SPECIAL REPORT
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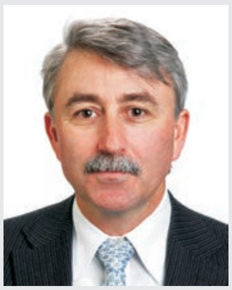
FATCA and Underlying Companies: Pin the Tail on the Elephant

By Peter A. Cotorceanu



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In this report, Cotorceanu discusses FATCA's treatment of trusts' underlying companies.

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I. Introduction

The Foreign Account Tax Compliance Act treatment of offshore[1] trusts is a mess. That's the good news. FATCA's treatment of the underlying companies (UCs) of trusts is even worse. It leaves those of us charged with classifying UCs blindfolded, groping around in the dark, hopelessly trying to pin FATCA's classifications of UCs somewhere near the tail of the elephant that is FATCA.

Why? Because there's not one word about UCs in the entire 1,000-plus pages of final, temporary, and proposed FATCA regulations,[2] the model intergovernmental agreements and their annexes, or the various IRS notices on FATCA. Nada. Zilch.

Incredible, really. The regs do, of course, directly address trusts' FATCA entity classification in the now-famous examples 5 and 6.[3] And the model IGAs contain a deemed-compliant status specifically for trusts.[4] As for UCs — well, you can hear a pin drop.

But offshore trusts, at least those run by commercial trust companies, almost always hold their assets through UCs. Therefore, if you were going to address trusts in the regs and IGAs, wouldn't you also want to — need to, really — address UCs as well? Otherwise, your guidance would be aimed at just half a structure. And, arguably, the less important half at that. After all, it's the UC that owns the structure's assets and that will therefore be interacting directly with the financial intermediaries in which the structure's bank and other accounts are held. Those financial intermediaries will be demanding Forms W-8BEN-E or other documentation specifying the FATCA classification of the UC, not the trust. Thus, as important as FATCA's classification of trusts is, its classification of UCs is even more so to financial intermediaries.

Why, then, would the drafters of the regs and IGAs address trusts but not say a peep about UCs? Is it possible that they simply didn't know that offshore trusts usually use UCs?

You betcha. For reasons we'll explore later, UCs aren't used with U.S. trusts. And the drafters of the FATCA regs and IGAs aren't experts in the offshore trust industry. Thus, the drafters' only point of reference was a world in which UCs don't exist. As the Yiddish proverb goes, "To a worm in horseradish, the whole world is horseradish."

It's a shame, really. FATCA's failure to mention UCs makes classifying those entities as foreign

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[1]As used in this report, the terms "offshore" and "foreign" mean non-U.S.

[2]T.D. 9610; T.D. 9657; T.D. 9658.

[3]Reg. section 1.1471-5(e)(4)(v), examples 5 and 6.

[4]These are so-called trustee-documented trusts. Model 1 IGA, Annex II, Art. IV.A; Model 2 IGA, Annex II, Art. IV.A. All references in this document to the model IGAs and their annexes are to the November 4, 2013, versions of those documents. And citations to specific provisions of the IGAs are to the Model 1 reciprocal, preexisting tax information exchange agreement (TIEA) or double tax convention (DTC) and the Model 2 preexisting TIEA or DTC versions, respectively.

financial institutions (FFIs) or nonfinancial foreign entities (NFFEs) unnecessarily tricky and uncertain. Frankly, as we'll see, it's sometimes not much more than guesswork.

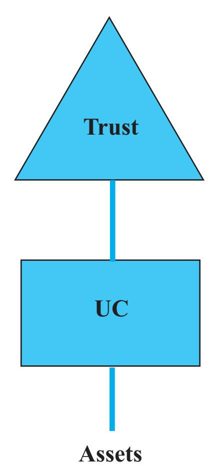
This report is the third in a series intended to clarify FATCA's treatment of offshore trusts and related entities. In the first report,[5] I likened analyzing FATCA's treatment of trusts to eating an elephant, which can be done only one bite at a time. That report addressed FATCA's classification of offshore trustees. The second report focused on FATCA's classification of trusts.[6] In this report, I try to pin FATCA's treatment of UCs as close to the elephant's hindquarters as possible.

First, however, let's take a quick look at why and how commercial offshore trust companies use UCs and why U.S. trustees don't.

II. Typical Offshore Trust Structures

The typical offshore trust structure with a commercial trust company as trustee looks like this:

Figure 1



UCs are usually formed in offshore jurisdictions popular for providing those companies. For cost and other reasons, the British Virgin Islands (BVI) and the Bahamas are two of the most popular jurisdictions, even for trusts established under the laws of different countries. Thus, it's not uncommon to see a trust from one offshore jurisdiction with a UC from a different country, for example, a Jersey or Singapore trust with a BVI or Bahamian UC.

A UC's directors are usually either individuals or other companies whose sole function is to serve as directors. For UCs offered by commercial trust companies, individual directors will typically be employees of the trust company, and corporate directors[7] will normally be wholly owned subsidiaries of the trust company. Those corporate directors are usually shell companies that own no assets. Their own directors are commonly employees of the trust company. Thus, whether individual or corporate directors are used, the ultimate decision-makers for UCs used by commercial trust companies will most often be employees of the trust company.

A. Why UCs?

Offshore trustees use UCs for three main reasons: (1) to allow trusts to own assets in jurisdictions that don't recognize trusts; (2) to shelter assets from estate, inheritance, or succession taxes (so-called death taxes); and (3) to protect trustees from liability arising from UCs' assets.

1. Holding assets in jurisdictions that don't recognize trusts. Trusts are an invention of the common law. Therefore, in the absence of specific legislation or ratification of the Hague Convention on the Law Applicable to Trusts and on Their Recognition, trusts are generally not recognized in non-common law countries. In those countries, it is usually impossible to title property in a trust's name. This problem is avoided if the assets are held in a UC because companies are recognized worldwide.

2. Avoiding death taxes. Assets owned directly in a trustee's name are sometimes subject to death taxes when the settlor dies. However, in many cases, holding assets in a well-managed UC avoids those taxes. For example, U.S. shares and real estate are "U.S. situs" for U.S. federal estate tax purposes and, as such, are subject to estate tax if owned by non-U.S. persons directly or through trusts with specified strings attached (that is, revocable trusts and some irrevocable trusts). If, however, a trust's only asset is shares in a well-managed offshore UC, and the UC owns U.S.-situs assets, the UC generally shields those assets from U.S. estate tax.[8]

3. Protecting trustees from liability. Using a UC may protect a trustee from liability arising from a trust's assets. For example, trusts often incur debts,

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

[6]Cotorceanu, "FATCA and Offshore Trusts: A Second Bite of the Elephant," *Tax Notes*, Sept. 2, 2013, p. 1007.

[7]As used in this report, the term "corporate directors" refers to companies that serve as directors of other companies, not to companies' directors generally.

[8]Exceptions include U.S.-situs assets gratuitously transferred to trusts whose assets are otherwise includable in the settlor's estate and U.S.-situs assets transferred directly to those trusts' UCs. *See* section 2104(b) and TAM 9507044.

whether through contracts or torts (for example, a trust may take out a loan or a trust asset might be negligently operated, causing injury or death). If the liability is enforced in a jurisdiction that doesn't recognize trusts, the trustee will be liable for the debt and may be unable to limit its liability to the trust's assets. After all, as far as the jurisdiction in question is concerned, trusts don't exist. Thus, assets held in a trustee's name as trustee of a (nonexistent) trust are owned by the trustee, period. Therefore, any liability arising from those assets should be enforceable against all of the trustee's assets, including not only its personal assets but also the assets of its other (nonexistent) trusts. Ouch! Using UCs can avoid this problem because every country recognizes the limited liability of well-managed companies.

If UCs are so great and so ubiquitous in the offshore world, why aren't they used in the United States? First, trusts are recognized in the United States, so titling property in a trust's name is no problem. Second, because U.S. persons are subject to estate tax on worldwide assets, not just U.S.-situs assets, using an offshore UC won't prevent inclusion in a U.S. person's taxable estate. And finally, a trustee's liability arising from a trust's assets (rather than from the trustee's own malfeasance) doesn't usually extend beyond those assets themselves. Since trusts are recognized in the United States, a U.S. court enforcing the liability will know where a trust's assets end and where a trustee's own assets and those of its other trusts begin.

With that brief introduction, let's turn to the issue at hand: how UCs should be classified under FATCA.

