FATCA proposed regulations: what should asset managers do now?

Interpretation and implementation of the FATCA rules will pose significant challenges for the alternative investment industry and requires significant planning.

By Dmitri Semenov, Maria Murphy, Ann Fisher and Jun Li
The long-anticipated and voluminous Foreign Account Tax Compliance Act (FATCA) Proposed Regulations (REG-121647-10) were released on February 8, 2012. On the same day, the governments of the United States, France, Germany, Italy, Spain and the United Kingdom issued a joint statement on an intergovernmental approach to improving international tax compliance and implementing FATCA. This article discusses key issues affecting the asset management industry arising from the Proposed Regulations and the intergovernmental agreement, and certain steps that asset managers need to take now to analyze and implement these rules with minimum business interruption.
Background
FATCA, which became part of the Internal Revenue Code under the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act, P.L. 111-147, March 18, 2010), represents the US government’s most aggressive challenge to US tax evasion by US persons holding assets in non-US banks, custodians, certain insurance companies and investment vehicles. FATCA incorporates new Internal Revenue Code Sections 1471 through 1474 (also referred to as the “Chapter 4” provisions). The objective of FATCA is to ensure that non-US entities are not used to block disclosure to the IRS of the foreign financial accounts and offshore investments of US individuals and certain US entities (“specified US persons”). FATCA applies to “withholdable payments,” which include US-source dividends, interest and other fixed or determinable annual or periodical (FDAP) income, and gross proceeds from the sale of US stocks and debt instruments, as well as to certain other payments (“passthru payments”), which are payments attributable to withholdable payments, as defined under rules still being developed. Beginning no earlier than January 1, 2017, withholding on other payments (“foreign passthru payments”) may be required.

To persuade non-US entities to disclose their underlying investors/owners/account holders, FATCA essentially requires withholding agents making withholdable payments to a “foreign financial institution” (FFI) (which includes all non-US alternative investment funds) to withhold a 30% tax, unless the FFI fulfills certain compliance requirements. Specifically, FATCA requires that the FFI either enter into an agreement (discussed below) with the IRS to become a “participating FFI” (PFFI), or establish that it is exempt from FATCA or deemed to be in compliance. The Chapter 4 provisions also apply to withholdable payments made to a non-US entity that is not an FFI (non-financial foreign entity or NFFE), which, to avoid the 30% FATCA withholding, must identify any substantial US owners, certify that it has no substantial owners, or document that it is exempt from FATCA. US alternative investment funds will not need to enter into an agreement but will be treated as a withholding agent under FATCA, as discussed below.

The Proposed Regulations, building on the guidance issued in three prior IRS Notices,7 provide additional guidance on the implementation of rules in Sections 1471 through 1474. The Proposed Regulations attempt to develop a practical approach with respect to FATCA implementation with detailed guidance on due diligence and documentation requirements, as well as definitions and exceptions, among other items. However, the Regulations reserve for later guidance on some other key topics, including the determination of passthru payments on which PFFIs will be required to withhold. The provisions of the agreement that PFFIs will enter into with the IRS will be issued later this year.

FATCA’s impact on US investment funds
One of the four categories of a “financial institution” is an entity that is engaged (or holding itself out as being engaged) “primarily” in the business of investing, reinvesting or trading in securities, partnership interests, commodities, notional principal contracts, insurance or annuity contracts, or any interest (including a futures or forward contract or option) in such an item. The Proposed Regulations provide the Chapter 4 obligations of “withholding agents” (US or non-US) with special rules for PFFIs.4

As withholding agents, US investment funds will be required to perform FATCA due diligence procedures on their investors for the purpose of documenting their status as entities vs. individuals and as US vs. non-US Also, as withholding agents, US funds will be required to withhold a 30% FATCA tax on withholdable payments that are made to non-US entities that fail to document one of the following: (1) their status as PFFIs; (2) their status as NFFEs with no substantial US owners; (3) their status as NFFEs and the identities of their substantial US owners; or (4) the basis for a FATCA withholding exemption, e.g., an excepted NFFE or a deemed-compliant FFI (discussed below). This means that, although US-based funds are not required to enter into an agreement with the IRS to implement FATCA, these funds, as US withholding agents, must begin to evaluate non-US entity accounts for purposes of FATCA starting January 1, 2013. Proper FATCA classification of pre-existing investors and new investors is needed so that US investment funds will be prepared to withhold if required on withholdable payments made after December 31, 2013, and to be able to carry out the required year-end reporting described below.

