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Alert Memo
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Summary of the Impact of the FATCA Proposed Regulations on Investment Funds

I BACKGROUND

On February 8, 2012, the United States Department of the Treasury and Internal Revenue Service released proposed regulations implementing sections 1471 through 1474 of the Internal Revenue Code (commonly called "FATCA"). The proposed regulations would impose reporting and withholding obligations on "foreign financial institutions" (or "FFIs") that enter into an "FFI agreement". Under the proposed regulations, *starting in 2014*, FFIs that do not enter into an FFI agreement would be subject to a 30% withholding tax on U.S.-source interest, dividends, and other types of passive income ("FDAP income"). The proposed regulations defer imposition of a withholding tax on gross proceeds from the sale of property producing U.S.-source dividends and interest until 2015.[1] A more detailed discussion of the proposed regulations is included in our February 15, 2012, alert memo "Treasury and the IRS Release Proposed Regulations under FATCA and a Joint Statement with Other Countries Regarding an Intergovernmental Approach to FATCA Implementation" (the "Alert Memo").

Foreign private equity funds, hedge funds, and similar investment funds ("investment funds") and foreign entities affiliated with investment funds would generally be treated as FFIs under the proposed regulations. They would generally need to enter into FFI agreements (or be able to become compliant), and they would be subject to the full range of reporting and withholding obligations imposed on FFIs. There are certain rules regarding FFIs that may be "deemed compliant" but, in practice, they will generally not be relevant to investment funds. This summary focuses on some of the practical aspects of complying with the proposed regulations as an investment fund.

- *U.S. Investment Fund Entities Would Not Themselves Be FFIs*. U.S. entities (including U.S. investment funds and portfolio companies) would not be FFIs under the proposed regulations.
    - U.S. funds would not be FFIs. However, foreign feeder funds, alternative investment vehicles, parallel funds, and foreign blocker corporations organized in

[1] U.S.-source FDAP and such gross proceeds are together "withholdable payments" under the proposed regulations.

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connection with a U.S. fund would not be eligible for an exclusion and would all generally be FFIs. Because the proposed regulations would treat these entities very similarly to foreign investment funds, the remainder of this summary includes such foreign entities affiliated with U.S. investment funds as "foreign investment funds".

  - U.S. investment funds and U.S. portfolio companies would have an obligation to withhold on certain payments made to noncompliant FFIs and certain "non-financial foreign entities" (or "NFFEs").

- *Foreign Investment Funds Would Generally Be FFIs*. The proposed regulations do not contain a broad-based exception to FFI status for foreign investment funds. Foreign investment funds that do not enter into FFI agreements would generally be subject to withholding.

  - Private equity funds would be unable to qualify for an exemption available to holding companies that own the stock of subsidiaries engaged in active nonfinancial businesses.

  - A "qualified collective investment vehicle" would be able to qualify for deemed-compliant FFI status, but only if regulated in its country of incorporation *as an investment fund*. Although the precise scope of this exemption is unclear, it is likely intended to capture regulated investment entities like foreign mutual funds.[2]

  - A publicly traded corporation could qualify as an "excepted NFFE", but publicly traded partnerships (*e.g.*, certain publicly traded foreign permanent capital vehicles) *would* be subject to classification as FFIs.[3]

  - Certain fund entities may be able to qualify as "certified deemed-compliant" FFIs under special rules for "owner-documented FFIs," to the extent the owner-documented FFI provides documentation to a designated withholding agent that agrees to report and withhold with respect to the entity.

II STRUCTURING TO RESPOND TO FATCA

- Because a wide variety of foreign entities affiliated with investment funds would be FFIs, newly formed funds and foreign investment fund entities should generally include in their organizational or operating documents flexible provisions to allow for the filing of an FFI

[2] Exceptions available for certain investment entities are discussed in more detail on pages 10-11 of the Alert Memo.

[3] This summary does not generally address the rules in the proposed regulations that would govern NFFEs, because few if any investment funds would qualify as such. The NFFE rules are discussed in the Alert Memo.

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agreement (including gathering the necessary information about their owners and other account holders).

  - Even foreign investment funds not intending to derive withholdable payments (and which would thus not be subject to withholding before the foreign passthru payment rules are implemented in 2017) may change investment strategies or may not have occasion to amend their operating documents before foreign passthru payments become subject to withholding.
  - Existing foreign investment funds should consider whether to amend their operating documents to include flexible provisions relating to a possible future FFI agreement.
  - Prior IRS notices had stated that withholding on "recalcitrant" account holders was intended to provide relief for participating FFIs that could not collect the information necessary under their FFI agreements with the IRS, but that IRS and Treasury were considering whether and in what circumstances an FFI agreement might be terminated due to the number of long-term recalcitrant account holders.[4] This created concern that in some situations a fund (or particular fund entity) might need to "close" the financial account of such recalcitrant holders (i.e., kick them out of the fund in some manner). The proposed regulations do not currently appear to adopt such a requirement, although it will ultimately depend on the terms of the FFI agreement the IRS adopts for investment funds.

- Because it is unclear how information sharing between affiliated funds will work under the final rules, each investment fund should have the flexibility to collect the information it needs on its own behalf (instead of, for example, relying on documentation collected and retained by its affiliated asset manager).
- Because the rules for determining the payee of a withholdable payment would sometimes impose FATCA withholding tax on lower tier entities in an investment fund structure, all investment fund entities in the chain should ensure that, under their organizational or operating documents, they have the flexibility to collect the necessary information about their *indirect* owners (both affiliated and unaffiliated) as well as their direct owners.
- To properly allocate any FATCA withholding tax imposed, each investment fund that is a pass-through for U.S. tax purposes (whether it expects to be directly owned by third parties or not) should have the flexibility to specially allocate the burden of any FATCA withholding tax to the ultimate indirect owner that gave rise to the withholding obligation.