III. UCs: FFIs or NFFEs?

As mentioned in the previous reports on FATCA's classification of trustees and trusts, every entity in the world is either an FFI or an NFFE, and no entity can be both.[9] NFFEs are defined in the negative, that is, NFFEs are entities that are *not* FFIs.[10] Therefore, to classify an entity under FATCA, one must begin with the definition of an FFI. Moreover, because the regs and the IGAs define FFIs differently, one must address UCs' classification under both regimes separately. In addition, one must also analyze how the United Kingdom has implemented its IGA because the U.K. FATCA regulations[11] and guidance notes[12] define FFIs very differently from how the model IGAs, not to mention the U.K. IGA itself, define them, and other countries are expected to follow the United Kingdom's lead in their own implementing legislation.

Finally, we will also briefly consider the recently released draft crown dependencies' FATCA guidance notes.[13] Although that document does not address FATCA's classification of UCs as such, it does consider the impact a UC has on its parent trust's FATCA classification.

This much is certain:

- If a UC's asset manager is a professional firm, a UC is (1) an FFI (specifically, a Type B investment entity under the regs and an investment entity under the U.K. IGA) *if* at least half the UC's income comes from financial assets; and (2) an FFI (specifically, an investment entity) under the model IGAs *regardless* of the UC's income.
- In limited circumstances, a UC may be a holding company FFI under the regs and the U.K. IGA, although this is probably not what the drafters of those documents intended.

In contrast, the answers to the following questions are unclear:

- whether a UC can be a Type A investment entity FFI under the regs;
- whether a UC can be a custodial institution FFI under the model IGAs; and
- whether a UC whose directors are offshore shell companies can be a Type B investment entity FFI under the regs or an investment entity FFI under the IGAs if the UC's asset manager is an individual.

[9]Under the regs, an FFI is a foreign entity that falls into one or more of the five categories of FFI defined in that document. Reg. section 1.1471-(5)(e)(4)(v). An NFFE is a foreign entity that is not an FFI. Reg. section 1.1471-1(b)(74). The IGAs take a similar approach except that they have only four categories of FFI, and the definitions of those FFIs differ, sometimes substantially, from the definitions of the corresponding categories of FFIs in the regs. Model 1 IGA, Art. 1.1 (g)-(k); Model 2 IGA, Art. 1.1 (g) and (i)-(l). Note: The IGAs actually refer to financial institutions (FIs), not FFIs, because the entities covered by an IGA are not foreign to the IGA partner jurisdiction in question. However, for simplicity's sake, this report refers to both FIs and FFIs as FFIs.

[10]Reg. section 1.1471-1(b)(74); Model 1 IGA, Annex I, Art. VI.B.2.; Model 2 IGA, Annex I, Art. VI.B.2.

[11]HMRC, "International Tax Compliance (United States of America) Regulations 2013" (Aug. 7, 2013) (hereinafter "U.K. regulations" or "U.K. regs").

[12]HMRC, "Implementation of International Tax Compliance (United States of America) Regulations 2013 Guidance Notes" (Aug. 14, 2013) (hereinafter "U.K. guidance notes" or "guidance notes").

[13]International Tax Compliance (Crown Dependency) Regulations 2014 — Guidance Notes, Jan. 31, 2014 (hereinafter "CD guidance notes").

A. The Regs

Under the regs, an FFI is any financial institution that is a foreign entity.[14] An entity is any person other than an individual,[15] and a foreign entity is any entity that is not a U.S. person.[16] In defining U.S. person, the regs cross-reference the code, under which a corporation organized under U.S. law is considered a U.S. person.[17] Thus, any company not organized under U.S. law, including a UC, that meets the definition of a financial institution is an FFI.

There are five main categories of financial institutions under the regs, although the last two categories each contain two subcategories: (1) depository institutions; (2) custodial institutions; (3) investment entities; (4) insurance companies and some related holding companies; and (5) treasury centers and specific types of holding companies.[18]

UCs aren't depository institutions; only true retail banks meet the definition of that term.[19] Further, UCs aren't custodial institutions because they don't earn the type of income required for that category of FFI.[20] UCs also fall well outside the definitions of insurance companies and related holding companies[21] and treasury centers.[22] That leaves only investment entities (category 3) and specific types of holding companies (one of two subcategories of category 5). These types of FFI are addressed below.

1. Investment entity. The regs create three types of investment entity:

1. one that ''primarily conducts as a business'' specified activities ''for or on behalf of a customer'' (a Type A investment entity)[23];
2. one whose gross income is ''primarily attributable'' to specified investment activities and that is ''managed by'' a depository institution, a custodial institution, a specified insurance company, or a Type A investment entity (a Type B investment entity)[24]; and
3. a collective investment vehicle or one of several types of funds (a Type C investment entity).[25]

Typical UCs aren't collective investment vehicles or funds as defined in the regs, so they're not Type C investment entities. What about Type A and Type B investment entities?

a. Type A investment entity. For a UC to be a Type A investment entity under the regs, it must primarily conduct the following activities as a business ''for or on behalf of a customer'': (1) financial trading; (2) portfolio management; or (3) ''otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons.''[26] Because offshore trust companies almost never have in-house investment expertise, their UCs, just like their trusts, rarely conduct the first two types of activities — that is, financial trading or portfolio management. Rather, UCs usually delegate those activities to third parties, whether a professional investment firm or bank, the settlor, or a person chosen by the settlor.

Do UCs conduct the third type of activity listed, that is, do they invest, administer, or manage funds, money, or financial assets on behalf of other persons? As we've seen, UCs don't themselves generally invest their assets but delegate that task to others. Do UCs administer or manage funds, money, or financial assets? Those that hold at least some bankable assets[27] do — they open and close bank and other financial accounts, they pay bills, they transfer funds, they declare dividends, and so on.

But do UCs conduct these activities as a business ''for or on behalf of a customer'' and ''on behalf of other persons,'' both of which are required of Type A investment entities?

[14] Reg. section 1.1471-5(d).

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

[16] Reg. section 1.1473-1(e).

[17] Reg. section 1.1471-1(b)(132); section 7701(a)(30) and (a)(4).

[18] Reg. section 1.1471-5(e)(1)(i)-(v).

[19] A depository institution ''accepts deposits in the ordinary course of a banking or similar business.'' Reg. section 1.1471-5(e)(1)(i). The regs don't define the phrase ''accepts deposits'' or even the term ''deposits.'' However, they do define a depository account, which presumably is what an institution would have to offer to be deemed to accept deposits. Reg. section 1.1471-5(b)(3)(i). Under that definition, a depository account means any account that is a ''commercial, checking, savings, time, or thrift account, or an account that is evidenced by a certificate of deposit, thrift certificate, investment certificate, passbook, certificate of indebtedness, or any other instrument for placing money in the custody of an entity engaged in a banking or similar business for which such institution is obligated to give credit.'' *Id.*

[20] Twenty percent or more of a custodial institution's gross income must be the sort of income only true money managers earn, *e.g.*, custody fees, account maintenance fees, and transfer fees; commissions and fees from executing and pricing securities transactions; and income earned on the bid-ask spread of financial assets. Reg. section 1.1471-5(e)(1)(ii), -5(e)(3)(i) and (ii).

[21] Reg. section 1.1471-5(e)(1)(iv).

[22] Reg. section 1.1471-5(e)(5)(i)(D).

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

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

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

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

[27] For these purposes, financial assets include shares (whether closely held or publicly traded), bonds, partnership interests, insurance and annuity contracts, and any interest in any of the foregoing. Reg. section 1.1471-5(e)(4)(ii), cross-referencing in part section 475(c)(2)'s definition of a security.

UCs don't generally charge fees. An entity that doesn't charge fees isn't literally in business and doesn't literally have customers. But commercial trust companies that provide trusts with UCs aren't charities. Some portion of every fee for a trust with a UC is attributable to the UC and its activities, even if bundled in with the trustee's own fee and not separately itemized or accounted for. Can one blithely ignore this economic reality? Practically speaking, aren't UCs *sort of* in business and *kind of* have customers? At least if the trusts that own them are provided by a commercial trust company? It would seem so.

But even if a UC can be said to be in business and have customers, are its activities performed on behalf of its customers or other persons? Again, practically, probably so — a UC's sole function is to act as a holding entity for a trust, the very purpose of which is to benefit other persons.

