IMPACT OF FATCA ON FOREIGN FUNDS

The breadth and complexity of the FATCA requirements in the proposed regulations issued by the IRS and Treasury Department pose significant challenges for many foreign funds and other foreign investment entities. Covered entities should prepare to enter into agreements with the IRS and begin to consider what amendments to their fund documents and changes to their processes are necessary for compliance.

Mary Conway
PARTNER
DAVIS POLK & WARDWELL LLP
Mary is a Partner in the firm's Tax Department and is based in the firm's New York office. Her practice focuses on investment management matters, including the formation and operation of private equity funds, hedge funds, mutual funds and other pooled investment vehicles.

Rachel D. Kleinberg
PARTNER
DAVIS POLK & WARDWELL LLP
Rachel is a Partner in the firm's Tax Department and is based in the firm's Menlo Park office. Her practice focuses on advice to corporate and private equity fund clients on mergers and acquisitions, joint ventures, spinoffs and reorganizations, as well as cross-border restructurings.

The tax provisions introduced in the Foreign Account Tax Compliance Act (FATCA) impose a 30% US withholding tax as an enforcement mechanism for a worldwide reporting regime designed to prevent US persons from using offshore investments to evade US federal income tax. Onerous reporting rules apply to "foreign financial institutions" (FFIs), which include foreign private equity funds, foreign hedge funds, foreign parallel entities of US funds, foreign blockers, and even foreign holding companies used by funds to acquire portfolio companies.

New proposed regulations, released in February 2012 by the Internal Revenue Service (IRS) and Treasury Department (Proposed Regulations), provide guidance on the FATCA reporting and withholding regime. The IRS previously issued preliminary guidance under FATCA in a series of notices (*IRS Notice 2010-60, IRS Notice 2011-34* and *IRS Notice 2011-53*).

This article provides an overview of FATCA's impact on foreign funds and other foreign investment entities, particularly in light of the Proposed Regulations.

>> For more information on the Proposed Regulations, search IRS Issues Proposed Regulations on FATCA on our website.

FATCA OVERVIEW

Once effective, FATCA will impose a 30% US withholding tax on any "withholdable payment" or "foreign passthru payment" made to an FFI unless the FFI complies with specified due diligence, reporting and withholding requirements or qualifies for one of certain narrow exemptions (see below *Narrow Exemptions for FFIs*). Subject to certain exceptions, a withholdable payment is:

- US-source "fixed or determinable annual or periodical" (FDAP) income (generally, US-source interest, dividends, rents and other types of payments, regardless of whether they are currently subject to US withholding tax).
- Gross proceeds from the sale of any property that could produce US-source dividends or interest (including US stock and loan principal repayments from a US borrower).

A foreign passthru payment is any payment (other than a withholdable payment) if the payment is both:

- "Attributable to" withholdable payments.
- Made by an FFI that meets the reporting requirements of FATCA.

Foreign passthru payments can include, for example, distributions to a foreign fund's equityholders if the fund complies with the FATCA reporting requirements.

Under the Proposed Regulations, many of the effective dates for FATCA reporting and withholding have been extended. In particular:

- Withholding on US-source FDAP income, such as dividends and interest, begins in 2014.
- Withholding on gross proceeds begins in 2015.
- Withholding on foreign passthru payments will not begin before January 1, 2017.

Under a grandfathering rule, FATCA withholding does not apply to payments in respect of, or gross proceeds from the disposition of, "obligations" (generally, instruments with a stated maturity date that are not treated as equity for US tax purposes) that are outstanding on January 1, 2013 and that are not materially modified after that date.

A foreign fund will be subject to the FATCA withholding tax on withholdable payments and foreign passthru payments it receives unless it either qualifies for one of the narrow exemptions or becomes a "participating FFI" by entering into an "FFI agreement" with the IRS. Under its FFI agreement, the foreign fund will be required to perform specified due diligence, reporting and FATCA withholding functions. The IRS will begin accepting FFI agreements by January 1, 2013. Generally, FFIs will need to:

- Enter into FFI agreements by June 30, 2013 to avoid the FATCA withholding that begins in 2014.
- File their first reports by September 30, 2014.

