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Brief Accompanying Request to Appear Before the
House of Commons Finance Committee Regarding Bill C-31

A. SUMMARY

As an initial matter, we would like to make it clear that our firm has no political interest in the issues described below. Additionally, our firm has no economic interest nor does it represent any taxpayer regarding these issues. We are simply concerned that certain material provisions of Bill C-31 will unintentionally harm Canadians if left unamended.

The implementing legislation in Bill C-31 regarding the Foreign Account Tax Compliance Act (FATCA) requires refinement. On February 5, 2014, Canada and the United States signed an intergovernmental agreement regarding FATCA (Canadian IGA), which relieves Canadian entities subject to FATCA from many of the onerous obligations they would have otherwise faced under FATCA.[1] That same day, the Department of Finance issued draft legislation required under Canadian law to implement the Canadian IGA and requested comments thereon. Our firm submitted comments on the draft legislation to the Department of Finance by the requested deadline of March 10, 2014.

While well intended, the draft legislation proposed by the Department of Finance to give effect to the IGA exacerbates the situation. Most importantly, the legislation takes the definition of "financial institution," one of the most—if not *the most*—important term defined in the Canadian IGA, and eviscerates it by narrowing it to an exclusive list of 13 entity types. In doing so, Canada has obscured the application of FATCA through the Canadian IGA. If the legislation becomes law, it may either: a) prevent the Canadian IGA from entering into force; or b) cause over withholding on certain payments to Canadian entities subject to FATCA—particularly, private Canadian trusts. This would lead to the affected Canadian entities having to incur tremendous administrative burden to recover the otherwise unnecessary withholding taxes. Ultimately, the legislation forces Canadian financial institutions into an unfortunate (and unintended) dilemma: whether to comply with Canadian law—and suffer the consequences under FATCA—or comply with FATCA—and suffer the consequences under Canadian law. In either case the affected Canadian entity is the loser.

The legislation also sends the wrong message to the international community in light of the OECD's new common reporting standard for the automatic exchange of information between tax authorities worldwide (OECD CRS), which is based on the U.S.'s intergovernmental agreements regarding FATCA (IGA).[2] Simply put, the legislation will harm affected Canadian entities. Therefore, the legislation should be amended to make it consistent with the Canadian IGA.

B. INTRODUCTION TO FATCA

FATCA is one of the most controversial modern bodies of U.S. tax law. It was born from the ashes of the UBS tax scandal, and seeks to combat offshore tax evasion by U.S. persons through the use of non-U.S. financial entities and investment structures.[3] This flavour of tax evasion has traditionally worked because of the robust bank secrecy laws in other jurisdictions (notably, Switzerland). FATCA does away with this by imposing an innovative withholding tax regime on foreign[4] entities' payments of certain types of U.S.-source income if they fail to report certain information to the IRS. The principal criticism of FATCA appears to be that it is unilateral, extraterritorial, and improperly passes the costs of detecting tax evasion—traditionally borne by government—to private parties.[5]

When boiled down to its essence, FATCA turns certain foreign entities into information gatherers for the IRS. FATCA was designed to combat offshore tax evasion, and it does so indirectly by imposing an expansive and powerful withholding tax on certain passive payments of U.S.-source income to certain foreign entities that fail to comply with FATCA's reporting regime.

Under the Code and Treasury regulations, FATCA divides any entity into one of two mutually exclusive groups: "foreign financial institution" (FFI) or "non-foreign financial institution" (NFFE).[6] Certain FFIs and NFFEs must report information regarding the accounts and other ownership interests of U.S. persons or face a 30 percent withholding tax on certain U.S.-source payments, including interest, dividends, royalties, and gross proceeds from sales of assets that can produce U.S.-source interest or dividends.[7] The Canadian IGA, which generally provides a more favourable regime by overriding the default FATCA rules in the Code and the Treasury regulations, uses the terms "financial institution" to roughly refer to FFIs, and NFFEs exist through annex I(VI)(B)(2).[8]