Nevertheless, one should pause before concluding that UCs satisfy these requirements. Unlike trusts, well-managed UCs have separate legal identity and, legally speaking, act solely on their own behalves. True enough, their activities inure to the benefit (or detriment) of others, but they don't act for others as such, not even their shareholders. If they did, they would be mere nominees or agents. Thus, one would have to ignore not only commercial reality but also juridical personality to conclude that UCs act on behalf of other persons.

Which view — the legal or practical — is better? As with many questions under FATCA, there is no one right answer. What's one to do then? My general rule of thumb in these cases is to choose the answer that in most situations will result in more disclosure, on the theory that it's better to be uber-compliant than (arguably) undercompliant. But even the validity of this approach is debatable. The IRS and domestic tax authorities would presumably prefer more versus less disclosure, but settlors and beneficiaries would presumably prefer the reverse. Pick your poison.

As I say, my preferred poison is to err on the side of uber-compliance. FFIs generally must disclose more information than NFFEs.[28] Thus, it's tempting to conclude that UCs should be considered to act for or on behalf of a customer and other persons. However, two important considerations militate against this conclusion.

First, the Type A investment entity category was written with asset managers and investment advisers — not trusts, let alone UCs — in mind.[29] Second, as we'll see later, most UCs will be Type B investment entities in any event. Thus, it's not as if failing to classify UCs as Type A investment entities will generally make them NFFEs and result in (potential) undercompliance in most cases. In my view, these two considerations win the day, and most UCs should not be Type A investment entities under the regs.

Am I confident in this view? Not at all. For all I know, this pins the tail on this issue closer to the elephant's head than to its rump. There's just so darn much wiggle room in reg. section 1.1471-5(e)(4)(iii)(A) when it comes to UCs. Plus, we're trying to interpret a provision aimed at an entirely different industry in the absence of any guidance whatsoever about UCs anywhere in FATCA, let alone in this context. However, on balance, I believe this reading of the reg checks the most boxes: It respects the separate juridical personality of UCs; it's consistent with the IRS's intent that the reg cover asset managers and investment advisers; and it won't generally prevent a UC from being an FFI in any event, so it shouldn't result in undercompliance.

If one takes the opposite (and perfectly reasonable) view that UCs do in fact act for or on behalf of customers and other persons, one more hurdle remains before a UC can be a Type A investment entity. The UC must conduct the relevant activities primarily as a business. The "primarily" requirement is met if the UC's gross income "attributable to such activities" equals or exceeds 50 percent of the UC's total gross income over a specified period.[30] What income is attributable to these activities — that is, attributable to administering or

[28]*But see supra* note 6, at 1013-1014, for instances in which classification as an NFFE will result in more disclosure than classification as an FFI.

[29]Preamble to T.D. 9610, 78 F.R. 5886. "The final regulations generally remove from the financial account definition debt or equity interests in *investment entities that are described solely in section 1.1471-5(e)(4)(i)(A), which are generally investment advisors or asset managers*" (emphasis added).

[30]Reg. section 1.1471-5(e)(4)(iii)(A). In general, the period in question is the shorter of (1) the three-year period ending on December 31 preceding the year in which the determination is made, or (2) the period during which the entity has been in existence. *Id*. This testing period should be amended by adding an ending date to prong 2 for entities that have been in existence for less than three years as of the previous December 31. Otherwise, the determination of those entities' income goes all the way up to the date the calculation is made. Unless one has real-time knowledge of the amount of the UC's income, it will be impossible to make this calculation. Besides, the calculation would fluctuate day to day with changes in the UC's income. Therefore, the entity's status as an FFI or NFFE could change just as frequently. The following amendment to prong 2 would fix this glitch: "(2) the period ~~during which the entity has been in existence~~ beginning when the entity came into existence and ending on December 31 preceding the year in which the determination is made."

managing funds, money, or financial assets? Logically speaking, it has to be the fees for the UC's services, not the UC's investment income.

Remember, UCs almost never manage their investments themselves but delegate that task to others. Thus, the only activities that UCs conduct that can even theoretically make them Type A investment entities are *non-investment* activities that comprise administering and managing funds, money, or financial assets — the sorts of activities mentioned earlier (opening and closing bank and other financial accounts, paying bills, transferring funds, declaring dividends, etc.). The UC's income attributable to those activities can only be the portion of the (bundled) trustee's fees due to the UC's services. Although this income goes to the trustee, not directly to the UC, it should presumably be treated as the UC's own income for this purpose.

Calculating this mystical charge will be problematic, to say the least. First, given that trustees don't in fact separately itemize for UCs' services, a trustee would have to essentially pluck a number out of thin air and ascribe it to a UC's activities. Second, depending on the types of assets the UC holds, one might have to further splice the UC's imaginary fees into two subcategories: one attributable to administering or managing ''funds, money, or financial assets'' and one attributable to administering or managing other assets.

Indeed, it's not even clear exactly what is encompassed within the phrase ''funds, money, or financial assets.'' The meaning of money is relatively clear, and the phrase ''financial assets'' is defined in the regs, but the meaning of funds in this context is uncertain.[31] The term ''funds'' is not defined in the regs. It's possible that the word is used in reg. section 1.1471-5(e)(4)(i)(A)(3) in its usual sense to mean liquid assets. However, it's also possible that ''funds'' as used here means any type of asset whatsoever — it is drawn from the Financial Action Task Force's (FATF's) 2012 Recommendations on International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation, which give it that expansive meaning.[32] If the definition of funds is limited to liquid assets and a UC contains both liquid assets and illiquid assets such as real estate (which would not be funds, financial assets as defined in the regs, or money), one would have to determine how much income was attributable to administering or managing ''funds, money, or financial assets'' and how much to administering or managing the illiquid assets. Good luck with that.

Once one has jumped through these hoops, one has to then compare the UC's fees attributable to administering and managing funds, money, or financial assets against the UC's total gross income over the relevant testing period. Only if the former equals or exceeds 50 percent of the latter would the UC primarily conduct the relevant activities as a business.

Seldom will this be the case. A UC's investment performance would have to be pretty poor if the fees it (fictionally) charges for administering and managing its funds, money, or financial assets were at least half of its total income, including its investment income. And even if the UC's assets were mostly non-income-producing assets held for personal enjoyment or long-term investment that produced little if any income (for example, art, car collections, or yachts), the UC's pretend fees for administering any nominal liquid assets (for example, held to pay running costs) would presumably be less than the UC's pretend fees for administering and managing the trust's (mostly) non-income-producing illiquid assets. Only if one concludes that the term ''funds'' as used in reg. section 1.1471-5(e)(4)(i)(A)(3) is as expansive as the corresponding term in the FATF recommendations from which it is drawn (that is, that ''funds'' includes essentially all assets of whatever kind) would a UC whose assets were mostly non-income-producing tangible assets have fees for administering its funds, money, or financial assets that would likely equal or exceed 50 percent of its total income. Thus, even if one concludes that UCs are in business and have customers and that they conduct their activities for or on behalf of their customers or other persons, seldom will they primarily conduct their activities as a business.

In sum, FATCA's classification of UCs as Type A investment entities is problematic. The ''correct'' answer depends in part on how literally versus functionally one interprets the ''business,'' ''customer,'' and ''on behalf of'' requirements. But even if one adopts a broad interpretation of those requirements, rarely will a UC's deemed fees from administering and managing its funds, money, or financial assets equal or exceed half its total gross income, including its investment income. Thus, probably few if any UCs should be classified as Type A investment entities.

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[31] *See supra* note 6, at 1021-1022, for a discussion of the drafting history of the inclusion of the term ''funds'' in reg. section 1.1471-5(e)(4)(iii)(A).

[32] As used in the FATF recommendations, the term ''funds'' refers to ''assets of every kind, whether corporeal or incorporeal, tangible or intangible, movable or immovable, however acquired, and legal documents or instruments in any form, including electronic or digital, evidencing title to, or interest in, such assets.'' FATF recommendations at 117. The FATF recommendations are *available at* http://www.fatf-gafi.org/recommendations.

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

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

2. the UC must be "managed by" a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A investment entity (the managed by test).[33]

i. The gross income test. An entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets if the gross income attributable to those activities equals or exceeds 50 percent of the entity's gross income during the testing period.[34] Only financial assets are captured in the gross income test. In other words, unlike the test for a Type A investment entity, money and funds are not included.

