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U.S. pension plans may face unwarranted obligations to disclose controlling persons to fund managers and other non-U.S. financial institutions under rules implementing the common reporting standard (CRS) that would not be imposed on similarly structured pension plans in so-called participating jurisdictions. In this article, the author discusses how to revise CRS guidance to make disclosure obligations consistent for all pension plans, whether or not organized in a jurisdiction that participates in the CRS regime.

It is generally accepted that pension plans pose little risk of tax evasion, which is why they are often exempted from reporting obligations under the OECD's common reporting standard (CRS) and similar rules under the U.S. Foreign Account Tax Compliance Act. Yet under CRS guidance, U.S. pension plans may face unwarranted obligations to disclose controlling persons to fund managers and other non-U.S. financial institutions that would not be imposed on similarly structured pension plans in participating jurisdictions. CRS guidance should be revised to make disclosure obligations consistent for all pension plans, regardless of whether they are organized in a jurisdiction that participates in the CRS regime.

Background

CRS is an international framework for the automatic exchange of financial information among jurisdictions to prevent tax evasion. More than 90 jurisdictions have either taken steps to implement CRS or have committed to doing so. Those participating jurisdictions include states popular among investment fund managers for organizing fund vehicles, such as the Cayman Islands, the British Virgin Islands, Guernsey, and Jersey. The United States is not a participating jurisdiction.

Under CRS, financial institutions (FIs) in participating jurisdictions that are not exempt from reporting obligations (referred to as "reporting FIs") are required to perform diligence regarding their account holders (and for investment funds, their investors) to determine which accounts and fund interests are reportable accounts that must be disclosed to the participating jurisdiction in which the reporting FI is subject to reporting. Some FIs, such as specific types of pension plans and government entities, are exempt from treatment as a reporting FI because they present a low risk of being used for evading tax. Participating jurisdictions receiving information from reporting FIs will then share that information with other participating jurisdictions based on the residence of the reported owner of assets. For example, if the Cayman Islands receives information regarding Reportable Person A — a resident of Country Z, a participating jurisdiction — and his financial asset holdings in the Cayman Islands, the Cayman Islands will report that information to Z. Broader information reporting is made if a reportable person is identified as having more than one jurisdiction of residence. Thus, the CRS regime allows each participating jurisdiction to obtain information regarding the financial asset holdings of some of its residents elsewhere in the world.

Because the United States is not a participating jurisdiction, a reporting FI would not be required to report information regarding financial accounts held by U.S. persons.

A reportable account (which may include interests in investment funds) is one held by a person resident in a participating CRS jurisdiction (a reportable person). However, reportable accounts do not include those held by publicly traded corporations or specific affiliates of those corporations, governmental entities, international organizations, central banks, or FIs. For CRS purposes, FIs include custodial institutions, depository institutions, investment entities, and specified insurance companies.[1] An entity is classified as an investment entity if it meets one of two tests. Under the first test, an entity is an investment entity if it primarily 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, foreign exchange, commodities, and so forth;
- individual and collective portfolio management; or
- otherwise investing, administering, or managing financial assets or money on behalf of other persons.

Under the second test, an entity is an investment entity if it is managed by another FI and its gross income is primarily attributable to investing, reinvesting, or trading financial assets. For those tests, an entity is treated as primarily conducting as a business one or more of the activities above, or its gross income is primarily attributable to investing, reinvesting, or trading in financial assets, if the gross income attributable to the relevant activities is at least 50 percent of the entity's gross income during a specified period (very generally, the shorter of the entity's existence or three years). An entity is managed by another if the managing FI directly or indirectly performs the investment activities described above and has discretionary authority to manage the managed entity's assets (in whole or in part).

A reportable account also includes a financial account held by a passive nonfinancial entity (NFE) with one or more controlling persons that are reportable persons. A passive NFE includes an investment entity that is managed by another FI and is not resident in a participating jurisdiction. An investment entity resident in a nonparticipating jurisdiction that is managed by a FI is not treated as an FI but rather as a passive NFE that will be required to disclose controlling person information to the FI where it holds an account.

U.S. Pension Plans as FIs or Passive NFEs?

Under CRS, the typical pension plan likely would be treated as an FI, and would generally fall in the nonreporting financial institution (NRFI) subcategory. NRFIs include:

- government entities, international organizations, or central banks;
- pension funds having specific characteristics;
- entities presenting a low risk of being used to evade tax that are defined in domestic law as an NRFI, if the entity's status as an NRFI does not frustrate the purposes of the CRS;
- an exempt collective investment vehicle; and
- a trust, if the trustee is a reporting FI and reports all required information for all reportable accounts of the trust.

For those purposes, a government entity includes a political subdivision of a jurisdiction and any wholly owned agency or instrumentality, as well as integral parts (such as any agency with governing authority) and entities that are wholly owned and controlled by a government entity.