C. PROPOSED SUBSECTION 263(2): DEFINITION OF LISTED FINANCIAL INSTITUTION IS INCONSISTENT WITH THE CANADIAN IGA AND SHOULD BE AMENDED

Proposed subsection 263(2) eviscerates the definition of financial institution found in the Canadian IGA because only a "listed financial institution" in subsection 263(1) will be classified as a financial institution subject to FATCA under Canadian law. A listed financial institution is defined by reference to an exclusive list of thirteen entities, which does not include private Canadian trusts that would otherwise be included as a financial institution under article 1(1)(g) of the Canadian IGA. Ultimately, this restrictive definition will result in confusion for Canadian entities that have cross-border affairs and are not classified as financial institutions under Canadian law, but are financial institutions under the Code and the Treasury regulations or another

[1] Agreement Between the Government of the United States of America and the Government of Canada to Improve International Tax Compliance through Enhanced Exchange of Information under the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Feb. 5, 2014, *available at* http://www.fin.gc.ca/treaties-conventions/pdf/ FATCA-eng.pdf [hereinafter Canadian IGA].
[2] OECD, *Standard for Automatic Exchange of Financial Account Information* (Feb. 13, 2014), at 1-7, *available at* http://www.oecd.org/ctp/exchange-of-tax-information/Automatic-Exchange-Financial-Account-Information-Common-Reporting-Standard.pdf [hereinafter OECD CRS].
[3] See Hiring Incentives to Restore Employment Act, Pub. L. no. 111-147, section 501, 124 Stat. 71 (2010) [hereinafter HIRE Act].
[4] Unless otherwise noted, the word "foreign" is used in this brief to refer to non-U.S. persons. IRC section 7701(a)(30).
[5] Joshua D. Blank and Ruth Mason, "Exporting FATCA," 142 *Tax Notes* 1245, 1246 (Mar. 17, 2014).
[6] IRC sections 1471(a) and 1472(a).
[7] IRC section 1473(1)(A).
[8] Canadian IGA, supra note 1, at article 1(1)(g) and (q).

IGA.[9] The result would be unnecessary withholding for private Canadian trusts that have financial accounts with non-Canadian financial institutions or U.S. assets that generate U.S.-source payments.

It is unclear whether the U.S. Congress intended to classify trusts as financial institutions subject to FATCA when the law was originally introduced in 2009 and enacted in 2010. The term "trust" is mentioned only six times in the relevant sections of the Code and never in the context of a financial institution.[10] The Treasury regulations, however, are replete with references to trusts and two examples explicitly provide that trusts can be financial institutions.[11] IRS officials have further confirmed this.[12] The U.K.'s guidance notes specifically contemplate that certain trusts will be classified as financial institutions,[13] and Ireland's guidance notes echo this conclusion.[14] Furthermore, a U.S. Senate Subcommittee has previously described trusts as "enablers" of tax evasion and abuses, suggesting that trusts are properly subject to FATCA.[15] The OECD CRS confirms that an effective reporting regime should "limit the opportunities for taxpayers to circumvent reporting by using interposed legal entities or arrangements" by requiring financial institutions to look-through "shell companies, trusts or similar arrangements" to determine who the individual behind the account or ownership interest actually is.[16]

1. Consequences of Narrowing the Definition of Financial Institution

FATCA belongs to a unique body of law, the enforcement of which does not rely on the action of any sovereign but rather on rational economic decisions made by market participants. FATCA generally provides that before the payor transfers U.S.-source withholdable payments to the payee, the payor must ascertain the status of the payee and determine whether FATCA withholding is required.[17] If the legislation is passed into law, the result would be a definition of financial institution that is different in Canada, the United States, and other jurisdictions. When both the payor and payee are Canadian residents, there is little chance for confusion or unnecessary withholding.

