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August 2018

Journal of

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Exempt organizations are being asked to classify themselves
in subscription agreements and forms provided to international investment vehicles.

Classification of Exempt Organizations Under U.S. FATCA, U.K. IGA, & OECD CRS

PAUL D. CARMAN AND CHRISTIE R. GALINSKI

Whether or not exempt organizations are international in their operations, many are international in their investments, intentionally or unintentionally.[1] As an increasing number of jurisdictions have entered into intergovernmental agreements (IGAs) related to FATCA[2] or agreed to mandate compliance with the OECD[3] common reporting standard (CRS), exempt organizations are being asked to classify themselves in subscription agreements and forms provided to the investment vehicles.

This article considers the classification of three types of exempt organizations under U.S. FATCA, the IGA with the United Kingdom, and CRS. The types of organizations discussed are governmental entities, pension funds, and traditional charities.

Background

Several years ago, the United States embarked on a program to attempt to discover financial accounts held by U.S. persons in non-U.S. jurisdictions that were not otherwise being disclosed voluntarily. The focus of the program was not on tax exempts, but rather on U.S. taxable persons that were trying to hide money offshore. The first attempts at discovering the scofflaws were made through subpoenas and litigation, which had varying success.[4] Congress then shifted to an approach based on requiring the collection and reporting of information on U.S. persons by non-U.S. financial institutions.

Congress' new approach required an extensive matrix of IGAs pursuant to which other countries agreed to allow their financial institutions to collect the information and turn it over to the appropriate governmental authority. In negotiating the IGAs, the United States convinced the partner countries that the issue was not just a U.S. concern. As the disclosures in the Panama Papers confirmed, taxpayers hiding money from the government is a worldwide issue.[5] The United Kingdom was one of the first partner jurisdictions to promulgate its own domestic legislation and guidance to implement the terms of the IGA. Because the United Kingdom was a leader in the adoption of its own legislation and guidance, its approach has been quite influential as other countries have adopted implementing legislation and guidance. Of course, the legislation and guidance of each country may vary.

The concept of the collection and automatic exchange of information was so popular among tax authorities that the OECD took up the cause and promulgated a CRS that is based on, but slightly different from, the U.S. requirements. Thus, U.S. persons with international investments may have three or more regulatory regimes that apply to an investment: U.S. FATCA, the IGAs, legislation and guidance of the country into or through which the investment is made, and the OECD CRS.

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U.S. FATCA

As mentioned above, the goal of FATCA was to collect information on U.S. scofflaws hiding money offshore. Congress took the approach of imposing a withholding tax on U.S.-source payments to non-U.S. financial institutions that failed to collect the information or turn it over.

A financial institution for these purposes is any entity that (1) accepts deposits in the ordinary course of a banking or similar business, (2) as a substantial portion of its business holds financial assets for the account of others, or (3) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.[6]

IRC Section 1471 says that withholdable payments to a non-U.S. financial institution (FFI) that do not meet certain requirements are subject to withholding tax equal to 30% of the amount of the payment.[7] Under the Code, to avoid being subject to the withholding tax, an FFI must enter into an agreement with Treasury pursuant to which the FFI agrees to (1) obtain such information regarding each holder of each account that the FFI maintains as is necessary to determine which (if any) of such accounts are U.S. accounts;[8] (2) comply with such verification and due diligence procedures as Treasury may require with respect to the identification of U.S. accounts; (3) for any U.S. account that such FFI maintains, report annually the information described below with respect to such account; and (4) deduct and withhold a tax equal to 30% of any pass-through payment that such institution makes to a recalcitrant account holder or another FFI that does not meet the requirements described above.[9]

Thus, under the Code, withholdable payments to FFIs will generally be subject to withholding unless the FFI enters into an agreement ("FFI Agreement") with the IRS to determine whether the entity has any direct or indirect U.S. account holders or is an excluded or a deemed compliant FFI.[10] A withholdable payment under FATCA includes (1) any payment of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income if such payment is from sources within the United States; and (2) any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from sources within the United States.[11]

The FFI must also agree to comply with U.S. Treasury requests for additional information with respect to any U.S. account maintained by such institution, and in any case in which any non-U.S. law would prevent the reporting of any information with respect to any U.S. account maintained by the FFI, to attempt to obtain a valid and effective waiver of such law from each holder of such account; and if such a waiver is not obtained from each such account holder within a reasonable period, to close the account.[12]

In general, the agreement described above between the FFI and Treasury would require the FFI to provide Treasury the following information annually with respect to each U.S. account that the FFI maintains:

- Name, address, and taxpayer identification number (TIN)[13] of each account holder that is a specified U.S. person[14] and, for any account holder that is a U.S.-owned non-U.S. entity,[15] name, address, and TIN of each substantial U.S. owner of such entity.

Pension funds and traditional charities are given preferred treatment under the Code in terms of reporting by financial institutions into which they invest

- Account number.
- Account balance or value.
- Gross receipts and gross withdrawals or payments from the account.[16]

The 30% tax under Section 1471(a) does not apply to payments to the extent that the beneficial owner is any (1) non-U.S. government, political subdivision of a non-U.S. government, or wholly owned agency or instrumentality of any one or more of the foregoing; (2) international organization; (3) non-U.S. central bank of issue; or (4) other class of persons that Treasury identifies.[17]

Under the Code, it might appear at first that governmental entities would be exempt from FATCA reporting but pension funds and traditional charities would not. However, pension funds and traditional charities are given preferred treatment in terms of the reporting by financial institutions into which they invest. Neither is included in the definition of "specified U.S. person," so a financial institution into which the pension or traditional charity invests would not be required to include the account in its reporting to the IRS.

So if governmental entities are exempt beneficial owners and pensions and traditional charities are not specified U.S. persons, when could exempt entities be subject to FATCA reporting? On the face of the Code, a pension or charity could be subject to FATCA reporting if the entity is a non-governmental investment entity.