Pension funds considered NRFIs include pension funds of government entities, as well as:

- Broad participation funds, which are established to provide retirement, disability, or death benefits to current or former employees (provided no one has a 5 percent interest), as long as it reports to its tax authority and is subject to local regulations. Other requirements include that the fund: (i) must generally be exempt from tax on investment income because of its status as a retirement or pension plan; (ii) must receive

[1] The typical private equity or hedge fund would be considered an investment entity and thus an FI for that purpose.

50 percent of contributions from the sponsoring employers; (iii) must allow distributions or withdrawals only if specified events (such as retirement, disability, or death) occur; or (iv) contributions by employees cannot exceed $50,000 annually.
- Narrow participation funds, which are established to provide retirement, disability, or death benefits if: (i) the fund has fewer than 50 participants; (ii) the sponsoring employer is not an investment entity or passive NFE; (iii) employer and employee contributions are limited by reference to the employee's earned income and compensation; (iv) participants not resident in the jurisdiction where the fund is established are not entitled to more than 20 percent of the fund's assets; and (v) the fund is subject to governmental regulations and reports information to the tax authorities.

NRFI status asks whether the institution is required to undertake diligence for its investors or account holders and report information regarding those persons to the tax authorities. From the perspective of a reporting FI (such as an investment fund) gathering information concerning its own investors or account holders, there is no practical difference between a regular reporting FI and an NRFI. From the reporting investment fund's perspective, if an investor is an FI, the only thing that must be determined is whether the investor is a regular FI or a passive NFE. If the investor is not a passive NFE, no reporting or additional diligence is required. That makes sense, because if the investor is a reporting FI, it will do its own reporting on its investors or account holders and controlling persons, which avoids duplicative reporting. There is no diligence or reporting for NRFIs because the OECD has determined that those entities present a sufficiently low risk of tax evasion. Many self-certification forms requested by FIs ask whether an institution is an NRFI or not. Because reporting FI status and NRFI status result in the same reporting outcome for an investor, forms that request NRFI status technically request more information than needed to satisfy the FI's diligence and reporting obligations.

While it is reasonably clear that a pension fund organized in a participating jurisdiction is generally an NRFI and not automatically a passive NFE, the same is not true of pension funds in nonparticipating jurisdictions such as the United States. As noted, under CRS, an investment entity in a nonparticipating jurisdiction that is managed by an FI is automatically treated as a passive NFE. Thus, it is possible that a U.S. pension fund could be both an NRFI and passive NFE, depending on how its investments are handled. Those multiple potentially applicable categories create confusion when an investment fund or other non-U.S. FI asks a U.S. pension fund to complete a self-certification form and choose from several possible selections.

The regular FI category is far preferable from the pension plan's perspective, because it eliminates unnecessary disclosure of controlling person information to the investment fund or FI on the certification form, as would be required if the passive NFE category were selected. However, if the choice involving less disclosure is selected (FI or NRFI), the U.S. pension plan risks being viewed as having incorrectly completed the form and potentially breaching applicable representations in the fund subscription agreement or other application form if it doesn't select the passive NFE category. A better reading of the CRS guidance appears to be that a U.S. pension plan is an FI in its own right based on its own investment activities on behalf of its beneficiaries (regardless of whether it is externally managed) and because the managed by category of FIs seems intended to apply to entities that would not otherwise be treated as FIs. Moreover, treating a U.S. pension plan as an FI other than as managed by an FI places it on equal footing with non-U.S. pension plans in participating jurisdictions. Even so, the lack of clarity in the rules presents a dilemma for U.S. pension plans in completing forms.

U.S. Pension Plans as Managed by FIs

As noted, there are two tests for determining whether an entity is an investment entity and thus an FI for CRS purposes. As a result of their investment activities on behalf of plan beneficiaries, U.S. pension plans generally would be treated as investment entities and therefore as FIs (commonly referred to as Type 1 investment entities). They may also qualify as managed by investment entities (or Type 2 investment entities) if outside discretionary asset management expertise is used and therefore could potentially be treated as passive NFEs. If both tests are met — as a result of both the plan's own business activities and outside discretionary management — it is unclear whether the pension plan can certify that it is an FI in its own right despite using outside discretionary management services or whether the external discretionary management automatically triggers Type 2 status.

As discussed, under CRS guidance, an entity is managed by an FI if that FI has discretionary authority to manage the assets of the entity in whole or part. The CRS guidance does not clarify what amount of assets an asset manager must have discretionary authority over to result in the pension plan becoming managed by the manager. It appears that a manager having discretionary authority over a single dollar will result in the pension plan becoming a managed by investment entity and therefore a passive NFE. Many pension plans grant discretionary authority over plan assets to outside asset managers to varying extents. However, only U.S. pension plans may be treated as managed by investment entities that would be classified as passive NFEs under CRS rules, whereas their non-U.S. counterparts would simply be treated as NRFIs with no further disclosure required.

Purpose of Passive NFE Status

The passive NFE category was designed to include investment vehicles that are established not for the benefit of fee-paying customers (as is the case with a private equity or hedge fund vehicle) but for the convenience of the owner of the assets that would otherwise personally hold and manage those investments outside the vehicle. The classic example of an entity falling in the passive NFE category is the family office, which is typically used to hold and manage investment assets and to serve as a tax planning vehicle for high-net-worth individuals and families. It is understandable why controlling person information on those entities would be useful to tax authorities.