However, when the payor is not a Canadian resident the decision to withhold becomes more complicated. If the payor does not withhold when required, it is personally liable for the withholding.[18] Thus, if a payor is uncertain of the status of a payee—because, for example, Canadian law limits the list of entities subject to FATCA under the legislation—the rational payor will withhold because to do otherwise would expose it to liability for the non-withheld amount. The result would be undesirable for Canadian cross-border investors, who would face excess withholdings and unnecessary transaction costs from obtaining refunds of the excess withholdings.

Additionally, the legislation may have much more dire consequences for Canadians under the Canadian IGA.

a. Narrowing the Definition of Financial Institution Will Lead to Overwithholding

Before making a payment subject to FATCA, a payor must determine the identity of the payee and its status under FATCA.[19] Private Canadian trusts will take the position that they are NFFEs under Canadian law and provide a certificate to the payor to that effect.[20] The payor is permitted to rely on such certificate unless the payor knows or has reason to know that the information provided is incorrect or receives notice from the IRS that the payee's claim of status is incorrect.[21]

The problem is that under the Treasury Regulations and the Canadian IGA, the private Canadian trust may *not* be an NFFE, but a financial institution. Because of this inconsistency, the Treasury regulations provide that payors must presume the payee is a nonparticipating FFI, and must withhold accordingly.[22] The Code makes the decision to withhold in this situation easier since it explicitly indemnifies the payor against claims and demands of any person for required FATCA withholding.[23] Moreover, a payor that withholds based on a reasonable belief that withholding is required is treated as if it was required for indemnification purposes.[24]

There are no penalties under FATCA for overwithholding, and the payor may—but is not required to—reimburse the payee for amounts that were overwithheld or use these amounts to set-off taxes otherwise required.[25] The combination of these rules—personal liability for FATCA withholding, lack of penalties for overwithholding, and absence of a requirement to reimburse or set-off overwithheld amounts—makes withholding the safest and default choice whenever the payor is in doubt. The only check on this behaviour would be the economic consequences to payors from their policy to overwithhhold. When the dust settles, payees will be left in the unenviable position of applying directly to the IRS for a refund of the overwithheld amount.

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[9] IRC sections 1471(a), 1472(a), 1473(1)(A), and 1474(a); U.S. Dept. of Treasury, Model 1A IGA Reciprocal, Preexisting TIEA or DTC (Nov. 4, 2013), at article 1(1)(g) and (j), available at http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Reciprocal-Model-1A-Agreement-Preexisting-TIEA-or-DTC-11-4-13.pdf.
[10] IRC sections 1471-1474.
[11] IRC reg. section 1.1471-5(e)(4)(v), examples 5 and 6.
[12] Lee A. Sheppard, "Who is a Manager Under FATCA," 138 Tax Notes 1164 (Mar. 11, 2013), at 1165 (statement by Jesse Eggert, Treasury associate international tax counsel); Jeremiah Coder and Lee A. Sheppard, "Officials Explain Final FATCA Reg Changes, Effect on Investment Funds," 2013 Tax News Today 15-4 (Jan. 23, 2013).
[13] U.K., Updated Guidance Notes, Implementation of the International Tax Compliance Regulations, section 2.36 (Feb. 28, 2014), available at http://www.hmrc.gov.uk/drafts/uk-us- FATCA-guidance-notes.pdf [hereinafter U.K. Guidance Notes].
[14] Irish Revenue, Guidance Notes on the Implementation of FATCA in Ireland, Chapter 2(2)(C) (Jan. 17, 2014) [hereinafter Irish Guidance Notes].
[15] U.S. Subcommittee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, 108th Cong., Tax Haven Abuses: The Enablers, the Tools and Secrecy, at 1 (2006), available at http://www.hsgac.senate.gov//imo/media/doc/TAXHAVENABUSESREPORT107.pdf?attempt=2.
[16] OECD CRS, supra note 2, at 7-8.
[17] IRC sections 1471(a), 1472(a), and 1473(1)(A); IRC reg. section 1.1471-3. For simplicity's sake, we will use the terms payee and payor to refer to entities subject to FATCA and withholding agents, respectively. See IRC reg. sections 1.1471-1(b)(96), (140), and -3(a); temp. IRC reg. section 1.1471-1T(b)(98).
[18] IRC sections 1471(a), 1472(a), and 1474(a); IRC reg. section 1471-3.
[19] IRC reg. section 1471-3.
[20] Canadian IGA, supra note 1, at annex I(IV)(D)(4), (V)(B), (VI)(B)(2); IRC reg. section 1.1471-3(d)(12).
[21] IRC reg. section 1471-3(d) and (e); temp. IRC reg. section 1.1471-3T(e)(4) (provides the standards for "reason to know").
[22] Temp. IRC reg. section 1.1471-3T(f)(4) and (9).
[23] IRC section 1474(a); see IRC reg. section 1.1471-3T(f)(9)(i). Compare IRC section 1461.
[24] IRC reg. section 1.1474-1(f).
[25] IRS rev. proc. 2014-13, 2014-3 IRB 419 (Dec. 26, 2013), at section 10.01; IRC reg. section 1.1474-2(a)(1)-(4). Although the payor may be subject to suit by the payee if its decision to withhold was unreasonable. Ibid. It is questionable, however, whether a payee would actually sue the payor when it can claim a refund from the IRS instead.