"Investment entity" means any entity that meets one of three tests in the Regulations. First, an entity is an investment entity if it conducts as a business primarily one or more of the following activities or operations for or on behalf of a customer: (1) trading in money market instruments (e.g., checks, bills, certificates of deposit, derivatives); non-U.S. currency; foreign exchange, interest rate, and index 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.[18]

Second, an entity is an investment entity if its gross income is primarily attributable to investing, reinvesting, or trading in financial assets and the entity is managed by another entity that is a financial institution.[19]

Third, an entity is an investment entity if it 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.[20]

1 In leveraged investment partnerships, it is common to funnel exempt investors through an offshore blocker to shield the organization from unrelated debt-financed income. See Section 514. (Unless otherwise stated, section references are to the Internal Revenue Code.)

2 Sections 1471-1474 (Chapter 4 of Subtitle A of the Code) are generally referred to as the FATCA provisions. The Foreign Account Tax Compliance Act of 2009 (H.R. 3933) (FATCA) introduced the provisions that were eventually adopted as part of the Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147, March 18, 2010) ("HIRE Act").

3 The OECD uses its information on a broad range of topics to help governments foster prosperity and fight poverty through economic growth and financial stability. Issues related to taxation are within the purview of the OECD. See http://www.oecd.org/tax.

4 For a historical discussion, see Sheppard, 125 Tax Notes 493 (November 2, 2009).

5 See, e.g., "Panama Papers Sprawling Web of Corruption," NY Times (April 5, 2016).

6 Section 1471(d)(5). This definition has been further elaborated by the Regulations, as discussed below.

7 Section 1471(a).

8 A U.S. account means any financial account that is held by one or more specified U.S. persons or U.S. owned non-U.S. entities. Section1471(d)(1)(A). Some exclusions apply for small accounts under $50,000 held by individuals. Section 1471(d)(1)(B). A financial account means, with respect to an FFI, a depository account, a custodial account, and any equity or debt interest in such FFI (other than interests that are regularly traded on an established securities market). Section 1471(d)(2).

9 Section 1471(b).

10 Section 1471(a).

11 Section 1473(1)(A).

12 Sections 1471(b)(1)(E) and (F).

13 The TIN may be the employer identification number of an entity or the social security number of an individual. Reg. 31.3406(h)-1(b)(1).

14 A "specified U.S. person" means any U.S. person other than (1) a corporation the stock of which is regularly traded on an established stock exchange; (2) a corporation that is a member of an expanded affiliated group that includes a corporation the stock of which is regularly traded on an established stock exchange; (3) an organization that is tax exempt under Section 501(a) or an individual retirement plan; (4) the United States or any wholly owned agency or instrumentality thereof; (5) a state of the United States, the District of Columbia, any possession of the United States, or any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing; (6) a bank; (7) a real estate investment trust; (8) a regulated investment company; (9) a common trust fund; and (10) certain split interest trusts. Section 1473(3).

15 A U.S.-owned non-U.S. entity is any non-U.S. entity that has one or more substantial U.S. owners. Section 1471(d)(3). A substantial U.S. owner means, with respect to a corporation, a specified U.S. person that owns, directly or indirectly, more than 10% of the stock of such corporation (by vote or value); with respect to a partnership, a specified U.S. person that owns, directly or indirectly, more than 10% of the profits or capital interests in the partnership; with respect to a trust, any person treated as an owner of any portion of such trust and, to the extent provided in the Regulations, any specified U.S. person that holds, directly or indirectly, more than 10% of the beneficial interests of such trust. Section1473(2)(A). For an FFI that is an investment vehicle, the previous sentence is applied using a 0% threshold rather than a 10% threshold. Section 1473(2)(B).

16 Section 1471(c)(1).

17 Sections 1471(c)(1)(D)-(G).

18 Reg. 1.1471-5(e)(4)(i)(A).

19 Reg. 1.1471-5(e)(4)(i)(B).

20 Reg. 1.1471-5(e)(4)(i)(C).

The second type of investment entity above is a managed entity. This is the category into which exempt organizations that are classified as financial institution are most likely to fall. A managed entity is an investment entity if its gross income is primarily attributable to investing, reinvesting, or trading in financial assets and the entity is managed by another entity that is a financial institution. An entity is managed by another entity for purposes of this test if the managing entity performs, directly or through another third-party service provider, (1) trading in money market instruments (e.g., checks, bills, certificates of deposit, derivatives); non-U.S. currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures; (2) individual or collective portfolio management; or (3) investing, administering, or managing funds, money, or financial assets on behalf of the managed entity.[21]

A managed entity is treated as an investment entity only if it is managed by a financial institution. If it is managed by one or more individuals, it will not be treated as an investment entity.[22]

Governmental entities. The 30% tax under Section 1471 does not apply to payments to exempt beneficial owners.[23] Certain governmental entities, such as sovereign wealth funds, may qualify as exempt beneficial owners. A governmental entity may be an exempt beneficial owner if it is either an integral part or a controlled entity of any (1) non-U.S. government, (2) political subdivision of a non-U.S. government, or (3) wholly owned agency or instrumentality of either a non-U.S. government or its political subdivision.[24] In addition, an entity may be an exempt beneficial owner if all of its investors qualify under the previous sentence.[25]

An integral part of a non-U.S. sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a non-U.S. country. The net earnings of the governing authority must be credited to its own account or to other accounts of the non-U.S. sovereign, with no portion inuring to the benefit of any private person. An integral part does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity. All of the facts and circumstances will be taken into account in determining whether an individual is acting in a private or personal capacity.[26]

In a different context, the IRS has examined whether an entity is an integral part of the government. In Rev. Rul. 87-2, 1987-1 CB 18, the IRS considered whether a government created an entity and has the right to select and remove its governing body, control its investments and expenditures, monitor its daily operation, and abolish it, and whether the entity is required to maintain adequate books and records and make formal reports to the government. In private rulings, the IRS has also looked at whether the government has made a substantial financial commitment to the entity.[27] Another factor is whether the entity uses government employees to conduct its business.[28]

It is currently unclear which factors will be used for the U.S. Regulations to determine whether an entity is an integral part of a non-U.S. government. However, it is quite likely that the rulings considering the question in other areas of the Code will be influential.

