations 2013 Guidance Notes'' (2013) (published August 14, 2013), section 2.2, at 11 (hereinafter ''U.K. guidance notes''). Thus, a UC, regardless of whether it's made a check-the-box election, should not be ignored under a Model 1 IGA. This will produce an odd result if the trust is in a jurisdiction governed by the regs but the UC is in a Model 1 IGA country. The trustee should, from the trust's perspective, treat a disregarded UC as if it didn't exist (and therefore presumably as if its shares weren't financial assets for purposes of the gross income test), but the UC should still be treated as a separate entity under the IGA.

[53]This should be true regardless of whether the payment takes the form of a dividend or liquidation proceeds, if it is income. However, a true return of capital or principal should not count for purposes of the gross income test. Many UCs are funded with non-interest-bearing loans rather than capital contributions. In those cases, payments from the UC to the trust take the form of repayments of principal. One could argue that a non-interest-bearing loan is not an investment and that repayments of principal in those cases are not income. However, it's doubtful that the IRS would respect the form of those transactions, especially given that they are not at arm's length and no interest is charged. The safest course, therefore, would be to treat all payments from UCs to trusts (except for true returns of capital) as income from investing in financial assets, even if characterized under local law as interest-free loan repayments.

assets directly or through a UC. Nevertheless, trust companies that use UCs will no doubt welcome the administrative convenience of having all those trusts have the same FATCA status (that is, as FFIs). This would also obviate the need to monitor the sources of those trusts' income annually to see whether the gross income test is met (except perhaps to check for those infrequent cases in which no payments are made by the UC to the trust in the relevant gross income testing period, as discussed earlier). Unfortunately, the need for annual monitoring won't simply vanish — as we will see in the next article in this series, it will merely be pushed down one level to the UC. Moreover, even trust companies that routinely use UCs generally have a few trusts that hold their assets directly.[54] Some of those trusts may well derive their income primarily from nonfinancial assets. Thus, uniform FATCA status for all the trusts of an offshore trust company will be the exception, not the norm.

In sum, only the following trusts will fail the gross income test: (1) trusts that derive most of their income from nonfinancial assets held directly and not through UCs during the relevant testing period, and (2) trusts that receive no income at all from their UCs during that period.

b. The managed by test. The gross income test is just one piece of the puzzle. Remember, a trust must satisfy both the gross income test and the managed by test to be a Type B investment entity FFI.

A foreign entity meets the managed by test if specific types of FFIs perform any of the activities of a Type A investment entity FFI on the managed entity's behalf.[55] The activities in question are, essentially, financial trading, managing investments, and "otherwise investing, administering, or managing funds, money, or financial assets."[56] Thus, the FATCA regs define management of the entity in terms of management of the entity's assets.

The managed by test is illustrated in the trust context by examples 5 and 6 in the FATCA regs.[57] In Example 5, a non-grantor foreign trust[58] consists solely of financial assets, and all its income comes from those assets (thus meeting the gross income test). The trustee, an individual, manages and administers the trust's assets and does not hire a third party to perform any of the Type A investment entity FFI activities on the trust's behalf. The trust is not a Type B investment entity FFI because it is managed solely by an individual (the individual trustee), who also acts as investment manager.

The facts in Example 6 are the same as those in Example 5 except that the trustee is a trust company that is an FFI. The example states that because the trust is managed by an FFI, the trust is a Type B investment entity FFI.[59]

Examples 5 and 6 are not as clear as they could have been. They deal with only two scenarios: when an individual manages both the trust and its assets (Example 5 — the trust is not an FFI); and when an FFI performs both functions (Example 6 — the trust is an FFI). It would have been helpful if the regs had provided at least one example in which an entity performed one function and an individual performed the other, such as the common situation in which a trust has a corporate trustee but an individual investment manager. It would have been even more helpful if the examples had mentioned whether the trust had a UC, given the effect of UCs on the gross income test.

Despite the examples' shortcomings, however, their import is clear. By treating trust management and asset management as coterminous, they say in effect that if *either* the trustee *or* the investment manager is a depository institution FFI, a custodial institution FFI, a specified insurance company FFI,

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[54]This might be, for instance, for tax and other reasons. For example, settlors resident in some countries who use a limited power of attorney to manage a UC's investments can cause the UC to have a permanent establishment in that country. This will make the UC subject to tax there. Trusts without UCs can avoid this problem because the PE concept doesn't generally apply to trusts.

[55]Reg. section 1.1471-5(e)(4)(i)(B). The managing entity must be a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A investment entity.

[56]Reg. section 1.1471-5(e)(4)(i)(A).

[57]Reg. section 1.1471-5(e)(4)(v).

[58]The relevance of the non-grantor status of the trust in Example 5 is unclear. An IRS official who was asked about the example's reference to a non-grantor trust is reported to have said that grantor trusts would probably not be considered investment entity FFIs. *See* Jaime Arora, "Draft FFI Registration Form Expected Soon," *Tax Notes*, Apr. 1, 2013, p. 22 (referencing statements made at a March 27 American Bar Association Section of Taxation webcast on FATCA compliance). This is puzzling. Several things in the regs depend on the grantor versus non-grantor status of a trust, *e.g.*, who the account holder in the upstream FFI is (reg. section 1.1471-5(a)(3)(ii)), who the payee is (reg. section 1.1471-3(a)(3)(ii)), and who a substantial U.S. owner is (reg. section 1.1473-1(b)(1)(iii)(A)). However, nothing in the definition of a Type B investment entity FFI, or of any other investment entity FFI for that matter, turns on whether the trust is a grantor or non-grantor trust.

[59]Technically, not just any FFI managing entity will make the managed entity a Type B investment entity FFI. Rather, as already mentioned, the managing entity must be a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A investment entity. Reg. section 1.1471-5(e)(4)(i)(B). The only other types of FFI, however, are types B and C investment entities, and holding companies and treasury centers that meet specific requirements under reg. section 1.1471-5(e)(1)(v). Those entities will seldom manage trusts.

or a Type A investment entity, and assuming the gross income test is met, the trust will be a Type B investment entity FFI.

