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Guernsey issues guidance on classification of investment entities for the Common Reporting Standard

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On 29 July 2016, the States of Guernsey Income Tax ("ITO") published their latest bulletin on guidance in relation to the implementation of the Common Reporting Standard ("CRS") in Guernsey. Bulletin 2016/6 repeats the text of the definition of Investment Entity, as set out in Section VIII A(6) of the CRS and affirms the Supplementary Guidance Notes published in draft on 24 December 2015 in relation to the CRS.

This client bulletin explains the significance of Bulletin 2016/6 and why its publication is timely.

Background

By 30 June 2016, Reporting Guernsey Financial Institutions had filed their first set of reports to comply with UK FATCA and their second set of annual reports to comply with US FATCA. These reports were compiled by Financial Institutions under the terms of the intergovernmental agreements ("IGAs") signed on 22 October 2013 (for the UK IGA) and 13 December 2013 (for the US IGA), both of which were introduced with effect from 1 July 2014. Now those same Financial Institutions are starting to prepare for the CRS which was introduced in Guernsey with effect from 1 January 2016.

Given that, in the main, the steps to review, identify and report on accounts follow the same approach, whether under US FATCA, UK FATCA or CRS, Financial Institutions that have already gone through the process of filing reports under FATCA in 2015 and 2016 should be well placed to leverage that experience as they prepare for CRS.

However, there are traps for the unwary and in this context the publication by the ITO of Bulletin 2016/6 draws attention to one such problem area, being the classification of entity account holders. This is because an entity that is "managed by" another Financial Institution could itself be classified as an investment entity under the definition of that term in both the IGAs and the CRS. However, there are subtle differences in the terminology used in each definition and consequently how these terms are interpreted in practice. These differences are now being reflected in guidance published by different jurisdictions, and as a result, the differing approaches are coming to the attention of Financial Institutions and their advisers, who were seeking clarification on the definition of investment entity.

Definition of investment entity

In both the IGAs and the CRS the definition of investment entity has two limbs; one limb under which entities are classified as investment entities in their own right and the other limb for entities which qualify as such under the "managed by" test. In order to determine whether an entity that is managed by a Financial Institution is an investment entity, the IGAs offer the choice of two alternative tests; the test that appears in the US FATCA Regulations or a simpler test that is set out in the IGAs themselves. The US FATCA Regulations test requires the managed entity's gross income to be primarily attributable to the investing, reinvesting or trading in Financial Assets in order to be classified as an investment entity. An entity's gross

income is said to be "primarily attributable" to the relevant activity if it is equal to or exceeds 50% of its total gross income from all sources. By contrast, the IGAs test makes no reference to Financial Assets or the need to review the gross income of the entity concerned in order to qualify as an investment entity.

For those Financial Institutions that applied the US Regulations' test to classify managed entities in order to comply with US FATCA and UK FATCA, they would be able to continue to rely on that same criteria for the purposes of CRS. For those Financial Institutions that applied the simpler test of the IGAs, rather than opting for the US FATCA Regulations test, they now find that they have to revisit that classification and, in addition, review the entity's gross income to see if it is primarily attributable to the investing, reinvesting or trading in Financial Assets.

Consequences dependent upon classification

Apart from the additional resources required to revisit a classification, what are the consequences of this difference in approach for those Financial Institutions and their managed entities which are affected?

Where an entity has been classified as an investment entity under the "managed by" limb of the IGAs test for FATCA purposes the result is that the entity itself is responsible for the reporting of financial information in respect of its own investors. Often the fulfilment of that duty is delegated to the third party service provider which manages the entity. This is permitted under the IGAs and CRS. However, under the "managed by" limb of the definition of investment entity in the CRS, that same entity could potentially fail to meet the gross income test and as a consequence be classified instead as a Passive Non-Financial Entity ("Passive NFE"). In this case, the obligations to collate and report information on Financial Accounts maintained for the entity passes to the Financial Institution(s) at which those Financial Accounts (if any) are maintained, which could be in a number of jurisdictions. The reporting of data could, as a result, become fragmented as it is collated by entirely separate institution(s). Furthermore, reports would only be triggered if the Controlling Person behind that entity is identified as being resident in a Participating Jurisdiction. Whilst there is no intention to avoid reporting the correct information, the scope and nature of the information to be collated and then reported can differ depending upon the classification of the entity itself – either as an investment entity or as a Passive NFE. This has led to calls for clarification by Financial Institutions, as they gear up for CRS.