For purposes of the exempt beneficial owner rules, a controlled entity is an entity that is separate in form from a non-U.S. sovereign or that otherwise constitutes a separate juridical entity, provided that (1) the entity is wholly owned and controlled by one or more non-U.S. sovereigns directly or indirectly through one or more controlled entities; (2) the entity's net earnings are credited to its own account or to other accounts of one or more non-U.S. sovereigns, with no portion of its income inuring to the benefit of any private person; and (3) the entity's assets vest in one or more non-U.S. sovereigns upon dissolution.[29]

Income does not inure to the benefit of private persons if such "persons" (within the meaning of Section 7701(a)(1)) are the intended beneficiaries of a governmental program carried on by a non-U.S. sovereign, and the program activities constitute governmental functions under the Section 892 Regulations.[30] In general, activities performed for the general public with respect to the common welfare or that relate to the administration of some phase of government are considered governmental functions. For example, the operation of libraries, toll bridges, or local transportation services and activities substantially equivalent to the activities of the Federal Aviation Authority, Interstate Commerce Commission, or Postal Service will all be considered governmental functions.[31]

Retirement funds. A retirement fund is treated as an exempt beneficial owner under U.S. FATCA if it is described in at least one of the categories listed below. In addition, if a withholding agent may treat a withholdable payment as made to a payee that is a retirement fund in accordance with Reg. 1.1471-3, the agent may also treat the fund as the beneficial owner of the payment.[32]

A retirement fund may qualify an exempt beneficial owner under a tax treaty if it is established in a country with which the United States has an income tax treaty in force. The fund must be entitled to benefits under the treaty on income that it derives from sources within the United States (or it would be entitled to those benefits if it derived any such income) as a resident of the other country under a treaty that satisfies any applicable limitation on benefits (LOB) requirement, and is operated principally to administer or provide pension or retirement benefits.[33]

A fund may also qualify as an exempt beneficial owner as a broad participation retirement fund if it is established to provide retirement, disability, or death benefits, or any combination thereof, to beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered. The fund must meet the following requirements: (1) does not have a single beneficiary with a right to more than 5% of the fund's assets; (2) is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country where the fund is established or operates; and (3) satisfies one or more of the following requirements:

- The fund is generally exempt from tax on investment income under the laws of the country in which it is established or operates due to its status as a retirement or pension plan.
- The fund receives at least 50% of its total contributions (other than transfers of assets from retirement and pension accounts described in the Regulations) from retirement and pension accounts described in an applicable Model 1 or Model 2 IGA, or from other retirement funds that are exempt beneficial owners or described in an applicable Model 1 or Model 2 IGA from the sponsoring employers.
- Distributions or withdrawals from the fund are allowed only on the occurrence of specified events related to retirement, disability, or death (except rollover distributions to retirement and pension accounts described in the Regulations), to retirement and pension accounts described in an applicable Model 1 or Model 2 IGA, or to other retirement funds that are exempt beneficial owners or described in an applicable Model 1 or Model 2 IGA, or penalties apply to distributions or withdrawals made before such specified events.
- Contributions (other than certain permitted make-up contributions) by employees to the fund are limited by reference to earned income of the employee or may not exceed $50,000 annually.[34]

A retirement fund that does not qualify as a broad participation fund may qualify as an exempt beneficial owner as a narrow participation retirement fund, if it is established to provide retirement, disability, or death benefits to beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for prior services rendered, provided that:

1. The fund has fewer than 50 participants.
2. The fund is sponsored by one or more employers and none of these employers is an investment entity or passive nonfinancial foreign entity (NFFE).[35]
3. Employee and employer contributions to the fund (other than transfers of assets from (a) other retirement plans, (b) retirement and pension accounts described in the Regulations, or (c) retirement and pension accounts described in an applicable Model 1 or Model 2 IGA) are limited by reference to earned income and compensation of the employee, respectively.
4. Participants that are not residents of the country in which the fund is established or operated are not entitled to more than 20% of the fund's assets.
5. The fund is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country where the fund is established or operates.[36]

Finally, a fund formed pursuant to a pension plan that would meet the requirements of Section 401(a), other than the requirement that the plan be funded by a trust created or organized in the United States, is an exempt beneficial owner under U.S. FATCA.[37] Reg. 1.401-1(b)(1)(i) says, in part, that a pension plan under Section 401(a) is a plan established and maintained by an employer primarily to provide for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. The Regulations also say that a pension plan may provide for the payment of a pension due to disability and for incidental death benefits.[38] Section 401(a) has certain minimum participation and discrimination standards. A pension plan fails to meet the requirements of Section 401(a) if it permits an employee to withdraw any part of the employee's accrued benefit (other than a benefit attributable to vol-

[21] Reg. 1.1471-5(e)(4)(i)(B).
[22] *Id.*
[23] Section 1471(f); Reg. 1.1471-6(a).
[24] Reg. 1.1471-6(b).
[25] Reg. 1.1471-6(g).
[26] Reg. 1.1471-6(b)(1).
[27] See e.g., Ltr. Ruls. 200409033, 200307065, 200210024.
[28] GCM 39601 (February 9, 1987).
[29] Reg. 1.1471-6(b)(2).
[30] Reg. 1.1471-6(b)(3)(i).
[31] Temp. Reg. 1.892-4T(c)(4).
[32] See Reg. 1.1471-3(d)(9)(ii).
[33] Reg. 1.1471-6(f)(1).
[34] Reg. 1.1471-6(f)(2)(iii).
[35] See Reg. 1.1471-1(b)(80). A passive NFFE is defined in Reg. 1.1471-1(94).
[36] Reg. 1.1471-6(f)(3).
[37] Reg. 1.1471-6(f)(4).
[38] Reg. 1.401-1(b)(1)(i).

untary employee contributions) prior to certain distributable events, e.g., retirement, death, disability, severance of employment, or termination of the plan.[39]