In my earlier report, I concluded that most offshore trust companies are Type A investment entity FFIs.[60] That being the case, and given the above analysis, all trusts administered by offshore trust companies will *ipso facto* satisfy the managed by test, at least when there aren't any individual co-trustees (and, depending on the facts, perhaps even when there are — see below). If those trusts also satisfy the gross income test (which they will if they derive most of their income over the testing period from financial assets), they will be Type B investment entity FFIs.

However, the following important questions remain unanswered concerning trusts with individual trustees:

- Does a trust meet the managed by test merely because its UC's assets are professionally managed? After all, the UC is a separate legal entity, and the trust's own assets (that is, the shares of the UC) don't meet the managed by test if the trustee is an individual. Because the examples in the FATCA regs don't mention UCs, one is left to guess whether management of a UC's assets should be treated as management of the trust's own assets. In my view, it should not. True enough, it makes little practical sense for a trust with an individual trustee but a professional asset manager to be treated as an FFI if it doesn't have a UC but as an NFFE if it does. However, there is nothing in the FATCA regs to suggest that the separate legal personality of a UC should be ignored when classifying a trust.
- Does the power to give merely nonbinding investment advice rise to the level of managing assets for purposes of the managed by test? The relevant Type A investment entity FFI activities (trading, portfolio management, investing, administering, and managing) all seem to require decision-making or actual execution. Nevertheless, two earlier examples (examples 1 and 2) both conclude that an investment adviser can be a Type A investment entity FFI.
- What if there is more than one manager (for example, co-trustees or multiple investment managers), consisting of a mix of individuals and entities? In those cases, is the trust or its assets managed by an entity merely because one of the managers is an entity? Or, by analogy to the control test mentioned earlier, must the entity manager(s) be able to act independently of the individual manager(s) and the individual manager(s) not be able to act independently of the entity manager(s)?
- How much of a trust's assets must meet the managed by test for the trust to be a Type B investment entity FFI? For example, trusts often have multiple investment accounts, sometimes with more than one financial intermediary. What if all but one of those accounts, or the account(s) holding almost all the assets, is managed by an individual and the rest by an entity? If the trust has an individual trustee, is the managed by test met merely because one account or a few assets are managed by an entity performing Type A investment entity FFI activities for the trust? Or is there a de minimis threshold?

  Perhaps only a trust the majority of whose assets are managed by an entity should be deemed to satisfy the managed by test. A 25 percent threshold has also been suggested.[61] Either way, when should the relevant percentage be determined given that asset values fluctuate?
- What happens if the manager changes? This could happen, for example, when a trustee is replaced or the investments are being directed by an individual who later switches to a so-called discretionary mandate managed by a financial intermediary. FFI versus NFFE status must be determined annually — how much of the year must the trust or its investments be managed by an entity for the test to be met? Any part of the year? More than half of the year? Or does it depend on who's managing at the end of the year? At the beginning of the year?

  One approach would be to treat only trusts managed for more than half of the year by an entity as meeting the managed by test. A more conservative approach might be to treat any trust managed at any point during the year by an entity as meeting the test, at least when that management is for more than a nominal period.

In sum, trusts with commercial trust companies as the sole trustee will *ipso facto* meet the managed by test. Therefore, those trusts will be Type B

[60]This conclusion was subject to limited exceptions for commercial trust companies that derive their income primarily from nonfinancial assets, and some PTCs.

[61]Letter from Payson Peabody, managing director and tax counsel of the Securities Industry and Financial Markets Association, to various IRS and Treasury officials (June 21, 2013).

investment entity FFIs if they also meet the gross income test — that is, if most of their income comes from financial assets, including from a UC.

For the reasons stated earlier, this means that the only trusts administered by commercial trust companies that will be NFFEs will be trusts that hold their assets directly and not through UCs and whose income derives primarily from nonfinancial assets (including cash).[62] Remember, however, that this does not necessarily mean that a trust most of whose *assets* are nonfinancial will be an NFFE — one must trace the source of the trust's income.

Other NFFE trusts will be trusts with both an individual trustee and an individual investment manager.

NFFE trusts will also include trusts administered by PTCs if the PTCs don't charge fees (and therefore aren't in business and don't have customers) and any asset manager is an individual, not a professional firm. One might argue that when a PTC itself doesn't charge fees but its directors do, the PTC is effectively in business and has customers, acting as it must through its (paid) directors. Even so, if the trusts derive most of their income from nonfinancial assets, they won't be investment entities.

IV. IGAs

A. Introduction

The above analysis covers trusts in non-IGA countries. An entity in a Model 1 IGA country is generally governed exclusively by the IGA,[63] whereas an entity in a Model 2 IGA country is governed by the FATCA regs except to the extent they are inconsistent with the IGA.[64] However, when it comes to whether an entity is a financial institution versus an NFFE, both IGAs trump the FATCA regs.[65]

Both model IGAs, like the FATCA regs, define financial institutions and NFFEs by reference to entities.[66] The IGAs define an entity as ''a legal person or a legal arrangement such as a trust.''[67] Thus, trusts are as much entities under the IGAs as they are under the regs. Therefore, just as under the regs, as long as a trust is foreign, as described earlier, it will be either a financial institution or an NFFE under the IGAs.

The classification of trusts under the IGAs has undergone a recent, potentially game-changing development. The U.K. FATCA regulations and guidance notes[68] have essentially rewritten the U.K. IGA's definition of an investment entity financial institution. It is expected that other countries will use these documents as a template for their own FATCA guidance.[69] If they do, trusts' treatment under those IGAs will be radically altered. Accordingly, this report addresses the classification of trusts under both the unadulterated version of the IGAs and the U.K.'s rewrite.