UCs with mostly bankable assets (other than cash, which is not a financial asset under FATCA) or closely held shares will generally meet the gross income test because most of their income will come from investing, reinvesting, and trading in financial assets. Note that unlike the test for determining whether a UC is a Type A investment entity, it's the investment income of the UC, not the fees attributable to the UC's activities, that is relevant under the gross income test. This is because a UC receives income from investing, reinvesting, and trading in financial assets even when a third party, not the UC itself, makes the investment decisions.

As I've noted elsewhere regarding trusts,[35] the floating lookback testing period for the gross income test means that a UC can flip back and forth between being an FFI and an NFFE depending on whether it derived most of its income in the relevant period from financial or nonfinancial assets. Moreover, as pointed out in the same report, it's the sources of the trust's income, not the type of assets as such, that are controlling.[36] Thus, nonfinancial assets that don't produce any income, such as art or other assets held for personal enjoyment rather than investment and resale, don't factor into the gross income test at all.

ii. The managed by test. Even if a UC meets the gross income test (and most will), it will be a Type B investment entity only if it also meets the managed by test. As previously noted, the managed by test is met if the UC is managed by a depository institution FFI, a custodial institution FFI, a specified insurance company FFI, or a Type A investment entity.[37] "Managed by" for this purpose means performing, directly or through a third party, any of the activities of a Type A investment entity on the entity's behalf[38] — that is, financial trading, portfolio management, or "otherwise investing, administering, or managing funds, money, or financial assets." Examples 5 and 6 in the regs, which deal with trusts, make clear that the managed by test can be satisfied for either the entity itself or its assets.[39]

Banks are depository institutions as defined in the regs,[40] and asset management firms are Type A investment entities.[41] Thus, if the UC's assets are managed by a bank or an asset management firm, the UC will meet the managed by test and, if it also meets the gross income test, will be a Type B investment entity. But UCs' assets are often managed by individuals, not institutions. For example, UCs often grant a power of attorney over their financial accounts to the trust's settlor or the settlor's delegate, especially if the trust instrument reserves power over the trust's investments to the settlor. In those cases, the UC will meet the managed by test only if the UC as an entity (as opposed

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

[34]The period is the same as the period for testing whether the "primarily" requirement is met for a Type A investment entity, *i.e.*, the shorter of (1) the three-year period ending on December 31 of the year preceding the year in which the determination is made, or (2) the period during which the entity has been in existence. Reg. section 1.1471-5(e)(4)(iv). As mentioned previously, the second prong of this test should, like the first prong, specify that the period ends on December 31 of the prior year.

[35]*See supra* note 6, at 1012.

[36]*Id.* at 1011-1012.

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

[38]*Id.*

[39]Reg. section 1.1471-5(e)(4)(v), examples 5 and 6:

Example 5. Trust managed by an individual. On January 1, 2013, X, an individual, establishes Trust A, a nongrantor foreign trust for the benefit of X's children, Y and Z. X appoints Trustee A, an individual, to act as the trustee of Trust A. Trust A's assets consists solely of financial assets, and its income consists solely of income from those financial assets. Pursuant to the terms of the trust instrument, Trustee A manages and administers the assets of the trust. Trustee A does not hire any entity as a third-party service provider to perform any of the activities [of a Type A investment entity]. Trust A is not [a Type B investment entity] because it is managed solely by Trustee A, an individual.

Example 6. Trust managed by a trust company. The facts are the same as in Example 5, except that X hires Trust Company, an FFI, to act as trustee on behalf of Trust A. As trustee, Trust Company manages and administers the assets of Trust A in accordance with the terms of the trust instrument for the benefit of Y and Z. Because Trust A is managed by an FFI, Trust A is a [Type B investment entity].

[40]Reg. section 1.1471-5(e)(1)(i).

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

to its assets) is managed by a depository institution, custodial institution, specified insurance company, or Type A investment entity.

Who manages a UC as an entity? It's tempting to think the trustee does. After all, UCs are owned 100 percent by their trustees, albeit in the trustees' fiduciary capacity. Plus, as already discussed, the directors of UCs owned by trusts run by commercial trust companies are usually either trust company employees or corporate directors that are wholly owned by the trust company and whose own directors are trust company employees.

If indeed a UC is managed by the trustee, the managed by test will be met for essentially all UCs of trusts run by commercial trust companies because commercial trust companies are almost inevitably Type A investment entities.[42] Therefore, those UCs would all be FFIs if the gross income test were also met, which would be the case whenever at least half the UC's gross income comes from financial assets. And it wouldn't matter who managed the UC's investments.

But does a trustee really manage a UC as an entity? In short, no. A UC, indeed any company, is managed by its executives and directors, not by its shareholders. UCs aren't operating companies, so they don't have executives as such. And directors owe fiduciary duties to the companies on whose boards they sit. This is as true of directors who are employees of a trust company as it is of completely independent directors, corporate or individual. Admittedly, trust company employees will usually do the trust company's bidding, whether they sit on UCs' boards or on the boards of the UCs' own corporate directors. But if conflicts arise, trust company employees who merely kowtow to their employer's wishes in violation of their duties to the companies on whose boards they sit would be in breach of fiduciary duty. Take, for example, a trust company that instructs its employee-directors to misappropriate its UCs' assets for the trust company's benefit. Does anyone doubt that the employee-directors must refuse to follow their employer's instruction?

Thus, UCs as entities are not managed by trustees — at least they shouldn't be. If in a given case they are, the UCs in question are effectively shams and the trust company and its clients have more to worry about than just FATCA entity classification.[43]

[42]*See supra* note 5, at 414-416.

[43]For example, sham UCs would not be respected as the beneficial owners of their assets under the qualified intermediary rules and would not operate to shield their assets from any applicable death taxes.

As mentioned, well-managed UCs are managed by their directors. If the directors are all individuals, the managed by test won't be met for the entity itself because only entities, not individuals, can be FFIs, including the sorts of FFIs that must be the managing entity under the managed by test (depository institution FFIs, custodial institution FFIs, specified insurance company FFIs, and Type A investment entities). Thus, a UC with only individual directors and whose assets are not managed by a professional firm will not be a Type B investment entity.

What of a UC with corporate directors? Are corporate directors depository institutions, custodial institutions, specified insurance companies, or Type A investment entities? They're not depository institutions (as we've seen, that category is limited to retail banks); they're not custodial institutions (they don't earn the sort of income only true money managers earn); and they're not specified insurance companies. That leaves only Type A investment entities.

Are corporate directors Type A investment entities? More specifically, do corporate directors "primarily conduct as a business . . . for or on behalf of a customer . . . administering or managing funds, money, or financial assets on behalf of other persons?" UCs' corporate directors, just like the UCs they manage, don't typically bill for their services. However, just as with UCs, one can argue that those directors should still be treated as being in business and having customers given the commercial nature of professionally managed trusts. And corporate directors of UCs with bankable assets unquestionably administer and manage funds, money, or financial assets on behalf of others — that is, on behalf of the UCs on whose boards they sit. Even if they don't invest the assets themselves, they (or their delegates) open and close the UCs' financial accounts, make payments from those accounts, receive and deposit assets for the UC, declare and pay dividends, and so on. And because corporate directors are generally shell companies that have no investments of their own, any fees they are deemed to earn for their activities will typically be 100 percent of their total income, so the requirement that they primarily conduct their activities as a business would be met.

Therefore, the typical corporate directors of a commercial trust company's UCs that hold bankable assets arguably should be classified as Type A investment entities.

Would this be the right result? As already pointed out, the Type A investment entity category was primarily aimed at investment advisers and asset managers. It's one thing to extend the category to trust companies and other non-investment professional entities, but it's quite another to say that it encompasses shell companies that have no function other than acting as corporate directors. Indeed, as demonstrated below, the regs suggest that the IRS doesn't think that corporate directors are FFIs (which, by necessary implication, means that the IRS doesn't believe they are Type A investment entities).

The regs contain two categories of sponsored deemed-compliant FFIs: registered deemed-compliant FFIs and certified deemed-compliant FFIs. The sponsor of a registered deemed-complaint FFI must be an entity that is authorized to act on the FFI's behalf.[44] The regs give the following examples of potential sponsors that might satisfy these requirements: fund managers, trustees, *corporate directors*, or managing partners.[45] In contrast, the sponsor of a certified deemed-compliant FFI must be a participating FFI, a reporting Model 1 FFI, or a U.S. financial institution that is authorized to manage the FFI and enter into contracts on the FFI's behalf.[46] The relevant regulation gives the following as examples of entities that might meet these requirements: professional managers, trustees, or managing partners.[47] Corporate directors are conspicuously absent from that list.