Traditional charities. Although not mentioned directly in the Code, the U.S. FATCA Regulations exclude certain exempt organizations from classification as financial institutions, thus excluding them from the potential 30% withholding under FATCA. The first exclusion is for organizations that have qualified for exemption under Section 501(c), other than an insurance company described in Section 501(c)(15).[40] Section 501(c)(3) applies to organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competitions, or for the prevention of cruelty to children or animals. In general, for U.S. tax purposes, to be recognized as exempt under Section 501(c)(3), an organization must submit an application to the IRS for approval of such status.[41]

There are some exceptions from the requirement that a non-U.S. organization apply for recognition of exemption. Places of worship qualify as exempt without an application.[42] In addition, U.S. income tax treaties contain some provisions for automatic recognition. The treaties with Germany and the Netherlands provide for reciprocal recognition of exempt status and the treaties with Canada and Mexico provide for reciprocal recognition of exempt status and reciprocal deductibility of contributions.[43] The treaty with Israel provides for reciprocal deductibility of contributions but not reciprocal recognition of exempt status.

The requirement that non-U.S. charitable organizations apply for recognition of exempt status also does not pertain to any non-U.S. organization that has received substantially all of its support (other than investment income) from sources outside the United States.[44] For these purposes, 85% or more of an organization's support will be considered "substantially all."[45]

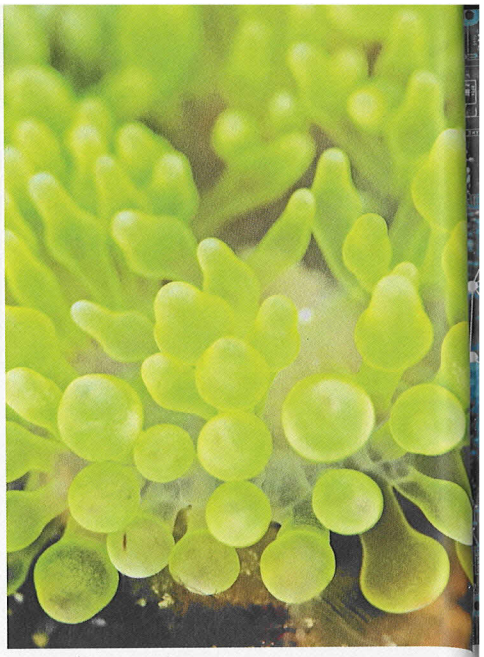
Also, a non-U.S. entity that is not exempt under Section 501(a), but that is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, is excluded from the definition of a financial institution if (1) the entity is exempt from income tax in its country of residence; (2) the entity has no shareholders or members who have a proprietary or beneficial interest in its income or assets; (3) the laws that apply to the entity require the entity's income and assets to be used for its charitable purposes; and (4) the laws that apply to the entity require that on liquidation or dissolution of the entity, all of its assets be distributed to a governmental entity or another charity.[46]

If a charity that otherwise would be classified as a financial institution does not meet either of the foregoing exceptions, it would need to look for the broader, more generally applicable exceptions under U.S. FATCA, or qualify under any applicable registration requirements.

U.K. IGA

On September 12, 2012, the United Kingdom became the first of many countries to enter into an IGA with the United States with regard to the implementation of FATCA. Annex II of the U.K. IGA, which lists the excluded and excepted entities, was amended by an exchange of notes, June 7, 2013. The U.K. IGA entered into effect August 11, 2014.[47]

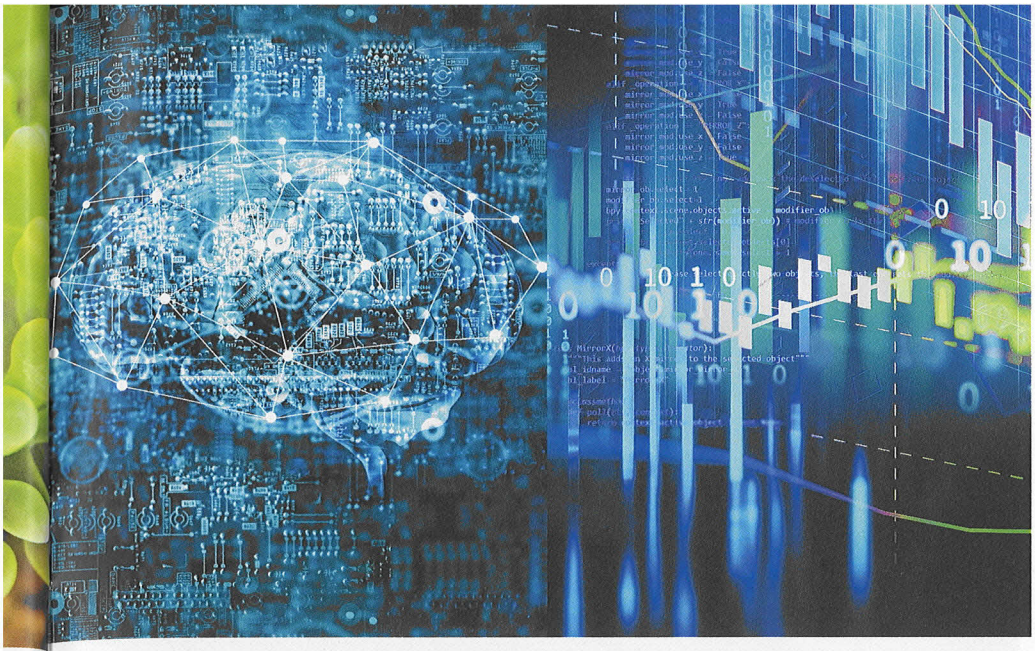
Background—IGAs. In some cases, non-U.S. law would prevent an FFI from reporting directly to the IRS the information required by the FATCA statutory provisions and the Regulations, thus potentially exposing the FFI to withholding. Such an outcome would be inconsistent with FATCA's declared objective to address offshore tax evasion through increased information reporting. To overcome these legal impediments, Treasury has negotiated with non-U.S. governments to develop two alternative model IGAs that facilitate the effective and efficient implementation of FATCA in a manner that removes domestic legal impediments to compliance. In 2012, Treasury first released Model 1 and Model 2 IGAs to avoid local-law limitations that would otherwise limit an FFI's ability to comply with the FATCA requirements.