Eventually, these misclassified Canadian payees will be reported to the IRS under the Treasury regulations or another IGA,[26] and the IRS—assuming it recognizes the Canadian IGA as enforceable—may apply the procedures in articles 5 or 8 of the IGA, or worse, terminate the IGA.[27] Interestingly, Canada would be required to apply its domestic law—including applicable penalties—to address any significant non-compliance identified in an IRS notice, and if that non-compliance exceeds 18 months, even Canadian resident payors will be required to withhold 30 percent on U.S.-source withholdable payments.[28]

b. Narrowing the Definition of Financial Institution May Invalidate the Canadian IGA

Alternatively, the United States may view the legislation as an invalid implementation of the Canadian IGA under article 10(1), thereby precluding the Canadian IGA for entering into force. If so, Canadians would be subject to the more stringent default rules under the Code and the Treasury regulations, where the withholding regime is much less forgiving.[29] Ultimately, the legislation puts Canadian financial institutions in a dilemma where they must decide whether they will comply with Canadian law—and suffer the consequences under FATCA—or comply with FATCA—and suffer the consequences under Canadian law. Then again, the United States could invoke article 8 of the Canadian IGA and request a consultation to resolve the differences between the Canadian legislation and the IGA.

Finally, the United States may treat the legislation as Canada's abrogation of its obligations under articles 2 and 3 of the Canadian IGA, thereby precluding all entities with inconsistent FATCA classifications under the legislation—such as private Canadian trusts—from being treated as FATCA compliant and subjecting them to withholding under article 4(1). Reporting Canadian financial institutions would then again be subject to the default rules under the Code and the Treasury regulations.

2. Most Private Canadian Trusts should be Classified as Financial Institutions

Most private Canadian trusts should be treated as financial institutions under the Canadian IGA as custodial institutions, investment entities, or both. This is supported by the text of the Canadian IGA, the Treasury regulations, the U.K. guidance notes, the Irish guidance notes, U.S. Senate Subcommittee reports on tax haven abuses, the OECD CRS, earlier IRS guidance on FATCA, and commentary by officials of the IRS and Treasury. Furthermore, the Canadian IGA's reference to the Financial Action Tax Force (FATF) Recommendations should not be used as support for a more restrictive reading of the term investment entity under the Canadian IGA and cannot be used to restrict the more general term financial institution.

a. Definition of Financial Institution Under the Canadian IGA Includes Private Canadian Trusts

