taxnotes® international

Volume 86, Number 1 ■ April 3, 2017

CRS and FATCA: Different Weapons, Same Game?

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Reprinted from *Tax Notes Int'l*, April 3, 2017, p. 75

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FEATURED PERSPECTIVE

CRS and FATCA: Different Weapons, Same Game?

by Ashley Fife

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In this article, the author discusses key differences between the Foreign Account Tax Compliance Act and the OECD's common reporting standard from the perspective of an international private client practitioner.

Elimination of tax evasion and increasing tax revenue are widely stated objectives of the common reporting standard (CRS)[1] and the Foreign Account Tax Compliance Act.[2] However, the modest increase in tax revenue in the United States following the introduction of FATCA may confirm an alternative view that the real purpose of FATCA is to allow the U.S. government access to private financial information so it can control the global financial industry.[3] FATCA and the CRS are each designed to, at a minimum, require reporting financial institutions (RFIs)[4] to report information on the interests that reportable persons have in reportable "financial accounts."[5] The CRS and FATCA have many similarities in their approach to due diligence and reporting requirements. The OECD,[6] the architect of the CRS, intended this so that RFIs could substanitially use the procedures and systems they had begun developing in connection with FATCA.

The CRS has a significantly wider scope than FATCA. FATCA requires reporting with respect to U.S. taxpayers who beneficially own financial accounts. The CRS requires reporting for tax residents in CRS "participating jurisdictions,"[7] of which there are now more than 100. Further, the CRS requires reporting on tax residents that control or beneficially own financial accounts. This article explores key differences between FATCA and the CRS from an international private client practitioner's perspective.

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[1]The Standard for Automatic Exchange of Financial Account Information, developed by the OECD in response to the G-20's request and approved by the OECD Council on July 15, 2014.

[2]FATCA is the revenue-raising part of the U.S. government's 2010 job stimulus legislation, the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act), and now reflected in reg. sections 1.1411 to 1.1474 of the U.S. Code of Federal Regulations.

[3]Jack Brister and Ashley Fife, "How FATCA and CRS Have Changed the World as We Knew It," presentation to The New York State Society of Certified Practicing Accountants International Tax Conference (Jan. 26, 2017).

[4]RFIs are financial institutions that are required to report financial account information in connection with FATCA or the CRS as the case may be. FATCA uses the term "reporting FFIs," but this article also refers to reporting foreign financial institutions as "RFIs" for convenience.

[5]The CRS definition of financial account includes an account maintained by a "financial institution," including a "depositary account" and a "custodial account," and in the case of an "investment entity," and "equity or debt interest" in the financial institution, in each case, with certain exceptions.

[6]The OECD was formed by the Convention on the Organisation for Economic Cooperation and Development in 1961, an intergovernmental economic organization with 35 member countries, founded to stimulate economic progress and world trade.

[7]Jurisdictions whose governments have signed a competent authority agreement (see definition herein) and are committed to exchanging financial account information in accordance with CRS.

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Bilateral vs. Multilateral Aspects

FATCA and the CRS developed differently. FATCA was introduced by U.S. legislation that imposed on financial institutions outside the U.S. (foreign financial institutions)[8] an obligation to, with some exemptions, register with the Internal Revenue Service, perform due diligence, and report to the IRS on financial accounts held by U.S. taxpayers. FATCA implemented one of the most aggressive pieces of extraterritorial legislation ever.

Many jurisdictions entered into separate bilateral intergovernmental agreements with the U.S., agreeing to implement laws to:

- require local RFIs to comply with FATCA due diligence and reporting requirements; and
- provide that such compliance would not cause RFIs to breach local data protection laws.

There are two main types of IGAs. Model 1 IGAs require local RFIs to report information to the local government's competent authority to forward to the IRS. Model 2 IGAs require local RFIs to enter into an FFI agreement with the IRS and report information directly to the IRS.