US investment funds, as US withholding agents, must file certain year-end reporting forms with the IRS to report Chapter 4 “reportable amounts” paid to non-US persons on Forms 1042 (Annual Withholding Tax Return for US Source Income of Foreign Persons) and 1042-S (Foreign Person’s US Source Income Subject to Withholding) and the tax withheld, if any, for the preceding tax year. Chapter 4 reportable amounts are US-source FDAP income (whether or not subject to Chapter 4 withholding and including a passthru payment that is US-source FATCA income) paid on or after January 1, 2014; gross proceeds subject to withholding under Chapter 4; and foreign passthru payments (a term to be defined in future Regulations) subject to withholding under Chapter 4.5

While effectively connected income (ECI) is specifically excluded from the definition of “withholdable payment,” ECI is subject to reporting under Chapter 4. Reporting of ECI paid to non-US persons is consistent with the Chapter 3 reporting rules and the government’s objective of determining how much income is received by persons who are required to file US income tax returns and report such income. Further, US withholding agents must file forms (to be provided by the IRS) to report the substantial US owners of certain entity account holders.

FATCA’s impact on non-US investment funds
Consistent with the prior IRS FATCA Notices,7 the Proposed Regulations provide that anything that would be commonly understood to be an investment fund, hedge fund, private
equity fund, venture capital fund, or the like will generally be a “financial institution” under FATCA. A non-US investment fund that becomes a PFFI has responsibilities under its FFI agreement (FFI Agreement) to identify and document its US investors, report certain payments to recipients, and withhold on withholdable (and ultimately foreign passthru) payments made to recalcitrant investors and certain counterparties and payees. A non-US fund receiving (as a payee) withholdable payments will need to comply with FATCA to ensure that it will not be subject to FATCA withholding on these payments. Certain non-US funds may be able to mitigate FATCA’s impact by obtaining deemed-compliant status.

The FFI Agreement (expected to be released in the summer of 2012) will, among other things, require a PFFI to:

1. Perform due diligence on its investors to determine which are US accounts or US-owned foreign entities.
2. Adopt written policies and procedures governing the PFFI’s compliance with its responsibilities under the FFI Agreement.
3. Withhold 30% from withholdable payments made to investors who (a) do not qualify for an exception from the documentation requirements; (b) refuse to document their status and waive any local secrecy laws; or (c) are FFIs that are not PFFIs.
4. Perform three types of reporting: (a) on identified US accounts; (b) on recalcitrant accounts; and (c) on withholdable payments to certain entity recipients (including NFFEs and non-participating FFIs) whether or not these payments are subject to withholding.
5. Conduct periodic internal reviews of its compliance (rather than periodic external audits) and certify compliance to the IRS.
6. Obtain waivers when investors’ local laws would prevent a PFFI from reporting US account holder information as required under the FFI Agreement, or redeem the investors’ interest.

The Proposed Regulations state that the FFI Agreement generally will apply to all members of an expanded affiliated group (EAG) of which the PFFI is a member (see below on the definition of an EAG). However, the FFI Agreement will provide guidelines on situations where the IRS may enter into a transitional FFI Agreement with an FFI, even if a branch of the FFI or a member of the FFI’s EAG is unable to comply with terms of the FFI Agreement due to local-country laws.

If an FFI (e.g., an offshore feeder or master fund, non-US alternative investment vehicle or non-US mutual fund) wants to become a PFFI to ensure that FATCA withholding will not apply to any payments made to it, the FFI will have to enter into the FFI Agreement or qualify as an FFI that is either deemed compliant or exempt from FATCA. To ensure that no such withholding will apply, the fund should enter into its agreement prior to the earliest effective date for FFI Agreements, July 1, 2013.

