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Qualification of trusts

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Abstract

Distinguishing between discretionary and all other types of trust, this article emphasizes that, according to Swiss tax law principles, discretionary beneficiaries have expectancies but no legal claims against the trustee. As long as discretionary beneficiaries do not receive anything from the trust, they are not subject to reporting. This does not only apply with respect to Common Reporting Systems (CRS)/Multilateral Competent Authority Agreement (MCAA) but also with respect to Foreign Account Tax Compliance Act (FATCA).

Qualification of trusts

Trusts are either fiscally transparent, ie grantor trusts, or taxable entities, ie irrevocable trusts. There are different kinds of irrevocable trusts. An irrevocable trust can either convey mandatory or alternatively discretionary benefits.

There are different 'reporting categories' for trusts: Trusts are entities and are either 'Investment Entities' (IEs) or 'Non-Financial Entities' (NFEs).

A trust falls under the definition of an 'investment entity' if it passes both the 'gross income test' and the 'managed by' test (if it fails either one of these tests then the trust in question is a NFE)

The 'gross income' test looks at the income of the entity. If more than 50 per cent of said entities income is passive income than it may qualify as an IE. For all practical purposes passive income can best be defined in the sense of 'FDAP-income' (Fixed, Determinable, Annual or Periodical Income) pursuant to sections 871(a) and 881(a) IRC.

The 'managed by tests' looks at a trust that is managed by an IE, typically by a trust company.

If the trust is an IE than is has to report its 'equity interest'.

If the trust is not an IE, than it is by definition (and as a fall back) a NFE. In order to be reportable, the NFE must be a passive NFE, ie more than 50 per cent of its gross income must be passive income. If the trust qualifies as a Passive NFE than it has to identify the 'Controlling Persons'.

There are two methods of reporting. Reporting occurs either directly, that is from the 'Financial Institution' (FI) in the requested country to the tax authorities of the requesting country or indirectly, that is from the FI to the competent authority of its country of residence and from there to the competent authority of the requesting country.

It should be noted that according to Swiss law it is not possible to establish a trust.

If Switzerland or the Principality of Lichtenstein would be the reporting country and either Swiss or Liechtenstein law where to apply, this would mean:

Reporting and Identification Requirements affecting Beneficiaries

I. FATCA U.S—CH (Intergovernmental Agreement Model 2)

Article 2 CH-FTCA Law states that US law shall apply unless the FATCA Agreement directs otherwise.

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Switzerland has put in place with the USA an 'Intergovernmental Agreement' (IGA) Model 2, allowing for a facilitated application of FATCA. Swiss law applies if the FI in question has been incorporated under the laws of Switzerland.[1]

IGA Model 2 incorporates a direct reporting from the Swiss-based FI to the IRS. Other countries having entered into an IGA Model 2 are, *inter alia*, Japan, Bermuda, and Hong Kong.

Under the IGA Model 2, the term 'financial account' has been defined by making reference to the US Treasury Regulations.

According to TD 9610, the term 'financial account' has the meanings set forth in section 1.1471-5B. In this context, it will be important to distinguish between 'mandatory distributions' and 'discretionary distributions'.

In case of a foreign trust that is an investment entity and therefore a financial institution, any equity interest held by a US person, has to be reported, this means an interest held by:

- a person who is an owner of all or portion of the trust under US grantor trust rules;
- a beneficiary who is entitled to a mandatory distribution from the trust; and
- a beneficiary who may receive a discretionary distribution from the trust, but only if such person receives a distribution in the calendar year.

If the trust in question is part of an irrevocable discretionary structure and if no discretionary distributions occurred during a given calendar year, then there is (at least in theory) no reporting obligation under the IGA Model 2.

If the FI that manages the trust acts as a sponsoring entity for said trust, then it has to file Form 8966 (in this case there is no need for the sponsored trust to file Form 8966). Form 8966 has also to be filed by the trustee of a 'owner documented trust'. This reporting is being referred to as 'chapter 4 reporting'; as per Form 8966 it includes:

- the name, address, and US tax identification number of the US person;
- the account balance;
- interest income;
- dividend income; and
- gross proceeds from the sale of assets.