In contrast, the CRS is an international standard developed by the OECD. Jurisdictions wanting to participate in the CRS can do so by one of following methods:

- Ratifying a legal instrument, such as a treaty, which provides for automatic exchange of information with jurisdictions with which the ratifying jurisdiction agrees to exchange information.
- Enacting legislation to impose the due diligence and reporting requirements on local RFIs.
- Signing an OECD model competent authority agreement (model CAA), which may be bilateral or multilateral and which may be reciprocal or nonreciprocal, whereby the participating jurisdiction agrees to implement CRS due diligence and reporting, and exchange information. The CAAs link the legal basis for exchange of information (that is, the legal instrument) with the domestic legislation. The CAAs are comparable to, and were developed from, Model 1 IGAs. There is no Model 2 IGA equivalent under the CRS.

The legal instrument may be one of the following:

- The Multilateral Convention on Mutual Administrative Assistance on Tax Matters (model convention). The model convention is a multilateral agreement with treaty status developed by the OECD and designed to promote international cooperation for better operation of national tax laws.[9]
- A double taxation agreement that provides for automatic exchange of information.[10]

Notably, the Bahamas, Singapore, and Hong Kong have entered into bilateral CAAs. Switzerland has signed a multilateral CAA and ratified the model convention but has received some criticism for being too selective of the jurisdictions with which it is willing to exchange information.[11]

Under the CRS, despite the multilateral nature of the model convention and the multilateral CAA, the exchange of information itself takes place on a bilateral basis so that each partner jurisdiction only receives information on financial accounts held or controlled by their tax residents.

Even when jurisdictions enter into a multilateral CAA, they must separately specify (by lodging Annex E to the CAA with the OECD Secretariat) the participating jurisdictions with which they agree to exchange information. Also, each participating jurisdiction is required to set out in its Annex E any conditions the listed jurisdictions are required to satisfy before the CAA is activated.[12]

CRS: No Withholding Tax

FATCA requires ''withholding agents'' (which may include U.S. branches of FFIs) to withhold 30 percent from withholdable payments (for example, U.S.-source income and gross sale proceeds that may include U.S.-source income) and pay that sum to the IRS from reportable accounts with noncompliant account holders.

U.S. Citizenship vs. Tax Residency

Under FATCA, RFIs are required to report in respect of financial accounts owned by U.S. taxpayers (essentially, U.S. citizens and green card holders).

Under the CRS, a ''reportable person'' is a person who owns or controls a financial account and is tax resident in the partner jurisdiction with which information is being exchanged. The global aggregate of reportable persons in the 100-plus participating jurisdictions far exceeds the number of U.S. taxpayers that hold reportable accounts under FATCA.

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[8]Note that whereas FATCA refers to ''FFIs,'' the CRS refers to ''financial institutions.''

[9]Article 6 of the model convention provides the option for signatories to participate in automatic exchange of information.

[10]For example, containing the standard OECD model convention article 26.

[11]*See* Tax Justice Network, ''Switzerland Information Exchange: Tweak, Tweak and Something Will Always Remain'' (Nov. 26, 2016).

[12]For example, satisfaction of standards of confidentiality and data protection safeguards.

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Reciprocity of Information Exchange

Initially, FATCA did not require the U.S. government to report any information to its FATCA partner jurisdictions. Following negotiations with other G-20 countries, the U.S. government released a model reciprocal IGA.[13]

Under reciprocal IGAs, the U.S. government will not exchange information on:

- cash accounts held by entities, including those that are resident in the FATCA partner jurisdiction;
- noncash accounts, whether held by individuals or entities (including those that are resident in the FATCA partner jurisdiction) unless the accounts earn U.S.-source income.
- ''controlling persons''[14] of any entities having financial accounts in U.S. financial institutions, irrespective of whether those entities are from the partner jurisdiction or from third countries, and even if those entities are owned and controlled by residents of the partner jurisdiction.

The CRS is fully reciprocal, except when a jurisdiction has signed a nonreciprocal CAA.[15] This, combined with the number of participating jurisdictions and the multilateral approach, has resulted in more than 1,450 CRS exchange relationships, exponentially more than under FATCA.