A partner jurisdiction signing an agreement with the United States based on the Model 1 IGA agrees to adopt rules to identify and report information about U.S. accounts that meet the standards in the Model 1 IGA. FFIs covered by a Model 1 IGA that are not otherwise excepted or exempt under the agreement must identify U.S. accounts pursuant to due diligence rules adopted by the partner jurisdiction and report specified information about the U.S. accounts to the partner jurisdiction.[48] The partner jurisdiction then exchanges this information with the IRS automatically.[49] These standards are intended to ensure that the IRS will receive the same quality and quantity of information about U.S. accounts from FFIs covered by a Model 1 IGA as it receives from FFIs applying the U.S. Regulations.

U.K. IGA reporting. Under the U.K. IGA, U.K. financial institutions are required to report investor information to Her Majesty's Revenue & Custom (HMRC) rather than to the IRS directly. In some cases, a U.K. financial institution was required to register with the IRS to obtain a global intermediary identification number (GIIN). In other cases, a U.K. financial institution may qualify for exceptions to both registration and reporting.

Under the U.K. IGA, a financial institution includes a custodial institution, a depository institution, an investment entity, or a specified insurance company.[50] Although it would be theoretically possible for a nonprofit organization to be a custodial institution, a depository institution, or a specified insurance company, the most likely reason that a nonprofit would



Under the U.K. IGA, the most likely reason that a nonprofit would be classified as a financial institution would be that it is an investment entity

be classified as a financial institution would be that it is an investment entity.[51]

"Investment entity" under the U.K. IGA means 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 (e.g., checks, bills, certificates of deposit, derivatives); 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.[52]

U.K. classification under FATCA. Although the language of the U.K. IGA could be interpreted as requiring a nonprofit to have customers to be classified as an investment entity, the U.K. International Exchange of Information Manual indicates that, like under the U.S. Regulations, an entity may be an investment entity if it is managed by a financial institution and meets the financial assets test as described below. For these purposes, an entity is managed by a financial institution if that financial institution performs, directly or through another service provider, one or more of the following activities or operations: trading in money market instruments; foreign exchange; exchange, interest rate, and index instruments; transferable securities; commodity futures trading; individual and collective portfolio management; or otherwise investing, administering, or managing funds or money on behalf of the entity. An entity is not regarded as managed by a financial institution if that financial institution does not have discretionary authority to manage the entity's assets either in whole or in part.[53]

An entity meets the financial assets test if its gross income is attributable primarily to investing, reinvesting, or trading in financial assets. In a similar test, HMRC required that at least 50% of its income be attributable to investing, reinvesting, or trading in financial assets in the shorter of (1) the three-year period ending on December 31 in the year preceding that in which its status as in investment entity is to be determined; or (2) the period in which the entity has been in existence.[54]

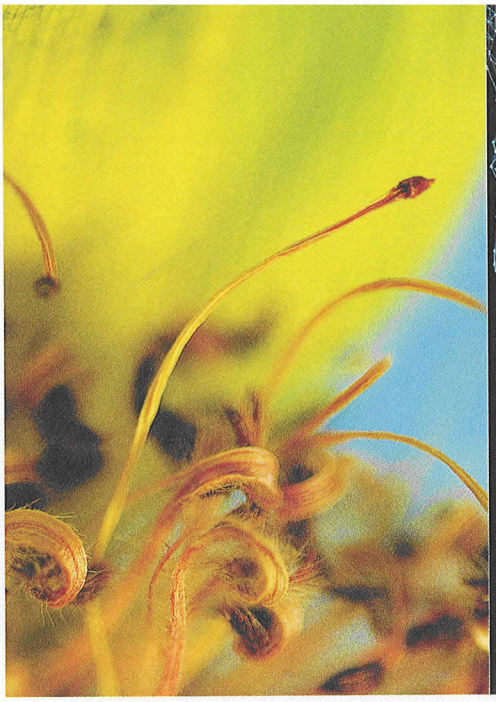
For entities that would meet the definition of a financial institution, the lowest amount of due diligence and reporting would apply to a "non-reporting United Kingdom financial institution," which means any United Kingdom financial institution or other entity resident in the United Kingdom that is identified in Annex II of the IGA as a non-reporting United Kingdom financial institution or that otherwise qualifies as a deemed-compliant FFI, an exempt beneficial owner, or an excepted FFI under relevant U.S. Regulations.[55] A non-reporting United Kingdom financial institution will not need to obtain a GIIN or carry out the due diligence that will apply to many financial institutions.[56]

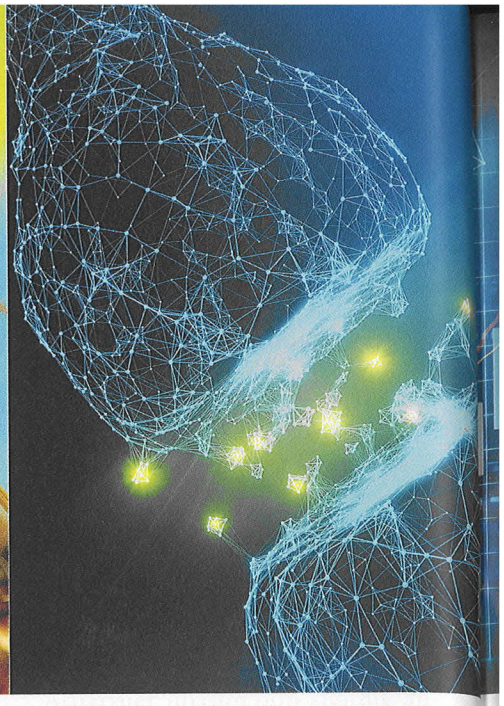
Governmental entities. The U.K. IGA treats the governments of the United Kingdom, Northern Ireland, Scotland, Wales, and the relevant local governments as exempt beneficial owners.[57] However, funds comprising U.K. governmental entities are not expressly treated as exempt beneficial owners. Such funds may be subject to the registration and due diligence requirements that generally apply to financial institutions.