The Canadian IGA states that financial institution means a custodial institution, a depository institution, an investment entity, or a specified insurance company.[30] Before delving into the definition of these terms, it is necessary to read the Canadian IGA holistically for perspective. When read holistically, the text of the Canadian IGA supports the conclusion that certain private trusts are financial institutions. To define "equity interest," article 1(1)(v) of the Canadian IGA contemplates that trusts will constitute financial institutions. This language is broad and applies to determine the equity interests for any trust, not just trusts that are widely held or offered to the public.[31] Also note that trusts cannot generally be engaged in a business in the United States to be classified as a trust for U.S. tax purposes.[32]

Furthermore, the Canadian IGA provides that an "entity" means a "legal person or a legal arrangement such as a trust."[33] Why include trusts directly in these definitions if they are not subject to FATCA? If Treasury intended to exclude trusts from the definition of financial institution, it could have easily done so by omitting trusts from these definitional terms. We must avoid interpreting the provisions of the Canadian IGA in a way that renders other provisions or text unnecessary or that would defeat FATCA's policy. The legislation contained in Bill C-31 accomplishes precisely that by reading all private trusts out of the Canadian IGA through its restriction on the definition of financial institution.

Also note the omission of the exclusion in annex II(IV)(A) of the Model 1A IGA from the Canadian IGA. That provision creates an exclusion from FATCA for trusteed-documented trusts, or trusts with certain financial institutions as a trustee.[34] This omission also suggests that the United States intends to treat certain Canadian trusts as financial institutions subject to FATCA.

i. Certain Private Canadian Trusts Qualify as Investment Entities Under the Canadian IGA

An investment entity is defined under article 1(1)(j) of the Canadian IGA as follows:

> The term "Investment Entity" means any Entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:
>
> a. trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;
> b. individual and collective portfolio management; or
> c. otherwise investing, administering, or managing funds or money on behalf of other persons.
>
> This subparagraph 1(j) shall be interpreted in a manner consistent with the similar language set forth in the definition of "financial institution" in the Financial Action Task Force Recommendations.

[26] IRC reg. section 1.1471-4(c); Model 1A IGA, supra note 9, at article 4(1).
[27] Canadian IGA, supra note 1, at article 10(2).
[28] Ibid. at article 5(2)(b).
[29] Compare ibid., at articles 4(1) and 5(2) with IRC reg. section 1.1471-4.
[30] Canadian IGA, supra note 1, at article 1(1)(g).
[31] See proposed paragraphs 263((1)(j) and (k). See also IRC reg. section 1.1473-1(b)(3)(ii) for the elaborate rules applicable for determining a person's beneficial interest in a trust.
[32] IRC reg. section 301.7701-4(b). Business trusts may be reclassified as corporations or partnerships for U.S. tax purposes. Ibid. See also *Morrissey v. Commissioner*, 296 US 344 (1935).
[33] Canadian IGA, supra note 1, at article 1(1)(gg).
[34] Model 1A IGA, supra note 9, at annex II(IV)(A).

This definition is not meant to be read lightly, it is dense, technical language that is more manageable to understand when digested one piece at a time. First, note that only entities can be investment entities. Many jurisdictions see trusts as "legal relationships," not entities. Trusts are entities, however, for FATCA.[35] Second, ignoring the parenthetical in the first clause and the FATF reference in the flush language, it is relatively clear that trusts do not fall under the definition of investment entity. Trusts do not have customers, they have beneficiaries.[36] Furthermore, trusts generally cannot be engaged in a business to qualify as a trust under U.S. tax law.[37] Accordingly, the parenthetical is necessary to qualify a trust as an investment entity for U.S. tax purposes. Third, when read in light of the parenthetical, trusts are investment entities if they are managed by an entity that is in the business of providing the three enumerated services to customers.[38] Fourth, what does "managed by" in the parenthetical mean? Although the Canadian IGA does not define it, the Treasury regulations add some clarity by providing two examples showing that the managed by threshold is not very high.[39] The management component is satisfied—and the trust is an investment entity under the Treasury regulations—if the trustee manages the trust itself or the investment assets of the trust.[40] Mere advice, however, may not constitute management.[41]

