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Proposed FATCA Withholding Regulations: Impact on Investment Funds and Managers

by James Wall

On February 8, 2012, the Internal Revenue Service ("IRS") issued a detailed set of proposed regulations that provide much-awaited guidance on the new U.S. withholding tax regime imposed under the Foreign Account Tax Compliance Act ("FATCA"). All investment funds that invest directly or indirectly in U.S. securities will be impacted by these regulations and will need to start planning their approach to compliance with this new regime.

Simultaneously with the issuance of the proposed regulations, the governments of the U.S., France, Germany, Italy, Spain, and the U.K. released a joint statement announcing an intergovernmental framework for FATCA implementation and international tax compliance. Pursuant to this framework, foreign financial institutions (including investment funds) in such countries will disclose their FATCA information to their respective governments who will in turn forward the information to the IRS. This framework may ultimately become the foundation for much broader information exchanges among tax authorities around the world.

Background

FATCA was incorporated into the Hiring Incentives to Restore Employment ("HIRE") Act that became law on March 18, 2010. The goal of FATCA is to require non-U.S. financial institutions and certain other non-U.S. entities to provide information to the IRS identifying U.S. persons invested in non-U.S. financial accounts. Financial accounts include depository accounts, custodial accounts, any debt or equity interest in a foreign financial institution ("FFI"—other than interests that are regularly traded on an established securities market)—and any cash value insurance contract or annuity contract. For example, ownership of a partnership or other equity interest in a foreign hedge fund or private equity fund would constitute a "financial account."

The "stick" the IRS will use to force compliance is a new 30 percent withholding tax on "withholdable payments" made to non-participating FFIs. Withholdable payments include all U.S. source dividends, interest, rents, and royalties and gross proceeds from the sale or disposition of any property that can produce dividends or interest from U.S. sources.

FFIs are broadly defined to include non-U.S. entities that accept deposits, hold financial assets for the account of others, or engage primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities. FFIs will generally include banks, securities brokers and dealers, hedge funds, collective and family investment vehicles, private equity funds, trust companies, and other such institutions.

Guidance So-Far

The IRS released two lengthy Notices (Notices 2010-60 and 2011-34) that provided some helpful, albeit incomplete, guidance on how the FATCA regime will operate. The IRS then issued Notice 2011-53, which extended the effective dates for when FATCA withholding would commence and included certain implementation steps needed to be in place.

The Proposed Regulations

The most common mechanism for becoming a "participating" FFI, and thereby avoiding the imposition of the 30 percent withholding tax on withholdable payments, will be for FFIs to enter into a written contract (the so-called "FFI Agreement") with the IRS that will obligate the FFI to comply with the due diligence and reporting requirements of FATCA. The proposed regulations do not include a draft FFI Agreement. It is anticipated that a draft of the FFI Agreement will be issued in the latter half of 2012.

However, the proposed regulations are voluminous and provide extensive guidance on many previously unclear aspects of FATCA. Some of the key highlights are as follows:

- The definition of FFI is expanded to include insurance companies;
- The categories of entities that may register or certify as "deemed compliant" under FATCA is expanded;
- A responsible officer of an FFI will be required to certify that the FFI has complied with the FFI Agreement;
- A third-party audit with respect to compliance will not be required;
- The deadline for issuing obligations that are "grandfathered" from withholding is extended from March 18, 2012 to December 31,2012;
- A transition rule is provided for FFIs located in jurisdictions that prohibit the tax withholding or reporting required by FATCA;
- "Financial account" is defined to exclude debt and equity interests issued by banks and brokerage firms but does include bank, brokerage, and money market accounts or equity interests in hedge funds and private equity funds and certain insurance contracts;
- The burden associated with reviewing records of pre-existing accounts to determine U.S. status is reduced by eliminating the need to review records for certain low value accounts and by eliminating the rules set forth in the Notices for so-called "private banking accounts;"
- Commencement of FATCA withholding on so-called "pass thru payments" is delayed until January 1, 2017, but reporting with respect to such payments will commence earlier;
- No withholding will be required for certain short-term obligations and payments made in the ordinary course of a withholding agent's business for non-financial services, goods, and the use of property; and
- A staggered set of due dates is provided for reporting requirements. (These reporting requirements commence at different times between September 30, 2014 through 2018.)