1. Model IGAs as published. As detailed below, essentially all offshore trusts that either have a professional corporate trustee or whose assets are managed by a professional investment firm will be investment entity financial institutions under the IGAs. Thus, unlike under the FATCA regs, the source of a trust's income and the nature of its assets and activities are completely irrelevant under the IGAs. And whether a trust has a UC should be relevant to the trust's classification under the IGAs only if the trustee is not a commercial trust company. In that case, the trust will be an FFI only if it has no UC and its assets are managed by a professional firm — provided, that is, one takes the view that management of a UC's assets is not to be conflated with management of the parent trust's assets.

Trusts with individuals as both trustees and asset managers will be NFFEs under the IGAs.

Trusts with PTCs as trustees should also be NFFEs if their assets are managed by individuals and the PTCs (and their directors?) don't charge for their services. If a professional investment firm manages the assets or if the PTC charges fees (and possibly also if one or more of its directors charge fees), the PTC would be an investment entity financial institution.

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[62]As mentioned previously, another narrow exception may be a trust with a UC that distributes no income to the trust during the relevant gross income testing period.

[63]Preamble to T.D. 9610, at 17. *See also* art. 4.1 of the Model 1 IGA (stating that subject to some exceptions, financial institutions in the FATCA partner country that comply with their reporting obligations under the IGA will be treated as complying with their reporting obligations under the statute).

[64]Preamble to T.D. 9610, at 18.

[65]Reg. section 1.1471-5(d). Note, too, that any term not defined in an IGA is generally interpreted under local law, with a meaning under local tax law prevailing over a meaning under other local law. Model 1 IGA, art. 1.2; Model 2 IGA, art. 1.2.

[66]Model 1 IGA, art. 1.1.g-k (financial institutions) and Annex I, art. VI.B.2 (NFFEs); Model 2 IGA, art. 1.1.g and i-l (financial institutions) and Annex I, art. VI.B.2 (NFFEs).

[67]Model 1 IGA, art. 1.1.g.g.; Model 2 IGA, art. 1.1.a.a.

[68]HMRC, ''The International Tax Compliance (United States of America) Regulations 2013'' (Aug. 7, 2013) (hereinafter, U.K. regs); U.K. guidance notes, *supra* note 52.

[69]For example, Ireland's own draft FATCA guidance notes draw heavily on the U.K. precedent, specifically the December 2012 draft U.K. guidance notes, *supra* note 16. *See* the May 3, 2013, draft Guidance Notes on the Implementation of FATCA in Ireland, *available at* http://taxpolicy.gov.ie/consultations/fatca-consultation/ (click on FATCA Notes on Implementation).

a. Depository institution financial institutions. For present purposes, the definition of a depository institution financial institution in the IGAs conforms in all material respects to the corresponding definition in the FATCA regs. Thus, foreign trusts generally won't be financial institutions under the IGAs for the same reasons they won't be under the regs — they don't accept deposits and they don't provide trust and fiduciary services.

b. Custodial institution financial institutions. The basic definition of a custodial institution financial institution in the IGAs is also identical in all material respects to the corresponding definition in the FATCA regs: an entity that holds, as a substantial portion of its business, financial assets for the account of others.[70] One need look no further than this basic definition to conclude that trusts aren't custodial institution financial institutions under the IGAs.

As mentioned earlier, trusts aren't in business. Indeed, the very definition of a trust for U.S. tax purposes precludes that possibility. Although the IRS had taken the position that foreign trust companies were likely to be custodial institution FFIs under the proposed regs,[71] it has never indicated that offshore trusts themselves would be custodial institution FFIs.

c. Investment entity financial institutions. The IGAs' definition of an investment entity differs markedly from the corresponding definition in the FATCA regs. Rather than the three types of investment entities in the regs (types A, B, and C), the IGAs contain only one type of investment entity, which is defined as follows:

> 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[72];
>
> (2) individual and collective portfolio management; or
>
> (3) otherwise investing, administering, or managing funds or money on behalf of other persons.[73]

This definition is to be interpreted consistently with the similar language in the definition of financial institution in the Financial Action Task Force's (FATF's) 2012 Recommendations on International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation.[74]

The definition tracks fairly closely the definition of a Type A investment entity under the regs.[75] However, there are several significant differences:

- The parenthetical "(or is managed by an entity that conducts as a business)," a phrase to which I will return in a moment, doesn't appear in the FATCA regs' definition of a Type A investment entity.
- The regs require that the entity primarily conduct the listed activities as a business, but the word "primarily" is not in the IGAs.
- There is no percentage of income test in the IGAs to measure whether an entity (or the entity that manages it) conducts the relevant activities as a business.
- The term "financial assets" appears in the regs but is absent from subparagraph (3) above. This leaves just "funds or money" as the types of assets an entity must administer or manage to qualify as an investment entity under that provision.[76]

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[70]Model 1 IGA, art. 1.1.h; Model 2 IGA, art. 1.1.i.

[71]Notice 2010-60, 2010-37 IRB 329, at 330. Under the final regs, trust companies won't in fact be custodial institution FFIs because of the regs' very narrow definition of the sorts of income custodial institution FFIs must earn. Interestingly, although the IGAs don't contain that narrow definition of income, the U.K. FATCA guidance notes effectively reinsert it into the U.K. IGA. U.K. guidance notes, *supra* note 52, section 2.27, at 38. Thus, for entities governed by the U.K. IGA, there are two reasons (as there are under the regs) to reject custodial institution status for trusts: (1) trusts aren't in business; and (2) in any event, they don't earn the sorts of income required for custodial institution status.

