# Changes to the CRA's FATCA/CRS guidance for financial accounts held by trusts

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Canadian financial institutions (FIs) are subject to the due diligence and reporting obligations in Part XVIII (FATCA) and Part XIX (CRS) of the *Income Tax Act* (Canada).

With respect to a financial account of a trust that is a non-financial foreign entity for FATCA or a non-financial entity for CRS (a trust), an FI must report the particular account on its FATCA information return or CRS information return if the trust has one or more "controlling persons" that are either (i) a citizen of the United States or (ii) a tax resident of a jurisdiction other than Canada. Controlling persons of a trust include its settlor, trustee, protector (if any), beneficiary and any other natural person exercising ultimate effective control over the trust.

The Canada Revenue Agency (CRA) recently announced important new administrative positions affecting FATCA and CRS compliance in respect of financial accounts held by trusts. These new administrative positions were announced by CRA through the following:

- CRA's *Guidance on the Canada-U.S. Enhanced Tax Information Exchange Agreement* (the FATCA Guidance) and *Guidance on the Common Reporting Standard* (the CRS Guidance), which were recently amended on March 10, 2022; or
- Oral responses provided by CRA officials at the roundtable discussion at the Canadian Tax Foundation's annual conference held in Toronto on November 29, 2022 (the November 2022 Roundtable).

## What you need to know

- CRA recently amended its administrative position for financial accounts held by trusts in the following ways:
  - For the purposes of both FATCA and CRS, FIs are required to apply enhanced procedures to identify when distributions are made to discretionary beneficiaries of a trust;
  - For the purposes of CRS, CRA has adopted the Organization for Economic Co-operation and Development's (the OECD) broad interpretation of an "indirect distribution". This broad interpretation expands the situations in

which a discretionary beneficiary is considered to have received a distribution from the trust such that they would be considered a controlling person of the trust; and
    - For the purposes of CRS, CRA has adopted the OECD's expanded definition of a trust's "controlling persons" to include not just the trust's settlor, but also any other person that makes a significant contribution to the trust after it has already been settled.
- CRA's new administrative positions do not apply equally to FATCA and CRS. Accordingly, FIs must be mindful of these differences when considering their obligations under the separate compliance regimes.
- The newly announced administrative positions are already in effect, therefore, FIs should ensure that their compliance manuals and internal procedures are updated as soon as possible to reflect these changes.

# New administrative positions for financial accounts of trusts

## FATCA & CRS: Enhanced procedures to identify discretionary beneficiaries

A discretionary beneficiary is only considered a controlling person of a trust in the calendar year in which they receive a distribution from the trust. Accordingly, a trust that has discretionary beneficiaries may have different controlling persons from one year to the next depending on whether a distribution is made to the discretionary beneficiary in the particular year.

As mentioned in our previous article, Latest FATCA/CRS Guidance: What Canadian financial institutions need to know, CRA amended the FATCA Guidance and CRS Guidance on March 10, 2022. The revised FATCA Guidance and CRS Guidance require FIs to have appropriate procedures in place to ensure they are notified when a distribution is made to a discretionary beneficiary of the trust in a given year to enable the trustee to disclose such beneficiary as a controlling person. Examples of such procedures include:

- The FI seeks annual refreshment of the self-certification (*i.e.,* the trustee is required to re-certify whether any members of the class of beneficiaries who have received distributions since the previous certification are discretionary beneficiaries); or
- The FI requires the trustee, as a condition of holding the account and on an as needed and a timely basis, to provide a new certification when the trustee has made or will make a distribution to a discretionary beneficiary (*e.g.,* this condition may be included in the account opening documents).

## CRS: Meaning of "indirect distribution"

CRA has always taken the position that a "beneficiary" of a trust for both FATCA and CRS is any person that (i) has the right to receive, directly or indirectly, a mandatory distribution or (ii) receives, directly or indirectly, a discretionary distribution from the trust. This means that a discretionary beneficiary may be considered a controlling person of the trust for calendar years in which they received an "indirect distribution"

from the trust. However, until the November 2022 Roundtable, CRA had not provided any guidance on what an "indirect distribution" means.

At the November 2022 Roundtable, CRA indicated that the meaning of "indirect distribution" for purposes of CRS may be inferred from the following comment made by the OECD in a " frequently asked questions" document posted to the OECD's website (the FAQ Website):

> Indirect distributions by a trust may arise when the trust makes payments to a third party for the benefit of another person. For example, instances where a trust **pays the tuition fees** or **repays a loan taken up by another person** are to be considered indirect distributions by the trust. Indirect distributions also include cases where the trust grants a **loan free of interest or at an interest rate lower than the market interest rate or at other non-arm's length conditions**. In addition, the **write-off of a loan** granted by a trust to its beneficiary constitutes an indirect distribution in the year the loan is written-off [emphasis added].

