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FATCA: Implications for Non-US Funds

A General Guide for Determining the Applicability of FATCA to Non-US Funds.¹

I. What Is FATCA?

FATCA refers to the US Foreign Account Tax Compliance Act (contained in Sections 1471 through 1474 of the US Internal Revenue Code). FATCA was enacted in 2010 in order to reduce perceived offshore tax evasion by US persons holding assets through offshore accounts that were not subject to US information reporting to the Internal Revenue Service (“**IRS**”) under the existing reporting system. As discussed below, FATCA generally requires certain foreign (*i.e.*, non-US) entities that are not exempt from, or deemed to be compliant with, FATCA to either register with the IRS and conduct certain diligence and reporting regarding their investors and account holders or be subject to 30% US withholding tax on certain US-source income paid to the entity. Many countries have entered into intergovernmental agreements (“**IGAs**”) with the United States that modify the basic FATCA rules set forth in the US Treasury regulations promulgated under FATCA.

II. Does FATCA Apply to Me?

FATCA applies to foreign entities that are foreign financial institutions (“**FFIs**”). FFIs are foreign entities that:²

- accept deposits in the ordinary course of a banking or similar business;
- hold financial assets for the account of others as a substantial portion of their business;
- are foreign investment entities, including entities that conduct certain investment and asset management activities for customers, entities that are managed by other FFIs and the gross income of which is primarily attributable to investing, reinvesting or trading in financial assets and certain collective investment vehicles with investment strategies of investing, reinvesting or trading in financial assets;³
- are insurance companies that issue investment-like contracts or annuity contracts or
- are certain holding companies or treasury centers that are members of corporate groups that include FFIs or that are formed by certain investment vehicles.

This definition is very broad and encompasses entities that would not typically be considered to be financial institutions, such as private equity funds, hedge funds, venture capital funds, certain family investment vehicles and other similar investment funds (other than investment funds wholly owned and controlled by foreign sovereigns). FATCA also applies to foreign feeder funds, alternative investment vehicles, parallel funds and foreign blocker entities organized in connection with such foreign investment funds or US funds.

¹ This publication is intended as an overview of these issues and does not address all aspects of FATCA. It should not be regarded as legal advice.

² This definition is drawn from the US Treasury regulations and may be modified to varying degrees by an applicable IGA or country-specific guidance notes, as discussed below.

³ “Financial assets” are securities, partnership interests, commodities, notional principal contracts, insurance or annuity contracts or any interest (including a futures or forward contract or option) in a security, partnership interest, commodity, notional principal contract, insurance contract or annuity contract.

If a foreign entity is not an FFI, it is a “non-financial foreign entity” (an “**NFFE**”). An NFFE generally is not required to comply with the diligence and reporting requirements applicable to FFIs and described in this memorandum. However, in certain circumstances, an NFFE may be required to identify and make a certification to a withholding agent regarding US persons who own accounts or substantial interests in the NFFE.

III. When Does FATCA Apply?

FATCA applies when an FFI receives “**withholdable payments**,” which include:

- payments of US-source interest and dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other “fixed or determinable annual or periodic” gains, profits and income (so-called “**FDAP**” income) and
- gross proceeds from the sale or other disposition of any property of a type which can produce US-source interest or dividends, regardless of whether the recipient realized a gain (or loss) with respect to such property.⁴

In general, an FFI that does not derive, and is not treated as the payee of, any withholdable payments should not be subject to withholding under FATCA even if it does not become a Participating FFI or a deemed-compliant FFI (as explained below).

Payments of FDAP income are potentially subject to FATCA withholding as of July 1, 2014. Gross proceeds from the disposition of property that can produce US-source interest and dividends will only be subject to FATCA withholding for dispositions occurring after December 31, 2016. FATCA does not apply, however, with respect to FDAP income derived from, and gross proceeds from a disposition of, any “**grandfathered obligations**.”⁵ In addition, prior to January 1, 2017, a payment made by a secured party, or to a secured party other than a nonparticipating FFI,⁶ with respect to collateral under a collateral agreement securing certain transactions, including debt instruments and derivative financial instruments, will not be subject to FATCA withholding, provided that only a commercially reasonable amount of collateral is held by the secured party as part of the collateral arrangement. This is the case even if the securities posted as collateral would not themselves be considered “grandfathered obligations.”

