ACTEC COMMENTS ON POTENTIAL REVISIONS OF RECOMMENDATION 25 –

AREA OF FOCUS FOR PRIVATE SECTOR ENGAGEMENT

[Sent via email to tanna.chong@fatf-gafi.org.]

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit the comments below relating to FATF's review of R.25 of the FATF Recommendations in relation to beneficial ownership of legal arrangements. These comments are submitted as a supplement to oral comments provided by ACTEC's representative, Carolyn A. Reers, during the Private Sector Consultation Meeting that was held via Zoom on 12 November 2021.

ACTEC is a professional organization of approximately 2,400 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and generation-skipping transfer tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

ACTEC commends the FATF for seeking comments from stakeholders, including designated non-financial businesses and professions (DNFBPs) to better meet its stated objective of preventing the misuse of legal arrangements for money laundering or terrorist financing. ACTEC has chosen to limit its comments to those questions posed in its paper entitled "Private Sector Engagement Areas of Focus - R25 Review" that ACTEC believes are most closely related to the purposes and mission of ACTEC, and the situations in which ACTEC Fellows are most frequently involved with their clients.

I. Definition of Legal Arrangements in Common/Civil Law Systems

2. What are key challenges with understanding the nature/structure of common law express trusts and civil law legal arrangements?

One of the primary challenges to understanding the nature/structure of common law express trusts and civil law legal arrangements is finding standard, shared characteristics between them at all. A fundamental principle of creating a trust is the separation of legal title and control over assets placed in a trust from the creator of the trust, called the "settlor" or "grantor". Once placed "in trust", it is the trustee who thereafter holds legal title to the assets and holds the power and responsibility of managing, investing and distributing those assets solely on account of the trust beneficiaries. There are many civil law legal arrangements that share characteristics of trusts, for example, a Mexican fideicomiso where title to property is held by a Mexican bank, but they are not trusts because the assets still belong to the individual creating the fideicomiso. An anstalt is another example of a civil law arrangement where founders retain rights to assets owed by the entity and no separate "beneficiary" exists. These arrangements are effectively nominee agreements more properly governed by contract principles, and distinguishable from trusts where there is a separation of ownership and control between the settlor and the trustee, who owes legal duties to the trust beneficiaries rather than the settlor. Trusts are unique legal arrangements to which different compliance rules should apply.

The Hague Convention of 1985 on the Law Applicable to Trusts and their Recognition was implemented in order to provide signatory countries with a standard set of principles for recognizing trusts and determining certain key governance principles such as the identification of governing law and the authority of the trustee. It does not attempt to harmonize the different legal systems applicable to trusts. Article 2, however, does find common legal principles that define a trust. Specifically, it states:

> *For the purposes of this Convention, the term "trust" refers to the legal relationships created - inter vivos or on death - by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.*
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> *A trust has the following characteristics -*
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> *a) the assets constitute a separate fund and are not a part of the trustee's own estate;*
> *b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;*
> *c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.*

Note that the definition applies to the property construct of a trust and has no applicability to the taxation of trusts, which is regulated by a country's own, separate tax laws. For example, although many civil law countries (e.g., Italy, Spain, France) do not have a body of trust law (either by common law or code), their tax authorities have developed (and continue to develop) rules for the taxation of trusts.

Unlike other legal arrangements that can be understood and interpreted as more aligned to the laws of contracts (even though not constituted as a "regular" contractual relationship), trusts are uniquely characterized by the separation of ownership between the settlor and the trustee, and the legal duties that the trustee owes to the trust beneficiaries and not to the settlor.[1] For these reasons, trusts should be dealt with differently in the interpretation and application of R.25.

II. Beneficial Ownership Information of Legal Arrangements

4. What are key challenges with understanding and verifying who are beneficial owners in the context of trusts and other types of similar legal arrangements? How do the concepts of "ownership" and "control" apply with respect to trusts and other types

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[1] Although trust law sometimes allows for the settlor and the trustee to be the same individual during the settlor's lifetime, the separation of legal title and control still characterizes the arrangement and the duties of the trustee run solely to the beneficiaries of the trust, who may or may not include the settlor during his or her lifetime. To illustrate, in the United States, if the settlor creates a trust of which he is also the trustee but becomes incapacitated, the management and control of the trust assets pass under trust law to the next named trustee and do not revert to the settlor or require the intervention of a court to determine questions of management and control. Further, the beneficiaries remain as defined under the trust instrument.

of similar legal arrangements? How does this understanding of beneficial ownership differ from the understanding of beneficial ownership of legal persons (e.g., companies)?

A key challenge that exists with understanding who are beneficial owners in the context of trusts is that the legal person with "control" over the assets of a trust (i.e., the trustee) is not the same legal person whose assets were contributed to create the trust (i.e., the settlor or grantor). Further, the actual "beneficial interest" in the assets of a trust belongs solely to the beneficiaries named or described in the trust instrument; neither the settlor nor the trustee have any beneficial interest in the assets of a trust unless also named as a beneficiary of the trust.