Pension funds. The U.K. IGA treats as an exempt beneficial owner any pension scheme or other retirement arrangement established in the United Kingdom and described in Article 3 (General Definitions) of the U.S.-U.K. tax treaty, including pension funds or pension schemes covered by IRS Ann. 2005-30, 2005-1 CB 988, on the mutual agreement on the qualification

39 Rev. Rul. 56-693, 1956-2 CB 282, as modified by Rev. Rul. 60- 323, 1960-2 CB 148.
40 Reg. 1.1471-5(e)(5)(v).
41 Section 508.
42 Section 508(c)(1).
43 In Notice 99-47, 1999-2 CB 391, the IRS indicated that it would presume all Canadian registered charities were private foundations unless the charities submitted financial information to the Service demonstrating that a classification other than that of private foundation is appropriate. In general, organizations that are tax exempt under Section 501(c)(3) are treated as private foundations unless they can demonstrate that they fall into one of several exceptions. Section 509(a).
44 Section 4948(b).
45 Reg. 53.4948-1(b).
46 Reg. 1.1471-5(e)(5)(vi).
47 www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.
48 Model 1A Reciprocal, Preexisting TIEA or DTC Art. 2, par. 2 a) (November 30, 2014).
49 Model 1A Reciprocal, Preexisting TIEA or DTC Art. 3, par. 5 (November 30, 2014).
50 U.K. IGA Art. 1, par. 1.g).
51 HMRC International Exchange of Information Manual (IEIM) 400790.
52 U.K. IGA Art. 1, par. 1.j).
53 IEIM 400790.
54 *Id.*
55 U.K. IGA Art. 1 par. 1.q).
56 HMRC Implementation of the International Tax Compliance (United States of America) Regulations 2013, Guidance Notes, sec. 2.1.
57 U.K. IGA Annex II par. I A.

Most exempt organizations would prefer to be classified under CRS as a non-reporting financial institution if the organization is a financial institution





of certain U.K. pension arrangements.[58] Under the treaty, "pension scheme" means any plan, scheme, fund, trust, or other arrangement established in the United Kingdom that is (1) generally exempt from income taxation in the United Kingdom, and (2) operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.[59]

As described in Ann. 2005-30, the U.S. and U.K. Competent Authorities agreed that the following types of U.K. arrangements are "pension schemes" as Article 3(1)(o) defines that term:

- A U.K.-resident unit trust if the following conditions are met: (1) the trust deed says specifically that only pension schemes that are not subject to U.K. capital gains tax or corporation tax may participate in the trust; and (2) any tax paid by the trustee of such a trust is deemed to be paid by the unitholder pension schemes such that the tax is refunded to the pension schemes.
- A fund, plan, or arrangement to which an occupational or individual pension scheme contributes by paying premiums to an insurance company so long as the following conditions are met: (1) the insurance company places contributions by the pension scheme in a fund that is generally exempt from tax in the United Kingdom; (2) the insurance company allocates a number of units to the contributing pension scheme, so that the value of the pension scheme's investment is represented by a proportionate share of the total value of the fund; (3) the return on the pension scheme's investment is not fixed; (4) the return to the contributing pension scheme is linked directly to the value of its share of the total return to the fund identified through the unit mechanism under (2); (5) all return on investment inures only to the benefit of the contributing occupational or individual pension scheme and not to the insurance company shareholders; and (6) to the extent that there is withholding on foreign-source income received by the fund, the return to the underlying pension scheme is diminished. Any tax so paid is effectively borne by the pension scheme, and the insurance company does not benefit from it.

Thus, a variety of arrangements that may have the appearance of being investment funds may qualify as pension schemes for purposes of the U.K. IGA.

Traditional charities. Under the U.K. IGA, nonprofit organizations are to be regarded as deemed-compliant financial institutions and will not have any reporting requirements in relation to any financial accounts that they may hold.[60] This category applies to (1) any entity registered as a charity with the Charity Commission of England and Wales; (2) any entity registered with HMRC for charitable tax purposes; (3) any entity registered as a charity with the Office of the Scottish Charity Regulator; and (4) any Community Amateur Sports Club if so registered with HMRC.[61] Under FATCA, such nonprofit organizations are deemed-compliant financial institutions and not required to register with the IRS or report to HMRC.[62]

Unfortunately, as with U.K. IGA's treatment of governmental entities, investment funds comprising entirely exempt organizations are not explicitly excluded from the reporting and due diligence rules. Thus, such funds would usually need to register and undertake the due diligence generally required of financial institutions.

OECD CRS

In September 2013, the G20[63] endorsed an OECD proposal for a global model for automatic exchange of information. The OECD obtained consensus for a standard in July 2014.[64] The global model of automatic exchange is intended to apply to financial account information.[65] Like FATCA, CRS requires financial institutions to collect account information and report it to an applicable governmental entity.[66]

The financial institutions that CRS covers include custodial institutions, depository institutions, investment entities, and specified insurance companies, unless they present a low risk of being used for tax evasion and are excluded from reporting.[67] The financial information to be reported with respect to reportable accounts includes interest, dividends, account balance or value, income from certain insurance products, sales proceeds from financial assets, and other income generated with respect to assets held in the account or payments made with respect to the account.[68] Reportable accounts include accounts held by individuals and entities (which includes trusts and foundations), and the standard includes a requirement to look through passive entities to report on the relevant controlling persons.[69]

An investment entity means, for CRS purposes, any entity (1) that primarily conducts as a business for or on behalf of a customer (a) trading in money market instruments (e.g., checks, bills, certificates of deposit, derivatives); foreign exchange; exchange, interest rate, and index instruments; transferable securities; or commodity futures trading; (b) individual and collective portfolio management; or (c) otherwise investing, administering, or managing financial assets or money on behalf of other persons; or (2) the gross income of which is attributable primarily to investing, reinvesting, or trading in financial assets, if the entity is managed by another entity that is a financial institution.[70]