FFI expanded affiliated group – definition and relevance

As a general rule, each FFI that is a member of an EAG must become a PFFI or registered deemed-compliant FFI as a condition for any member of the group to obtain the status of either a PFFI or a registered deemed-compliant FFI. The definition of EAG under Section 1471(e)(2) (which, in turn, references Section 1504(a)) is incorporated into the Proposed Regulations. Under this definition, members of an affiliated group need to be connected through direct or indirect stock ownership with a common parent and connected with other members of the group by direct common ownership. Common ownership for corporations means more than 50% by vote and value of the corporation. For partnerships and other non-corporate entities, more than 50% ownership by value, directly or indirectly, of the beneficial interests in the partnership or other non-corporate entity is required. These requirements may be satisfied in certain structures (e.g., in a typical master-feeder structure, the offshore corporate feeder fund owns more than 50% of the master fund that is treated as a partnership for US tax purposes). The testing should be done case by case. However, since the general partner (GP) entity normally owns 1% or less of the various fund vehicles, and the management company normally does not hold any equity interest, the non-US GP and non-US management company entities generally will not meet the required common ownership threshold and should not be viewed as part of the affiliated group. Therefore, it may be more challenging to administer FATCA requirements for a group of connected investment funds because the concept of “lead FFI” (discussed in the Preamble to the Proposed Regulations as a point of future guidance), which would serve as the lead contact for FATCA compliance, is not expected to apply in most alternative fund structures because the fund manager may be a US entity or an NFFE.

It is unclear whether the concept of a centralized compliance option, which was introduced as a possible means of simplifying fund compliance in Notice 2011-34, 2011-19 IRB 765, but not included in the Proposed Regulations, will be incorporated into future guidance for funds with a common asset manager or other agent.

PFFI “election to be withheld on” Section 1471(b)(3) provides that a PFFI may elect to be withheld on rather than withhold on payments to recalcitrant account holders and non-participating FFIs. However, the Proposed Regulations allow only certain FFIs to use the
Section 1471(b)(3) election: (1) a PFI that is also a qualified intermediary (QI); or (2) a foreign branch of a US financial institution that is a QI. To the extent that an investment fund is not a QI, it is unlikely that the fund will be able to avail itself of this election. Unless the investor in the investment fund is a QI, this provision is unlikely to have much impact on investment funds. Still, some funds may choose to restrict their investors from making this election.

The government’s limitation of the “election to be withheld on” provision to QIs is consistent with the objective to “conform” the withholding regimes of Chapter 3 and Chapter 4 because under Chapter 3, only QIs have the ability to choose to be responsible for the withholding or to require their counterparty to be responsible. Limiting the Chapter 4 “election to be withheld on” provision to QIs saves the withholding agents a substantial amount of work and potential FATCA liabilities.

PFFI compliance obligations and compliance certifications

The FFI Agreement will require the PFFI’s responsible officer to make two certifications with respect to its identification procedures for pre-existing obligations (e.g., a fund agreement executed prior to the FFI Agreement’s effective date). Unless both certifications are made, a fund’s PFFI status will terminate.

The first certification must be made within one year of the effective date of the FFI Agreement. Under this certification, the responsible officer must certify that the PFFI has completed the required due diligence review of the fund’s pre-existing individual investors that are high-value accounts and, to the best of the responsible officer’s knowledge, the PFFI did not have any formal or informal practices or procedures in place at any time from August 6, 2011 (120 days from official publication date of Notice 2011-34) through the date of such certification to assist investors in the avoidance of FATCA.

The second certification requires the responsible officer to certify within two years of the effective date of its FFI Agreement that the PFFI has completed the account identification procedures and documentation requirements for all pre-existing obligations (entities are included) or, if it has not obtained the documentation required from an investor, that the PFFI treat such investor in accordance with the requirements of the FFI Agreement.

The IRS has requested comments regarding alternative due diligence or other procedures that should be required for PFFIs that are unable to make the first certification (e.g., the fund did not have any formal or informal policies or procedures that would assist investors in avoiding FATCA).

Periodic responsible officer compliance certification required under the FFI agreement

In lieu of requiring a third party to perform an agreed-upon procedure review as provided in Chapter 3 for QIs, the FFI Agreement will require, among other things, that the PFFI (1) adopt written policies and procedures governing the PFFI’s compliance with its responsibilities under the FFI Agreement; (2) conduct periodic internal reviews of its compliance; and (3) periodically provide the IRS with a certification and certain other information that will allow the IRS to determine whether the PFFI has met its obligations under the FFI Agreement.

Based on the results of such reviews, the responsible officer of the PFFI will periodically certify to the IRS the PFFI’s compliance with its obligations under the FFI Agreement, and may be required to provide certain factual information and to disclose “material” failures with respect to the PFFI’s compliance with any of the requirements of the FFI Agreement.