If the entity in question qualifies as a passive NFE, then it has to identify its 'substantial', ie greater than 10 per cent, US owners by vote or value. In case of a trust, this identification/disclosure requirement affects all 'Controlling Persons', as this term has been defined in Article 2, paragraph 1 (32) FATCA Agreement (entered into between the USA and Switzerland on 13 February 2013) and includes:

- the settlor,
- the trustees,
- the protectors (if any), and
- the beneficiaries or class of beneficiaries and any other natural person exercising ultimate effective control over the trust.

Any NFE must file Form W-8BEN-E in order to identify its substantial US owners (more than 10 per cent), in case of a trust its Controlling Persons, with the US withholding agent in order to avoid 30 per cent withholding on withholdable payments (including gross sales proceeds).

This is an easy to fill in 'check the box form', which includes a special category for trusts.

While there can be Swiss resident passive NFEs, such as eg a limited liability company that has been incorporated in Switzerland and which has no employees or offices of its own, it is difficult to imagine a situation in which a foreign trust could qualify as a passive NFE. A foreign trust that merely holds a Swiss bank account, which is not effectively managed by either by a Swiss resident FI (the bank) or by a

1. Agreement between Switzerland and the USA for Cooperation to facilitate the Implementation of FATCA, signed in February 2013, art 2, para 1 (13).

Swiss resident trustee (a trustee company), will not be subject to any Swiss reporting.

2. FATCA US Principality of Liechtenstein (Intergovernmental Agreement Model I)

Unlike Switzerland, Liechtenstein has entered with the USA an IGA Model 1, thus one incorporating an indirect reporting method. The great majority of the requested countries entered into an IGA Model 1.

Under IGA Model 1, the meaning of an equity interest in a trust is different from the IGAS Model 2 situation. Under the IGA Model 1 Agreement, a financial account includes, in case of an entity that is a financial institution solely because it is an investment entity (as in the case of a non-US trust, that has a financial institution as a trustee), any equity or debt interest in that financial institution (ie the trust). However, under the IGA Model 1 Agreement, an equity interest in a trust is considered to be held by:

- any person treated as a settlor or beneficiary of all or portion of the trust; or
- any other natural person exercising ultimate effective control over that trust.

Under IGA Model 1, a specified US person is treated as being a beneficiary of a trust if such person 'has the right to receive directly or indirectly (eg through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust'(eg Article 1 (v) Model 1 IGA US—Liechtenstein, dated as of 19 May 2014)

The wording 'may receive' applied to a discretionary structure, without the clause 'but only if such person receives a distribution in the calendar year', seems to result in the reporting of all US discretionary beneficiaries, regardless of whether they receive a distribution or not.

For FATCA purposes and subject to a trust being managed by an IE, it makes a significant difference as to whether the reporting jurisdiction with regard to a discretionary beneficiary is an IGA Model 1 country, such as eg Liechtenstein (clear preference for a NFE), or alternatively an IGA Model 2 country, such as eg Switzerland or Bermuda (clear preference for an IE).

3. Switzerland: OECD CRS/MCAA

Switzerland has adopted the OECD CRS Standard by simply attaching it as annex to the 'Multilateral Competent Authority Agreement (MCAA) that has been adopted by virtue of the CH-AIA Law dated as of 15 December 2015. Presumably, this new law will be enacted as of 1 January 2017.

There is not as yet a list of countries with which Switzerland will engage in a multilateral and automatic exchange information. The list of countries with which there will be a multilateral EoI must be authorized by a parliamentary decree ('*Bundesbeschluss*') that is not subject to a voluntary referendum.

There are, however, several countries with which a bilateral AIA Agreement has been signed (eg Australia, Canada, Japan, South Korea, Italy), but for the time being none of these bilateral AIA Agreements has been ratified as yet.