The difference is seemingly attributable to the IRS's belief that corporate directors won't generally be FFIs. This becomes clear when one lists side by side the above requirements for the sponsors of the respective categories:

Registered Deemed-Compliant Sponsor		**Certified Deemed-Compliant Sponsor**	
Entity	**Examples:** Fund managers, trustees, **corporate directors**, or managing partners	Participating FFI, reporting Model 1 FFI, or U.S. financial institution	**Examples:** Professional managers, trustees, or managing partners (corporate directors *not* listed)
Authorized to act on the sponsored entity's behalf		Authorized to manage the FFI and enter into contracts on the FFI's behalf	

Corporate directors are authorized to act on their companies' behalves, one of the requirements for the sponsor of a registered-deemed-compliant FFI. By the same token, corporate directors are generally authorized to "manage" and "enter into contracts on behalf of" their companies — one of the requirements for the sponsor of a certified deemed-compliant FFI. Thus, the different wording describing the sponsor's authority vis-à-vis the sponsored entity doesn't explain why corporate directors are listed as examples for the registered, but not the certified, category.

Now take a look at the other requirement for each category. The sponsor of a registered deemed-compliant FFI must be an entity, but it doesn't have to be an FFI. Corporate directors (as that phrase is used in this report) are definitely entities, so it makes sense for them to be listed as potential sponsors of registered deemed-compliant FFIs. However, the sponsor of a certified deemed-compliant FFI must be either an FFI (participating or reporting Model 1) or a U.S. financial institution. The most logical explanation for the absence of corporate directors as examples of potential sponsors of certified deemed-compliant FFIs is that the sponsors have to be FFIs or U.S. financial institutions. What else explains the lack of parallelism with the examples of potential sponsors of registered deemed-compliant FFIs? The drafter of this provision presumably looked at the requirement that the sponsor of a certified deemed-compliant FFI be an FFI or U.S. financial institution and concluded that corporate directors won't typically satisfy this requirement.

Can one say with certainty that a UC's corporate directors aren't Type A investment entities, at least when the UC holds bankable assets? Absolutely not. Assuming one gets past the business and customer requirements, corporate directors arguably meet the requirements for this category. But the IRS's own seeming doubt that corporate directors are FFIs must give one pause. My own view, which is based on little more than reading the few clues the IRS has given and on gut instinct, is that typical corporate directors shouldn't be classified as Type A investment entities. This would mean that a UC would be a Type B investment entity only if it met the gross income test and its assets were managed by a professional firm. In other words, UCs whose directors were typical shell company corporate directors and whose assets were managed by individuals would not be Type B FFIs even if they met the gross income test.

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[44] Reg. section 1.1471-5(f)(1)(i)(F)(3)(i).

[45] *Id*.

[46] Reg. section 1.1471-5(f)(2)(iii)(B)(3). Curiously, the September 2013 technical corrections deleted the requirement that the sponsor of a certified deemed-compliant FFI be authorized to manage the FFI and enter into contracts on behalf of the FFI but that change was reversed in the proposed and temporary regs issued on February 20, 2014.

[47] *Id*.

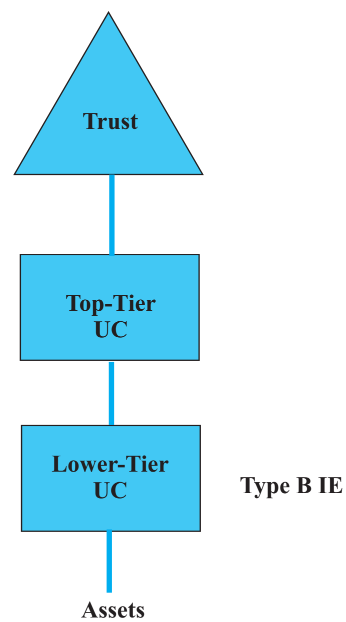
As if the above uncertainties weren't enough, the regs leave the following important questions unanswered under the managed by test.[48]

> Is the managed by test met if one or more managers are individuals and one or more are entities that are Type A investment entities, for example, a UC with multiple investment accounts, some of which are managed by an individual and some by Type A investment entities? Examples 5 and 6 in the regs, which address the managed by test for trusts (but sadly, not UCs) don't shed any light — Example 5 assumes that the both the trust and all its assets are managed by an individual, and Example 6 assumes that both the trust and all its assets are managed by an FFI.
>
> How much of a UC's assets must meet the managed by test? For example, does a UC with all individual directors meet the managed by test if almost all its assets are not professionally managed (for example, a UC that holds a valuable art collection for the settlor's private enjoyment plus a small professionally managed financial account that contains just enough funds to pay the trust's running costs, such as insurance and trustees fees)?
>
> What happens if the manager changes, for example, when the investments are being managed by a professional firm that is replaced with an individual or vice versa? FFI versus NFFE status must be determined annually — how much of the year must the trust or its investments be managed by a Type A investment entity for the test to be met?

There are no clear answers to any of the above questions. As explained earlier, my general rule of thumb in these cases is to choose the option that will result in the greatest disclosure under FATCA. Being an FFI generally generates more disclosure than being an NFFE, and satisfying the managed by tests will result in FFI status if the gross income test is also met. Therefore, all else being equal, it's probably safest to assume that a UC meets the managed by test if *any* of its managers are Type A investment entities, if *any* of its assets are managed by a Type A investment entity, and, in either case, if these criteria are met for *any* part of the year. Yet again, however, this is pure guesswork because the regs just aren't clear.

2. Holding company. A topic that's received scant, if any, attention is whether UCs can be holding company FFIs under the regs. That category is aimed at holding companies that are part of large corporate structures the regs refer to as expanded affiliated groups (EAGs). However, the definition of holding company FFIs encompasses literally any UC whose primary activity is holding the stock of another company if the UC owns more than 50 percent by vote and value and the other company meets specific criteria, as detailed below. The most common situation in which a UC might be a holding company FFI is when the second-tier company is a Type B investment entity, as illustrated in the following diagram:

Figure 2



An entity is a holding company (but not necessarily a holding company FFI) if "its primary activity consists of holding (directly or indirectly) all or part of the outstanding stock of one or more members of its" EAG.[49] As I pointed out in my last report, a trust is an entity under FATCA.[50] Thus, in theory, trusts can be holding companies. However, as a practical matter they won't be because their primary activity is not to hold their UCs' shares but, for example, to act as succession planning vehicles.[51]

UCs, however, can be holding companies. The definition of an EAG under the regs is complicated.

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[48]For a discussion of similar issues in the context of trusts' entity classification, see *supra* note 6, at 1016.

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

[50]*See supra* note 6, at 1009.

[51]Under the final regs, trusts couldn't be holding companies if they were at the very top of a structure, which they would be in a typical offshore trust setup (reg. section 1.1471-5(i)(2)(ii)). However, that limitation was removed by the temporary and proposed regulations issued on February 20.

It is based on the definition of the same term in the code but with FATCA-specific modifications.[52] Stripped to its essentials, it applies to companies connected by the 50 percent vote-and-value test mentioned above. Although the term EAG conjures up images of large, complicated corporate structures, an EAG can consist of as few as two companies. Thus, any UC whose primary activity is to hold the shares of another company is literally a holding company if the UC holds at least half the voting rights and value of the other company. A UC's very purpose is to hold a trust's assets. Thus, if a UC's sole or main asset is the shares of another company, and if the 50 percent test is met, the UC will fall within the definition of a holding company because its primary activity will be to hold the shares of the other company.

To be a holding company FFI, a holding company must either (1) be part of an EAG that includes a depository institution, custodial institution, insurance company, or Type B or C investment entity; or (2) be formed in connection with, or availed of by, a collective investment vehicle or one of several types of funds or similar investment vehicles.[53] UCs don't typically satisfy prong 2 above and won't typically hold more than 50 percent of the shares of depository institutions, custodial institutions, insurance companies, or Type C investment entities. However, UCs will sometimes hold all the shares of a Type B investment entity and, if they do, would fall within the definition of holding company FFIs.