IV. I Receive Withholdable Payments – What Do I Need to Do?

a. Become a “Participating FFI”

To comply with FATCA, an FFI generally is required to enter into an “**FFI Agreement**”⁷ with the IRS and become a Participating FFI, unless:

- the FFI is subject to a Model 1 IGA (which may depend on its country of organization or tax residence, as discussed below)⁸ or

⁴ In addition, beginning no earlier than 2017, withholding may also be required with respect to “foreign passthru payments.” An initial notice issued by the IRS in 2011 proposed that noncustodial payments by an FFI (such as interest payments on savings accounts at the FFI) would be subject to FATCA withholding in proportion to the percentage of US assets owned by the paying FFI, referred to as its “passthru payment percentage.” However, the current US Treasury regulations under FATCA reserve on the definition of a foreign passthru payment, and it is unclear whether, or to what extent, withholding on foreign passthru payments will be required.

⁵ The most important category of grandfathered obligations comprises obligations, such as debt obligations, outstanding on July 1, 2014 and not materially modified thereafter. Equity interests do not qualify as grandfathered obligations regardless of when they are issued.

⁶ A nonparticipating FFI is an FFI that has chosen not to become a Participating FFI and is not an exempt beneficial owner, an excluded FFI or a deemed-compliant FFI, as explained below.

⁷ The current FFI Agreement is available at <http://www.irs.gov/pub/irs-drop/rp-14-38.pdf>. The FFI Agreement is a standard agreement that is the same for every FFI.

⁸ See Part V for countries that have signed IGAs with the United States or are currently treated as having signed IGAs because they have reached agreements in substance with the United States.

- the FFI qualifies for one of several exceptions, including exceptions for “deemed-compliant” FFIs (discussed below) and certain other types of FFIs that are specifically identified as “**exempt beneficial owners**”⁹ or excluded under the applicable US Treasury regulations.¹⁰

An FFI that is required to become a Participating FFI must enter into an FFI Agreement with the IRS by registering through the FATCA internet portal that is available at www.irs.gov/fatca-registration. An FFI Agreement that was entered into before July 1, 2014 has an effective date of June 30, 2014.¹¹ Once an FFI has registered with the IRS as a Participating FFI, the IRS must approve the registration and, upon approval, the IRS issues a “global intermediary identification number” (“**GIIN**”) to the FFI. The IRS has published an electronic “**IRS FFI List**” of Participating FFIs and registered deemed-compliant FFIs, which is updated periodically and which is available at:

<http://www.irs.gov/Businesses/Corporations/FATCA-Foreign-Financial-Institution-List-Search-and-Download-Tool>. The IRS FFI List is important because both US withholding agents and Participating FFIs generally are required to verify an FFI’s GIIN, which an FFI is required to furnish with its certification that it is a Participating FFI or a registered deemed-compliant FFI, in order to avoid FATCA withholding on withholdable payments made to the FFI.

Registration as a Participating FFI requires, in addition to the provision of certain identifying information about the FFI, a designation of a “**responsible officer**” and other persons acting as points of contact for the IRS. The FFI’s responsible officer must electronically sign the agreement with the IRS.

Once an FFI enters into an FFI Agreement and becomes a Participating FFI, it generally may terminate the FFI Agreement by providing notice to the IRS through the FATCA registration portal. Such an FFI will become a nonparticipating FFI unless it qualifies as an excluded FFI or is deemed compliant with FATCA. A Participating FFI that terminates its FFI Agreement will be required to notify all withholding agents that make payments to it of its change in FFI status.

b. Become a “Registered Deemed-Compliant FFI”

FFIs that qualify as “**deemed-compliant FFIs**” are not required to enter into FFI Agreements. There are two categories of deemed-compliant FFIs: “**certified deemed-compliant FFIs**”¹² and “**registered deemed-compliant FFIs**.” An FFI subject to a Model 1 IGA (and not otherwise exempt or deemed-compliant) generally automatically qualifies as a registered deemed-compliant FFI as long as it complies with the registration requirements of the applicable IGA. Certain registered deemed-compliant FFIs subject to a Model 1 IGA are subject to diligence and reporting requirements, but the requirements are less stringent than those applicable to a Participating FFI, as described in Part VIII(a). However, other Model 1 registered deemed-compliant FFIs within one of the subcategories described in the next paragraph may have no diligence or reporting requirements. An FFI subject to a Model 2 IGA (and not otherwise exempt from application of the FATCA rules) generally are subject to many of the same requirements as a Participating FFI. However, an FFI subject to a Model 2 IGA may qualify as a registered deemed-compliant FFI if it meets the requirements of one of the types of registered deemed-compliant FFIs listed in Annex II of the applicable Model 2 IGA or if it meets the requirements of one of the types of registered deemed-compliant FFIs provided for in the US Treasury regulations.

