

# CRS and FATCA: The Basics for Private Wealth

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This introductory guide is relevant to structures holding private wealth established in Jersey, Guernsey, BVI and the Cayman Islands.

## Introduction

The Common Reporting Standard (CRS) and its US equivalent, the Foreign Account Tax Compliance Act (FATCA), are international tax information gathering mechanisms, based on automatic exchange of information (AEOI). The reporting is done on an annual basis rather than being based on specific requests issued by one tax authority to another.

Since their inception in the mid-2000s, various regimes have been implemented around the world, including in Jersey, Guernsey, the BVI and the Cayman Islands where structures to hold private wealth such as trusts and foundations are commonly established<sup>1</sup>. The result is that, for all entities established in the places where such regimes have been implemented, it is routine to undertake an analysis of the impact of the CRS and FATCA and, where relevant, for reports to be made by them or on their behalf by trust and corporate services providers.

The purpose of this guide is to give a brief description of the treatment of entities under the CRS and FATCA, with a particular focus on private wealth holding structures. By necessity in a guide of this length, it is not possible to deal with the rules in detail, but rather the aim is to provide an overview of the subject.

## The Basic Principles

FATCA, which was enacted in the US before the CRS was created, is concerned solely with gathering tax information for the IRS in respect of the assets of US persons. By contrast, the goal of the CRS is to gather tax information about the assets of individuals resident in each country participating in the CRS (known as 'Participating Jurisdictions') and held in accounts situated in other Participating Jurisdictions and reporting that information back to the tax authorities of the Participating Jurisdiction in which the individual is resident.

Under the CRS, every legal entity resident in a Participating Jurisdiction must be classified as either a 'Financial Institution' or a 'Non-Financial Entity'. There are detailed rules as to how this should be done.

The concepts and nomenclature used in the CRS are generally mirrored in FATCA. A similar classification process must therefore be followed under FATCA except that entities are either classified as 'Foreign Financial Institutions' or as 'Non-Financial Foreign Entities'. For convenience, in the rest of this guide reference is made only to Financial Institutions and Non-Financial Entities in relation to both FATCA and the CRS.

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<sup>1</sup> The major exception is the US which has not implemented the CRS, instead relying on FATCA to obtain tax information about US persons in respect of their accounts in Financial Institutions outside the US. However, FATCA is for most purposes non-reciprocal, i.e. it does not require reporting of information in respect of accounts of non-US persons.

This has a broader significance than might be assumed because the concept of Financial Institution has a meaning much wider than merely banks, custodians, investment managers and insurance companies (i.e. financial institutions in the ordinary meaning) and extends to many other types of entities such as personal investment holding companies not carrying on any financial services business. It is wider still because 'entity', for the purposes of the CRS and FATCA, extends not just to companies but also to structures regarded by many legal systems as not having legal personality, such as trusts.

Under the CRS and FATCA, all Financial Institutions have an obligation to identify the holders of the accounts held in them (known as '**Financial Accounts**'). They must then make annual reports (usually around mid-year) to their local tax authority in respect of the value of those accounts at the end of the previous calendar year and the identity of those account holders (or in the case of account holders that are entities, the identity of their '**Controlling Persons**'<sup>2</sup>) who are resident in other Participating Jurisdictions (or US persons in the case of FATCA). A few weeks later, the local tax authority will forward those reports, on a confidential basis, to the tax authority of the other Participating Jurisdiction (or the IRS in the case of FATCA), which can then use the information for the purposes of its own tax gathering and in order to detect tax evasion.

By contrast, the obligations of Non-Financial Entities are limited to disclosing information about themselves and their Controlling Persons to the Financial Institutions where they have accounts.

### **Classification into Financial Institutions and Non-Financial Entities**

As noted above, a key factor in the treatment of an entity under the CRS and FATCA is its classification. If an entity is not a Financial Institution, then it is by default a Non-Financial Entity.

The classification rules involve a number of different tests, but the main one of relevance to entities typically administered on behalf of clients to hold private wealth (known as '**Investment Entities**'), has the effect that an entity is a Financial Institution if:

- (a) its gross income is primarily attributable to investing, reinvesting, or trading in '**Financial Assets**' (the '**Gross Income Test**'); and
- (b) the entity is managed by another Financial Institution (the '**Managed By Test**').

An entity meets the Gross Income Test if at least 50% of the gross income of the entity is attributable to investing, reinvesting, or trading in Financial Assets. For these purposes, the expression 'Financial Assets' is widely defined but does not include a direct interest in real property or physical commodities.

An entity meets the Managed By Test if another entity which is a Financial Institution performs, either directly or through another service provider, any specified activities or operations on behalf of the entity. These include investing, administering or managing Financial Assets.

### **Identifying Financial Accounts in Financial Institutions**

An entity that is classified as Financial Institution must undertake due diligence to identify its Financial Accounts.

The expression 'Financial Accounts' includes equity or debt interests and therefore includes shares in companies and beneficial interests in trusts (as to which see further below).

The purpose of the due diligence process is to identify individuals or entities (known as '**Reportable Persons**') holding such interests who are resident in CRS Participating Jurisdictions or who are US persons so that the interest can be reported to the correct tax authority on an annual basis via the CRS and FATCA reporting network. In the case of entities holding such interests, it is necessary also to identify their Controlling Persons.

### **Reporting by Financial Institutions**

Once the due diligence process has been completed, the Financial Institution reports the relevant information gathered to its local tax authority. The local tax authority passes that information in a

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<sup>2</sup> The expression 'Controlling Persons' generally corresponds with the term 'beneficial owner' as normally encountered in the context of the KYC/CDD requirements imposed by anti-money laundering regulations.

prescribed format to the CRS Participating Jurisdictions where the Reportable Persons are resident (or the IRS in the case of US persons).