The Proposed Regulations do not define or provide examples of a “material” failure. We anticipate that more clarity on what constitutes a material failure will be provided in the model FFI Agreement or guidance accompanying the model. Treasury and the IRS requested comments regarding the scope and content of such reviews and the factual information and representations that FFIs should be required to include as part of such certifications. The Preamble to the Proposed Regulations states that the IRS intends to provide the requirements to conduct the periodic reviews and the certifications in the FFI Agreement or in other guidance.

Simplified compliance approach between US and foreign governments

On the same date that the Proposed Regulations were released, the United States, France, Germany, Italy, Spain and the United Kingdom issued a joint statement to the effect that they were exploring an intergovernmental approach to improving international tax compliance and implementing FATCA. Under this approach, an FFI in a participating country would report US account holder information directly to the government in that country, and FFIs would not be required to enter into a comprehensive FFI Agreement with the IRS, but rather would be subject to an IRS registration requirement. The joint statement further provided that this approach would be implemented under bilateral agreements, each of which is to be a FATCA implementation agreement between the United States and a partner country.

The goal of the approach is to simply facilitate the reporting. It will not exempt offshore funds from FATCA compliance, although compliance will be simplified by replacing an IRS agreement with a registration requirement, removing the requirements for withholding on withholdable and foreign passthru payments, and terminating accounts of recalcitrant account holders.

Luxembourg, Ireland and the Cayman Islands, which are major centers for the alternative investment industry, are currently not part of this intergovernmental approach. However, it is expected that additional countries will join.

While the approach contemplated in the joint statement may simplify FATCA compliance, it raises additional multi-
Identifying and documenting the payee for FATCA purposes

To prevent FATCA withholding, a fund needs to document its payees and account holders for FATCA purposes. The Proposed Regulations provide the various categories of payees/investors and the documentation on which a withholding agent may rely to document each category. The following are the categories of payees (some of which contain several subcategories):

1. US persons
2. PFFIs
3. Registered deemed-compliant FFIs
4. Exempt beneficial owners
5. Excepted FFIs
6. NFFEs
7. Non-US individuals
8. Non-participating FFIs
9. Certified deemed-compliant FFIs
10. Owner-documented FFIs
11. Territory financial institutions

Further, similar to the withholding rules under Chapter 3, a single owner of a disregarded entity is the payee. There are exceptions for payments to non-US branches of FFIs that have FATCA compliance restrictions, but such exceptions are generally not relevant for alternative investment funds.

A withholding agent that makes a withholdable payment to a flow-through entity other than a flow-through entity listed above will be required to treat the partner, beneficiary, or owner as the payee.

The flow-through treatment described above will affect the documentation that a withholding agent will be required to obtain for payments of US-source FDAP income to alternative investment funds structured as partnerships (other than WPs). For such payments made after December 31, 2013 (subject to a transition exception), a US fund, as a withholding agent, will be required to withhold 30% on the entire payment (assuming that the US fund is paying all US-source FDAP income) unless the US fund receives a valid withholding certificate (e.g., Form W-8 or W-9 or, in certain instances, documentary evidence, such as an organizational document from the partner as described above, along with Form W-BIMY from the partnership).

Payee/FFI classifications relevant to alternative investment industry

The Proposed Regulations provide some helpful guidance on the types of non-US entities that are eligible for reduced or exemption from FATCA compliance. In terms of reduced FATCA compliance, certain types of deemed-compliant FFIs, particularly certain qualified collective investment vehicles and restricted funds, may allow certain alternative funds to avoid having to enter into FFI Agreements.

Treating funds as deemed-compliant FFIs and therefore exempt from FATCA withholding

For certain FFIs that are not likely to have US investors, or pose a low risk of having US investors, the IRS has created a FATCA classification called “deemed-compliant FFIs.” Each deemed-compliant FFI classification contains multiple qualification requirements as well as continuing procedural requirements with which the FFI must comply. The deemed-compliant FFI categories are:

1. Registered deemed-compliant FFIs
2. Certified deemed-compliant FFIs
3. Owner-documented FFIs

Although there are various types of deemed-compliant FFIs, certain types of particular relevance to funds in these three categories are discussed below.

Registered deemed-compliant FFIs

Registered deemed-compliant FFI funds need to register with the IRS, but do not need to enter into an FFI Agreement. In addition, the chief compliance officer or a person with similar standing will need to certify that the FFI meets the applicable conditions for registered deemed-compliant status as of the date that the FFI registers with the IRS for such status.