REQUIREMENTS FOR FATCA COMPLIANCE

As discussed above, a foreign fund that does not become a participating FFI will generally be subject to a 30% FATCA withholding tax not only on US-source dividends and interest, but also on gross proceeds from the sale of US stock or debt. In addition, if a foreign fund is not a participating FFI or does not qualify for one of the narrow exemptions described below (see below *Narrow Exemptions for FFIs*), the beneficial owner of a payment to the fund (in general, the fund itself, if the fund is treated as a corporation for US tax purposes, or the fund's partners or beneficiaries, if the fund is treated as a partnership or trust for US tax purposes) will not be entitled to a refund of any withheld FATCA tax unless it is a resident of a country that has an income tax treaty with the US.

Therefore, a foreign fund that is treated as a corporation for US tax purposes and is a resident of a non-treaty jurisdiction, such as the Cayman Islands, will not be entitled to a refund of FATCA withholding tax imposed on a payment to the fund even if the fund's investors are exempt from the FATCA withholding tax.

Any foreign fund that is currently a withholding foreign partnership (that is, a foreign partnership that has agreed with the IRS to act as a withholding agent under the non-FATCA US withholding tax regime) must become a participating FFI to maintain its status as a withholding foreign partnership.

FFI AGREEMENTS

To become a participating FFI, a foreign fund or other foreign investment entity must enter into an FFI agreement with the IRS. Under the Proposed Regulations, an FFI agreement will require the FFI to:

- **Obtain information from investors to determine which of its investor "accounts" are "US accounts."** This information will generally be on revised IRS Forms W-8 and W-9. Accounts are equity and debt interests in the fund that are not regularly traded on an established securities market. US accounts are accounts held by "specified" US persons (that is, US persons other than certain excepted entities, such as tax-exempt organizations, publicly traded corporations, banks and certain brokers and dealers) (Specified US Persons) or certain foreign entities with US owners.
- **Comply with specified verification and due diligence procedures relating to its investors.** For existing investor accounts with values above a stated threshold amount ($250,000 for accounts of entities maintained at an office or branch outside the US and $50,000 for accounts of individuals), a participating FFI must generally review its existing investor information (including manual searches of files, in the case of an individual investor with an account in excess of $1,000,000) to determine each investor's FATCA status and, in certain circumstances, must obtain certifications from the investor. With respect to new accounts, the FFI will generally be required to obtain IRS Form W-8 or W-9 and review other information it collects in order to determine the investor's FATCA status. The due diligence requirements for existing accounts and, to a lesser extent, for new accounts, will rely significantly on participating FFIs' existing procedures, including due diligence required by "know your customer" and anti-money laundering rules. These due diligence requirements will nevertheless require changes to many funds' data management systems.
- **Report to Treasury on an annual basis certain information about each US account it maintains.** Information that must be reported includes:
  - the investor's name, address and taxpayer identification number;
  - the account value (which generally can be the value normally used by the fund for reporting to investors); and
  - the amount of payments made to the account.

  At the election of the foreign fund or investment entity, the reporting requirement will be phased in, with reporting on payments (other than certain gross proceeds) beginning with respect to 2015 and full reporting beginning with respect to 2016.

The Proposed Regulations reserve on the precise definition of, and the rules applicable to withholding on, foreign passthru payments.