[4] *See* Notice 2010-60, 2010-37 IRB 329; Notice 2011-64, 2011-37 IRB 231. *See also* Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives To Restore Employment Act," Under Consideration by the Senate (JCX-4-10), p. 40.

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- In certain cases, it may be possible to have withholding and reporting obligations with respect to some fund entities effectively allocated to a central designated withholding agent by qualifying the fund entities as "owner-documented FFIs".

III INFORMATION COLLECTION AND REPORTING

- *Each Foreign Investment Fund Would Need To File An FFI Agreement*. The FFI agreement would require the FFI to report certain information about the investment fund's U.S. "account" holders, including identifying information, the "account number", the "account balance" or value, and any payments made to the account during the calendar year.
  - For this purpose, the account balance or value can be the value normally used by the investment fund (*e.g.*, GAAP for a private equity fund, or mark to market NAV for a hedge fund). While it is not clear what "account balance" or value would be relevant for a partnership profits interest, it is likely that the tax capital account would be sufficient.
  - Starting in 2015 all payments to U.S. accounts of an FFI would be reported (not just payments from U.S. sources).
- *Account Holders Would Generally Include Equity and Debt Owners*. Under the proposed regulations, equity or debt interests in a foreign investment fund would generally be "accounts", unless the interest was regularly traded on an established securities market.
  - It would be possible for some publicly traded FFIs to have no accounts at all (although non-traded debt, etc., of the FFI would still be an account). Such FFIs would still need to enter into an FFI agreement to avoid being subject to withholding tax on payments made to them.
  - An interest would be regularly traded for this purpose if it met certain minimum trading thresholds in the prior calendar year and was listed on a designated U.S. or foreign securities exchange. It is unclear under the proposed regulations how an interest in an FFI might qualify as regularly traded (and thus excluded from the definition of an "account") in the first year following the FFI's IPO.
  - Under the proposed regulations, options or other derivative instruments issued by an investment fund are not explicitly included in the definition of an equity interest.
- *Burden of FFI Reporting By Investment Funds*. Compared to other FFIs, investment funds may face a lighter reporting burden.[5]

[5] The Alert Memo discusses the specific account diligence requirements imposed on FFIs and U.S. withholding agents in more detail on pages 12-15.

  - Investment funds have fewer account holders than other FFIs (*e.g.*, banks), make fewer payments to their account holders, and require more information when an account is entered into as a matter of course (*i.e.*, through a subscription agreement).
  - Many account holders of investment funds would be: FFIs (*e.g.*, funds of funds) that are themselves seeking to comply with FATCA; exempt entities, such as entities owned by foreign sovereigns (including multiple foreign sovereigns, and even if engaged in commercial activity) and foreign pension funds; or U.S. persons that had already provided an IRS Form W-9.

- *Several Aspects Of The Application Of These Requirements To Investment Funds Remain Unclear*. The proposed regulations do not contain detailed rules about the timing and procedure of entering into an FFI agreement. For example:
  - It is not clear how soon after formation an FFI agreement must be entered into to be retroactive to formation—this will be particularly relevant to private equity funds that may need to form FFIs (*e.g.*, AIVs) on short notice.
  - The proposed regulations would not implement a suggestion contained in an earlier IRS notice that all investment funds affiliated with a common asset manager could execute a single FFI agreement.
  - Investment funds affiliated with a common asset manager would often not meet the ownership requirement to be treated as an "expanded affiliated group". The preamble to the proposed regulations discusses future guidance governing the registration of expanded affiliated groups of FFIs, but whether streamlining procedures will be provided for other groups of FFIs is unclear.

- *Both FFIs and U.S. Investment Funds Would Need To Identify Payees*. In order to comply with their withholding obligations under the proposed regulations, U.S. payors would need to identify payees that are FFIs and NFFEs.
  - FFIs will have comparable obligations imposed on them under their FFI agreements.
  - The rules governing the determination of the payee of a withholdable payment are complex. Both U.S. and foreign investment funds may in some situations be required to look through unaffiliated owners that are pass-through entities for U.S. tax purposes (*e.g.*, a fund of funds).
  - The rules in the proposed regulations to allow information sharing between related branches, mutual funds, or brokers would not appear to apply to investment funds.

IV **WITHHOLDING**

- *U.S. Investment Funds Would Need to Withhold On Payments To Noncompliant FFIs And Certain NFFEs*. Because of the deemed payee rules in the proposed regulations, even U.S. investment funds with no direct foreign owners would potentially have withholding obligations.
  - The proposed regulations would in some cases impose withholding on a lower tier entity in an investment fund structure (*e.g.*, an entity not owned by unaffiliated third parties).
  - For example, a participating corporate FFI (*e.g.*, a blocker) would be treated as a payee and not withheld on, while a participating pass-through FFI might be looked through and withheld on if it had indirect owners that were nonparticipating FFIs or recalcitrant account holders. The structures used by investment funds may therefore affect potential withholding taxes under FATCA (particularly prior to the effectiveness of rules requiring withholding on foreign passthru payments in 2017).
- *Each Foreign Investment Fund Could Have Withholding Obligations*. In addition to requiring it to gather information and report on its U.S. owners, a foreign investment fund's FFI agreement would require it to withhold on withholdable payments paid to noncompliant FFIs, recalcitrant account holders and certain other entities.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our U.S. partners and counsel listed under Tax under the "Practices" section of our website at http://www.clearygottlieb.com.

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