The following provisions of the proposed regulations are likely to be most relevant to investment funds and their managers:

Deemed Compliant FFIs. Deemed compliant FFIs are treated as FATCA compliant even though they are not required to enter into a FFI Agreement with the IRS. The proposed regulations specify three categories of deemed compliant FFIs:

a. **Registered FFIs.** These FFIs will have to register with the IRS to establish their exemption and, among other things, must obtain an FFI-EIN. Eligible entities include certain "local" banks, qualified collective investment vehicles (an entity regulated in its country of formation as an investment fund), restricted funds (funds that cannot sell interests to U.S. persons), and FFIs subject to intergovernmental agreements.

Deemed compliant FFIs are treated as FATCA compliant even though they are not required to enter into a FFI Agreement with the IRS.

i. **A Qualified Collective Investment Vehicle ("QIV")** may qualify as deemed compliant FFI if it is regulated in its country of incorporation or organization as an investment fund. The proposed regulations do not indicate the level of regulation required. It is not clear, for example, if a Cayman Islands entity that is registered with the Cayman Islands Monetary Authority would meet this requirement. Each holder of record of certain debt interest and any equity interest in the QIV must be a participating FFI, a registered deemed compliant FFI, an exempt beneficial owner, or a U.S. person that is not a "specified U.S. person" (e.g. a publicly traded company or a RIC or REIT).

ii. **Restricted Funds.** This category appears to be designed for Undertakings for Collective Investment in Transferable Securities ("UCITS"), which are common investment funds in Europe. Like a QIV, the restricted fund must be regulated in its country of formation as an investment fund and the country must be FATF compliant (e.g. Ireland, Luxembourg, and the UK). In addition, interests in the fund may be sold only through compliant distributors and it must have distribution agreements in place that prohibit sales of interests to U.S. persons, non-participating FFIs, and certain other persons. It must also comply with various account identification and account redemption rules.

iii. **Intergovernmental Agreements**. FFIs that comply with FATCA according to the terms of an intergovernmental agreement (e.g. certain funds organized in the UK, France, Spain, Italy, or Germany) will qualify for deemed compliant status.

b. **Certified FFIs.** These may include certain small local banks, non-U.S. retirement funds, not-for-profit organizations, and certain banks and brokers with only low value accounts.

c. **Owner Documented FFIs.** An FFI that maintains all of its accounts with a designated withholding agent, which is a U.S. financial institution or participating FFI, will be certified deemed compliant with respect to that withholding agent only. An owner documented FFI will be required to provide its designated withholding agent with all due diligence documentation required by the IRS and the withholding agent will need to agree to report to the IRS. Certain hedge funds may be able to take advantage of this exception but it does not come without its own set of compliance.

It should be noted that deemed compliant status does not provide an exemption from FATCA. Such status comes with its own set of administrative burdens and some funds may find maintaining such status equally (if not more) burdensome than simply entering into the FFI Agreement with the IRS. Many funds will likely not qualify for deemed compliant status and the FFI Agreement will be the only way to avoid FATCA withholding.

Payments to Partnerships and Trusts. For payments of U.S. source fixed or determinable annual or periodical ("FDAP") income made to non-FFI partnerships and trusts and participating FFIs that are partnerships or trusts, the "payee" is the partner or beneficiary for FATCA withholding and reporting purposes. For payments to a nonparticipating FFI or to a participating FFI with respect to payments other than U.S. source FDAP, the foreign fund will be considered the payee.

Due Diligence Requirements. Fund and asset managers will have to put in place new processes for identification of investors in order to comply with the FFI Agreement or be considered deemed compliant, as the case may be.

Verification of Compliance. The responsible officer of each asset manager or fund will be ultimately responsible for FATCA compliance. The responsible officer of an FFI will be expected to certify that the FFI has complied with the terms of the FFI Agreement. However, verification of compliance through a third-party audit will not be required.

Next Steps

A public hearing on the proposed regulations is scheduled for May 15, 2012. It is likely that many interested parties will provide comments in connection to such hearing.

Although there likely will be further changes made to the proposed regulations before they are finalized, the basic framework for FATCA compliance is now known and it would be in the best interest of affected parties to start planning for compliance now. ■

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