[72]The word "trading" here should be deleted. The subparagraph begins with the word "trading," so its repetition here is a mistake. The word appeared in the original draft of the Model 1 IGA, but that mistake was corrected in the original draft Model 2 IGA and in the final regs (reg. section 1.1471-5(e)(4)(i)(A)(1)), both of which postdated the first draft of the Model 1 IGA. When revised model IGAs were published on May 9, the language was aligned in both models. Unfortunately, it was aligned the wrong way — instead of deleting the word "trading" from both drafts, it was included in both drafts. The mistake was carried through to the subsequent versions of the IGAs, released on July 12 and August 19. It should be tidied up.

[73]Model 1 IGA, art. 1.1.j; Model 2 IGA, art. 1.1.k.

[74]*Id.* The FATF recommendations are *available at* http://www.fatf-gafi.org/recommendations.

[75]It also tracks closely the FATF definition of a financial institution from which it is drawn. However, the FATF definition lists 13 types of activities that can make an entity a financial institution. FATF recommendations at 115-116. Of those, only the three activities listed above made it into the IGAs and into the definition of a Type A investment entity under the regs.

[76]One less consequential difference is that the words "foreign exchange" and "exchange" in subparagraph (1) are replaced in

(Footnote continued on next page.)

Without the ''managed by'' parenthetical, the IGAs' definition of an investment entity would cover only the equivalent of the regs' Type A investment entity. As we've already seen, trusts are not Type A investment entities under the regs because they don't conduct business and don't have customers. Thus, the parenthetical was necessary if the IGAs were to cover trusts.

The ''managed by'' language is Treasury's crude attempt to bootstrap a rough equivalent of a Type B investment entity under the regs into the IGAs. Remember, a Type B investment entity must meet the managed by test discussed earlier. More specifically, a Type B investment entity must be managed by another entity that conducts the activities of a Type A investment entity on its behalf. Thus, by including the ''managed by'' parenthetical in a definition that otherwise covers Type A investment entity equivalents only, Treasury was attempting to include both Type A and quasi-Type B investment entities under the IGAs in one fell swoop.

Nevertheless, a ''managed by'' investment entity financial institution under the IGAs differs from a Type B investment entity under the FATCA regs in two respects. First, as mentioned earlier, under the regs, the entity must be managed by a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A investment entity.[77] Under the IGAs, however, only an equivalent Type A investment entity will do as the managing entity.

This difference is of little consequence when it comes to the classification of trusts. As pointed out in my last report, offshore commercial trust companies will almost inevitably be Type A investment entities under the regs and, despite compelling arguments to the contrary, will be treated as investment entity financial institutions under the IGAs. Likewise, professional investment firms will be Type A investment entities under the regs and investment entity financial institutions under the IGAs. Therefore, the fact that an entity managed by a depository institution financial institution, a custodial institution financial institution, or a specified insurance company financial institution won't be an investment entity financial institution under the IGAs has no real-world impact on the classification of trusts.

Much more significantly, the IGAs have completely dispensed with the regs' gross income test for investment entity financial institutions. As mentioned earlier, a Type B investment entity under the regs must meet both the managed by test and the gross income test.[78] The net effect of the IGAs' abandoning the gross income test is that *every* entity that is managed by an investment entity financial institution under the IGAs is itself an investment entity financial institution.

What does ''managed by'' mean in the IGAs? Unlike the FATCA regs, the IGAs don't define that phrase. Presumably, however, it should be given a comparable meaning in both documents. If it is, the phrase refers to either managing the entity itself or managing the entity's assets.

d. Managing the trust itself. A trustee is the entity that manages a trust itself. Thus, if a trustee meets the other requirements of this definition, its trusts will be investment entity financial institutions under the IGAs. So, are trustees investment entity financial institutions under the IGAs?

In my previous report, I questioned whether trustees meet the definition of an investment entity financial institution under the FATCA regs. As mentioned, the IGAs require that their definition of an investment entity financial institution be interpreted consistently with the definition of a financial institution in the FATF recommendations.[79] The FATF recommendations don't treat trust companies as financial institutions but as designated nonfinancial businesses and professions.[80]

Despite considerable doubt whether most trust companies should be classified as investment entities under the IGAs, trust companies would do best to assume that they are. It is inconceivable that the IRS would countenance a different result. Example 6 in the regs assumes that the trust company in question is an FFI. Although Example 6 doesn't say which type of FFI, it suggests that the trust company is a Type A investment entity FFI because it mentions that the trustee ''manages and administers'' the trust's assets, language used in the definition of a Type A investment entity. And the definition of an investment entity financial institution in the IGAs is cloned (with the modifications already indicated) from the regs' definition of a Type A investment entity. Thus, it's hard to imagine a principled reason why the IRS would intend a different result for trust companies under those two definitions. In that light, the IGAs' instruction to construe the definition of an investment entity

the regs with ''foreign currency'' and ''foreign exchange,'' respectively. Reg. section 1.1471-5(e)(4)(i)(A)(1).

[77]Reg. section 1.1471-5(e)(4)(i)(B).

[78]*Id.*

[79]Model 1 IGA, art. 1.1.j; Model 2 IGA, art. 1.1.k.

[80]The FATF recommendations include within the definition of designated nonfinancial businesses and professions trust companies ''that are not covered elsewhere under [the] Recommendations'' if the companies act as trustees of express trusts as a business. FATF recommendations at 112-113. Trust companies are not covered elsewhere in the recommendations.

consistently with the definition of a financial institution under the FATF recommendations should be seen as nothing more than a clumsy attempt to align treatment of specified entities under both the FATF recommendations and FATCA. Unfortunately, this attempt was seemingly made without understanding that both trusts and trust companies are treated very differently under those regimes.

Assuming then, as I believe we must, that offshore commercial trust companies will generally be investment entity financial institutions under the IGAs, *every* entity, including trusts, managed by those companies will themselves be investment entity financial institutions. The *only* criterion is that the entity be managed by an entity that satisfies the requirements of an investment entity financial institution — that is, an entity that conducts as a business on behalf of customers any of the listed activities. It matters not what the trust's assets are, it matters not what the trust's income is, and it matters not whether the trust has a UC. It also matters not whether the trust has a professional investment manager; the trust company itself manages the trust as an entity, which automatically fulfills the managed by requirement.