This administrative position means that CRA is taking a much broader view on the scenarios in which a discretionary beneficiary is considered a controlling person of the trust under CRS. This is because the discretionary beneficiary may be considered to have received a distribution if the trust acted in *any* manner that provided *any* form of economic benefit to the beneficiary (even if the beneficiary never received anything directly from the trust).

However, CRA's administrative position may not necessarily be correct at law. More specifically, CRA may be incorrect on its interpretation of "indirect distribution" for CRS for two reasons:

- CRA asserts that its new administrative position is correct because subsection 270(2) of the *Income Tax Act* (Canada) requires the interpretation of "controlling persons" to be consistent with the OECD guidance on this point unless the context specifies otherwise. However, the statutory provision actually requires the interpretation of "controlling persons" to be consistent with the OECD's *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (the OECD Standard) unless the context specifies otherwise. Since CRA's administrative position relies on the FAQ Website (as opposed to the OECD Standard), CRA's new administrative position may not be correct at law considering the requirements of subsection 270(2).
- In *Canada v Alta Energy Luxembourg S.A.R.L.*, the Supreme Court of Canada held that OECD commentary issued *after* the date Canada agreed to the OECD Standard may not be relevant to the Canadian interpretation of the OECD Standard. This is because the Canadian government may not have agreed to the subsequent interpretation at the time it signed onto the OECD Standard. Since the FAQ Website was published in February 2019 (many years after the Canadian government agreed to the OECD Standard), CRA's new administrative position may not be correct.

As discussed above, CRA appears to take the position that its broad interpretation of "indirect distribution" applies only to CRS and not FATCA. This appears to be legally correct, since there is no statutory obligation that requires FATCA to be interpreted in the same manner as CRS. In other words, OECD commentary on CRS should not

affect the interpretation of FATCA, since CRS and FATCA are separate regimes, which may impose different obligations on FIs. Accordingly, CRA's new administrative position results in an inconsistency between FATCA and CRS on the proper interpretation of "indirect distribution", thereby creating a discrepancy between FATCA and CRS on whether a discretionary beneficiary received a distribution in a calendar year such that they are a controlling person for that particular year. Accordingly, CRA has left an important question unanswered – since the OECD commentary only applies to "indirect distributions" for CRS purposes, how is the same term interpreted when used in the FATCA context?

### CRS: Expanded meaning of "settlor"

For certain trusts, the named settlor (the Legal Settlor) contributes a nominal amount to the trust on its creation, but another person (the Pseudo Settlor) subsequently makes a substantive contribution of assets to the trust.

At the November 2022 Roundtable, CRA stated that both the Legal Settlor and Pseudo Settlor may be controlling persons of the trust for purposes of CRS. CRA's position relies on the fact that the statutory definition of "controlling persons" for CRS is *non-exhaustive*, thus a Pseudo Settlor may still be a controlling person even though the statutory definition does not mention Pseudo Settlors.

CRA's position that Pseudo Settlors may be a controlling person of a trust is limited to CRS only. The decision not to extend this administrative position to FATCA is likely because FATCA has an *exhaustive* definition for a trust's controlling persons that does not include Pseudo Settlors.

## Action steps for FIs & How BLG can help

As mentioned in our previous article, Winter and FATCA/CRS audits are coming for financial institutions, CRA expects to begin on-site audits of FIs for purposes of assessing FATCA and CRS compliance very soon. A significant element of these audits will involve reviewing the FI's FATCA and CRS policies. It is important that FIs update their policies and procedures to ensure that they align with CRA's most recent administrative positions, including those applicable to financial accounts of trusts that are discussed in this bulletin. In particular, FIs must ensure their FATCA and CRS policies are amended to encompass the additional procedures for detecting distributions to discretionary beneficiaries.

As discussed above, FIs have some flexibility in choosing the additional procedures that they will use to detect when distributions are made to discretionary beneficiaries. FIs that wish to adopt additional procedures in the form of amended account agreements should update their account agreements as quickly as possible to ensure any new financial accounts opened by trusts are compliant with CRA's new administrative position. FIs adopting this approach must also carefully consider how account agreements with existing account holders will be amended.

Furthermore, CRA's new administrative position on indirect distributions and Pseudo Settlors may result in trustees having to consider different factors when determining the trust's controlling persons under each of FATCA and CRS. FIs may consider developing

two separate self-certification forms for financial accounts held by trusts: one for determining the account holder's FATCA status and another for determining the account holder's CRS status. Alternatively, FIs that wish to use a single self-certification form to satisfy their due diligence obligation under each of FATCA and CRS should consider amending the combined self-certification form to add further instructions that clearly address the different considerations for determining a trust's controlling persons under each of FATCA and CRS.

If you would like to discuss how your organization may operationalize the changes applicable to financial accounts held by trusts, or if you would like assistance with revising your organization's FATCA and CRS policies in preparation for upcoming CRA audits, please don't hesitate to contact any of the authors or key contacts below.

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