The information reported in respect of each Financial Account is:

- (a) the name, address, jurisdiction(s) of residence, tax information number (or 'TIN') and date and place of birth (in the case of an individual) of each Reportable Person that is an account holder of the account and, in the case of any entity that is an account holder the same details in respect of any Controlling Person of the entity that is a Reportable Person;
- (b) the account number (or functional equivalent in the absence of an account number);
- (c) the name and identifying number (if any) of the Financial Institution; and
- (d) the account balance or value as of the end of the relevant calendar year or other appropriate reporting period or, if the account was closed during such year or period, the closure of the account.

### **Non-Financial Entities**

An entity that is classified as a Non-Financial Entity must be further classified either as an Active Non-Financial Entity or a Passive Non-Financial Entity.

Most Non-Financial Entities that are established to hold private wealth are typically Passive Non-Financial Entities, with the result that their obligations under the CRS and FATCA are confined to disclosing their identity and the identity of their Controlling Persons to Financial Institutions (e.g. banks or investment managers) where they have accounts. This will initially be done as part of the process of opening the account with the Financial Institution.

### **Treatment of Trusts**

As trusts do not generally have legal personality in the same way as companies, the CRS and FATCA have some particular rules dealing with them. These include the following.

#### *Residence of the Trust*

When considering trusts, it is necessary to determine in which jurisdiction the trust is resident for the purposes of the CRS and FATCA. This is because it is the CRS and FATCA legislation as implemented in the jurisdiction of residence that governs classification and reporting. For these purposes, a trust is considered to be resident in the jurisdiction where one or more of its trustees are resident; the proper law of the trust is not relevant.

#### *Classification*

The Gross Income Test and the Managed By Test apply to trusts as they do to other entities. The Managed By Test is usually treated as satisfied, in the case of a trust, where a professional trust company acts as a trustee of the trust.

#### *Financial Accounts*

Where a trust is a Financial Institution, its Financial Accounts include the interests of beneficiaries in the trust whether they have fixed entitlements or are merely discretionary beneficiaries (though if they are a discretionary beneficiary they are only treated as having a Financial Account in the year in which a distribution is made to them).

In addition, any settlor and any person exercising 'ultimate effective control' over the trust (e.g. some protectors) are deemed to have a Financial Account in it whether or not they have any equity interest as a matter of trust law. In normal circumstances, those Financial Accounts are to be reported as having the value of the totality of the trust assets. The meaning of 'ultimate effective control' is the subject of some debate amongst practitioners.

#### *Controlling Persons*

Where a Financial Account in a Financial Institution is held by a trust that is a Non-Financial Entity, the rules require the Financial Institution to report the Controlling Persons of the trust (in so far as they are

Reportable Persons). This means the settlor, the trustee, the protector (if any), the beneficiaries and any other persons exercising ultimate control over the trust.

## Illustrations

The following basic illustrations are intended to illustrate the operation of the CRS. In each illustration, if the relevant individual were a US person, then the reporting would ultimately be made to the IRS under FATCA.

### *Illustration 1*

An individual is resident in a CRS Participating Jurisdiction, such as Italy, and has a bank account in another CRS Participating Jurisdiction, such as Jersey. The bank, being a Financial Institution, reports information about the account annually to the Jersey tax authority which then forwards that information to the Italian tax authority.

### *Illustration 2*

The same fact pattern as Illustration 1, except the owner of the bank account is a Jersey company which is a Non-Financial Entity and it has Controlling Persons (e.g. individual shareholders) who are resident in Italy. In that case, the company would have to provide details of those Controlling Persons to the bank as the Financial Institution and that information would then be annually reported and forwarded in the same way.

### *Illustration 3*

All of the shares in a BVI incorporated company are beneficially owned by an individual who is a UK resident (the UK being a CRS Participating Jurisdiction). If the company is classified as a Financial Institution, then the company would be obliged to report annually to the BVI tax authority the existence and value of the shares in the company (i.e. the Financial Account held by the individual) and the details of the individual. The BVI tax authority would then pass on that information to the UK tax authority, i.e. HMRC.

### *Illustration 4*

A trust has a Cayman resident professional trustee and is classified as a Financial Institution. The trustee would be obliged to make annual CRS reports in respect of the settlor, any person exercising 'ultimate effective control' over the trust and any beneficiaries having a fixed entitlement in the trust and any beneficiaries who receive discretionary distributions. Those reports would ultimately be received by the tax authorities in the place of residence of the relevant individuals if they are resident in CRS Participating Jurisdictions.

### *Illustration 5*

A trust has a Guernsey resident trustee but fails the Gross Income Test and is classified as a Passive Non-Financial Entity. The trust has a bank account with a Guernsey Financial Institution. The Guernsey Financial Institution would be obliged, on an annual basis, to report the value of the bank account together with the Controlling Persons of the trust to the Guernsey tax authority which would then forward those reports to the relevant CRS Participating Jurisdictions.

## Contacts

A full list of contacts specialising in International Trusts and Private Client law can be found [here](#).

This guide is only intended to give a summary and general overview of the subject matter. It is not intended to be comprehensive and does not constitute, and should not be taken to be, legal advice. If you would like legal advice or further information on any issue raised by this guide, please get in touch with one of your usual contacts. You can find out more about us, and access our legal and regulatory notices at [mourant.com](https://www.mourant.com). © 2024 MOURANT ALL RIGHTS RESERVED