In order for Swiss law to apply, the POEM of the FI in question must be in Switzerland; in case of a trust it is enough if one of the trustees is a Swiss resident.[2] If the trust merely has its accounts in Switzerland but is not at the same time 'managed by' a Swiss resident FI (because the bank does not have discretionary authority to manage the trust assets[3]), then said trust will by definition be a NFE. As under Swiss law, trusts are an unknown institution, said NFE will not be subject to the Swiss reporting legislation. If trustees are, however, residents of Switzerland as well as in other countries then this will result in 'double reporting' (which may lead to double taxation).

The wording of the CRS that has been attached to the MCAA establishes a 'status quo'. Article 8 CH-AIA Law indicates that any changes affecting said CRS standard

2. CH-AIA Law, art 5, para 4.
3. OECD, Standard for Automatic Exchange of Financial Account Information in Tax Matters, OECD 2014, Commentary of CRS, VIII (17).

requires parliamentary approval before they can be applied in Switzerland. Where domestic law does, however set a CRS standard of its own, such domestic provision will therefore take precedence over the CRS established by the OECD (by virtue of the Declaration of 6 May 2014). One domestic provision that will take precedence over the 2014 version of the CRS is Article 9, paragraph 2 CH-AIA Law. This is a '*quid pro quo*' provision stating that trusts qualifying as NFEs shall have the same favourable treatment as trusts qualifying as IE.

If the trust qualifies as an IE, because it meets both the gross income and the managed by test, then one would again have to look at the meaning of 'equity interest' as per CRS VIII, C, 4:

> A Reportable Person will be treated as being a beneficiary of a trust if such Reportable Person has the right to receive directly or indirectly (for example through a nominee) a mandatory distribution or may received, directly or indirectly, a discretionary distribution from the trust.

This wording corresponds to the one which is also being used in IGA Model 1 Agreements.

Starting from the definition of the term 'equity interest' (as per CRS VIII, C, 4), one will, however, have to revert to Commentary CRS, VIII, 70:

> For these purposes a beneficiary who may receive a discretionary distribution from the trust will only be treated as a beneficiary of a trust if such person receives a distribution in the calendar year or other appropriate reporting period (i.e. either the distribution has been paid or is made payable)

This is also in line with the Financial Action Task Force (FATF) Recommendations (where reference is made to an 'accumulation period').

In case of a trust that is an NFE, the CRS adopts the enlarged ownership definition as per CRS D, 6 including:

- the settlor(s)
- the trustee(s)
- the protector(s), if any
- the beneficiary(ies) and
- any other natural person(s)exercising ultimate effective control over the trust.

Based on Article 9, paragraph 2 CH-AIA Law (the '*quid pro quo*' provision) a NFE is, however, entitled to benefit of the same favourable treatment as if it would be an IE. In the Federal Council's Report introducing the new CH-AIA Law,[4] there is a Commentary, which reads as follows:

As far as beneficiaries are concerned, one has to distinguish between those who can claim a mandatory distribution and those who may be entitled to a discretionary distribution. In case of the latter a reporting Swiss Finance Institute can chose to report these beneficiaries only with respect to the years in which they have actually received a distribution. The FIs must, however, adopt precautionary measures allowing them to then identify these beneficiaries.

For MCAA/CRS reporting purposes, it therefore makes no difference as to whether the trust in question qualifies as an IE or a NFE. In both instances, discretionary beneficiaries must only be reported with respect to the years in which they have actually received a distribution from the trust.

4. Switzerland: AIA with the European Union

An Agreement regarding the AIA with the European Union (EU) has been signed on 27 May 2015. This Agreement will lead to a general overhaul of the Savings Tax Agreement, originally signed as of 24 October 2004.

The new Savings Tax Agreement is subject to parliamentary approval; a schedule for parliamentary debates has not been published as yet.