Definition of Investment Entity

The definition of investment entity under FATCA and the CRS is important from a private client practitioner's perspective because it largely determines whether an entity will be a financial institution or a nonfinancial entity (NFE),[16] in turn, essentially determining whether an entity will be an RFI and what information is reported on the entity's account holders.

Under both the CRS and FATCA, the definition of investment entity provides for two types of investment entity:

- entities that are investment entities in their own right because they carry on the business of providing financial services to customers; and
- entities that qualify as investment entities because they satisfy a ''managed by test'' and a ''financial assets test.''[17]

To satisfy the financial assets test, the managed entity's gross income needs to be ''primarily attributable'' to investing, reinvesting, or trading in financial assets. An entity's gross income is said to be primarily attributable to the above activities if it is equal or exceeds 50 percent of its gross total income from all sources.

IGAs do not include a financial assets test. Consequently an entity may be an investment entity under the IGAs if its financial assets are managed by an RFI. Under the IGAs, an entity may elect to apply the FATCA definition of investment entity to determine an entity's status. However, the simplified test is unavailable under the CRS, so entities that use it for the purpose of categorization under the IGAs may need to revisit their CRS classification.

CRS's Focus on Control

FATCA focuses on identifying U.S. taxpayers' beneficial ownership in non-U.S. passive financial investments. The IGAs go further, requiring RFIs to report on controlling persons of financial accounts held by passive NFEs[18] if the RFIs do not elect to apply the FATCA regulations. This is the case even if the controlling person does not have a beneficial interest in the financial account. The FATCA regulations do not include the ''controlling person'' concept. The CRS does. Under the CRS, RFIs are unable to make such an election.

Treatment of Trust Protectors

Financial Institution Trusts

Under the CRS, if a protector is tax resident in a partner jurisdiction, the reporting jurisdiction in which the trust is resident for CRS purposes will generally be

[13]That is, a Model 1A IGA.

[14]Under the CRS, ''controlling persons'' means the natural persons who exercise control over an entity. In the case of a trust, the term means the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust.

[15]A number of offshore financial centers do not impose income or other taxes and have consequently signed nonreciprocal CAAs because they do not require information from partner jurisdictions for tax purposes.

[16]FATCA and the IGAs use the acronym ''NFFEs,'' but the acronym ''NFEs'' is used in this article to also cover NFFEs under FATCA and the IGAs. There are essentially two types of NFEs: active and passive. Active NFEs are non-reporting entities and are themselves non-reportable. The CRS, FATCA, and the IGAs contain extensive definitions of active NFEs, but most notably for the purposes of this article:

- active NFEs are NFEs of which less than 50 percent of the entity's gross income for the preceding reporting period is passive income and less than 50 percent of its assets were held to produce passive income during the reporting period; or

(Footnote continued in next column.)

- entities that, *inter alia*, are established exclusively for charitable or philanthropic purposes and have no private members who have an interest in or can benefit from its income or assets.

[17]Also known as the ''gross income test.''

[18]Adopting the approach reflected in the Financial Action Task Recommendations 2012, which focus on control over entities in the context of money laundering, conflating concepts of beneficial ownership, and control.

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required to automatically exchange information with the partner jurisdiction about the protector irrespective of whether:

- the trust is a financial institution or a passive NFE; or
- the protector exercises control over the trust, or holds an equity interest[19] or debt interest[20] in the trust.[21]

The protector's reportable account balance would be the value of the assets held in the account with the RFI.

Under the IGAs, a protector of a financial institution trust:

- is not an account holder unless it exercises "ultimate effective control"[22] over the trust, or is a trust beneficiary, or otherwise holds a "debt interest" or "equity interest" in the trust; and
- consequently, in the above scenario, would generally not be a reportable person.

The FATCA regulations require RFIs to report on "specified U.S. persons," essentially being U.S. taxpayers, who have equity or debt interests in financial institution trusts. The IGAs permit RFIs to apply this approach.

Passive NFE Trusts

Under the IGAs and the CRS, an RFI with which a trustee of a passive NFE trust holds an account will generally be required to report details about the trust's protector, including the protector's deemed "account balance"[23] to each partner jurisdiction in which the protector is tax resident.

