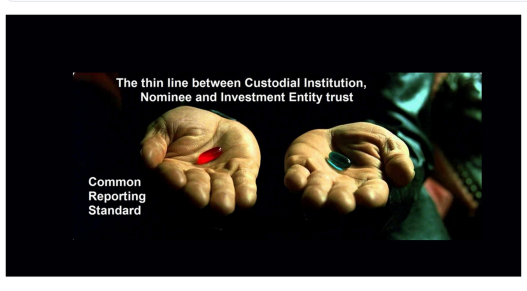

If an entity owns a Passive NFE and collects the dividends, is it a Custodial Institution, Investment Entity, Passive NFE or a Nominee?

Mark Morris
CRS and CARF expert. No, truly.

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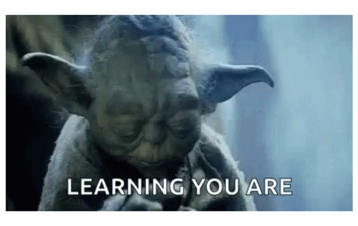
Puzzling Issues

- Much confusion there is, regarding CRS and what the custodial account of a Custodial Institution is.
- The Custodial Institution is the FI that is insufficiently covered by CRS Commentary and its Guidelines and the OECD CRS-related FAQ.
- The OECD FAQ update at the end of February 2019 briefly explains the income test with payments to third parties for services of Special Purpose Vehicle Custodians. This indeed adds fuel to the WTF factor.
- This leads me to cover:

(a) How the custody income test accounts for a custodian earning significant financial income from the assets it holds, and

(b) Whether a custody account exists if the entity must (i) immediately distribute the assets/income it collects, or (ii) there are conditions where the Custodian will never distribute the income/assets.

Unsurprisingly, it matters whether the entity is a Custodial Institution or not



If an entity holds financial assets, which includes shares in a Passive NFE subsidiary, for the account of others, is the entity a Custodial Institution, a Nominee or an Investment Entity?

- What's the difference, everything gets reported in the end?
- Err no, not that simple. This is important because CRS treats the reporting in radically different ways.

1. As a **Nominee**, the reporting FI uses AML to identify for whom the account is being held and if its an entity, the Controlling Persons
2. As a **participating jurisdiction Investment Entity trust** the entity must report on its Account Holders including beneficiaries with distributions, settlor, protector, debt interest, etc.
3. If it's a **non-participating jurisdiction Investment Entity**, then the FI maintaining the trust's assets reports on the Account Holders including beneficiaries regardless of distribution but not on debt interest.
4. As a **participating jurisdiction Custodial Institution** the entity reports on whose behalf the account is kept.

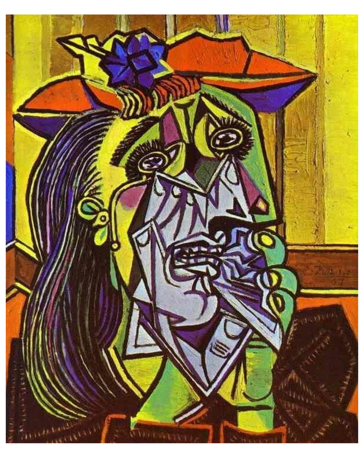
5. If it's a non-participating CI, no reporting takes place

A. Custodial Institution

Custodian Income

- Note that the CRS income test for a Custodial Institution concerns income it earns for itself, and **not for the account of others**. This may be misunderstood. A Custodial Institution holds financial assets on account of others but will collect financial income generated from the assets held. The custodial earnings test is that at least 20% of its gross income is from custody-like fees.
- **Attention**: do not include in the Custodial Institution gross income what the Custodial Institution collects for the account of others. The custody-like fees for the income test are:

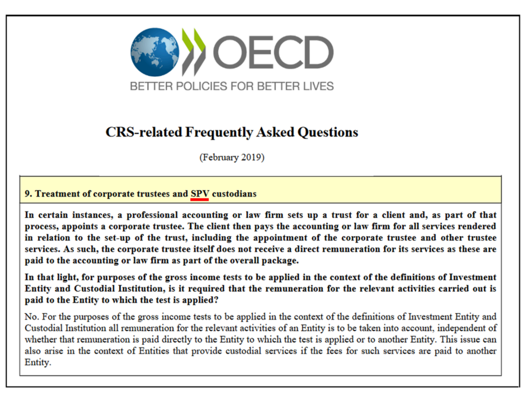
1. Custody, account maintenance, and transfer fees
2. Commissions and fees earned from executing and pricing securities transactions concerning Financial Assets held in custody
3. Income earned from extending credit to customers concerning Financial Assets held in custody (or acquired through such extension of credit)
4. Income earned on the bid-ask spread of Financial Assets held in custody
5. **Fees for providing financial advice concerning Financial Assets held in (or potentially to be held in) custody by the entity** ⬅
6. For clearance and settlement services.



WTF: Note the weird fee ⬅ for pt. 5: Financial advice on assets that potentially be may held??

Fees paid to third parties - must these be related entities?

- This topic is covered in detail in several articles I published and covers various countries ignoring the OECD CRS FAQ *(Cyprus, Hong Kong, Ghana, New Zealand, Australia, Saudia Arabia, Canada, and Mauritius)*
- The OECD CRS FAQ 2019 page 14 Q.9 update refers to these fees paid to any other entity for the relevant activities, can be taken into account for the 20% income test.



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CRS-related Frequently Asked Questions

(February 2019)

9. Treatment of corporate trustees and SPV custodians

In certain instances, a professional accounting or law firm sets up a trust for a client and, as part of that process, appoints a corporate trustee. The client then pays the accounting or law firm for all services rendered in relation to the set-up of the trust, including the appointment of the corporate trustee and other trustee services. As such, the corporate trustee itself does not receive a direct remuneration for its services as these are paid to the accounting or law firm as part of the overall package.