This is a striking result. It makes no sense at all. It is, however, the ineluctable consequence of how the IGAs define an investment entity financial institution: If an entity is managed by an investment entity financial institution, it is itself an investment entity financial institution, period, full stop, end of story. The upshot is that many trusts that would be NFFEs under the regs will be financial institutions under the IGAs.

This lack of symmetry is unfortunate, especially for trustees that have trusts in countries covered by an IGA as well as in countries covered by the regs. Indeed, the IGAs were supposed to make life easier, not more difficult, for firms in IGA countries.[81] However, the compliance obligations of NFFEs under the IGAs (merely identifying U.S. controlling persons to withholding agents) are much lighter than those of financial institutions (after mandatory due diligence, identifying and reporting any U.S. account holders and details about their accounts). Thus, if more trusts covered by IGAs will be financial institutions than under the regs, IGA countries got the short end of the stick.[82]

On the other hand, if essentially all trusts run by commercial trust companies in IGA jurisdictions will be financial institutions, those trust companies will have only one compliance plan to follow for those structures. And they won't have to annually monitor the sources of their trusts' income or who's managing the assets. This would be a welcome result.

Trust companies shouldn't get too giddy, however. As I will explain in my next report, UCs won't necessarily have the same FATCA classification as trusts under the IGAs. Thus, while uniformity is certainly "a consummation devoutly to be wished,"[83] it is elusive under FATCA.

What is one to make of the omission of the term "financial assets" from the third prong of the IGAs' definition of an investment entity financial institution? Nothing at all.

Before diving into the reasons why, let's get our bearings — FATCA is so complicated that it's easy to lose sight of the forest for the trees. The sorts of assets an entity holds are potentially relevant in two contexts in the definition of an investment entity. In the definition of a Type A investment entity financial institution under the regs and an investment entity under the IGAs, it's relevant to the sorts of assets an entity "otherwise invest[s], administer[s], or manag[es]." Those assets must be (under the regs) "funds, money, or financial assets" and (under the IGAs) "funds or money." It's that discrepancy that we're now considering. But bear in mind as well that under both the regs and the IGAs, the entity must conduct the activities as a business for or on behalf of a customer. As we've already seen, trusts can't meet that test. However, an entity that does meet that test can make an entity it manages an investment entity. And remember, too, that under the regs (but not under the IGAs), the managed entity must derive most of its income from "investing, reinvesting, or trading in financial assets." There is no mention of "funds or money" in this latter context. Thus, as relevant to trusts, the issue we are considering is the sorts of assets the *managing entity* (whether a trust company or investment manager) must invest, administer, or manage to turn a trust into an investment entity. We are *not* considering the sorts of assets from which the *managed entity* (that is, a trust) must derive its own

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[81]In the words of the regs' preamble, "In consideration of the full cooperation by the partner jurisdiction, the model agreements contemplate a number of simplifications and burden reductions associated with the application of FATCA in the partner jurisdiction." Preamble to T.D. 9610, at 17.

[82]Trust companies in the United Kingdom, however, have a potential out. The U.K. FATCA guidance notes state that a U.K. financial institution that identifies a provision of the regs or

(Footnote continued in next column.)

another IGA that it would prefer to apply may contact HMRC to discuss the issue. *Id*. at 9. U.K. guidance notes, *supra* note 52, section 1.3, at 8.

[83]*Hamlet*, Act 3, Scene 1 (from Hamlet's famous "to be or not to be" soliloquy). The consummation Hamlet was referring to was death, a slightly more portentous consummation than uniformity under FATCA. Still, FATCA is part of the U.S. tax code, and you know what they say about death and taxes.

income under the regs — those assets are expressly limited to financial assets.

As explained below, the fact that the term ''financial assets'' appears in the regs but not in the IGAs regarding the sorts of assets a managing entity must invest, administer, or manage is simply a drafting quirk due to poor coordination between IRS officials, who drafted the regs, and Treasury officials, who drafted the IGAs. However the phrase ''funds or money'' as used in the IGAs is every bit as expansive as — and, if you can believe it, possibly more so than — the phrase ''funds, money, or financial assets'' as used in the regs.

The drafting chronology of the two provisions is revealing:

- The proposed regs were drafted first by the IRS. They contained only one definition of an investment entity. That definition referred to the following assets: ''securities (as defined in section 475(c)(2) without regard to the last sentence thereof), partnership interests, commodities (as defined in section 475(e)(2)), notional principal contracts (as defined in section 1.446-3(c)), insurance or annuity contracts, or any interest (including a futures or forward contract or option) in such security, partnership interest, commodity, notional principal contract, insurance contract, or annuity contract.''[84]
- The model IGAs were drafted next by Treasury officials. The IGAs' definition was not based on the proposed regs' definition but was instead drawn from the FATF recommendations' definition of a financial institution (hence the IGAs' directive to interpret its definition of an investment entity consistently with that definition). This was a sensible approach given that the FATF recommendations set an international benchmark. Thus, the FATF definition is much more appropriate for inclusion in international agreements than a definition like the one in the proposed regs, which cross-references specific provisions of the U.S. tax code and regulations that wouldn't be familiar to IGA partner countries.

  The FATF recommendations' definition refers only to ''funds or money.'' Hence, the model IGAs' definition, which is based on it, uses the same phrase.