- **Report to Treasury certain foreign-source payments that it makes to non-participating FFIs in 2015 and 2016.** This rule is designed to deter non-participating FFIs from using participating FFIs as FATCA "blockers" prior to 2017 (when foreign passthru payments will be subject to FATCA withholding, absent a further extension of the effective date).
- **Withhold FATCA tax from withholdable payments and foreign passthru payments that it makes to certain account holders.** After the relevant effective date, the FFI will be required to withhold FATCA tax from withholdable payments and foreign passthru payments that it makes to:
  - any recalcitrant account holder (meaning, a holder who refuses to provide the information required by FATCA);
  - any non-participating FFI; and
  - any "qualified intermediary" if it has elected to have its US withholding obligations satisfied by the payor. Generally, a qualified intermediary is a foreign entity acting as an agent that has agreed with the IRS to undertake certain reporting and other functions under the non-FATCA US withholding tax regime.

  The Proposed Regulations reserve on the precise definition of, and the rules applicable to withholding on, foreign passthru payments. Under a controversial approach proposed in prior IRS guidance, the extent to which a payment made by a participating FFI would be treated as a foreign passthru payment would generally be determined by reference to the percentage of the participating FFI's assets that constituted "US assets" rather than by tracing the payment to withholdable payments received by the participating FFI. Treasury and the IRS have requested comments on approaches that would reduce the burden of calculating foreign passthru payments.
- **Provide any additional information requested by Treasury regarding US accounts.**
- **Request each holder of a US account to waive any foreign law that would otherwise prevent the reporting of any of the required information.** If a waiver is not obtained, the FFI will need to close the account.

An FFI will be able to register with the IRS and submit FATCA filings electronically. In addition, a responsible officer of an FFI will be required to make certain periodic certifications to the IRS with respect to the FFI's compliance with its FFI agreement.

It is not clear how long a foreign entity will have after its formation to enter into an FFI agreement. This could be a significant issue for the creation of foreign fund entities (such as blockers and co-invest vehicles) that are frequently and quickly formed in connection with specific investments.

Treasury and the IRS previously stated that they were considering whether an FFI agreement might be terminated due to the number of recalcitrant account holders. Accordingly, many foreign funds have been concerned that they might be required to remove investors who did not provide the necessary FATCA forms and information. This could be a particular problem for closed-end foreign funds, which may not be able to replace investors easily. While the Proposed Regulations do not currently contain any provisions on this issue, these types of provisions may be included in the actual FFI agreements.

In prior guidance, Treasury and the IRS stated that they are considering a centralized compliance option for foreign funds advised by a common investment manager, which would reduce the compliance burden for related foreign funds. Under this proposal, the investment manager would execute a single FFI agreement on behalf of each fund it advises and would be responsible for the funds' compliance with their obligations under FATCA.

However, the Proposed Regulations do not address this option. The preamble to the Proposed Regulations states that Treasury and the IRS intend to establish a coordinated application and oversight process for affiliated groups of FFIs. Because entities in a fund complex advised by a common investment manager will generally not constitute an affiliated group of FFIs for this purpose, this coordinated process will generally not be available to foreign funds.

NARROW EXEMPTIONS FOR FFIs

The Proposed Regulations provide for three special classes of entities that will be exempt from the FATCA withholding tax:

- Entities that are excluded from the definition of financial institution (including certain holding companies and start-up entities).
- Deemed compliant FFIs.
- Exempt beneficial owners, including foreign governments and certain foreign retirement funds.

These categories are quite narrow, and most foreign investment entities will not qualify for one of them. For example, holding entities in fund structures, including blocker entities, will not qualify for the exclusion from the definition of "financial institution" that is available to most holding companies.

Despite prior statements that Treasury and the IRS were considering treating FFIs with regularly traded interests (such as foreign exchange-traded funds) as a category of deemed compliant FFIs, the Proposed Regulations do not provide any special treatment for regularly traded foreign investment entities. Because regularly traded interests in an FFI will not be treated as "accounts" for FATCA purposes, an exchange-traded fund will not be required to identify and report information with respect to the holders of these interests. However, unless the regularly traded foreign investment entity is treated as one of the types of deemed compliant FFIs described below, it will be required to enter into an FFI agreement and to withhold on foreign passthru payments.