For example, commercial trust companies prefer to use UCs from their offshore jurisdictions of choice. Those jurisdictions aren't typically parties to double tax treaties and, therefore, UCs formed there don't typically benefit from the reduced rates of withholding tax often available to entities formed in jurisdictions that have those treaties. In those cases, a lower-tier UC from a favorable treaty jurisdiction might be used to hold the trust's investments in order to qualify for reduced withholding rates.[54] If those investments are managed by a professional investment firm (thus meeting the managed by test) and at least half of the lower-tier UC's gross income is from investing in financial assets (thus meeting the gross income test), the lower-tier UC will be a Type B investment entity and the top-tier UC would meet the definition of a holding company FFI.[55]

Being a holding company FFI has two potentially significant consequences for UCs. First, if an entity is both a holding company FFI and an investment entity, it cannot qualify for the FATCA compliance paths of a (1) sponsored, closely held investment vehicle (a type of certified deemed-compliant FFI) or (2) owner-documented FFI. Both of those categories require that the entity be an FFI solely because it is an investment entity.[56] As discussed in the previous section, UCs will be Type B investment entities if they meet the managed by and gross income tests and may also, arguably at least, be Type A investment entities if they hold funds, money, or financial assets, which include unlisted shares.[57] Thus, any UC that falls into either of these categories of investment and is also a holding company FFI is precluded from becoming an owner-documented FFI or a sponsored, closely held investment vehicle.

Second, a UC that is a holding company FFI cannot be a participating FFI (PFFI) or a registered deemed-compliant FFI unless all members of its EAG that are FFIs are also PFFIs, deemed-complaint FFIs, exempt beneficial owners, or (during a two-year transition period only) so-called limited FFIs.[58] Thus, if the top-tier UC is an FFI and wants to become a PFFI or registered deemed-compliant FFI, the lower-tier UC, if it is an FFI, must be a PFFI, deemed-complaint FFI, or exempt beneficial owner (or during the transition period, a limited FFI). This

[52]Reg. section 1.1471-1(b)(39) and -5(i)(2), the latter cross-referencing section 1504(a).

[53]Reg. section 1.1471-5(e)(1)(v).

[54]However, this strategy works only for investments from countries whose tax treaties don't contain so-called limitation of benefits clauses. Those clauses typically look through an entity to its ultimate beneficial owner to determine if that person, not the entity itself, is resident in the treaty partner jurisdiction and thus qualifies for reduced withholding rates.

[55]The regs exempt from FFI status (and treat as an NFFE) an entity that would otherwise be a holding company FFI if the entity is an ''excepted nonfinancial group entity.'' Reg. section 1.1471-5(e)(5)(v). Two of the many requirements of an excepted nonfinancial group entity are that, subject to limited exceptions, no more than 25 percent of the EAG's gross income can be passive income and no more than 25 percent of the fair market value of the EAG's assets can be assets that produce or are held for the production of passive income. These requirements won't generally be met in the sorts of cases in which a UC is a holding company FFI, *i.e.*, when it holds the shares of a Type B investment entity. Remember, to be a Type B investment entity, at least 50 percent of the lower-tier UC's income must be from investing, reinvesting, or trading in financial assets. That being the case, and given that the top-tier UC's only true income will typically be dividends from the lower-tier UC, usually most (if not all) of the EAG's (*i.e.*, both companies') gross income will be passive income and most (if not all) of the FMV of the EAG's (*i.e.*, both companies') assets will be assets that produce or are held for the production of passive income.

[56]Reg. section 1.1471-5(f)(2)(iii))(A) (certified deemed-compliant; sponsored, closely held investment vehicle), and -5(f)(3)(ii)(A) (owner-documented FFI).

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

[58]Reg. section 1.1471-4(e)(1) (PFFIs and registered deemed-compliant FFIs) and -4(e)(2)(iii) (limited FFIs).

won't generally be a problem — if the trustee wants the top-tier UC to be a PFFI or registered deemed-compliant FFI, it would presumably want the lower-tier UC to be one as well.

Let's take a step back. As we've seen, a top-tier UC can fall within the four corners of the definition of a holding company FFI. But a two-tier UC structure isn't really what the concept of a holding company FFI was intended to cover. The holding company FFI concept was aimed at large corporate structures, not two-tier UCs. The rules were designed to "ensure that holding companies . . . cannot be used by financial groups with nonparticipating FFIs or limited FFIs to shelter payments from chapter 4 withholding."[59] A two-tier UC structure isn't in any meaningful sense a financial group even though it may literally fall within that concept. And only the most foolish trust company would use a two-tier UC structure to try to avoid FATCA withholding. Thus, one should hesitate before mechanically applying rules to UCs designed for entirely different entities, especially given that the end result will be to foreclose FATCA compliance paths (that is, sponsored, closely held investment vehicle and owner-documented FFI) that would otherwise be available to the top-tier UC.

In conclusion, a UC that holds funds, money, or financial assets should probably not be classified as a Type A investment entity even if the trustee is a commercial offshore trust company. However, a UC is a Type B investment entity if its assets are managed by a professional firm and at least half the UC's income comes from financial assets, which include most securities, including unlisted shares, but not cash. A UC whose assets are not managed by a professional firm but that has corporate directors is probably not a Type B investment entity, at least if the directors are typical shell companies whose sole purpose is to be corporate directors. Finally, a UC is literally a holding company FFI if its main asset is shares of another company, the UC owns at least 50 percent by vote and value of those shares, and the other company is itself a Type B investment entity. However, should those top-tier UCs really be classified as holding company FFIs, given that they are not the sorts of structures that category was aimed at and that classifying them as holding company FFIs will preclude otherwise available compliance paths if the top-tier UCs are also investment entities, which they often will be?

[59]Preamble to T.D. 9610, 78 F.R. 5889.

B. The IGAs

1. Introduction. The above analysis covers UCs in non-IGA countries. This section addresses UCs' FATCA classification in countries with IGAs. Also, it addresses classification under the U.K. IGA because the United Kingdom has, through the adoption of U.K-specific regulations and guidance notes, rewritten many aspects of its IGA. It is expected that other countries will use the U.K. FATCA regulations and guidance notes as templates for their own implementing legislation. If they do, UCs' treatment under those IGAs will be, just like UCs' treatment under the U.K. IGA, very different from what it is under the model IGAs.

a. Model IGAs as published. As detailed below, a UC is an investment entity under the model IGAs if it is managed by the equivalent of a Type A investment entity under the regs. Thus, unlike the regs, the IGAs don't have a gross income test for investment entities — meeting the IGAs' version of the managed by test is all that's required for an entity to be an investment entity. Therefore, UCs with professional investment firms as asset managers are *ipso facto* investment entity FFIs under the IGAs. What about UCs with individuals as asset managers but with corporate directors? These are likely not investment entities under the IGAs — corporate directors are probably not investment entities under the IGAs for the same reasons that they are probably not Type A investment entities under the regs.

UCs probably should not be classified as custodial FFIs under the IGAs even though the IGAs don't contain the regs' restrictive definition of the types of income an entity must earn to be a custodial FFI. UCs will not be holding companies under the IGAs because the IGAs don't contain that category of FFI.

The IGAs contain only the following four categories of FFI: (1) depository institutions; (2) custodial institutions; (3) investment entities; and (4) specified insurance companies.

The regs' FFI category of treasury centers and holding companies is not included in the IGAs. And UCs aren't insurance companies, let alone specified insurance companies. This leaves depository institutions, custodial institutions, and investment entities.

i. Depository institutions. UCs won't be depository institutions under the IGAs because, just like under the regs, that category is essentially limited to retail banks.[60]

[60]"The term 'Depository Institution' means any Entity that accepts deposits in the ordinary course of a banking or similar business." Model 1 IGA, Art. 1.1.i; Model 2 IGA, Art. 1.1.j.

ii. Custodial institutions. UCs are probably not custodial institutions under the IGAs. The definition of a custodial institution in the IGAs differs significantly from the definition of the equivalent term under the regs. As mentioned previously, under the regs, 20 percent or more of a custodial institution's gross income must be the sort of income only true money managers earn, for example, custody fees, account maintenance fees, and transfer fees; commissions and fees from executing and pricing securities transactions; and income earned on the bid-ask spread of financial assets.[61] Since UCs don't typically earn that sort of income, they are not custodial institutions under the regs. Under the IGAs, however, an entity is a custodial institution if it "holds, as a substantial portion of its business, financial assets for the account of others"[62] without any limitation on the sorts of income it must earn.

