TAX LAW/TRUST LAW

Tax compliance: the long arm of Uncle Sam

The compliance obligations of FATCA and CRS are generally handled by banks and investment management firms. But it is important for trustees of trusts in New Zealand to understand they too may have compliance obligations

Henry Brandts-Giesen

The transparency agenda as it applies to private wealth has become an important consideration for clients and advisors. Not only are transparency requirements here to stay but they are set to strengthen, broaden and deepen as data-gathering and sharing becomes more sophisticated and immediate than ever before.

The default setting is becoming automatic disclosure rather than 'on request' and authorities are investing in technology to enhance data-gathering, reporting and exchange and to enable international cooperation and collaboration in relation to enforcement.

The transition from privacy to transparency has been happening gradually for several decade. However, the years following the Global Financial Crisis of the late 2000s were when the move started to become effective.

The Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) were the *pièce de resistance*. They are important compliance regimes and should be considered and understood by private-wealth advisors in New Zealand.

The compliance obligations of FATCA and CRS are generally handled by banks and investment management firms. But it is also important for trustees of trusts in New Zealand to understand they too may have compliance obligations.

There seems to be a misconception that FATCA and CRS are relevant only where there are foreign settlors, trustees or beneficiaries but the reality is not so straightforward.

Henry Brandts-Giesen

All trusts should be reviewed at least annually to determine whether the trustees have compliance obligations. Even where there are none, the trustees will likely need to classify the trust for the purpose of opening and maintaining accounts with financial institutions.

Recent changes to tax law in New Zealand deem beneficiary current-account holders to be settlors in certain circumstances and many more trusts are likely to have registration and reporting obligations.

Until recently, the IRD appears to have taken a restrained approach to enforcing compliance with FATCA and CRS but increasingly trustees are being audited. This means all trustees, accountants, lawyers and others associated with trusts should have at least some understanding of the regimes.

Until recently, the IRD appears to have taken a restrained approach to enforcing compliance with FATCA and CRS but increasingly trustees are being audited

How FATCA works

FATCA is US legislation with a global effect, designed by the US Internal Revenue Service (IRS) to detect and prevent tax evasion by people who should be paying tax in the US. FATCA is highly complex and has a significant global impact on the way business is done by, with and through banks and other repositories of cash and securities.

FATCA was transposed into New Zealand law on 1 July 2014 by an intergovernmental agreement between the US and New Zealand.

It is different to previous mechanisms used by the US government to prevent tax evasion in that it places the onus of reporting to the IRS details of foreign accounts on the financial institutions used to hold financial assets, rather than the individual account holders. This is clever but not controversial.

What is contentious is that the definition of 'financial institution' in the legislation is extremely wide. For example, a trust is not an 'entity' in the legal sense of the word: it is a set of obligations binding someone (known as a trustee) who holds property for the benefit of others (known as beneficiaries). But FATCA regards trusts as entities and imposes on some trusts the obligation to register on the IRS website as a 'financial institution'.

Remarkably, this is so even where there are no US citizens or tax residents or US investments connected with the trust in question.

So, every New Zealand trust must determine whether or not it is a financial institution for FATCA purposes. If a trust is a financial institution, it must register as such on the IRS website and obtain a Global Intermediary Identification Number (also known as a GIIN).

There are some limited exemptions from this registration requirement – for example, where a trustee which itself is a financial institution undertakes all the reporting obligations of the trust of which it is trustee, or some other third party (known as a 'sponsoring entity') assumes such reporting obligations and there are no US persons connected with the trust.

However, this exemption will likely apply only where the trust is administered by a professional trust company (eg, Public Trust, Perpetual Guardian, Trustees Executors, etc in a New Zealand context). Most New Zealand trusts which are 'financial institutions' will be administered by trustees who are individuals or companies set up specifically to act as trustee, and will need to register.

Section 185G of the Tax Administration Act 1994 requires compliance with the relevant registration

Continued on page 05


Photo: manx_in_the_world / Getty Images

Continued from page 04

requirements. Failure to comply would constitute an offence and could lead to financial penalties for the trust and its trustees.

Family trusts

A family trust which holds only a family home will not be a financial institution and therefore will not be required to register. However, a family trust which holds real estate and/or a securities portfolio with an account at a bank or wealth manager under a discretionary investment mandate is likely to be a financial institution. In such cases, the trust is required to register on the IRS website unless it falls within one of the limited exemptions.

But if a trust receives income from real estate that exceeds a passive income (interest and dividends etc) from financial assets, then there is a process by which the trust can avoid being a financial institution. If it follows that process, it will not be required to register with the IRS.

Another consequence of a trust being a financial institution is that the trustees must carry out due diligence on the beneficiaries and other categories of persons (eg, settlors, trustees, creditors etc) to ascertain if any are US persons. If so, and subject to certain thresholds, then details of distributions and other information must be reported to the IRD which will, in turn, pass that information to the IRS.

US persons for FATCA purposes include a US citizen or tax resident individual and a US company, partnership or a US trust. A US citizen includes a person born in the US, having a US citizen parent or who is US-naturalised. A US tax resident includes a green card holder and someone who satisfies a substantial presence test.

The qualifying criteria are therefore very wide and require careful consideration by trustees, accountants, lawyers and others associated with trusts.

For example, a New Zealand-born and resident discretionary beneficiary of a family trust who has a parent who is also living in New Zealand but has retained US citizenship would be within the scope of the definition. If that beneficiary receives a distribution from the trust, then details may need to be reported even though neither the beneficiary nor the parent may have any other connection to the US.