The FATCA regulations require RFIs to report on "substantial U.S. owners" of passive NFE trusts. A "substantial U.S. owner" of a trust means any "specified U.S. person":

- treated as an owner of any portion of the trust under the U.S. grantor trust rules; and
- that holds, directly or indirectly, more than 10 percent of the beneficial interests of the trust.

The IGAs permit RFIs to report on substantial U.S. owners of passive NFE trusts in lieu of reporting on the trust's controlling persons. No comparable election is available under the CRS.

Central Registration System

FATCA requires FFIs to register with the IRS and obtain a global intermediary identification number (GIIN). The CRS does not have a central registration system and entities therefore cannot register for a GIIN under the CRS in order to become reporting entities.

Under FATCA (and the IGAs), an entity (such as a private trust company (PTC)) could obtain a GIIN to be treated as a reporting entity. This treatment is unavailable under the CRS for the reasons outlined above.

In some cases, the correct classification of a PTC may be unclear, whether under FATCA or the CRS. Under both FATCA and the CRS, an entity is a financial institution if it is an investment entity.[24] PTCs often are unregulated and may not carry on business for a profit or hold financial assets in a personal capacity.[25] Further, PTCs may not easily satisfy the "managed by test" or the "financial assets test." Consequently, PTCs, and the trusts they administer, may not readily be classified as investment entities and instead may be categorized as passive NFEs. This classification may be unattractive for clients under the CRS because banks and other RFIs are required to report the controlling persons of passive NFEs that hold financial accounts with them, but are not required to report controlling persons of financial institution's account holders unless the financial institution is resident in a nonparticipating jurisdiction.

Under FATCA (and the IGAs), a PTC may register with the IRS and obtain its own GIIN and undertake to carry out FATCA due diligence and reporting despite there being doubt about whether the PTC satisfies the definition of investment entity. Consequently, the PTC could attend to reporting on the trusts of which it is trustee and the trusts would not need to obtain their own GIINs. The trusts would qualify as "trustee documented trusts" and be "non-reporting FFIs."

The "trustee documented trust" classification is also available under the CRS. However, under the CRS, an analysis of the assets and activities of the PTC would be needed in each case to determine whether it satisfies

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[19]In the case of a trust that is a "financial institution" under the CRS, "equity interest" is considered to be held by any person treated as a settlor or beneficiary of a trust of such reportable person that has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust.

[20]Not a defined term under the CRS, so it would be given the meaning designated to that term under the domestic law of the RFI that is making the report.

[21]See OECD CRS FAQ (June 2016), which states that this is the position and has maintained this stance despite considerable criticism from industry.

[22]Notably, not a defined term under FATCA, the IGAs, or the CRS.

[23]The value of the financial account held with the RFI that is making the report, again irrespective of whether the protector is a trust beneficiary.

[24]An entity may also be a financial institution under the CRS if it is a "Custodian" or "Depositary Institution" each as respectively defined under the CRS. However, client entities, such as trusts, underlying companies, or PTCs, will, with some exceptions, most likely be classified as a financial institution under the CRS only if they fall within the definition of investment entity.

[25]See the first limb of the definition of investment entity set out above.

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the definition of investment entity to in turn ascertain if the PTC qualifies as an RFI.

CRS Provides Fewer Reporting Exemptions

There are no individual de minimis thresholds under the CRS for ''new accounts''; consequently, all financial accounts held by individuals in every reportable jurisdiction are reportable unless otherwise specifically exempted. The CRS applies an exemption for reporting only for ''preexisting accounts'' with an account value of up to $250,000.

There is no de minimis threshold for insurance policies' cash value under the CRS. FATCA provides a $50,000 threshold cash value on insurance policies before it requires the policy (that is, the financial account) and its owner to be reported.

Under FATCA, charities generally have no reporting obligations, often being classified as ''deemed compliant'' if they are financial institutions or an active NFE.

The predominant view appears to be that the CRS requires charities that are RFIs to complete due diligence and report on controlling persons and recipients of distributions.[26]

FATCA generally excludes from reporting accounts that hold listed shares or listed interests in certain investment vehicles, such as exchange traded funds. However, under the CRS, account holders of these products are generally reportable.