In summary, if we ignore the reference to FATF, a private Canadian trust will be classified as an investment entity—and therefore as a financial institution—if:

1. Either (a) the trust has a professional trustee or (b) the assets of the trust are managed by a professional manager; and
2. The professional trustee or manager is not an individual person.[42]

In the context of private Canadian trusts, this conclusion is consistent with the guidance notes issued by the U.K. and Ireland. The U.K. guidance notes specifically state that trusts are investment entities if a financial institution manages it on its behalf.[43] The Irish guidance notes echo the United Kingdom's position.[44] Moreover, an IRS official stated that the definition of investment entity in the IGAS should be defined consistently under foreign law. Ronald Dabrowski, IRS deputy associate chief counsel (international), stated that in defining investment entities subject to FATCA, the government does not intend there to be much daylight between the Treasury regulations and any IGA provisions.[45] He stated *"keep in mind that the IGAS will be under foreign law and will develop on their own, but the scope is meant to be the same."*[46]

Thus, certain private Canadian trusts will qualify as investment entities—and therefore financial institutions subject to the Canadian IGA—unless the FATF reference alters this treatment. The FATF reference, however, cannot be accorded that much weight.

ii. The IGAs' Reference to the FATF Recommendations

Recall that Canadian IGA provides that the definition of investment entity must be interpreted consistently with similar language in FATF's definition of "financial institution."[47] The reference to FATF is present in all the U.S. Model IGAS' definition of investment entity, as well as the IGAS with Ireland and the United Kingdom.[48] Recent public statements made by the Department of Finance show it believes the FATF reference in the definition of investment entity excludes private trusts from that definition, which would exclude private trusts from FATCA if that reference is read into the more general term financial institution.[49] We believe this conclusion would be erroneous under the text of the Canadian IGA itself and for the reasons below.

Close examination of the FATF definition of financial institution reveals it to be overly broad, contrary to other provisions of the Canadian IGA, and inconsistent with the definitions provided in the IGA. Consequently, the reference to FATF does little to advance a clear understanding of the term "financial institution" and should not be relied upon, particularly as support for a more restrictive interpretation of investment entity under the Canadian IGA or any permutation of financial institution under the legislation.[50]

Under FATF, trusts may be financial institutions if they trade in certain financial instruments, engage in portfolio management, administer cash or liquid securities on behalf of others, or otherwise invest, administer, or manage funds or money on behalf of others.[51] Moreover, a private trust must conduct its business "for or on behalf of a customer" to qualify as a financial institution under FATF.[52] This latter requirement would prevent many trusts from qualifying as a financial institution under FATF (trusts have beneficiaries not customers), but is not present in the definition of investment entity under the Canadian IGA. An investment entity does not have to conduct business for or on behalf of a customer under the Canadian IGA if it is managed by an entity that does so.[53]