4. Botschaft zur Genehmigung der multilateralen Vereinbarung der zuständigen Behörden über den automatischen Informationsaustausch über Finanzkonten und ihrer Umsetzung (Bundesgesetz über den automatischen Informationsaustausch in Steuersachen) vom 5. June 2015, BB 2015, S. 5494.

The EU-AIA Agreement will incorporate the OECD's CRS Standard as an annex. Although it has not been specified as yet, what the standard applicable in matters of trusts will be, one would, however, expect that the standards set forth in the CRS will be identical with the ones applicable with respect to the EU.

5. Principality of Liechtenstein: OECD CRS/ MCAA

Contrary to Switzerland, Liechtenstein has determined a CRS standard of its own, which has been been approved by the FL-Parliament on 15 November 2015.

Trust are entities and are either IE or NFEs.

In order to qualify as an IE, both the 'gross income' and the 'managed by' test (a trust managed by will itself become an IE) must be passed.[5]

Existing entities must until 31 December 2016 decide as to whether they qualify either as an IE or alternatively passive NFEs' (Article 4, paragraph 3, lit a FL-AIA Law). Who does not do anything will automatically be classified as an IE.

Passive NFE's have time until 30 June 2017 to identify and to report the 'Controllig Persons' (Article 5, Abs 1 FL-AIA Law and (if possible) to report on the TIN of the controlling person (Article 5, paragraph 2 FL-AIA Law).

For an AIA, that has been implemented with another country as of 1 January 2016, there is a due diligence obligation that lasts until 31 December 2017. In such a case, the reporting encompasses the period 2017, information for which has to be reported to the FL Tax administration until 30 June 2018 (as per B&A 73/2015 S. 81).

The FL-AIA Law protects 'discretionary structures' of a trust that is an IE:

Similar to the Swiss solution, FL-AIA Article 7, paragraph 2 also contains a 'quid pro quo' provision that incorporates CRS, Commentary VIII, 70 and which protects 'discretionary structures', regardless of whether they qualify as IE or as passive NFEs.[6]

General Anti-Abuse Provisions

6. Switzerland

Section 9 CRS refers to 'Effective Implementation' and requires each jurisdiction to put in place rules and administrative procedures to ensure an effective implementation of, and compliance with the necessary reporting and due diligence procedure. CRS Commentary on section IX, 4[7]:

> How the anti-avoidance rule for the CRS is drafted will depend on the general approach adopted by jurisdictions to addressing avoidance as well as to implement the CRS.

Article 31, paragraph1 CH-AIA Law states that Swiss FIs may not administer or give support to any artificial structures, the sole or the main purpose of which is the avoidance of reporting requirements as set forth by conventions or the CH-AIA Law. Who deliberately engages in activities that have been banned pursuant to Article 31, paragraph 1 CH-AIA Law can be fined for up to CHF 250'000. In case of negligence, said fine shall not exceed CHF 100'000.

The fourth AMLD will not be applicable in Switzerland, because Switzerland is not an EU Member State.

7. Principality of Liechtenstein

Article 26 FL-AIA Law aims in very general terms not to implement any legal or factual structures, the main purpose of which is to avoid any (reporting/identification) obligations set forth under applicable conventions or the FL-AIA Law.

The fines imposed under FL law are identical with the ones imposed under Swiss law.

The fourth AMLD became effective on 25 June 2015. The EU Member States (including Liechtenstein because of the 'acquit communautaire' provisions) have two years of time (until 24 June 2017) to convert this Directive into domestic law.

5. B&A 73/2015, S. 34.
6. B&A 73/2015, S. 98.
7. OECD (n 3) 208.

Once enacted in the various EU Member States (including Liechtenstein) the fourth AMLD will work as 'a superimposed' CRS standard.

8. Advising on the best jurisdiction to locate your client's trust

Aggressive tax planning is illicit; therefore, avoid any repeatedly utilized 'off-the shelf solutions'.

As long as you advise on a case-by-case basis on the pros or cons of having the client's trust managed either in this or in that jurisdiction, you are in general not engaging in any aggressive tax planning.

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