Do UCs meet these requirements? For the same reasons discussed in connection with Type A investment entities under the regs, UCs offered by commercial trust companies can arguably be said to be in business, even if the UCs don't themselves charge fees. However, UCs probably shouldn't be considered to hold their assets "for the account of others" for the same reason they shouldn't be deemed to conduct their activities "on behalf of other persons" for purposes of the test for Type A investment entities under the regs. Sure enough, a UC's sole function is to act as a holding entity for a trust. However, well-managed UCs have separate legal identity and, legally speaking, act on their own behalves. Thus, one has to ignore the separate legal personality of UCs to conclude that they hold their assets for the account of others. Again, however, one can't say that this is the one right answer — reasonable people can certainly conclude that economic reality, not legal nicety, should govern here.

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

> Any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:
>
> - trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;
> - individual and collective portfolio management; or
> - otherwise investing, administering, or managing funds or money on behalf of other persons.[63]

This definition is to be interpreted consistently with the similar language in the definition of financial institution in the FATF recommendations.[64]

The definition tracks fairly closely the definition of a Type A investment entity under the regs. However, there are several significant differences, which I have catalogued elsewhere.[65] The most significant difference for present purposes is the inclusion of the parenthetical "(or is managed by an entity that conducts as a business)," which doesn't appear in the regs' definition of a Type A investment entity.[66]

This parenthetical is Treasury's crude attempt to include a kind of Type B investment entity in the IGAs' definition of an investment entity. As already discussed, a Type B investment entity must meet the managed by test — that is, a Type B investment entity must be managed by another entity that conducts the activities of a Type A investment entity on its behalf. Thus, by including the "managed by" parenthetical in a definition that otherwise covers Type A investment entity equivalents only, Treasury was attempting to make the IGAs' definition of an investment entity do double duty by covering both quasi-Type A and quasi-Type B investment entities.

There are, however, two differences between a Type B investment entity under the regs and an entity captured by the "managed by" parenthetical under the IGAs. First, and less significantly, under the regs a Type B investment entity must be managed by one of the following types of FFI: a depository institution, a custodial institution, a specified

[61]Reg. section 1.1471-5(e)(1)(ii) and -5(e)(3)(i) and (ii).
[62]Model 1 IGA, Art. 1.1.h; Model 2 IGA, Art. 1.1.i.

[63]Model 1 IGA, Art. 1.1.j; Model 2 IGA, Art. 1.1.k.
[64]*Id*.
[65]For a detailed explanation of those differences, see *supra* note 6, at 1008.
[66]The most significant other difference is that the regs require that the entity primarily conduct the listed activities as a business, but the word "primarily" is not in the IGAs. As a result, there is no percentage of income test in the IGAs to measure whether an entity (or the entity that manages it) "conducts as a business" the relevant activities. Thus, presumably this portion of the test is satisfied with any level of business at all.

insurance company, or a Type A investment entity.[67] Under the IGAs, however, the managing entity must be an investment entity as defined in the IGAs, that is, essentially the equivalent of a Type A investment entity under the regs. This difference has no real-world impact when it comes to the classification of UCs. UCs will rarely, if ever, be managed by depository institutions, custodial institutions, or specified insurance companies. Thus, as a practical matter, only Type A investment entities (or their kissing-cousin IGA equivalents) will suffice as managing entities.

Second, and much more significantly, a ''managed by'' entity under the IGAs does not have to meet a gross income test — each and every entity that is managed by an investment entity under the IGAs is itself automatically an investment entity.

The IGAs don't define what managed by means. Presumably, however, just like under the regs, managing either the entity's assets or the entity itself would suffice. Thus, every UC whose assets are managed by a professional investment firm will be an investment entity under the IGAs. Those firms are themselves investment entities under the IGAs because they conduct financial trading, portfolio management, or other investment activities on the others' behalves. Therefore, every entity — including every UC — whose assets they manage are investment entities.

As for managing the UC itself, well, we've covered this ground already. UCs are — or they ought to be — managed by their directors. Individual directors can't be investment entities because they're not entities. And, as previously discussed, typical shell company corporate directors shouldn't be Type A investment entities under the regs — that category was designed for investment and asset management firms, and the IRS appears to believe that corporate directors aren't Type A investment entities. Because the definitions of a Type A investment entity under the regs and an investment entity under the IGAs are, for present purposes, largely identical, the same result should obtain under the IGAs. Again, however, one can't be sanguine about this conclusion. If one can get past the business and customer requirements, one can persuasively argue that corporate directors fall literally within the definition of investment entities under the IGAs because they ''administer or manag[e] funds or money on behalf of other persons.''[68]

In sum, all UCs whose assets are managed by professional investment firms are investment entities under the IGAs. In contrast, all UCs whose assets are managed by individuals and that have individual directors are not investment entities under the IGAs. They are not any other type of FFI under the IGAs, either, so they are NFFEs.[69] Much more uncertain is whether a UC whose assets are managed by individuals, but that has corporate directors, is an investment entity. The better view, in my opinion, is that they are not.

In any event, the same open questions remain as discussed earlier for UCs under the regs:

- is the managed by requirement met when there is a mix of both individual and professional entity managers;
- how much of a UC's assets must meet the managed by requirement for the UC to be an investment entity; and
- what happens if the manager changes from a professional firm to an individual, or vice versa?

b. U.K. IGA. The U.K. FATCA regulations and guidance notes make significant changes to the U.K. IGA as written. In many respects relevant to this report, the changes undo the differences between the IGA and the final U.S. FATCA regs. For example, the U.K. regulations and guidance notes do the following:

- They reinsert the limitation on the types of income a custodial institution must earn. Just like under the U.S. regs, 20 percent or more of the entity's income must come from the sorts of income only true money managers earn (for example, custody, account maintenance, and transfer fees; commissions and fees from securities transactions; and fees for providing financial advice, clearance, and settlement services).[70]
- They reinsert ''primarily'' before ''conducts as a business'' in the definition of an investment entity and adopt essentially verbatim the regs' definition of ''primarily conducts as a business'' (the entity's gross income attributable to

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

[68]As pointed out in my previous report, only ''funds or money,'' not ''financial assets,'' are included here in the IGAs. *See supra* note 6, at 1020. The regs include all three types of assets. However, the difference is inconsequential. As mentioned previously, the definition of an investment entity under the regs is to be interpreted consistently with the similar definition of financial institution under the FATF recommendations and, under those recommendations, ''funds'' includes every type of property imaginable, including financial assets.

[69]They will typically be so-called passive NFFEs because at least half their income will be passive income, at least half their assets' produce will be held for the production of passive income, and they will not generally meet any of other exceptions that would make them active NFFEs. Model 1 IGA, Annex I, Art. VI.B.2 and 3; Model 2 IGA, Annex I, Art. VI.B.2 and 3.

[70]U.K. guidance notes, section 2.27, at 37-38.

the relevant activities must equal or exceed 50 percent of its gross income over the testing period).[71]

- They reinsert the gross income test so that an entity that is managed by an investment entity is not an investment entity unless its gross income is primarily attributable to investing in financial assets.[72]
- They reinsert the one category of FFI that is present in the regs but absent in the model IGAs: treasury centers and holding companies.[73]

i. Custodial institutions. UCs aren't custodial institutions under the U.K. IGA for the same reasons they aren't under the regs: They don't earn the types of income required for that classification — that is, the types of income that money managers earn. Moreover, as mentioned previously, they probably shouldn't be classified as custodial institutions in any event because they don't hold their assets for others.

ii. Investment entities. The U.K. IGA, as rewritten by the U.K. regs and guidance notes, essentially incorporates the equivalents of both Type A and Type B investment entities under the U.S. regs, including in the latter case both the managed by and gross income tests. Assuming, as I do, that a UC does not conduct its activities on behalf of other persons, it's not the equivalent of a Type A investment entity. Therefore, it will be an investment entity under the U.K. IGA only if its assets are managed by a professional firm *and* most of its income comes from financial assets. Thus, unlike under the model IGAs, the mere fact that a UC's assets are managed by a professional firm is not alone enough to make the UC an investment entity. In essence, then, a UC will be an investment entity under the U.K. IGA in the same circumstances — and only in the same circumstances — it's an investment entity under the U.S. regs, which is to say it must meet both the managed by and gross income tests.

iii. Holding companies. As mentioned previously, holding companies are not included in the categories of FFI under the model IGAs. They are not mentioned in the U.K. IGA either. However, the United Kingdom has, by sheer fiat, inserted the concept into its own regulations and guidance notes.