[35] IRC reg. section 1.1471-1(b)(39); Canadian IGA, supra note 1, article 1(1)(gg). IRC reg. section 1.1471-1(b)(39) states that an "entity" is "any person other than an individual." Person is defined by reference to IRC section 7701(a)(1), which states a person is a "an individual, a trust, estate, partnership, association, company or corporation." Temp. IRC reg. section 1.1471-1T(b)(100). Accordingly, an entity includes a trust under the Treasury regulations.
[36] See IRC reg. section 301.7701-4(a). The term "customer," is not defined by the Canadian IGA or the Treasury regulations.
[37] IRC reg. section 301.7701-4(b). Business trusts may be reclassified as corporations or partnerships for U.S. tax purposes. Ibid. See also *Morrissey v. Commissioner*, 296 US 344 (1935).
[38] Canadian IGA, supra note 1, at article 1(1)(j).
[39] IRC reg. section 1.1471-5(e)(4)(v), examples 5 and 6.
[40] Ibid., at example 6.
[41] Sheppard, supra note 12, at 1165 (statement by Jesse Eggert, Treasury associate international tax counsel).
[42] See also Roy A. Berg, "In FATCA-Land a Canadian Trust is a Bank," *Moodys Gartner Blog*, Feb. 10, 2014, http://www.moodysgartner.com/in- FATCA-land-a-canadian-trust-is-a-bank/;
[43] U.K. Guidance notes, supra note 13, at section 2.36.
[44] Irish Guidance Notes, supra note 14, at Chapter 2(2)(C).
[45] Coder and Sheppard, supra note 12.
[46] Ibid.
[47] Canadian IGA, supra note 1, at article 1(1)(j) (flush language).
[48] Agreement Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland to Improve International Tax Compliance and to Implement FATCA, Sept. 12, 2012, at article 1(1)(j), *available at* http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Agreement-UK-9-12-2012.pdf; Agreement Between the Government of the United States of America and the Government of Ireland to Improve International Tax Compliance and to Implement FATCA, Jan. 23, 2013, at article 1(1)(j), *available at* http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/ FATCA-Agreement-Ireland-1-23-2013.pdf.
[49] Canadian IGA, supra note 1, at article 1(1)(g) and (j); Dean DiSpalatro, "Finance Bites Back at FATCA," *advisor.ca*, Apr. 2, 2014, http://www.advisor.ca/tax/tax-news/finance-bites-back-at- FATCA-criticism-148790.
[50] Proposed subsection 263(2) of the Act. I.e., "Canadian financial institution," "reporting Canadian financial institution," and "non-reporting Canadian financial institution." Ibid.
[51] FATF, *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: FATF Recommendations*, at 116-17 (Feb. 15, 2012), *available at* http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf [hereinafter FATF Recommendations].
[52] Ibid., at 116-17.
[53] Canadian IGA, supra note 1, at article 1(1)(j) (parenthetical).

First, the FATF definition of financial institution is over-inclusive and renders other provisions of the Canadian IGA superfluous. Numerous entities that qualify as financial institutions under the FATF definition fall outside the definition of investment entity under the Canadian IGA, including depository institutions, custodial institutions, and specified insurance companies.[54] Using FATF's definition of financial institution to interpret investment entity under the Canadian IGA would be inconsistent with the language of the IGA,[55] and would result in classifying virtually every type of banking entity as an investment entity, thereby rendering the other subcategories of financial institution found in the Canadian IGA superfluous.[56]

Second, "entity" is defined by the Canadian IGA as "a legal person or a legal arrangement such as a trust."[57] A "legal person" is not defined in the Canadian IGA (or the Treasury regulations),[58] but since the term "natural person" is used elsewhere in article 1,[59] it is reasonable to conclude that an investment entity under the IGA cannot be an individual person. Furthermore, the Treasury regulations define entity as "any person other than an individual."[60] Contrary to FATCA and the IGAs, financial institutions under FATF can be individual persons,[61] while it is generally understood that financial institutions under FATCA and the IGAs must be entities.[62] With these inconsistencies, it is difficult to obtain meaningful clarification of the term "investment entity" by reference to FATF. It is even more difficult to interpret investment entity "in a manner consistent with similar language set forth" in the FATF definition of financial institution, as the Canadian IGA so instructs.[63]

Third, FATF is mentioned only in the definition of investment entity,[64] and does not otherwise modify the Canadian IGA's definition of financial institution or its offspring, including custodial institution.[65] The legislation modifies the definition of financial institution wholesale; it is not limited to investment entities.[66]

Finally, a former Treasury official responsible for answering questions regarding FATCA disagrees with Canada's interpretation of the FATF reference. Jesse Eggert, former Treasury associate international tax counsel, stated that managed trusts will be financial institutions subject to FATCA to the extent they are managed by an FFI even if they would not be a financial institution under the FATF criteria.[67] Thus, the FATF reference should not be used to support a more restrictive interpretation of financial institution under proposed subsection 263(2).