  The word ''funds'' is defined extraordinarily broadly in the FATF recommendations. It means essentially every type of asset that exists. It refers to ''assets of every kind, whether corporeal or incorporeal, tangible or intangible, movable or immovable, however acquired, and legal documents or instruments in any form, including electronic or digital, evidencing title to, or interest in, such assets.''[85] You can't get much broader than that! Thus, financial assets are definitely included in the term.[86]

  Given that the IGAs' definition of an investment entity is to be interpreted consistently with the FATF's definition of financial institution, the word ''funds'' as used in both definitions should be given the same extremely broad meaning. Therefore, ''funds'' as used in the IGAs includes financial assets (and so much more).
- One might have expected that when the final regs came out, the IRS would have coordinated the regs' definition of an investment entity with the corresponding definitions in the model IGAs and FATF recommendations. And it tried to — kind of.

  As we've seen already, the final regs based their definition of a Type A investment entity largely on the definition of an investment entity in the IGAs (and therefore, by proxy, on the definition of financial institution in the FATF recommendations). This included adopting the ''funds or money'' language from those documents. However, the word ''funds,'' untethered from its FATF definition, is very vague, and the regs don't refer to the FATF definition as such. Thus, presumably to err on the safe side, the IRS tacked ''financial assets'' onto the end of ''funds or money.'' And the regs define financial assets to mean the exact same assets the IRS had included in the proposed regs, that is, securities, partnership interests, commodities, and so on as set forth in the first bullet point above. Thus, as far as the

[84]Prop. reg. section 1.1471-5(e)(1)(iii).

[85]FATF recommendations at 117.

[86]The FATF recommendations muddy the water somewhat by also defining ''funds *or other assets*'' (emphasis added). *Id.* What other assets could there possibly be that aren't already included in the all-encompassing definition of funds noted above? Indeed, the definition of funds or other assets doesn't really seem to add anything to the definition of funds. It includes all the assets listed in the definition of funds, which is basically all assets that exist, and also throws in financial assets, economic resources, and things like bank credits, travelers cheques, bank cheques, money orders, shares, securities, bonds, etc. But surely those assets are already included in ''assets of every kind, whether corporeal or incorporeal, tangible or intangible, movable or immovable, however acquired, and legal documents or instruments in any form, including electronic or digital, evidencing title to, or interest in, such assets.'' Bizarre, really.

regs' drafters were concerned, they'd covered both bases: They'd included not only the "funds or money" language from the IGAs but also the same assets covered by the proposed regs.

The bottom line is that one shouldn't read anything into the omission of the term "financial assets" from the definition of an investment entity financial institution in the IGAs. That definition includes the word "funds," which (interpreted consistently with the FATF recommendations) clearly includes financial assets.

The real question is what the term "funds" means in the regs. Unlike the IGAs, the regs don't tie that word back to the definition in the FATF recommendations. And presumably the regs' drafters didn't intend it to have the all-encompassing meaning it has in the FATF recommendations — otherwise, they wouldn't have felt compelled to tack "financial assets" onto the end of "funds or money." So, as counterintuitive as it is, perhaps the phrase "funds, money, or financial assets" as used in the definition of a Type A investment entity in the regs is actually narrower than the phrase "funds or money" as used in the IGAs. That would be weird, but it makes sense given the drafting history.

e. Managing the trust's assets. Even if a trustee is not an investment entity financial institution, the managed by requirement will be satisfied if the trust's assets are managed by an investment entity financial institution, that is, if the trust's assets are managed by a professional entity that conducts financial trading, portfolio management, or other investment activities on the trust's behalf.

However, the same open questions remain as discussed earlier for trusts under the FATCA regs:

- Does managing only a UC's assets equal managing the trust's assets?
- Is giving nonbinding investment advice "managing" assets?
- Is the managed by requirement met when there is a mix of both individual and entity managers?
- How much of a trust's assets must meet the managed by requirement for the trust to be an investment entity financial institution?
- What happens if the manager changes from a professional firm to an individual or vice versa?

Assuming a trust doesn't have a professional entity as either its trustee or investment manager, it will be an NFFE under the IGAs. It matters not what the trust's income or assets are.

In sum, almost all offshore trusts that are run by professional trust companies will be investment entity financial institutions under the IGAs. Trusts with individual trustees but professional entity asset managers also will be investment entity financial institutions, unless those trusts have UCs and one adopts the perfectly legitimate position that management of a UC's assets is not management of the trust's assets.

Only the following types of trusts are unlikely to be investment entity financial institutions under the IGAs (in which case they generally will be passive NFFEs): (1) trusts with both individual trustees and individual asset managers, and (2) trusts managed by PTCs that are uncompensated (and perhaps whose directors are also uncompensated) and whose asset managers (if any) are individuals.

f. U.K. IGA. The U.K. regs and guidance notes change everything. Potentially.

Why potentially? The documents' impact will depend on how many other IGA countries use them as templates. It is widely expected that other countries will do so, but no one knows how many countries or how faithfully. Stay tuned.

With the exception of the "managed by" parenthetical, the U.K. regs essentially reverse all of the discrepancies between a Type A investment entity under the regs and an investment entity under the IGAs.[87] Also, they effectively insert the gross income test into the "managed by" parenthetical. The combined effect of these changes is essentially to bring the U.K. IGA's definition of an investment entity full circle, back to the definitions of Type A and Type B investment entities under the regs.

From where does the United Kingdom get the authority to rewrite its IGA in this fashion? The U.K. IGA, like all Model 1 IGAs, provides that any term not defined in the IGA shall be interpreted under local law.[88] But investment entities *are* defined in the IGA, so this provision doesn't justify what the United Kingdom has done here.

The U.K. IGA also contains a most favored nation clause under which the United Kingdom is allowed the benefit of any more favorable terms of article 4 or Annex I of the IGA granted to another IGA country.[89] Recent IGAs permit the partner jurisdiction to use, and to allow financial institutions covered by the IGAs to use, definitions in the U.S. regs in lieu of corresponding definitions in the IGA, as long as that application would not "frustrate the

[87]Attached as Appendix II is a chart that highlights the key textual differences between the definitions of a Type A investment entity in the regs and an investment entity under the model IGAs and under the U.K. IGA as effectively rewritten by the U.K. regs and guidance notes.