Restricted funds: These are a type of registered deemed-compliant FFI. A restricted fund must be a regulated
investment fund under the law of its country, which must be a Financial Action Task Force (FATF)-compliant country. The FFI must meet certain requirements, e.g., that fund interests may be sold only by PFFIs, registered deemed-compliant FFIs, non-registering local banks, or “restricted distributors.”

Also, distribution of these interests must take place under distribution agreements that incorporate restrictions ensuring that fund interests cannot be held by US persons, non-participating FFIs, or US-owned passive NFFEs with one or more substantial US owners (unless the interests are both distributed by and held through a PFFI).

Further, the FFI must ensure that each distribution agreement requires the distributor to notify the FFI of a change in the distributor’s FATCA status within 90 days of the change; and the FFI must certify to the IRS that, as to any distributor that ceases to qualify as a permitted distributor, the FFI will terminate its distribution agreement within 90 days of being notified of the distributor’s change in status, and will acquire or redeem all debt and equity interests of the FFI issued through that distributor within six months of the distributor’s change in status. If the fund was not subject to sufficient restrictions prior to registration, it must identify accounts held by US persons and non-participating FFIs and redeem these accounts or withhold and report.

A restricted distributor must, inter alia, be organized and operated in a FATF-compliant country and meet local antimony laundering (AML) due diligence requirements. It must have a purely local business and have at least 30 unrelated customers that make up at least 50% of its customer base. Its gross revenue and assets under management are subject to size restrictions.

The restricted funds deemed-compliant category is responsive to industry comments related to reducing the compliance burden for retail funds. In particular, the IRS appears to have responded to certain comments from the European Fund and Asset Management Association (EFAMA) on the original proposals in Notice 2011-34 by removing the requirement that a restricted fund could not have direct individual investors.

Moreover, while the conditions for qualifying as a restricted distributor are narrow and focused on truly local and small operations, it is a welcome development that such entities need not register. Nevertheless, there will still be a significant operational burden on funds to ensure that, for example, their distributors meet the conditions to be considered a restricted distributor and to ensure that all distribution agreements are appropriately updated.

**Qualified collective investment vehicles:** A QCIV is another type of registered deemed-compliant FFI. An entity is a QCIV if all of the following apply: (1) it is an FFI solely because it invests, reinvests or trades in stocks, securities, etc., and is regulated as an investment fund in its country of incorporation or organization; (2) each record holder of direct debt interests over $50,000 or equity interests in the FFI or any other holder of a financial account with the FFI is one of the following: a PFFI, a registered deemed-compliant FFI, a US person other than a specified US person or an exempt beneficial owner; and (3) all other FFIs in the EAG are either PFFIs or registered deemed-compliant FFIs.

The deemed-compliant status accorded to a QCIV may be a significant exception for alternative funds that are considered “regulated” within the meaning of the Proposed Regulations. Luxembourg, Ireland, and Cayman Island funds are subject to a certain degree of regulation and it will need to be further confirmed whether this regulatory oversight is sufficient for purposes of meeting the definition of a QCIV. If that degree of regulation is sufficient, a typical offshore fund structure that has only US tax exempt and PFFI institutional investors could qualify for QCIV status.

**Certified deemed-compliant FFIs**

Certified deemed-compliant FFIs do not need to register with the IRS but must provide a withholding agent with specific documentation.

**Non-profit organizations:** This category of deemed-compliant FFI is not required to register with the IRS and is referred to as a certified deemed-compliant FFI because it must provide the withholding agent with specific documentation. It covers charitable and other similar organizations that are exempt from income tax in their home country, provided that no one has a proprietary interest in the assets or income of the entity. The exact details of how this provision will apply to some of the larger charity group structures are not clear.
Retirement funds: This category of deemed-compliant FFI also is not required to register with the IRS and is a certified deemed-compliant FFI because it must provide the withholding agent with specific documentation. A retirement fund can be within this category if it meets either of two sets of conditions. Both sets require that the fund be organized as a pension fund in its country of organization, that the amount of contributions be limited by reference to earned income, and that the amount of the fund’s assets to which each beneficiary is entitled be limited. One set of conditions adds the requirement that contributions are deductible or excluded from the beneficiary’s gross income or that 50% or more of the total contributions to the FFI are from the government or the employer. The alternative set of conditions adds three requirements: the fund must have fewer than 20 participants; the fund must be sponsored by an employer that is not an FFI or passive NFFE; and nonresidents of the fund’s country of organization must not be entitled to more than 20% of the fund’s assets.