⁹ “Exempt beneficial owners” generally include: (a) foreign governments and their political subdivisions, instrumentalities and controlled entities; (b) international organizations; (c) foreign central banks of issue; (d) governments of US territories; (e) certain foreign retirement plans and (f) entities wholly owned by other exempt beneficial owners.

¹⁰ Excluded FFIs include: (a) certain financial entities of a nonfinancial group; (b) nonfinancial start-up companies or companies entering into new lines of business; (c) entities in liquidation or bankruptcy; (d) certain foreign entities that are members of Participating FFI groups and (e) certain US and foreign nonprofit organizations.

¹¹ The effective date is relevant for the determination of which accounts qualify as “preexisting accounts” and certain other aspects of FATCA reporting.

¹² This category generally applies to small and local banks and certain other narrow categories of entities.

The categories of registered deemed-compliant FFIs provided for in the US Treasury regulations include: (i) certain local banks; (ii) non-reporting members of certain corporate groups; (iii) collective investment vehicles and certain restricted funds; (iv) qualified credit card issuers and servicers and (v) “sponsored investment entities” and controlled foreign corporations. The sponsored investment entity category provides an opportunity for fund managers and FFIs with multiple related entities to streamline and centralize compliance with FATCA requirements for their various investment funds and related entities. For an entity to be treated as a sponsored investment entity, a “sponsoring entity,” including a Participating FFI or a US financial institution, must agree to perform, on behalf of the sponsored entity, all due diligence, reporting and withholding requirements that the sponsored entity would otherwise have been required to perform as a Participating FFI.

Registered deemed-compliant FFIs must also register with the IRS, generally through the internet portal mentioned above, and obtain GIINs. They will then be listed on the IRS FFI List.

Please see the attached Annex for a chart to assist in classifying a foreign entity under FATCA.

V. What Is an IGA and Which Countries Have Entered into IGAs?

a. Model 1 IGAs

Countries that enter into **Model 1 IGAs** will establish local information reporting regimes pursuant to which FFIs that are subject to the IGA report FATCA-relevant information to the local taxing authorities (or possibly other governmental authorities). The information will then be furnished by the relevant local governmental authority to the US Department of the Treasury. An FFI that is subject to a Model 1 IGA and that is required to report FATCA-relevant information to the partner-country taxing authority does not need to enter into an FFI Agreement, but is required to register with the IRS and obtain a GIIN. However, an FFI that is subject to a Model 1 IGA is not required to obtain a GIIN or provide a GIIN to a withholding agent before January 1, 2015.

The table below lists the countries with which Model 1 IGAs have been signed and with which Model 1 IGAs have been agreed in substance:¹³

Model 1 IGA signed	Model 1 IGA agreed in substance
Australia, Belgium, British Virgin Islands, Canada, Cayman Islands, Costa Rica, Czech Republic, Denmark, Estonia, Finland, France, Germany, Gibraltar, Guernsey, Hungary, Honduras, Ireland, Isle of Man, Israel, Italy, Jamaica, Jersey, Latvia, Liechtenstein, Luxembourg, Malta, Mauritius, Mexico, Netherlands, New Zealand, Norway, South Africa, Spain, Slovenia and United Kingdom	Algeria, Anguilla, Antigua and Barbuda, Azerbaijan, Bahamas, Bahrain, Barbados, Belarus, Brazil, Bulgaria, Cabo Verde, China, Colombia, Croatia, Curaçao, Cyprus, Dominica, Dominican Republic, Georgia, Greenland, Grenada, Guyana, Haiti, India, Indonesia, Kosovo, Kuwait, Lithuania, Malaysia, Montenegro, Panama, Peru, Poland, Portugal, Qatar, Romania, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Saudi Arabia, Serbia, Seychelles, Singapore, Slovak Republic, South Korea, Sweden, Thailand, Turkey, Turkmenistan, Turks and Caicos Islands, Ukraine, United Arab Emirates and Uzbekistan