A few types of foreign investment vehicles may qualify as deemed compliant FFIs. In addition, a foreign investment vehicle (including a sovereign wealth fund) that is wholly owned by one or more exempt beneficial owners (for example, foreign governments or certain foreign retirement funds) will itself be treated as an exempt beneficial owner. Although these exceptions will provide relief to some foreign investment entities, most typical foreign private investment funds are unlikely to qualify as deemed compliant FFIs or as exempt beneficial owners.

A deemed compliant FFI will not have to file an FFI agreement, although it will be required to conduct certain FATCA-related due diligence. Foreign investment vehicles may qualify as one of the following categories of deemed compliant FFIs:

- Qualified Collective Investment Vehicles.
- Restricted Funds.
- Owner-Documented FFIs.

The first two categories (among others that generally are not applicable to foreign investment entities) are "registered deemed compliant FFIs," which are required to register with the IRS and generally cannot be affiliated with an FFI that is not a participating FFI or a registered deemed compliant FFI. Owner-Documented FFIs will be required to provide certain information about their investors to the applicable withholding agent.

Qualified Collective Investment Vehicles

To qualify as a Qualified Collective Investment Vehicle, a foreign entity must be regulated as an investment fund in its country of organization (for example, a foreign mutual fund). In addition, each holder of record of its equity interests and of its debt interests in excess of $50,000, as well as each other holder of any account it maintains, including its equity and debt interests that are not regularly traded, must be one of the following:

- A participating FFI.
- A US person other than an individual or other Specified US Person.
- An exempt beneficial owner.
- A registered deemed compliant FFI.

For example, a regulated foreign investment fund with regularly traded interests may qualify as a Qualified Collective Investment Vehicle if all its interests are held by clearing organizations that are participating FFIs.

Restricted Funds

In general, to qualify as a Restricted Fund, all of the following must apply:

- The foreign entity must be regulated as an investment fund in its country of organization and that country must comply with the rules of the Financial Action Task Force (an intergovernmental body that develops and promotes international policies to combat money laundering and terrorist financing).
- Interests in the foreign entity may be sold only through certain distribution channels (for example, through distributors that are participating FFIs) and may not be offered to US persons, non-participating FFIs or certain other types of foreign entities.
- The foreign entity must comply with certain other requirements intended to ensure that it does not directly or indirectly maintain accounts for Specified US Persons.

Owner-Documented FFIs

In general, to qualify as an Owner-Documented FFI, a foreign entity:

- Must be an FFI solely because it is a foreign investment entity (and therefore may not be a bank or insurance company).
- Must not be affiliated with any FFI other than an entity that is an FFI solely because it is a foreign investment entity.
- Must not maintain an account for any non-participating FFI.
- Must not issue debt, other than regularly traded debt, to any person in excess of $50,000.

> Treasury issued a joint statement with France, Germany, Italy, Spain and the UK announcing a plan to pursue bilateral agreements as an alternative to regular FATCA compliance for FFIs in those countries.

- Generally must submit to each cooperating withholding agent, on an annual basis, certifications and certain identifying information with respect to each of its equityholders.

A foreign investment entity that qualifies as an Owner-Documented FFI avoids FATCA withholding tax only with respect to payments from a withholding agent that meets both of the following requirements:

- Is either a US financial institution or a participating FFI.
- Agrees to collect and report to the IRS certain information with respect to the Owner-Documented FFI's equityholders.

Certain foreign family investment vehicles may qualify as Owner-Documented FFIs. However, most foreign hedge funds will not qualify because they will not meet the requirement that an Owner-Documented FFI not issue non-regularly traded debt in excess of $50,000. In addition, because this exception does not apply unless the withholding agent is a financial institution, it is unlikely to be very useful for many foreign private equity funds, which often receive income from other types of paying agents (for example, a US portfolio company engaged in a non-financial business).