An entity is a holding company under the U.K. guidance notes if its ''primary activity includes holding of (directly or indirectly) all or part of the outstanding stock of one or more related entities that are Financial Institutions.''[74] The definition in the guidance notes is essentially identical to the definition of a holding company in the U.S. regs except that (1) under the U.S. regs, the entity's primary activity must ''consist of'' rather than ''include'' holding the other company's stock; and (2) under the U.K. guidance notes, the other company must be a related entity rather than part of the holding company's EAG.

An entity is a ''related entity'' of another entity if either entity controls the other entity or the entities are under common control.[75] Control for this purpose includes direct or indirect ownership of more than 50 percent by vote or value.[76]

Thus, if a UC's primary activity includes holding the shares of another company, the UC owns more than half of the company's shares (by vote or value), and the other company is an FFI, the UC will be a holding company FFI under the U.K. IGA as implemented by the U.K. guidance notes. However, the same caveat applies here as in the discussion of holding company FFIs under the regs: One has to question whether the holding company FFI concept should really be applied to top-tier UCs given that those structures are far afield from what the holding company FFI concept was aimed at.

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[71]U.K. guidance notes, section 2.28, at 38-39.

[72]U.K. regs, sections 4 and 5, at 2-3; U.K. guidance notes, section 2.28, at 39-40.

[73]The U.K. regs refer to these as two separate categories, namely, ''a relevant holding company'' and ''a treasury company.'' U.K. regs section 3(1)(e) and (f), at 2. The U.K. guidance notes, just like the U.S. regs, lump the two categories together, and refer to the entities as holding companies and treasury centers (albeit with ''of Financial Groups'' tacked on at the end). U.K. guidance notes, section 2.30, at 41. For simplicity's sake, this report will refer to ''relevant holding companies'' under the U.K. regs and ''holding companies'' under the U.K. guidance notes as ''holding companies.''

[74]U.K. guidance notes, section 2.30, at 41. The definition of a holding company under the U.K. regs is more complicated: A holding company is (1) a person whose business consists wholly or mainly of holding (directly or indirectly) any shares or securities issued by a related entity that is a custodial institution, a depository institution, an investment entity, or a specified insurance company (this prong is similar, though not identical, to the definition of a holding company in the U.K. guidance notes); or (2) a person whose business consists wholly or mainly of holding shares or securities, and who has a ''qualifying relationship'' with a ''qualifying entity.'' U.K. regs, section 9. A qualifying entity means an entity that is, or is formed with a view to its becoming, an investment entity (essentially, an entity that meets both the managed by and gross income tests). U.K. regs, section 11(a). A person has a qualifying relationship with a qualifying entity if (1) the person is ''connected'' with the entity under section 1122 of the U.K. Corporation Tax Act of 2010, or (2) the person provides services or holds investments on behalf of the entity. U.K. regs, section 11(b).

[75]U.K. IGA, Art. 1.1.kk.

[76]*Id*. However, the U.K. IGA permits the U.K. competent authority to treat entities as not related if the entities are not part of the same EAG under section 1471(e)(2).

c. Crown dependencies' IGAs. The U.K. crown dependencies (CDs)[77] issued a joint draft of their proposed FATCA guidance notes on January 31, 2014. Comments are requested by March 14, and a revised draft is expected by March 31. The draft covers not just the CDs' IGAs with the United States, but also their so-called ''son-of-FATCA'' IGAs with the United Kingdom.[78]

The guidance departs significantly in many respects from the U.K.'s IGA FATCA guidance, including regarding trusts. For example, it expressly allows CD FFIs to apply the definition of investment entity under the U.S. regs (thus, expressly including types A, B, and C investment entities). Most significantly for present purposes, it is the very first FATCA document to expressly address UCs. It does so in several different contexts. The guidance confirms that a ''financial account'' in a trust includes all of the property in the trust including UCs.[79] In addition, if a trust qualifies as a non-reporting FFI, the guidance allows UCs and any subsidiaries of those UCs that are CD FFIs to be treated as non-reporting FFIs as well.[80] Finally, it makes clear that the gross income test for determining whether a trust is an FFI (that is, a type B investment entity) is determined by looking through any UCs to the UCs' own income:

> In determining whether a trust's gross income is primarily attributable to Financial Assets, it is important to consider the underlying source of the income. For example, while a real estate trust may hold its property through companies and so receives its income in the form of dividends, the underlying activity is property holding which is not a financial asset for this purpose. The trust would not be an Investment Entity in this case.[81]

This is a pragmatic approach and should be applauded. However, it addresses only trusts', not UCs', FATCA classification. Presumably, UCs' FATCA classification remains unchanged — one must look to those entities' own income, plus the managed by test, to see if they qualify as FFIs.

One might be tempted to conclude that, given this look through, a trust's own FATCA classification will always be the same as its UC's. This is a mistake. The trust's *income* for purposes of the gross income test will be the same as its UC's income (assuming all the structure's assets are held via the UC). However, whether the managed by test is met is a completely different matter. As already mentioned, trusts operated by commercial trust companies will inevitably meet the managed by test because such trust companies will be type A investment entities. But, as we've seen, unless a UC's assets are professionally managed, it will not meet the managed by test if its directors are individuals. And, for the reasons explained earlier, it is far from clear that a UC will meet the managed by test even if its directors are companies because it's not at all clear that typical corporate directors are themselves FFIs.

Where does this leave us? The draft CDs' guidance notes are a breath of fresh air given that they are first official document to even acknowledge the existence of UCs. However, they don't really break new ground in terms of classifying UCs under the IGAs — like the U.K.'s own FATCA guidance notes and regs, they reinsert the gross income test, albeit by carte blanche adoption of the regs' definition of an investment entity as opposed to surgical insertion. It will be interesting to see whether other IGA countries' own FATCA guidance follows the CDs' template or the U.K.'s template.[82] Indeed, perhaps the U.K. will now align its own guidance notes with the CDs'. Here's hoping it does because the CD guidance is far more detailed and well thought through than is the U.K's, at least with respect to trusts.

IV. Conclusion

FATCA is complicated enough when its rules are aimed at entities the IRS and Treasury had in mind when drafting the regs and IGAs. It is much more challenging when applied to entities like UCs that the IRS and Treasury apparently never thought of when constructing the rules. Hopefully this report has pinned FATCA's treatment of UCs at least moderately close to where it belongs on the elephant's body. If not, who can blame us? It's awfully dark with this blindfold on.

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[77]Guernsey, Jersey, and the Isle of Man.

[78]On February 3, 2014, the United Kingdom also issued its own draft guidance notes on its son-of-FATCA agreements with the CDs and Gibraltar. Implementation of International Tax Compliance (Crown Dependencies and Gibraltar) Regulations 2014 — Draft Guidance Notes, Feb. 3, 2014. However, this document adds nothing of substance to the current discussion: It recites that the United Kingdom will be introducing regulations to implement these specific son-of FATCA IGAs (*id.*, at 5) and for the most part simply cross references the U.K.'s IGA with the United States and instructs the reader to apply the U.K. regulations implementing that document.

[79]*Id.*, section 7.7, at 47.

[80]*Id.*, section 7.12, at 49.

[81]*Id.*, section 7.4.1, at 43.

[82]Ireland issued its own revised FATCA guidance notes on January 16, 2014. (Guidance Notes on the Implementation of FATCA in Ireland). Like the previous Irish draft guidance, this document follows the U.K.'s lead and clones much of the U.K.'s FATCA guidance.

This report concludes the trilogy intended to clarify the FATCA classification of trust companies, trusts, and UCs, respectively. However, FATCA's classification of entities as FFIs or NFFEs is not an end in itself — the IRS is not interested in ferreting out FFIs and NFFEs. No, the IRS wants to catch U.S. persons who are attempting to hide their assets offshore in FFIs and behind NFFEs. Thus, once a trust company has classified its entities as FFIs and NFFEs, it must identify any U.S. account holders of its FFIs and the substantial U.S. account owners or U.S. controlling persons of its NFFEs. My next articles will therefore focus on what are ''accounts'' and who are ''accountholders'' in FFI trusts and UCs, and who are substantial U.S. owners and U.S. controlling persons of NFFE trusts and UCs. Stay tuned.