The OECD CRS commentary says that for purposes of determining whether an entity is an investment entity, an entity is managed by another entity if the managing entity performs, directly or through a service provider, any of the activities or operations that otherwise would cause the investing entity to be an investment entity.[71] These activities and operations include trading in money market instruments; foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading; individual and collective portfolio management; or otherwise investing, administering, or managing financial assets or money on behalf of other persons. Further, the managing entity must have discretionary authority to manage the investing entity's assets.[72]

U.S. investment entities that are managed by another financial institution may be classified as a passive NFE (Non-Financial Entity).[73] Although passive NFEs do not have to comply with the more onerous due diligence and reporting rules of a financial institution, they may have to report information about their controlling persons.[74] In some cases, an entity could fall into the passive NFE category as well as one of the types of non-reporting financial institutions described below. When the rules allow either classification, a non-reporting financial institution would be the preferred classification since it would have minimal reporting obligations.

Classification under CRS. Reporting financial institutions are required to do the due diligence and make the reports that CRS contemplates,[75] so most exempt organizations would prefer to be classified as a non-reporting financial institution if the organization is a financial institution. A non-reporting financial institution for CRS purposes is a governmental entity, certain international organizations, certain retirement funds, any other entity that is identified as presenting a low risk of being used to evade tax, and a trust if the trustee is a reporting financial institution.[76]

Governmental entities. "Governmental entity" means, for CRS purposes, the government of a jurisdiction, any political subdivision of a jurisdiction (which includes a state, province, county, or municipality), or any wholly owned agency or instrumentality of a jurisdiction or of any one or more of the foregoing.[77] This category comprises the integral parts, controlled entities, and political subdivisions of a jurisdiction. An "integral part" of a jurisdiction means any person, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a jurisdiction.[78] The net earnings of the governing authority must be credited to its own account or to other accounts of the jurisdiction, with no portion inuring to the benefit of any private person.

A controlled entity means an entity that is separate in form from the jurisdiction or that otherwise constitutes a separate juridical entity, provided that (1) the entity is wholly owned and controlled by one or more governmental entities directly or through one or more controlled entities; (2) the entity's net earnings are credited to its own account or to the accounts of one or more governmental entities, with no portion of its income inuring to the benefit of any private person; and (3) the entity's assets vest in one or more governmental entities on dissolution.[79] For these purposes, income does not inure to the benefit of private persons if such persons are the intended beneficiaries of a governmental program, and the program activities are performed for the general public with respect to the common welfare or relate to the administration of some phase of government.[80] The inclusion of controlled entities within the definition of governmental entities opens the possibility that sovereign wealth funds may be non-reporting financial institutions.

Retirement funds. For CRS purposes, broad participation retirement funds, narrow participation retirement funds, and pension funds of a governmental entity are non-reporting financial institutions.[81] "Broad participation retirement

58 *Id.* par. I D.
59 Art. 3. par. 1.o).
60 Note 56, *supra*, sec. 2.12.
61 *Id.*; IEIM 401005
62 IEIM 401010.
63 The G20 is an international forum for the central banks and governments from 20 countries recognized as having major economies.
64 www.oecd.org/tax/automatic-exchange/about-automatic-exchange/.
65 OECD, Standard for Automatic Exchange of Financial Account Information in Tax Matters, Second Ed. (2017) ("SAEFAITM"), page 10.
66 *Id.* at 10.
67 *Id.* at 15, 43-45.
68 *Id.* at 15.
69 *Id.*
70 *Id.* at 44.
71 OECD, "CRS-Related Frequently Asked Questions," section VIII, A. Q&A.3 (April 2017), www.oecd.org/tax/automatic-exchange/common-reporting-standard/CRS-related-FAQs.pdf.
72 *Id.*
73 SAEFAITM at 58.
74 *Id.*
75 SAEFAITM at 29.
76 *Id.* at 45-46.
77 *Id.* at 46.
78 *Id.*
79 *Id.* at 46-47.
80 *Id.* at 47.
81 *Id.* at 46.

fund" means a fund established to provide retirement, disability, or death benefits, or any combination thereof, to beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, provided that the fund (1) does not have a single beneficiary with a right to more than 5% of the fund's assets; (2) is subject to government regulation and provides information reporting to the tax authorities; and (3) satisfies at least one of the following requirements:

- The fund is generally exempt from tax on investment income, or taxation of such income is deferred or taxed at a reduced rate, due to its status as a retirement or pension plan.
- The fund receives at least 50% of its total contributions (other than transfers of assets from other plans or from retirement and pension accounts) from the sponsoring employers.
- Distributions or withdrawals from the fund are allowed only on the occurrence of specified events related to retirement, disability, or death (except rollover distributions to other retirement funds or retirement and pension accounts), or penalties apply to distributions or withdrawals made before such specified events.
- Contributions (other than certain permitted make-up contributions) by employees to the fund are limited by reference to earned income of the employee or may not exceed $50,000 annually, applying the rules for account aggregation and currency translation.[82]

For CRS purposes, "narrow participation retirement fund" means a fund established to provide retirement, disability, or death benefits to beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, provided that (1) the fund has fewer than 50 participants; (2) the fund is sponsored by one or more employers that are not investment entities or passive non-financial entities; (3) the employee and employer contributions to the fund (other than transfers of assets from retirement and pension accounts) are limited by reference to earned income and compensation of the employee, respectively; (4) participants that are not residents of the jurisdiction in which the fund is established are not entitled to more than 20% of the fund's assets; and (5) the fund is subject to government regulation and provides information reporting to the tax authorities.[83]