iii. Certain Private Canadian Trusts Qualify as Custodial Institutions Under the Canadian IGA

In addition to being classified as an investment entity, private Canadian trusts will probably be financial institutions subject to FATCA as custodial institutions.[68] A custodial institution is defined as any "entity that holds financial assets for the account of others as a substantial portion of its business if the entity's gross income attributable to the holding of financial assets and related financial services equals or exceeds" 20 percent of its gross income during a certain time period.[69] Notably, the IRS initially took the position that foreign trusts are custodial institutions—and thus financial institutions—although the Treasury regulations subsequently precluded this position by significantly narrowing the types of income that constitutes "income attributable to holding financial assets and related financial services income," which is a prerequisite for the trust to qualify as a custodial institution.[70] The Canadian IGA, however, does not contain the limitation in the Treasury regulations and the legislation does not provide an option to apply the definitions in the regulations if they are more favourable under article 4(7) of the Canadian IGA. Accordingly, many private trusts should qualify as a custodial institution under the Canadian IGA, since trustees hold financial assets for others as a substantial portion of their business and the 20 percent threshold should be met for trusts holding primarily financial assets.

E. CONCLUDING COMMENTS

As mentioned, the Department of Finance's attempt to narrow the definition of financial institution in subsection 263(2) is well intentioned. It appears that it is the Department's desire to have "small trusts" exempt from the implications of FATCA or the IGA. In response to recent media commentary on the above issues, the Department of Finance publicly stated:

> "We would like to reiterate the [financial] industry's collective support for limiting these definitions for the purposes of the Canada-U.S. agreement . . . [subjecting personal trusts to FATCA] would have been administratively unworkable and extremely costly and time consuming for [financial institutions]," not to mention "confusing for clients."[71]

Unfortunately, it is not that simple. While some financial industry groups may provide praise to the attempt to narrow the definition of financial institution, it has been our experience that these groups may not completely understand what they are praising. The Department's attempt to narrow the definition ignores the inevitable consequences, namely unnecessary withholding tax, market confusion, and Canada being out of step with the rest of the world regarding FATCA and the standardized information exchange model recently released by the OECD.

We respectfully request the definition of financial institution be amended to prevent unnecessary harm to Canadians.

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[54] Ibid., at article 1(1)(g)-(i) and (k).
[55] Ibid., at article 1(1)(j) (the investment entity definition "shall be interpreted in a manner consistent with similar language set forth in the definition of 'financial institution' in the [FATF] Recommendations.").
[56] Ibid., at article 1(1)(g).
[57] Ibid., at article 1(1)(gg).
[58] E.g., IRC reg. section 1.1471-1(b).
[59] Canadian IGA, supra note 1, at article 1(1)(v) and (mm).
[60] IRC reg. section 1.1471-1(b)(39).
[61] FATF refers to individual persons as "natural persons," which is not defined in the FATF Recommendations; however, "legal persons" are entities other than natural persons, which strongly suggests that a natural person is an individual, flesh-and-blood person under FATF. FATF Recommendations, supra note 51, at 116 and 119.
[62] IRC reg. section 1.1471-1(b)(39); Canadian IGA, supra note 1, at article 1(1)(g)-(k) and (gg).
[63] Canadian IGA, supra note 1, at article 1(1)(j).
[64] Ibid., at article 1(1)(j).
[65] Ibid., at article 1(1)(g)-(i) and (k).
[66] Proposed subsection 263(2) of the Act.
[67] Sheppard, supra note 12.
[68] Canadian IGA, supra note 1, at article 1(1)(g) and (h).
[69] Ibid., at article 1(1)(h).
[70] IRC reg. section 1.1471-5(e)(3)(ii); temp. reg. section 1.1471-5T(e)(5)(ii); Canadian IGA, supra note 1, at article 1(1)(h).
[71] DiSpalatro, supra note 49.