CRS v FATCA

On the face of it, the CRS is portrayed as a global standard which is compatible with FATCA. Indeed, the Organisation for Economic Co-operation and Development (the "OECD"), which developed the CRS, states in its Implementation Handbook[1] that "an explicit objective when designing the Standard was to build on FATCA, and more specifically the FATCA IGAs, as by maximising consistency with the FATCA IGAs governments and financial institutions could leverage on the investment they are already making for FATCA. This was to ensure that a new international standard could be created, which would deliver the most effective tool to tackle cross-border tax evasion, while minimising costs for governments and financial institutions."[2]

The above comments seem to suggest that an approach which allows the IGAs definitions to be used interchangeably with the CRS definitions should be acceptable. If this were correct, then the classification of an entity as an investment entity under the "managed by" test of the IGAs would also be acceptable for the CRS, and its treatment as an investment entity as far as the reporting of data would be consistent. But is this right?

The Implementation Handbook continues by stating "While a large proportion of the Standard precisely mirrors the FATCA IGAs, there are also areas of difference. These differences are due to: the removal of US specificities (such as the use of citizenship as an indicia or tax residence and the references to US domestic law found in the FATCA IGAs); or where certain approaches are less suited to the multilateral context of the Standard, as opposed to the bilateral context of the FATCA IGAs." The OECD is warning that where there are differences, this is deliberate and for specific jurisdictional reasons.

The definition of investment entity is referred to in Part III of the Implementation Handbook, which states that, "While the wording of the definition of Investment Entity may differ between Model 1 IGAs and the Investment Entity in Section VIII, A, 6 of the Standard, the Standard was designed to achieve an equivalent outcome to that achieved through the Model 1 IGAs. Jurisdictions should therefore be able to rely on the approach in the Standard for purposes of both the Standard and the Model 1 IGAs"[3] (emphasis added).

The words emphasised suggest that, in cases of divergence between the definitions used in the IGAs and in the CRS, it is the CRS that should be applied (and not the other way around).

1 CRS Implementation Handbook, published 7 August 2015
2 See para 36, page 22 CRS Implementation Handbook
3 Page 88 CRS Implementation Handbook

Continued

Reconciliation

How is it then possible to reconcile consistency with divergence in the case of defined terms?

Perhaps the key lies in the fact that the OECD has confirmed that the CRS "often incorporates definitions and processes contained in the current US FATCA Regulations"[4]. Accordingly, based on this view, a jurisdiction can adopt a single approach to these areas, both in relation to implementing the CRS and the IGAs, provided that, where a choice is given in the IGAs to use the definitions of the US FATCA Regulations, its Financial Institutions have chosen to do so.

Guernsey's response

In view of the on-going debate regarding the correct classification of investment entities for CRS purposes, Financial Institutions have called for reassurance so that they can continue their preparations for CRS in the certainty that they are on the right track. Responding to this call in Guernsey, the ITO published Bulletin 2016/6 on 29 July 2016 and confirmed that only the CRS definition may be used for reporting under the CRS. This is consistent with, and confirms, the guidance published in paragraph 3.3.3 of the draft Supplementary Guernsey Guidance Notes published by the ITO on 24 December 2015. Thus, in Guernsey, Reporting Financial Institutions may need to check their original classification of entity account holders to ensure their classification of such accounts is consistent with the CRS and published guidance. The publication of Bulletin 2016/6 is timely as Reporting Guernsey Financial Institutions gear up to collate the appropriate financial data for the reporting period of 2016 in readiness for filing under CRS in 2017.

4 Para 38, page 22 CRS Implementation Handbook

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