In contrast to FATCA, there are no exemptions for ''sponsored investment entities'' under the CRS (see below).

'Sponsored Investment Entity' Option

Under FATCA (and the IGAs), a financial institution may be ''deemed compliant'' and therefore not be required itself to perform due diligence and report if an RFI has agreed to perform the due diligence and reporting obligations on its behalf and had registered with the IRS to do so. The ''sponsored investment entity'' route is being used by a number of underlying companies of trusts under the IGAs. In contrast, under the CRS, such entities will be responsible for their own due diligence and reporting, although they may delegate to a service provider. Under the CRS, the principal remains ultimately responsible for the due diligence and reporting performed by its delegates.

[26]However, the avoidance notes of some jurisdictions, such as the Bahamas, indicate that a charitable trust will not need to provide financial information if the charitable trust's income is mostly from gifts, donations, grants, legacies, and that if the charitable trust is not a financial institution it will be an active NFE with no reporting requirements.

'Look Through' Classification

Under FATCA (and the IGAs), any entity (referred to herein as Entity A) is permitted to either:

- ''Look through'' each entity in which it holds an account or interest (each referred to herein as Entity B) and consider the nature of Entity B's assets and source of income to classify Entity A as either a ''financial institution'' or an NFE. For example, if Entity B's underlying assets consists of real estate and its income consists of rental income, and Entity A's assets only consists of shares in Entity B or a shareholder loan to Entity B, both Entity A and Entity B may be classified as passive NFEs.
- Not apply the ''look through'' method of classification and determine its (that is, Entity A's) classification in its own right.

Under the CRS:

- Entity A is not permitted to look through to the assets and income sources of Entity B;
- Entity A's shares in and loans to Entity B are financial assets; and
- therefore, Entity A would be classified as an investment entity and be required to report on its reportable persons who are account holders.[27]

Is Cash a Financial Asset Under CRS?

Under the CRS, the definition of financial asset doesn't address cash. In contrast, under FATCA, cash is expressly categorized as a ''financial asset.'' This may result in some entities being classified as passive NFEs under the CRS rather than as investment entities.

Some examples:

- A trust that is managed by a financial institution but holds only cash, or cash and nonfinancial assets, is itself an investment entity and therefore a financial institution for FATCA purposes. However, the same entity may be classified as a passive NFE under the CRS if cash is not a financial asset under the CRS.
- A company that holds cash and no other assets would be a financial institution under FATCA.

[27]The OECD's CRS FAQ, *supra* note 21, states:

> An entity the gross income of which is primarily attributable to investing reinvesting, or trading real property is not an investment entity (irrespective of whether it is professionally managed) because real property is not a financial asset . . . if, instead, an entity is holding an interest in another entity that directly holds real property, the interest held by the first mentioned entity is a financial asset, and the gross income derived from that interest is to be taken into account to determine whether the entity will meet the definition of ''investment entity.''

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> However, if cash is not a financial asset for the purpose of the CRS, the company may be a passive NFE under the CRS.

This potentially different treatment could significantly affect structuring decisions under the CRS.

The CRS Implementation Handbook indicates that while the definitions of the term ''investment entity'' are different under the CRS and FATCA, the intention was to achieve an equivalent outcome. Nevertheless, the CRS Implementation Handbook does not have the force of law. The Society of Trust Estate Practitioners has asked the OECD to provide clarification.

Conclusion

FATCA and the CRS are complex and technical beasts. The CRS has a far broader scope and fewer exemptions than FATCA and the IGAs. IGAs permit RFIs to apply provisions from the FATCA regulations. Under the CRS, charities, PTCs, and other entities are more likely to be classified as passive NFEs, and RFIs with which such passive NFEs hold financial accounts will be required to report not only on the passive NFEs beneficial owners but on their controlling persons. In an age when privacy is increasingly scarce and valuable, clients may want to explore arrangements to legitimately reduce the number of RFIs and competent authorities that hold, report, or exchange financial information on them. An exploration of these planning techniques is for another time. ◆

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