Owner-documented FFIs
Owner-documented FFIs are required to document their status with a designated withholding agent that is either a US financial institution or a PFFI that agrees to report to the IRS as to any of the owner-documented FFI’s direct or indirect owners that are specified US persons.

These FFIs must be categorized as FFIs solely because they are primarily engaged in the business of investing. An owner-documented FFI will be treated as deemed compliant only with respect to payments for which it is not acting as an intermediary and that are received from withholding agents (designated withholding agents) that have agreed to treat the fund as an owner-documented FFI and to whom the FFI has provided required documentation. Also, the withholding agent must agree to report to the IRS all of the information required with respect to the FFI’s direct or indirect owners that are specified US persons. This category could be particularly relevant for family trusts and other investment vehicles.

Exempt beneficial owners: FATCA withholding does not apply to withholdable payments (or portions thereof) made directly, or through intermediaries, to “exempt beneficial owners” based on valid documentation. If an entity is an exempt beneficial owner, no IRS agreement or registration is required.

The categories of exempt beneficial owner are the following: (1) foreign governments, political subdivisions of a foreign government, and wholly owned instrumentalities and agencies of a foreign government; (2) international organizations and wholly owned agencies of an international organization; (3) foreign central banks of issue; (4) governments of US possessions; (5) certain non-US retirement plans; and (6) certain FFIs, i.e., entities primarily engaged in the business of investing, reinvesting or trading in securities, and wholly owned by one or more of the entities described above.

The last category is key for non-US funds organized as pension fund pooling vehicles or as vehicles reserved for a variety of investors that Treasury and the IRS recognize as posing a low risk of tax evasion.

To be treated as exempt, a non-US retirement plan must, broadly: (1) be the beneficial owner of payments made to it; (2) be established in a country with which the United States has an income tax treaty in force; and (3) generally be exempt from income taxation in its country of establishment and entitled to treaty benefits under the applicable US treaty. Alternatively, the retirement fund must: (1) be formed for the provision of retirement or pension benefits under the laws of the country in which it is established; (2) receive all of its contributions from government, employer or employee contributions that are limited by reference to earned income; (3) not have a single beneficiary with a right to more than 5% of the fund’s assets; and (4) be exempt from tax on investment income under the laws of the country where it is established or where it operates due to its retirement or pension fund status. Subject to conditions, a sovereign wealth fund could qualify as a controlled entity of a foreign government and, therefore, as an exempt beneficial owner under the Proposed Regulations.

Excepted NFFEs: A withholding agent is not required to withhold on a withholdable payment if the agent may treat the payment as beneficially owned by an excepted NFFE. Excepted NFFEs include (1) corporations, the stock of which is regularly traded on one or more established securities markets; (2) corporations that are members of the same EAG of regularly traded corporations; (3) entities that are organized or incorporated under the laws of a US possession and are directly
or indirectly wholly owned by one or more bona fide residents of the same US possession; (4) foreign governments, international organizations, foreign central banks, governments of US possessions, certain retirement funds and entities wholly owned by exempt beneficial owners (as discussed above); (5) active NFFE’s (less than 50% of the NFFE’s gross income for the preceding calendar year is passive income, or less than 50% of the assets held at any time during the preceding calendar year are assets that produce or are held for the production of passive income); and (6) excepted FFIs as described above. The entities listed in (4) are the same as those under “Exempt beneficial owners” above. Thus, payments made to these entities, when their status is documented as required, are exempt from all FATCA withholding.

The role of service providers and agents
From an IRS perspective, an investment fund (as a PFFI) will remain liable for FATCA compliance and any underpayments of FATCA tax even if third parties perform services for the fund, including fund administrators, distributors, transfer agents, investment banks, custodians and prime brokers. Investment funds need to determine what their third-party service providers are doing to be FATCA compliant.

Fund administrators: Fund administrators will play a key role in the FATCA compliance process. Many funds outsource investor relation functions to fund administrators who will collect investor information, perform the AML/KYC (anti money laundering/know your customer) process, and compute net asset value. For FATCA due diligence purposes, funds must reconcile the information maintained by the fund with the fund administrator’s data.