If a trust is not a financial institution for FATCA purposes, it may still have some (albeit more limited) obligations. For example, a trust could be a 'passive non-financial foreign entity' and therefore not be required to register with the IRS but, rather, inform any financial institutions with which it has accounts of any 'controlling persons' who are US citizens or tax residents. This would include a settlor, trustees, protector, beneficiaries or class of beneficiaries and any other natural person exercising ultimate effective control over the trust. The financial institutions would then be the ones to carry out reporting requirements under FATCA.

The CRS rules

Since the implementation of FATCA, the OECD was charged with designing a global FATCA system that was based on similar principles but globally focussed.

The outcome of this was the CRS, the essence of which is contained in a document called the *Standard for Automatic Exchange of Financial Account Information in Tax Matters*. Countries across the globe (other than the US) began to opt into this system; New Zealand began reporting in accordance with the CRS in 2018. The CRS has been modified and incorporated into New Zealand law in accordance with New Zealand legislation. Part 11B of the Tax Administration Act 1994 relates to foreign account information-sharing agreements.

The goal of CRS is the same as that of FATCA: to find local resident taxpayers who are maintaining accounts in overseas financial institutions.

If a resident of a CRS country has an account in a financial institution in another country, that financial institution must report to its home-country government. Assuming the home country has an agreement with the country where the taxpayer is resident, the home-country government will report the persons behind it to the tax-payer's home country.

This addresses a situation where a taxpayer tries to evade paying tax on income earned from the financial institution.

Like FATCA, the CRS divides trust entities into two categories using a similar classification system, being either a 'financial institution' or a 'non-financial entity'. Similarly, there are two sub-categories of a 'non-financial entity'. An 'active non-financial entity' is the likely classification for an entity that derives the majority of its income, within a reporting year, through the course of an active trade or business. A 'passive non-financial entity' is a non-financial entity that is not an 'active non-financial entity' (this is a catch-all definition) and generally includes entities deriving passive income from financial assets.

If the trustee is a 'financial institution' (such as a

Continued on page 13

Continued from page 05

professional trust company), then, assuming the underlying trust is also a 'financial institution', the trustee will ordinarily complete the CRS reporting on behalf of the trust.

However, if the trust is an active or passive non-financial entity, then it will need to certify as such with any financial institutions (such as banks or investment firms) where it holds accounts. The financial institution will then report information about a passive (but not an active) non-financial entity trust.

The important thing to note is that CRS places registration and reporting obligations only on financial institutions, including custodial financial institutions and investment entity financial institutions. Any entity which is an active or passive non-financial entity will not have any registration or reporting obligations for CRS purposes.

Rather, those active or passive 'non-financial entity' entities will need to certify as such with financial institutions they hold accounts with. Those financial institutions will then report information about any passive 'non-financial entity' account holder to the tax authority in accordance with CRS.

Settlors, beneficiaries and trustees

A practical consequence of a trust being classified as a financial institution under FATCA and/or the CRS is that information about foreign account holders will be reportable to the IRD and exchanged with the tax authority in the country in which they are resident.

Settlors and beneficiaries who receive distributions are classified as account holders so all trustees should be considering whether there are any settlors or beneficiaries whose interests in the trust should be reported.

The definition of 'settlor' includes all persons who have contributed assets to the trust (even if they are not named as settlors in the trust deed) and certain beneficiaries who have current accounts in the trust's financial statements.

Similarly, a person who is using and enjoying real estate owned by the trust is likely to be deemed to be a beneficiary and the value of that benefit is reportable.

The goal of CRS is the same as that of FATCA: to find local resident taxpayers who are maintaining accounts in overseas financial institutions

Enforcement

Liability for non-compliance with FATCA and CRS is attributed to trustees (and directors of corporate trustees) so it is important that all trustees, accountants, lawyers and others associated with trusts are familiar with the regimes.

Every trustee should be classified at each annual meeting of the trustees and, if necessary, reporting to the IRD should be done in a timely manner.

The Cayman Islands legislature recently vested the Cayman Tax Information Authority (TIA) with comprehensive FATCA and CRS audit powers for monitoring compliance with the Cayman FATCA and CRS law.

In so doing, the Cayman government set the legal basis for FATCA and CRS audits on the island and added new penalty provisions of up to five years' jail for fraudulent statements made to the TIA.

The long-anticipated audit amendments follow the introduction in late 2019 of a new CRS Compliance Declaration form. On this form, Cayman FIs must certify, amongst other things, that they have valid and comprehensive written policies and procedures in effect.

Switzerland has also imposed statutory CRS audits. The SFTA audit team requests and reviews written documents related to the CRS compliance of the Swiss FI, such as policies and procedures, training materials, IT updates and form templates.

There is increasing evidence of IRD stepping up its enforcement activity in this area. We are aware of situations where trustees in New Zealand have been requested by IRD to provide evidence of compliance in relation to trusts under their administration.

In one matter, a 'please explain' letter was sent by The Federal Central Tax Office of Germany to the appointor of a trust who was living in Hamburg after an automatic exchange of information between tax authorities about a trust in which she had no beneficial interest.

These compliance regimes are complicated but the obligations are manageable and there are various entity classification resources, reporting tools and experienced advisors available to help. ■

Henry Brandts-Giesen is a partner at Dentons Kensington Swan