In that light, for purposes of the gross income tests to be applied in the context of the definitions of Investment Entity and Custodial Institution, is it required that the remuneration for the relevant activities carried out is paid to the Entity to which the test is applied?

No. For the purposes of the gross income tests to be applied in the context of the definitions of Investment Entity and Custodial Institution all remuneration for the relevant activities of an Entity is to be taken into account, independent of whether that remuneration is paid directly to the Entity to which the test is applied or to another Entity. This issue can also arise in the context of Entities that provide custodial services if the fees for such services are paid to another Entity.

Paid for remuneration for the relevant activities independent of whether that remuneration is paid directly to the entity to which the test is applied or to another entity.

- In contrast, HMRC guidelines says to take into account payments made to ***related*** parties. But ***related*** is not defined.
- One envisages Custodial Institutions as regulated entities such as stock brokers or distributors that hold legal title to assets on behalf of customers and are part of the legal chain of ownership of interests in say Collective Investment Schemes.
- However, for the first time in dealing with Custodial Institutions, the OECD uses the term "**Special Purpose Vehicle Custodians**".
- This means any **regulated** or ***unregulated*** entity will qualify as a Custodial Institution (Except Canada which requires any FI to be regulated an listed) if (a) it is an entity including trusts, (b) holds financial assets on account of others, and (c) earns a substantial proportion of its income from custody-like fees.

B. Nominee

- A corporate nominee is a company which holds and administers securities or other assets as the registered owner on behalf of an actual owner. The OECD is serious in tackling the abuse of agents and mentions 'nominee' twelve times in the CRS e.g. *page 60 paragraph (E)(1) ... the nominee, if its not an FI, is **NOT** regarded as the account holder, but on behalf of the benefit of such **other person**'s is treated as holding the account.*
- Amazingly, the use of nominees to hide *other persons* continues in some tax havens.
- However, with some minor financial engineering, hey presto, a nominee is converted into a holding ann account for a non reportable Custodial Institution.
- Note the nominee entity charges custody-like fees for at least 20% of its income, it becomes a Custodial Financial Institution.

If the CI is located in a non-participating jurisdiction

C. Investment Entity trust

HMRC guidelines are useful regarding when trusts are Custodial Institutions.

> Where a trust meets one of the definitions for being a Financial Institution it is most likely to be an Investment Entity but it may, alternatively, meet the requirements for being a Custodial Institution.

> For example, shares held in trust may be in a Custodial Account and therefore subject to reporting by the trust as the Custodial Institution that holds the account. This may be the case where a trust such as an Employee Benefit Trust continues to hold financial assets, such as shares, for an employee after they have been granted.

> Where an Employee Benefit Trust holds shares for the future benefit of employees, but the shares are not allocated, then under most circumstances this right to a future allocation would not be a custodial account.

> Similarly, when shares are allocated and the trustee is directed to transfer the assets as soon as reasonably possible to the beneficiary, a broker, a custodian, etc., then the trust will not be treated as maintaining a financial account for the duration of time it takes to complete the transfer.

Talking to kindergarteners, if an entity must immediately distribute the assets it receives, then the entity does not maintain a custodial account for others.

- If the entity keeps assets for future unnamed allocation, then again, it does not maintain a custodial account.
- If an entity keeps assets on behalf of a named beneficiary, then it maintains a custodial account. If an entity keeps assets for someone else and immediately distributes the income generated by those assets then the income test will determine if it's a Custodial Institution or Investment Entity.
- E.g. if a trust maintains financial accounts for a child until a certain age, then that is a custodial account. However, the trust will only be a custodial institution if it passes the 20% income test. Not easy to follow, I know.

The confusing substantial portion income test

- The custodial's gross income attributable to holding of financial assets must be at least 20%. So, are the dividends collected by the entity part of the 20% income test? If so, the entity is unlikely to meet the 20% test for a Custodial Institution. Dividend income should be excluded from the custodial test if the entity is directed to transfer the dividend income as soon as reasonably possible to the beneficiary.
- This is the same as the HMRC guidelines asserting that assets collected and transferred to beneficiaries are not held in a custody account.
- Also, if the trustee has the discretion to decide who and when the dividends received are to be distributed, then obviously the trust is not maintaining a financial account for others and the trust will not be a Custodial Institution.
- Where a foundation, such as a Dutch STAK is holding assets on behalf of Depositary Receipt holders, then the foundation is indeed a Custodial Institution as it must distribute the dividends. to the Depositary Receipt holders.

D. Passive NFE

The company holding the Passive NFE is a itself a Passive NFE if:

- More than 50% of its income is derived from the fividends of its Passive NFE
- More than 50% of its assets is held for the production of passive income.
- If the cash (which is not a Financial Asset) is held for purposes other than to generate passive income, such as to buy a business, buy equipment then the entity fa ils the asset test to qualify as a Passive NFE.
- Note, the 2024 update to the OECD CRS-related FAQ confirms cash is not a financial asset

- The 2019 OECD FAQ also reminded that although cash does not earn interest, such as zero interest bonds or deposits, it is still regarded as being held for the purposes of producing passive income, and as such the cash is meets the Passive NFE asset test.

Summary

A trust which holds financial assets for the account of others, then:

1. It is **NOT** a Custodial Institution if the financial income and assets it collects are to be allocated immediately to a beneficiary. This is because it does not keep the financial assets and hence does not keep accounts for others.
2. It is a Custodial Institution if it keeps the shares of a subsidiary for the benefit of others, whether it distributes the dividends or not. Note the dividends it receives is not for its account and therefore dividends are not included in the 20% custodial income test.

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