A second key challenge is that "beneficial ownership" as a legal principle has become blurred by the use of this term in the context of international tax compliance. For example, the Foreign Account Tax Compliance Act ("FATCA") defines beneficial owner as "the person who is the owner of the income for tax purposes and who beneficially owns that income."[2] Although the Common Reporting Standard ("CRS") uses the term Controlling Person, whose definition corresponds to the term "beneficial owner" as described in FATF R.10 and the Interpretative Note on R.10 (i.e., the natural persons who own or control a customer, the natural person on whose behalf a transaction is being conducted, and those persons who exercise ultimate effective control through indirect means), CRS is a global initiative for the automatic exchange of financial information to fight tax evasion and improve tax compliance.

While these definitions have proven workable and practical for financial institutions conducting customer due diligence ("CDD") on trustees opening accounts for the trust assets they steward, they are impractical in the context of establishing a beneficial ownership standard for trusts in the context of combatting money laundering and terrorist financing. For example, it is common for trusts to name a class of beneficiaries (e.g., the descendants of the settlor) rather than a named beneficiary. The difficulty in applying beneficial ownership definitions to trusts is illustrated by the 25% threshold used to determine a "controlling owner" under R.10. If the beneficiaries are determined by reference to a class, and the trustee is given the discretion to distribute trust income and principal among the members of such class in such amounts and proportions as the trustee determines (this being by far the most common way to structure a modern trust), no beneficiary owns any particular percentage of the assts of the trust and the settlor has, by definition, relinquished ownership of the assets contributed to the trust in order to create the trust (regardless of whether such settlor remains subject to taxation related to the trust assets or income).

In other words, the definition of beneficial owner within the context of customer identity differs from that of the individuals entitled to a benefit from a trust at a time and manner determined by the trustee (i.e., the beneficiaries), and a different standard should apply for purposes of identifying the parties responsible for preventing the use of trusts for illegal means. Trust beneficiaries have no actual access or control over the assets held in a trust until the trustee says so. The proper responsible parties in the context of a trust are the trustee(s) and the protector (if any). Protectors are often named in modern trusts and a protector is typically charged with the duty of removing

[2] 26 C.F.R. §1.1441-1(c)(6)

and replacing a trustee. Since a protector has control over the identity of the trustee, this control position would warrant including such person with the trustee under a trust reporting standard.

5. What types of information are collected to establish beneficial ownership of trusts and other legal arrangements? What types of source documents could be used to establish the means and mechanism of control?

As described in Article 2 of the Hague Convention quoted above, trusts are legal arrangements whereby assets are placed under the control of a trustee for the benefit of one or more beneficiaries or for a specified purpose. This trust characteristic requires that the legal title to assets under the control of the trustee be placed in the name of the trustee. For example, a financial account in the name of a trust is registered as "Ann Smith, Trustee of the Doe 2021 Family Trust." The financial institution conducts all of its own AML/CDD as required under local law and guided by the FATF international principles in opening this account. Other types of assets commonly owned by trusts include hedge fund and private equity interests which are also highly regulated industries that require issuers to conduct AML/CDD guided by FATF principles. Other assets include real estate, art and antiquities, all of which are under increasing international AML regulation, also guided by FATF principles and local regulation. For example, in 2016 the United States, through its Financial Crimes Enforcement Network ("FinCEN") began issuing Geographic Targeting Orders ("GTOs") requiring title insurance companies to collect and report information about the persons involved in certain residential real estate transactions deemed to present AML risks.

In other words, AML reporting for trusts is done on two levels – first by the collection of information by the trustee, and second by the CDD obligations incumbent on financial institutions and other custodians of assets being placed in trust since legal title to an asset <u>must</u> change in order to create a trust relationship.

Further, beneficiary information is reported to competent authorities when beneficiaries actually receive distributions from trusts both under tax compliance laws and pursuant to FATCA/CRS reporting. For example, Trustees of United States domestic trusts must identify the beneficiaries to whom they distribute trust assets on the annual federal tax return that the trustee is required to file with the Internal Revenue Service (Form 1041). Trustees of a foreign grantor trust with an owner who is a United States person also must annually file IRS Form 3520-A, "Annual Information Return of Foreign Trust with a U.S. Owner." In addition, United States persons who receive distributions from a foreign trust, or who contribute assets to such a trust, must report such activity annually on IRS Form 3520.

V. Role of the Private Sector

10. To what degree do you consider that, in practice, identification of beneficial owners is inherently a part of a trustee's duties or should be made an explicit obligation?