¹³ Data current as of August 15, 2014. The IRS list of countries that have signed IGAs or have agreed upon IGAs in substance is updated regularly and is available at <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx>.

b. Model 2 IGAs

Model 2 IGAs differ from Model 1 IGAs in that they do not provide for information reporting to the partner-countries' taxing or other governmental authorities, and instead generally require an FFI to report relevant FATCA information directly to the IRS. Accordingly, an FFI that is subject to a Model 2 IGA generally must enter into an FFI Agreement unless it qualifies as a deemed-compliant FFI, an excluded FFI or an exempt beneficial owner under the applicable Model 2 IGA. Pursuant to its FFI Agreement, an FFI subject to a Model 2 IGA generally must comply with applicable due diligence rules, which may be modified by the Model 2 IGA.

The table below lists the countries with which Model 2 IGAs have been signed and with which Model 2 IGAs have been agreed in substance:¹⁴

Model 2 IGA signed	Model 2 IGA agreed in substance
Austria, Bermuda, Chile, Japan and Switzerland	Armenia, Hong Kong, Iraq, Moldova, Nicaragua, Paraguay, San Marino and Taiwan

c. Application and Interpretation of IGAs

FFIs that believe that they may be subject to an IGA should confirm the specific requirements of the IGA. Certain IGAs apply to FFIs that are "resident in" the relevant country. "Resident" may mean tax resident as defined under the country's existing laws or as specified in any legislation or guidance issued by the country regarding the IGA. In contrast, other IGAs, including the Cayman Islands' IGA, apply to FFIs that are "organized under the laws of" the relevant country. Accordingly, depending on the circumstances, an FFI may potentially be subject to multiple IGAs (in which case the treatment is currently unclear) or no IGA (in which case the default rules of the US Treasury regulations would apply). Several countries, including the United Kingdom, have issued detailed guidance notes to expand upon and clarify details of the relevant IGA. Such guidance notes continue to be issued and revised as the FATCA regime evolves, and may contain country-specific details and exceptions that differ from the US Treasury regulations and guidance notes issued by other IGA countries.

VI. What Happens if I Don't Comply with FATCA?

a. If You Receive Withholdable Payments

The primary consequence of not complying with FATCA is that withholdable payments that you receive will be subject to a withholding tax at a rate of 30%. US withholding agents generally must deduct and withhold tax at a 30% rate on:

- **withholdable payments** made to nonparticipating FFIs that are not exempt beneficial owners, excluded FFIs or deemed-compliant FFIs and
- payments of **US-source FDAP** made to Participating FFIs acting as intermediaries (other than withholding qualified intermediaries ("QIs")) or flow-through entities (other than withholding foreign partnerships or withholding foreign trusts), except to the extent Participating FFIs provide the US withholding agents with valid documentation that establishes the portion of the payment that is allocable to a class of payees for which no withholding is required.

¹⁴ Data current as of August 15, 2014.

b. If You Do Not Receive Withholdable Payments

If the FFI does not receive any withholdable payments, there will be no consequences under FATCA even if the FFI is noncompliant. However, there may be ancillary consequences to FFIs if they are considered to be nonparticipating FFIs for FATCA purposes. For example, it may be more difficult to open a bank account or enter into certain types of transactions or agreements with certain financial institutions, as some financial institutions may require that all counterparties be FATCA-compliant (even where the specific account or product involved would not raise FATCA withholding risks). Some investors may also request or even demand that FFIs become Participating FFIs, based on reputational concerns that may arise with respect to nonparticipating FFIs. In addition, some countries may require FFIs in those countries to comply with FATCA under legislation or regulations that implement an applicable IGA, even though FATCA compliance would otherwise be voluntary. For these reasons, some funds have decided to comply with FATCA, even where currently it is not directly relevant to such funds.

If the FFI does not currently receive any withholdable payments, but may do so in the future, then the FFI will be able to register under FATCA at that later date. However, any withholdable payments received prior to such registration will be subject to FATCA withholding.

VII. What Happens if One of My Investors Does Not Comply with FATCA?

If any investor is a nonparticipating FFI or a recalcitrant account holder,¹⁵ then an FFI (as a Participating FFI) will be required to act as a withholding agent and withhold tax at a 30% rate on withholdable payments to such nonparticipating FFI or recalcitrant account holder. FFIs that are subject to a Model 1 IGA generally are not required to withhold, although they must report information about their investors that are nonparticipating FFIs or recalcitrant account holders. The withholding requirements for FFIs that are subject to Model 2 IGAs are also relaxed in certain circumstances.