[88]U.K. IGA, art. 1.2.

[89]U.K. IGA, art. 7.

purposes'' of the IGA.[90] However, the United Kingdom hasn't adopted the regs' definition of an investment entity — it has tinkered with the U.K. IGA's definition to align it in many respects with the definitions of Type A and Type B investment entities under the regs, but it hasn't adopted the regs' definitions per se. Thus, the U.K. IGA's most favored nation clause also doesn't sanction what the United Kingdom has done.

There doesn't seem to be any other legal basis under which the United Kingdom can make wholesale changes like these. Although the United Kingdom can impose whatever restrictions it likes on entities within its jurisdiction, it doesn't have carte blanche to rewrite a bilateral agreement. As a practical matter, however, if the IRS isn't bothered by these changes, no one's likely to challenge them.

In one sense, the changes are salutary — the more the meanings of terms in both the IGAs and the regs are aligned (if not actually cloned), the better. However, this sort of ex post facto rewriting is emblematic of the herky-jerky moving target that FATCA has become.

In combination, the U.K. regs and guidance notes have accomplished the following:

- They have reinserted ''primarily'' before ''conducts as a business.'' They have adopted essentially verbatim the regs' definition of primarily conducts as a business (the entity's gross income attributable to the relevant activities must equal or exceed 50 percent of its gross income over the shorter of the three-year period ending December 31 of the prior year or the period during which the entity has been in existence).
- They require, just as do the regs, that a managed entity have gross income primarily attributable to investing in financial assets.[91] Unlike the final FATCA regs, however, the U.K. regs and guidance notes don't define the term ''primarily'' in this context. Presumably, however, it will be given a meaning consistent with the regs' definition and with the guidance notes' own definition of that word for the managing entity (that is, a 50 percent or more gross income requirement over the relevant testing period).

The definitions of investment entity in the U.K. regs and guidance notes do contain some anomalies. First, the definitions are inconsistent between the two documents. The regs require that the managing entity be a financial institution. Thus, presumably any type of financial institution (that is, a depository institution, a custodial institution, etc.), and not just an investment entity financial institution, will do as the managing entity.

In contrast, the guidance notes require in the main definition of an investment entity that the managing entity conduct ''as a business . . . for and on behalf of a customer'' one or more of the activities listed in that definition. In other words, under this provision, not just any financial institution will do as the managing entity. But even then, it's not entirely clear that under the guidance notes the managing entity must conduct the relevant activities as a business at all. The main definition says that it must. However, the explanatory text that follows mentions only that the managing entity must perform the listed activities, not that it must do so as a business (or, for that matter, that it must do so for or on behalf of a customer).[92]

Elsewhere, the guidance notes specifically state (like the U.K. regs) that a trust will be an investment entity, and therefore a financial institution, when the trust itself or its assets are managed by another financial institution.[93] So, does the managing entity have to be a financial institution (any type of financial institution?), or does it have to conduct the

[90]See art. 4.7 of the Norway and Germany IGAs, art. 4.7 and section 3.6 of the Statement of Mutual Cooperation and Understanding between the U.S. Department of the Treasury and the Authorities of Japan to Improve International Tax Compliance and to Facilitate Implementation of FATCA. A similar provision is included in the most recent versions of the model IGAs. Model 1 IGA, art. 4.7; Model 2 IGA, art. 3.6 (referring to more beneficial provisions of article 3 or Annex I).

[91]U.K. regs, *supra* note 68, sections 4 and 5, at 2-3; U.K. guidance notes, *supra* note 52, section 2.28, 39-40. The documents contain their own U.K.-specific definition of financial assets. U.K. regs, *supra* note 68, section 5, at 2-3; guidance notes, *supra* note 52, section 2.28, at 39-40. The definition includes any asset capable of being the subject matter of a transaction that is an ''investment transaction'' under regulation 14F of Part 2B of the Authorised Investment Funds (Tax) Regulations, 2006. *Id*. To this uninformed reader, those assets do not appear to include cash itself. If my reading is correct, the U.K. regs and guidance notes are also aligned in this respect with the U.S. regs.

[92]This is probably an oversight caused by unthinking adherence to inapposite language in the regs. You will recall that a Type B investment entity under the regs must be managed by a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A investment entity FFI, and that the term ''managed by'' in this context means performing any of the activities of a Type A investment entity FFI on the managed entity's behalf. Thus, under the regs, conducting the requisite activities is a necessary, but not sufficient, requirement of a managing entity. In the explanatory text referred to, the drafters of the U.K. guidance notes focused on just the activities in question, not that the managing entity must also meet the other requirements of the main definition. Given that the main definition clearly mandates that the managing entity meet those other requirements, the explanatory text should not be read to the contrary.

[93]U.K. guidance notes, *supra* note 52, section 2.36, at 48.

activities of an investment entity, and if so, must it do so as a business and on behalf of customers?

Second, the main part of the guidance notes' definition now requires that the entity conduct the relevant activities *primarily* as a business. However, the ''managed by'' language in the guidance notes contains no ''primarily'' requirement. In other words, in determining whether a managed entity is an investment entity, one must inquire only whether the managing entity conducts the relevant activities as a business, not whether it primarily does so. This would mean that the managing entity would not itself have to qualify as an investment entity, that is, that it would not have to earn 50 percent or more of its income from those activities. That result makes little sense — the regs, the model IGAs, and the U.K. IGA as written all require that the managing entity itself be a type of financial institution. There seems to be no logical reason why the U.K. authorities would want to take a different approach. Thus, it's probably best to assume that the omission of the term ''primarily'' in the ''managed by'' phrase in the guidance notes is an oversight.