The CRS Implementation Handbook mentions passive NFEs as a type of entity that poses a greater risk of tax evasion, so information regarding the controlling persons behind those entities may be of use to participating jurisdictions where those persons reside. Because the United States is not a party to CRS, the passive NFE category may also capture the typical U.S.-based private equity fund that uses an investment manager to manage the fund's investments.

Disclosure of Controlling Persons

If a U.S.-based pension plan grants discretionary management authority to an outside manager, it might be treated as a passive NFE and thus required to disclose controlling person information on its self-certification form. That creates two types of burdens on pension plans. First, controlling persons of such U.S. pension plans are often U.S. citizens, and because the United States is not a party to CRS, any non-U.S. FI receiving U.S. controlling person information is not required to report that information to its home jurisdiction because that jurisdiction will not be reporting that information to the United States. Thus, the disclosure of detailed information regarding the pension fund's U.S. controlling persons ultimately serves no purpose.

Second, many U.S. pension plans are organized as trusts, which are treated differently from other entities under the CRS controlling person disclosure rules. Those rules define a controlling person as a settlor, trustee, protector, beneficiary (if natural persons), and any other natural person with effective control over the trust. That definition could be read to include the trustees of the pension fund in question, various other persons involved in establishing the trust, and the plan beneficiaries on whose behalf the fund holds assets, thus potentially requiring disclosure of information regarding hundreds or even thousands of persons — the identities of which might change constantly. That would place great strain on U.S. pension plans that deploy capital in various investment funds throughout the year.

For a U.S. pension plan, that disclosure generally does not serve any anti-tax-evasion purpose because the vast majority of persons whose disclosure would be required would be U.S. persons whose information would not be exchanged with the United States under CRS. Further, U.S. pension plans (like their non-U.S. counterparts) generally do not pose a risk of tax evasion.[2] Obligating U.S. pension plans (which would generally be treated as NRFIs) to disclose controlling person information is also inconsistent with the point of disclosure by passive NFEs, in that the disclosure is a means to force disclosure of persons holding assets via non-FIs that potentially pose a risk of tax evasion. Treating an NRFI as a passive NFE solely because that NRFI is in a nonparticipating jurisdiction makes little sense because NRFIs have been exempted from reporting, so disclosing controlling person information by those institutions does not help meet anti-tax-evasion goals.

Further, the consequences of disclosure are mainly negative. First, that disclosure involves significant time and expense. There is also a concern regarding disclosure of private data with no specific standards for safeguarding that information. Finally, clearer rules will permit FIs and other parties requesting that information to be assured that no further information or documentation is required from that kind of account holder.

The potential disclosure obligation under CRS may be contrasted with the obligations of non-U.S. retirement funds under FATCA. Under FATCA, those funds that qualify as exempt beneficial owners are exempt from FATCA withholding and reporting obligations and are not required to disclose controlling person information to an FI or other party requesting the plan's FATCA classification. Treasury regulations under IRC section 1471(f)(4) treat those retirement funds as exempt from withholding and reporting on the basis that they pose a low risk of tax evasion. That a non-U.S. retirement fund might have some or all of its assets professionally managed by an outside discretionary manager does not cause it to lose its exempt beneficial owner status.

Similarly, U.S. retirement or other pension funds that meet similar requirements should be deemed exempt from CRS disclosure obligations because they pose a low risk of tax evasion. Perhaps the most straightforward way to accomplish that result is to carve out from the CRS definition of passive NFE any retirement fund or other pension plan organized in a nonparticipating jurisdiction that would be treated as an NRFI if organized in a participating jurisdiction, regardless of how its assets are managed. That would actually make a difference to the investment fund or other FI requesting a self-certification form if an investor or account holder indicated it is an NRFI (as opposed to the current state of affairs, with NRFI status meaning nothing to the requesting FI). To further clarify the exclusion, the OECD's standardized self-certification forms should provide that plans excluded from the passive NFE category should not select the managed by investment entity category but should instead select the other FI category, or otherwise be treated as an NRFI.

Conclusion

There is no principled reason why a pension or other similar benefit plan located in the United States or other nonparticipating jurisdiction should be treated as a passive NFE and thus required to disclose controlling person information solely because it uses outside discretionary management of its assets when its counterpart in a participating jurisdiction would not be treated that way. Excluding those entities from passive NFE status provides certainty to plan administrators (and counsel) that self-certification forms provided to a requestor will be accurate and not give rise to misrepresentation claims. ■

[2] The CRS permits, but does not require, an FI to complete diligence and report information to its home state if that state is not required to report the information (for example, because the controlling person is located in a nonparticipating jurisdiction). That appears to be the case even if that nonparticipating jurisdiction becomes a participating jurisdiction. That keeps FIs from having to go back and do diligence or report information on controlling persons in nonparticipating jurisdictions.