Thus, many—though not all—retirement funds will qualify as non-reporting financial institutions. Other types of retirement funds could potentially qualify as non-reporting financial institutions if they are classified by the relevant jurisdiction as low-risk non-reporting financial institutions.[84] A financial institution can be a non-reporting financial institution provided that (1) the financial institution presents a low risk of being used to evade tax; (2) the financial institution has characteristics substantially similar to any of the financial institutions explicitly treated as non-reporting financial institutions; (3) the financial institution is defined in domestic law as a non-reporting financial institution; and (4) the status of the financial institution as a non-reporting financial institution does not frustrate the purposes of CRS.[85]

A separate category of non-reporting financial institutions, an exempt collective investment vehicle, may allow investment funds that restrict their membership to retirement funds to qualify. "Exempt collective investment vehicle" means an investment entity that is regulated as a collective investment vehicle, provided that all of the interests in the collective investment vehicle are held by or through individuals or entities that are not reportable persons, except a passive non-financial entity with controlling persons who are reportable persons.[86]

Traditional charities. Traditional charities are not a category of non-reporting financial institutions. This means that when a charity is a financial institution, which is most likely to happen if it falls within the definition of investment entity[87] by virtue of having its financial assets managed by a financial institution, it is potentially in

scope as a reporting financial institution for CRS reporting. Under CRS, such nonprofit organizations are required to carry out due diligence processes to identify and report on any reportable persons.[88]

The CRS commentary says that a type of nonprofit organization that is a financial institution and does not satisfy all of the requirements of a governmental entity or a retirement fund cannot be defined in domestic law as a non-reporting financial institution solely because it is a nonprofit organization.[89] It may be possible to define this type of entity as a low-risk non-reporting financial institution, but the tests would need to be applied to each entity.

Application of the three reporting standards. When completing reporting paperwork for an exempt entity, the results may differ depending on which reporting standard is applied.

Governmental entities. The first example is a sovereign wealth fund, which is a state-owned investment fund. A sovereign wealth fund would likely be classified as an investment entity under U.S. FATCA, the U.K. IGA, and CRS because it would make investments and hire another entity to manage them. It would likely qualify as an exempt beneficial owner under U.S. FATCA since it would generally be a separate entity controlled by the non-U.S. government, assuming that its net earnings do not inure to a private person and its assets vest in a non-U.S. sovereign upon dissolution.

Under the U.K. IGA, the governments of the U.K., Northern Ireland, Scotland, and Wales and relevant local governments are non-reporting U.K. financial institutions that are treated as exempt beneficial owners. Nevertheless, if the fund was not itself one of those governmental entities and was merely owned or controlled by governmental entities, it may be subject to the registration and due diligence requirements that generally apply to financial institutions.

Like U.S. FATCA, CRS includes integral parts and controlled entities in its definition of a government entity, which is a non-reporting financial institution. Thus, sovereign wealth funds may be non-reporting financial institutions under CRS.

Retirement funds. A retirement fund would likely be classified as an investment entity under U.S. FATCA, the U.K. IGA, and CRS because it would make investments and either manage them or hire another entity to manage them. Under U.S. FATCA, most retirement and pension funds would be classified as exempt beneficial owners. Non-U.S. funds would generally be classified as exempt beneficial owners under U.S. FATCA if they were entitled to benefits under the U.S. tax treaty and are operated principally to administer or provide pension or retirement benefits. U.S. funds would generally qualify as exempt beneficial owners as long as they were either a broad participation fund, a narrow participation fund, or a pension under Section 401(a). This would cover the great majority of retirement funds.

Under the U.K. IGA; a variety of retirement plans would qualify as non-reporting U.K. financial institutions that are exempt beneficial owners because the definition of retirement plan or pension scheme includes the typical retirement fund. Under CRS, many retirement funds would be classified as non-reporting financial institutions, as long as they fit the definition of a broad or narrow participation fund or the pension fund of a governmental entity. If a fund did not fit into one of those categories it could be a non-reporting financial institution as a low-risk entity.

Charities. Under U.S. FATCA, the U.K. IGA, and CRS, some charities may be classified as financial institutions if their gross income is attributable primarily to investing and the entity's investments are managed by another entity. However, under U.S. FATCA, there is a broad exception for charities. U.S. charities that qualify under Section 501(c)(3) are excluded from the definition of a financial institution. Non-U.S. charities that are established in their country of residence and are tax exempt in that country will generally also be excluded.

Under the U.K. IGA, U.K. nonprofit charities that are registered as charities with the HMRC or other government entities will generally be classified as non-reporting U.K. Financial Institutions. Under CRS, unfortunately, traditional charities are not classified as non-reporting financial institutions. A charity could fall outside the CRS reporting requirements by falling outside the definition of financial institution in the first place (by managing its own investment portfolio or making sure that its income is not attributable primarily to investing) or by classifying as a low-risk entity, as described above.

Conclusion

As the discussion above shows, governmental entities, retirement funds, and traditional charities will all have a relatively easy time completing the declarations for FATCA and under the IGAs. However, some retirement funds and many traditional charities will have to look more closely at the declaration for CRS. Traditional charities that are classified as financial institutions because they maintain financial assets and have those assets managed by a financial institution may be subject to due diligence and disclosure requirements under CRS.

The question of classification is likely to come up whenever an exempt organization invests in a fund or another financial institution. Although the CRS rules are not yet implemented in the United States, many investments of exempt organizations are funneled through Cayman Island entities. The Cayman Islands has already adopted legislation to implement CRS.[90] Thus, a U.S. traditional charity would be subject to classification under the Cayman Island CRS if the charity invests through the Cayman Islands. Thus, even organizations not normally subject to tax need to carefully navigate the FATCA, IGA, and CRS rules to avoid unnecessary penalties or burdensome reporting. ●

82 *Id.* at 47-48.
83 *Id.* at 48-49.
84 *Id.* at 170.
85 *Id.*
86 *Id.* at 49.
87 IEIM 401010.
88 *Id.*
89 SAEFAITM at 172.
90 www.tia.gov.ky/pdf/CRS_Legislation.pdf. See also www.maplesandcalder.com/news/article/cayman-islands-issue-oecd-common-reporting-standard-regulations-1202.