Recommendation 25 mandates that a jurisdiction allowing for express trusts require <u>trustees</u> of trusts governed by its trust law to keep adequate, accurate, and current information on the identity of the settlor, the trustee(s), the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust. It further provides that trustees should not be prevented by law or enforceable means from providing competent authorities with any information relating to the trust, and that any information held pursuant to R.25 should be kept accurate and be as current and up-to-date as possible, and the information should be updated within a reasonable period following any change.

Trusts have existed under the common law of England for centuries and under the common law of the United States for more than two hundred years. In the United States, trusts are and always have been a creature of state law, with the laws varying among the fifty states and the District of Columbia. While there are federal implications (e.g., income taxation, death taxation, status in bankruptcy, ability to own assets under Securities Laws, etc.), it is state law that creates rights and duties that are then evaluated under applicable federal law. This is a bottom up approach rather than top down by federal statute or regulation. Nevertheless, certain fundamental, common legal principles apply to trusts.

In 2000, a Uniform Trust Code ("UTC") was adopted in the United States by the National Conference of Commissioners on Uniform State Laws and embodied the first national codification of the law of trusts. As stated in its prefatory note, the primary stimulus to the Commissioners' drafting of the UTC was the greater use of trusts in recent years, both in family estate planning and in commercial transactions, both in the United States and internationally. Although each State has the discretion to adopt all or parts of the UTC and to amend its provisions as they see fit, the UTC codifies many seminal trust principles that date back through the history of common law trusts, including the duties of a trustee.

These duties include:

1. The duty to administer the trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries;
2. The duty of loyalty, to administer the trust solely in the interests of the beneficiaries;
3. The duty to act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests; and
4. The duty to administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.[3]

It is impossible for a trustee to carry out his or her legal obligations under these principles without holding the information required under R.25.

The reason, however, that trustees should not be required to register the identity of the beneficiaries of trusts is that the beneficiaries do not hold actual ownership interests or control over a trust. They are entitled to benefit from a trust but do not own trust assets and do not control trust decisions.

[3] Article 8 of the Uniform Trust Code (Last Revised or Amended in 2010).

When they actually receive a benefit from a trust, tax and FATCA/CRS compliance already require that they be identified and that the precise benefit received be disclosed.

11. Are there any current requirements which you consider overly burdensome or from which certain legal arrangements should be exempted? If so, why?

Current requirements applicable to trusts are appropriate to address AML concerns and the FATF principles. Additional legal requirements would be overly burdensome, redundant and would significantly impair legitimate privacy rights and purposes for the creation of trusts, including the succession of family businesses, the protection and administration of assets for minor or incapacitated persons, the collective ownership of real property, the segregation and management of retirement plans, and all sorts of charitable purposes.

The FATF principles are implemented through a risk-based approach. "The risk-based approach allows countries, within the framework of the FATF requirements, to adopt a more flexible set of measures, in order to target their resources more effectively and apply preventive measures that are commensurate to the nature of risks, in order to focus their efforts in the most effective way."[4] Requiring multiple levels of reporting is antithetical to this approach. Trusts are by nature monitored by trustees, many of whom are commercial banks and trust companies already fully subject to AML/CDD regulation. Additional AML/CDD obligations arise at the level of retitling assets into the name of a trust upon the creation and funding of the trust. Further reporting occurs at the level of taxing the trust and/or beneficiaries receiving distributions from trusts.

Although trustees are and should be required to collect and maintain the information required under R.25, the general, centralized collection of this information by governments or in central registries should be limited to the identity of the trust settlor, the trustee(s) and the protector (if any).

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In closing, there remains a good deal of suspicion around trusts, yet there is little or no empirical evidence that trusts are being used to launder money or to facilitate terrorist or proliferation financing. There is a great deal of speculation, but no proof. As part of their reporting on the Pandora Papers, the Washington Post and the International Consortium of Investigative Journalists produced a podcast focused on trusts and, in particular, South Dakota's trust business in the United States, in which the journalist states "..to be clear we found no evidence in the documents that any of these trust companies in the United States, including Trident Trust, accepted money from criminal proceeds related to clients around the world." Their negative conclusions about trusts are really social, ethical and economic arguments, which while worthy of discussion, should not drive legislation that impacts civil liberties such as right to counsel, privacy, client confidentiality and attorney-client privilege. One of the reporters poses the question during the podcast of whether "even if it is legal" for people of questionable backgrounds to be moving their money to the U.S.,

[4] Introduction to the FATF Recommendations

do we want that to happen? That is, of course, a policy question. These concerns should not drive over-regulation and a rights-based, rather than risk-based, AML approach. Individuals should be permitted to arrange their affairs in ways they desire with basic privacy protections and, if needed, the right to counsel with appropriate privileges attached.

The collection of information on the settlor, the trustee(s) and the protector (if any) provides adequate risk-based measures.