ALTERNATIVE FATCA COMPLIANCE UNDER BILATERAL AGREEMENTS

In addition to publishing the Proposed Regulations, Treasury issued a joint statement with France, Germany, Italy, Spain and the UK announcing a plan to pursue bilateral agreements as an alternative to regular FATCA compliance for FFIs in those countries (referred to as partner countries). The proposed intergovernmental approach is intended to remove certain legal impediments to FATCA compliance and reduce costs for FFIs in the partner countries. Treasury has stated that it is in discussions with additional countries regarding these agreements.

FFIs organized in partner countries will not be required to enter into FFI agreements and will not be subject to FATCA withholding tax. They will also not be required to terminate the account of, or withhold FATCA tax from payments to, any recalcitrant account holder. Instead, the FFI will be required to collect information about US accounts and report the information to its local tax authorities. The government of the partner country will then transmit this information to the US.

Despite the intent of reducing administrative burdens and costs, it is possible that asset managers who sponsor funds in multiple jurisdictions would be subject to more onerous reporting requirements and costs under the bilateral agreements than they would under the basic FATCA regime.

It is not clear whether any bilateral agreements will be in place prior to June 30, 2013 (when an FFI would otherwise be required to have entered into an FFI agreement) or January 1, 2014 (when FATCA withholding begins).

FATCA PROVISIONS IN FUND DOCUMENTS

New foreign funds and other foreign investment entities should include provisions in their operational and organizational documents to address the FATCA requirements. In particular, a foreign fund's documents (including partnership agreements and subscription agreements) should:

- Permit the fund to enter into and comply with an FFI agreement.
- Require the fund's direct and indirect owners to provide FATCA-related information to the fund (generally on revised IRS Forms W-8 and W-9).
- Permit the fund to remove investors, if necessary under FATCA.
- Include waivers from investors of any provisions of foreign law that would prevent compliance with an FFI agreement.

In addition, some fund investors may seek assurances from a foreign fund that it will enter into and comply with an FFI agreement. The fund and investors may also seek indemnities for failures caused by any party that results in the imposition of a FATCA tax.

Because of the rules with respect to foreign passthru payments, the flexibility to be FATCA-compliant may be desirable even for foreign funds that do not intend to receive US-source payments. Existing foreign funds will need to consider whether they should amend their existing documents to include FATCA-related provisions.

Foreign funds will also need to consider how to remove investors should it become necessary under FATCA. In particular, a forced redemption of an investor's interest in the foreign fund could be a problem for a closed-end fund, because it may lead to a shortfall in capital without an easy means of obtaining alternative funding.

CLOs

It may be difficult for existing collateralized loan obligations (CLOs) and other foreign securitization vehicles to become participating FFIs. A typical CLO is governed by a trust indenture (or similar document), which specifies the types of assets that can be acquired and how payments will be made to the CLO's debt holders and equityholders. The trust indenture can generally be amended only with the approval of a supermajority of the affected class of the CLO's securities. Trust indentures that pre-date FATCA would not authorize the CLO to enter into an FFI agreement or to perform the various information-gathering and diligence functions. In addition, if an existing CLO does withhold FATCA tax from payments to its investors, the CLO might be allowed or required to terminate under the terms of the trust indenture.

There is no blanket exemption from FATCA requirements for existing CLOs, despite requests for an exemption in comment letters from the Loan Syndications and Trading Association (LSTA) and the Securities Industry and Financial Markets Association (SIFMA). Under the Proposed Regulations, debt obligations outstanding on January 1, 2013 are grandfathered from withholding requirements unless they are materially modified after that date. However, a material modification of a debt obligation held by a CLO (including certain amend-and-extend transactions) could subject the CLO to FATCA withholding. In addition, after the grandfathering date, a CLO may have difficulty reinvesting funds in new loans that are not subject to FATCA withholding.

The LSTA and SIFMA also requested in comment letters that any new foreign securitization vehicle be treated as a deemed compliant FFI if all interests in the vehicle are held through FATCA-compliant clearing systems, US financial institutions or participating FFIs. The Proposed Regulations, however, have not adopted a deemed compliant FFI category for these vehicles.