Distributors: Distributors may also be involved. Many funds raise capital by contracting with distributors. Depending on the contractual relationship, the distributor may be responsible for investor on-boarding, including AML/KYC, and may hold the assets. A distributor could be classified as an FFI for FATCA if it meets the FFI definition (e.g., holds client assets or owns fund shares or other investments as a result of purchasing and reselling shares in funds to meet the FFI definition).

Other agents: Onshore and offshore investment funds that use transfer agents, investment banks, custodians and prime brokers (“agents”) will need to address several questions related to FATCA compliance, including (1) whether the agent is in-house or outsourced; (2) who will determine when withholding is required (the fund or the agent); (3) whether the agent will rely on information/documentation provided by the fund or the transfer agent will request its own documentation; (4) what happens when information/documentation obtained by the fund/transfer agent does not reconcile; and (5) year-end reporting issues.

Funds remain liable for FATCA withholding
The use of third parties to fulfill FATCA compliance obligations (e.g., transfer agents, fund administrators) will not relieve a withholding agent/PFFI from compliance failures and ultimately under-withheld FATCA taxes. As with the Chapter 3 withholding regime, a withholding agent/PFFI that fails to withhold for FATCA purposes, despite knowing or having reason to know that a claim of non-US status is unreliable or incorrect, will be liable for the tax that should have been withheld, plus interest and penalties. This will apply to both foreign and US funds.

Timing issues for US and non-US investment funds
The Proposed Regulations provide revised start dates for the various FATCA withholding obligations, which have their own staggered start dates as well. Because FATCA implementation will involve the modification of systems, policies and procedures of financial institutions globally, the preliminary guidance provided a phase-in of FATCA withholding and reporting. The Proposed Regulations extend the timetable for certain FATCA withholding and reporting provisions.

Compliance and due diligence dates for non-US funds (PFFIs)
Online registration for PFFI status will begin no later than January 1, 2013. The first effective date for FFI Agreements is July 1, 2013, if the FFI application is submitted by June 30, 2013. For FFIs, investor due diligence for new investors (individual and entity) will begin no later than on July 1, 2013, or the effective date of the FFI Agreement, if later.

The schedule for investor due diligence for pre-existing entity investors is as follows: Due diligence generally must conclude: (1) for prima facie FFIs, within one year of the effective date of the FFI Agreement; and (2) for all other entities, within two years of the effective date of the FFI Agreement.

For PFFI investor due diligence for pre-existing individual investors, due diligence generally must conclude (1) for “high-value” investors, within one year of the effective date of the FFI Agreement; and (2) for all others, within two years of the effective date of the FFI Agreement.

The Proposed Regulations unfortunately do not provide more time for a US fund to get its house in order. Due diligence for all entity investors will begin January 1, 2013. Prima facie FFIs must be documented by January 1, 2014, and all other entities by January 1, 2015. New accounts are treated as recalcitrant if the information is not provided within 90 days of the account opening.

Withholding obligations of US funds
FATCA generally requires a withholding agent (other than a PFFI) to withhold on payments of US source FDAP and gross proceeds on disposition of securities that could produce US source income unless the withholding agent can reliably associate the payment with documentation on which it is permitted to rely to treat the payment as exempt from withholding. FATCA withholding is required with respect to US source FDAP paid after December 31, 2013 to (1) new accounts held by non-participating and presumed FFIs; and (2) pre-existing accounts held by “prima facie” FFIs.

Also, withholding is required on US source FDAP and gross proceeds paid...
Withholding obligations of PFFIs

Generally, a PFFI is required to begin withholding on US source FDAP payments to the following investor types starting January 1, 2014: (1) “new accounts” (e.g., an investor on-boarded after the effective date of the PFFI’s FFI Agreement) for recalcitrant individuals; (2) pre-existing accounts of high-value recalcitrant individuals; (3) pre-existing accounts for prima facie FFIs; and (4) certain types of pre-existing offshore entity accounts. January 1, 2015 is the general effective date for withholding on US source FDAP and gross proceeds paid to the remaining types of investors. As noted above, the Proposed Regulations reserve on the definition of foreign passthru payments and provide that withholding will not be required on such payments before January 1, 2017.