The less-than-meticulous drafting of the U.K. guidance notes aside, the intent of the U.K. revenue authorities is clear when it comes to the definition of an investment entity. HM Revenue & Customs' overarching aim is to bring within the IGA's scope the equivalents of both Type A and Type B investment entities under the regs, thus eliminating many of the inconsistencies between the U.K. IGA's definition of an investment entity and the regs' definition of that term. The result is that, just as under the regs, trusts will be investment entities in the United Kingdom when either the trust itself or the trust's assets are professionally managed by an entity, and most of its income comes from financial assets, including from a UC. On the other hand, trusts will be NFFEs if both the trustee and the investment manager are individuals.

V. Conclusion

What a mess! Lots of inconsistencies between the FATCA regs and the IGAs, inconsistencies between the U.K. regs and guidance notes, internal inconsistencies within the guidance notes, and lots of important unanswered questions under all the documents.

Talk about square pegs in round holes. Oh, that the IRS had not tried to force trusts into a FATCA classification ill-suited for them! Somehow, however, trust companies must muddle through this quagmire, and muddle they will.

This installment has been a big bite. But save room because there's lots of elephant left to eat. In my next report, I will discuss whether UCs are FFIs or NFFEs. In one way, FATCA's classification of UCs is much more significant than its classification of trusts. Most offshore trusts hold their assets through UCs, so it's UCs, not trusts, that generally are the account holders at banks and other financial intermediaries where trusts' assets are invested. Therefore, those intermediaries will be interacting directly with UCs much more than with trusts. Part of that interaction will be receiving Forms W-8BEN-E or substitute FATCA documentation stating the entity's FATCA classification.

What should the intermediaries expect to see on those forms? We shall see. For now, just know that FATCA's classification of UCs is much more difficult, and much more uncertain, than its classification of trusts. Keep some antacid handy for our next bite.

(Appendix tables appear on the following pages.)

Appendix I. FATCA Classification of Trusts — Conclusions

Regs	Model IGAs	U.K. IGA (as interpreted by U.K. FATCA Regs and Guidance Notes)
Depository FFI: No Reason: Don't accept deposits in ordinary course of banking or similar business (don't provide trust or fiduciary services)	Depository FI: No Reason: Don't accept deposits in ordinary course of banking or similar business (trust or fiduciary services not mentioned)	Depository FI: No Reason: Don't accept deposits in ordinary course of banking or similar business (trust or fiduciary services not mentioned)
Custodial FFI: No Reason: Don't earn required types of income (essentially, financial transaction fees and commissions) and not in business	Custodial FI: No Reason: Required income not defined, but not in business in any event	Custodial FI: No Reason: Required income not defined, but not in business in any event
Investment Entity FFI: Type A: No Reason: Not in business and don't have customers Type B: Yes Reason: (i) "Managed By" test met if commercial trust company is trustee or assets managed by professional firm (but query whether management of UC's assets = management of trust's assets) — Exceptions: Trusts with individual trustee or PTC that charges no fees (and PTC's directors charge no fees?) and individual asset manager (ii) "Gross Income" test met if ≥ 50% of gross income from financial assets (including from shares of UC) — Exceptions: Trusts with no UC if < 50% of gross income from financial assets Trusts that are not Type B IE FFIs will generally be Passive NFFEs unless they hold operating companies (directly or through UCs), in which case they will generally be Active NFFEs (subcategory of Excepted NFFEs) Type C: No Reason: Trusts are not collective investment vehicles or funds as defined	Investment Entity FI: Yes Reason: "Managed By" test met if commercial trust company is trustee or assets managed by professional firm (but query whether management of UC's assets = management of trust's assets) — Exceptions: Trusts with individual trustee or PTC that charges no fees (and PTC's directors charge no fees?) and individual asset manager Note: No "Gross Income" test under IGAs. Therefore, types of income and assets of trust are totally irrelevant — "Managed By" test is only criterion Trusts that are not IE FIs will generally be Passive NFFEs unless they hold operating companies directly, in which case they will generally be Active NFFEs	Investment Entity FI: Yes Reason: (i) "Managed By" test met if commercial trust company is trustee or assets managed by professional firm (but query whether management of UC's assets = management of trust's assets) — Exceptions: Trusts with individual trustee or PTC that charges no fees (and PTC's directors charge no fees?) and individual asset manager (ii) "Gross Income" test met if gross income primarily (≥ 50%?) from financial assets (including from shares of UC) — Exceptions: Trusts with no UC if < 50% of gross income from financial assets Trusts that are not IE FIs will generally be Passive NFFEs unless they hold operating companies (directly or through UCs), in which case they will generally be Active NFFEs
Specified Ins. Cos. & Related Holding Cos.: No Reason: Self-explanatory	Specified Ins. Cos. & Related Holding Cos.: No Reason: Self-explanatory	Specified Ins. Cos. & Related Holding Cos.: No Reason: Self-explanatory
Holding Co. or Treasury Center: No Reason: Not a company and primary activity is not entering into investment, hedging, and financing transactions for members of expanded affiliated group	Holding Co. or Treasury Center: Not Applicable	Holding Co. or Treasury Center: No Reason: Not a company and primary activity is not entering into hedging and financing transactions with or for related Financial Institutions

Appendix II. Definition of an Investment Entity

Regs (Type A IE Only) Highlighted Language Is in the Regs but Not the IGAs	Model IGAs Highlighted Language Is in the IGAs but Not the Regs	U.K. IGA (as "rewritten") Bracketed Language Does Not Appear in IGA, but Is Effectively Inserted by Regulations and U.K. Guidance Notes
(A) The entity **primarily** 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 (checks, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, andindex instruments; transferable securities; or commodity futures; (2) Individual or collective portfolio management; or (3) Otherwise investing, administering, or managing funds, money, **or financial assets** on behalf of other persons.	[A]ny 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 moneyon behalf of other persons.	Any Entity that **[primarily]** conducts as a business (or **[meets the Gross Income test and]** is managed by **a financial institution or by** an entity that conducts as a business) one or more of the following activities . . . 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.