VIII. Going Forward, What Do I Need to Do to Ensure That I Am FATCA Compliant?

a. Your Compliance Requirements if You Are a Participating FFI

Under its FFI Agreement, a Participating FFI generally must:

- follow specified due diligence procedures to identify its (i) US accounts, (ii) accounts held by nonparticipating FFIs and (iii) accounts held by recalcitrant account holders;
- report annually to the IRS with respect to such accounts;
- act as a FATCA withholding agent and withhold on withholdable payments to nonparticipating FFIs and recalcitrant account holders and
- establish a FATCA compliance program and have its responsible officer periodically certify to the IRS the effectiveness of the compliance program.

For FATCA purposes, an account is defined more broadly than a traditional bank account and generally includes equity and debt interests in investment entities and certain equity and debt interests in other financial institutions, in each case with exceptions for certain publicly-traded interests. As part of the diligence process, specific information must be obtained with respect to both newly-opened accounts and preexisting accounts, and the applicable procedures differ depending on whether the account holder is an individual or an entity.

¹⁵ A "recalcitrant account holder" is generally an account holder that has failed to provide the Participating FFI with the information necessary for the Participating FFI to determine whether the account holder is a US person or other information that the Participating FFI is required to report to the IRS.

For **newly-opened accounts**, a Participating FFI must implement appropriate account opening procedures so that the Participating FFI receives sufficient information to identify the account holder as US or foreign and, if foreign, determine its classification under FATCA. As part of the account opening process, the Participating FFI generally is required to obtain certification of the account holder's US or foreign status and, if applicable, its classification under FATCA.¹⁶

For **preexisting accounts**, a Participating FFI must conduct an initial review of its account holders within six months and a more thorough review within two years of the effective date of the FFI Agreement to determine which accounts are held by FFIs and US persons. Preexisting accounts generally are accounts maintained by the Participating FFI that are outstanding on June 30, 2014. However, pursuant to recent IRS guidance, accounts held by entities and opened on or after July 1, 2014 and before January 1, 2015 generally may be treated as preexisting accounts. More specifically:

- Prior to January 1, 2015,¹⁷ the Participating FFI must identify accounts held by *prima facie* FFIs.¹⁸ Those account holders identified as *prima facie* FFIs that do not provide certification that they are Participating FFIs, deemed-compliant FFIs, excluded FFIs or exempt beneficial owners will be subject to FATCA withholding beginning on January 1, 2015.
- Prior to July 1, 2015, individual accounts with a balance of more than \$1,000,000 on June 30, 2014 must be reviewed for specified characteristics that may indicate that the account holder is a US person.
- Prior to July 1, 2016, all other individual and entity accounts (other than certain low value accounts) must be reviewed for specified characteristics that may indicate that the account holder is a US person.

b. Your Compliance Requirements if You Are a Registered Deemed-Compliant FFI

Once registered, a registered deemed-compliant FFI generally must:

- maintain appropriate records;
- have its responsible officer certify every three years that it satisfies the requirements of a registered deemed-compliant FFI and
- notify the IRS of a change in circumstances that would make it ineligible for registered deemed-compliant status.

FATCA is an area that is continuing to evolve rapidly, particularly as additional IGAs are signed and IGA countries implement their own regulations and guidance. Funds should continue to monitor developments in countries relevant to them to ensure that they are aware of the current requirements to become and remain compliant with FATCA.

¹⁶ In general, these certifications are provided on the following IRS forms: (i) Form W-9 for US individuals and entities; (ii) Form W-8BEN for foreign individuals; (iii) Form W-8BEN-E for many foreign entities and (iv) certain other W-8 forms for foreign intermediaries and certain foreign exempt beneficial owners.

¹⁷ Each of the dates in this section assumes an effective date for the FFI Agreement of June 30, 2014.

¹⁸ A "**prima facie FFI**" is an entity that is designated in the withholding agent's electronic (searchable) database as an account holder that is (1) a qualified intermediary or a nonqualified intermediary or (2) for accounts maintained in the United States, documented or presumed to be a foreign account holder and assigned in the withholding agent's electronic (searchable) database one of a set of industry codes indicating that the entity is some kind of financial intermediary.

Annex

How does FATCA apply to you?