Timing and recommended approaches

Although the Proposed Regulations provide helpful guidance, many questions remain unanswered. The interpretation and implementation of the FATCA rules will pose significant challenges for the alternative investment industry. Overcoming these challenges requires significant planning. We believe the following are critical steps as part of the initial FATCA assessment process or to refresh the assessment if one has already been performed. The goal of the assessment is to identify the gaps between current processes and systems and FATCA-compliant processes and systems. The assessment is then followed by the creation of a target operating model that can be implemented in stages over the next several years to allow a fund to achieve compliance:

1. **Organizational awareness/education:** FATCA’s enterprise-wide reach requires an assignment of project ownership, people and budgets across business units (e.g., technology, operations, tax, legal/compliance). It is particularly important to increase FATCA awareness throughout the organization and across service lines.

2. **Legal entity analysis:** Assess current and potential legal entity structure and classification (e.g., investor analysis review quality and completeness of investor-level data and categorize investors into appropriate FATCA classifications, which will lead to an additional set of tasks depending on the classification).

3. **Investment analysis:** Identify which investments generate US source income, the payor/issuer of those investments, and the domicile and FATCA status of the payee.

4. **On-boarding process review:** Review current on-boarding process, including well-controlled Form W-8/W-9 collection and validation procedures. Documentation procedures will involve review of information gathered in the context of the due diligence required to comply with the AML/KYC rules. Meeting these standards could pose a challenge to many firms. The goal should be to have a repeatable process that satisfies periodic internal and IRS review/certification and reporting of account holders’ information by 2014.

5. **Coordination with administrators and other market participants:** Conduct conversations on roles and responsibilities that funds and their service providers (e.g., fund administrators, prime brokers, custodian, transfer agents) will play in the fund to achieve compliance.


3 The Proposed Regulations add an important clarification by defining “primarily” to mean that the entity’s gross income attributable to these activities equals or exceeds 50% of the entity’s gross income during the shorter of the three-year period ending on December 31 of the year in which the determination is made, or the period during which the entity has existed. This clarification is relevant in some cases where an entity receives income from the securities activities described above, as well as from portfolio management services.

4 The Proposed Regulations do not provide special Chapter 4 due diligence rules for a “U.S. financial institution” (the IRS Notices, supra note 2, use “USFI”). Instead, U.S. financial institutions are considered withholding agents and are subject to the Proposed Regulation provisions dealing with withholding agent responsibilities to document payees, report and withhold.

5 Withholding does not begin on gross proceeds until January 1, 2015, and for foreign passthru payments it will begin January 1, 2017 (at the earliest).

6 Withholding of Tax on Nonresident Aliens and Foreign Corporations.

7 Note 2, supra. See Semenov, Leventhal, Murphy and Li, “FATCA’s Impact on the Asset Management Industry,” 22 JOIT 26 (July 2011).

8 Source: www.fatf-gafi.org/pages/0,3417, en_32250379_32236992_1,1_1_1_1_1,00.html

9 “Presumed FFIs” include NFFEs that have not provided appropriate FATCA certifications.

10 Prima facie FFIs are payees that can be identified as a QI or non-QI in electronically searchable information, if they have failed to furnish required FATCA certifications, or for accounts maintained in the United States, a payee that is presumed or documented as a foreign entity for Chapter 3 purposes and the withholding agent’s electronically searchable information contains a North American Industry Classification System (NAICS) or Standard Industrial Classification (SIC) code indicating that payee is a financial institution. For instance, unit investment trusts, end management investment offices, and open-end investment funds would fall within the “prima facie FFI” category.

This article was first published in the June 2012 issue of Journal of International Taxation (Thomson Reuters/WG&L).

Contacts

Dmitri Semenov is a partner in the Financial Services Office of Ernst & Young LLP. Dmitri is based in New York and can be reached at +1 212 773 2552 or dmitri.semenov@ey.com.

Maria Murphy is an executive director in the Financial Services Office of Ernst & Young LLP. Maria is based in Washington, DC and can be reached at +1 202 327 6059 or maria.murphy@ey.com.

Ann Fisher is an executive in the Financial Services Office of Ernst & Young LLP. Ann is based in Boston and can be reached at +1 617 585 0396 or ann.fisher@ey.com.

Jun Li is a partner in the Financial Services Office of Ernst & Young LLP. Jun is based in New York and can be reached at +1 212 773 6522 or jun.li@ey.com.
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1205-1356624 NY
SCORE No. CK0533

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