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Round Two of FATCA Guidance: Notice 2011-34

What's New and What Remains on the Wish List for Non-U.S. Investment Funds

The U.S. Department of the Treasury ("Treasury") and the U.S. Internal Revenue Service (the "IRS") on April 8, 2011 issued Notice 2011-34, their second installment of written guidance under the Foreign Account Tax Compliance Act ("FATCA"). The following discussion highlights those areas of particular interest to non-U.S. investment funds.

Background

Included as a revenue offset in the Hiring Incentives to Restore Employment Act enacted on March 18, 2010 (the "HIRE Act"), FATCA adds new chapter 4 (sections 1471-1474) to the U.S. Internal Revenue Code of 1986, as amended (the "Code"). Chapter 4 of the Code imposes new information reporting and withholding requirements on "foreign financial institutions" ("FFIs," which term includes most non-U.S. investment funds, including UCITS funds, hedge funds and private equity funds)[1] with respect to certain U.S. investors or account holders ("U.S. accounts").[2] Compliance is enforced through a new 30% withholding tax on certain income and gross sales proceeds derived from U.S. sources (referred to as "withholdable payments")[3] by non-compliant FFIs, effective January 1, 2013.

On August 27, 2010, Treasury and the IRS published Notice 2010-60, which provided very preliminary initial guidance and requested comments on a number of issues relating to the implementation of FATCA. In particular, Notice 2010-60 identified non-U.S. collective investment vehicles that prohibit the sale of their interests to certain U.S. persons as a potential category of FFI that, subject to certain additional requirements, could possibly be deemed to be FATCA-compliant, and requested comments on a number of related points. In response, many commentators, including a number of asset management industry groups, submitted proposals to Treasury detailing various conditions under which non-U.S. investment funds could be either exempt from or deemed compliant with any FATCA obligations.

1 The term "foreign financial institution," as defined for FATCA purposes, includes non-US banks, broker-dealers, custodians, clearing agents, and insurance companies, in addition to non-U.S. investment funds.

2 "U.S. accounts" for which reporting is required under FATCA (referred to herein as "reportable U.S. accounts") include accounts held by U.S. persons (as defined for U.S. federal income tax purposes, with certain exceptions as noted below) and also accounts of certain non-U.S. entities that have such U.S. persons as owners. The categories of U.S. persons which do not trigger FATCA reporting include publicly traded corporations (and certain corporate affiliates), most U.S. tax-exempt entities, the United States and its agencies and instrumentalities, banks, real estate investment trusts, regulated investment companies (*i.e.,* U.S. mutual funds), and common trust funds.

3 "Withholdable payments" for FATCA purposes include dividends, interest (including portfolio interest and original issue discount), rents, annuities and royalties derived from U.S. sources, as well as gross proceeds from the disposition of securities that produce U.S. source dividends or interest.

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Notice 2011-34 responds to certain priority concerns identified by commentators and requests further comments on a number of issues, but is lacking in any meaningful relief for the vast majority of non-U.S. investment funds. A summary of those areas of Notice 2011-34 of particular interest to non-U.S. investment funds follows.[4]

Summary

Preexisting Individual Account Due Diligence

Notice 2011-34 modifies the procedures provided in Notice 2010-60 for identifying U.S. accounts among preexisting individual accounts,[5] and describes a new procedure for certifying completion of the due diligence requirements relating to preexisting individual accounts.

Although FFIs generally may rely on electronically searchable information[6] to determine whether preexisting individual accounts contain indicia of U.S. status that may require additional documentation from account holders, more stringent standards, requiring a diligent review of paper and electronic account files and other records, apply to "private banking accounts"[7] and certain "high value" accounts generally having a value or balance of $500,000 or more.

As part of the new certification procedure outlined in Notice 2011-34, the responsible officer of an FFI must certify that, between the publication date of Notice 2011-34 and the effective date of the FFI's FFI agreement, FFI personnel did not engage in any activity of assisting account holders as to strategies for avoiding identification of their accounts as U.S. accounts. Furthermore, the responsible officer must certify as to the existence of written policies and procedures prohibiting employees from providing such advice.

Passthru Payments

A FATCA-compliant FFI generally must agree to withhold tax (at a 30% rate) from any "passthru payment" made to a "recalcitrant account holder"[8] or non-compliant FFI. For this purpose, a "passthru payment" is defined as any withholdable payment or other payment attributable to a withholdable payment.

Notice 2011-34 generally treats any payment made by an FFI to an account holder as a passthru payment to the extent that the payment is a withholdable payment and, as to the remainder of the payment, in an amount equal to the passthru payment percentage of such payment. The passthru payment percentage generally is that percentage of an FFI's total assets that represent U.S. assets[9] as of each of the last four quarterly testing dates (generally coinciding with the FFI's fiscal quarters).

In a fund of funds context, an FFI may rely on the passthru payment percentage of any underlying FFI that is itself FATCA-compliant or deemed compliant, but only if the underlying FFI calculates and publishes its passthru payment percentage. A FATCA-compliant or deemed compliant FFI that fails to calculate and publish its passthru payment percentage in the manner set forth in Notice 2011-34 (generally within three months of its quarterly testing date on a website or other database searchable by the public) will be deemed to have a passthru payment percentage of 100%. An FFI that is neither FATCA-compliant nor deemed compliant will be presumed to have a passthru payment percentage of

4 Notice 2011-34 provides guidance in the following six areas: (i) due diligence procedures for FFIs identifying preexisting individual accounts; (ii) "passthru payment" calculations and withholding procedures; (iii) certain deemed-compliant FFIs; (iv) FFI reporting obligations with respect to U.S. accounts; (v) obligations of qualified intermediaries; (vi) treatment of expanded affiliated groups of FFIs; and (vii) the effective date of FFI agreements.

5 The term "preexisting individual account" refers to an account held by an individual as of the effective date of an FFI's agreement with the IRS to comply with FATCA (such agreement referred to herein as an "FFI agreement").

6 Notice 2011-34 defines the term "electronically searchable data" to include information that is stored in the form of an electronic database against which standard queries in programming languages may be used; the term does not include files or other information stored in an image retrieval system (such as .pdf files or scanned documents).

7 Private banking accounts include accounts of private banking, wealth management or similar departments of an FFI, as well as accounts of departments that (i) focus on servicing high net worth individuals or their families, (ii) provide personalized banking, investment advisory, trust and fiduciary, estate planning, philanthropic or other services not generally provided to account holders, or (iii) gather personal, financial and professional information about individual clients beyond that which ordinarily is gathered from retail customers.

8 The term "recalcitrant account holder" refers to an account holder which fails to comply with reasonable requests for information required by an FFI to comply with its FATCA obligations.

9 In a somewhat circular fashion, Notice 2011-34 defines a "U.S. asset" to include "any asset to the extent that it is of a type that could give rise to a passthru payment."

zero percent. The IRS intends to maintain a database that will permit FFIs and other withholding agents to determine whether an FFI is FATCA-compliant or deemed compliant.

It is unclear how the passthru payment mechanism will apply to FFIs that are treated as partnerships or otherwise tax transparent for U.S. federal tax purposes. Treasury and the IRS request comments regarding the application of passthru payment percentages to partnerships and other flow-through entities.

Certain Deemed-Compliant FFIs

Notice 2011-34 describes certain limited categories of FFIs that will be deemed to be FATCA-compliant. A deemed-compliant FFI generally will be required to (i) apply for deemed–compliant status with the IRS, (ii) obtain an IRS-issued FFI identification number ("FFI-EIN") identifying it as a deemed-compliant FFI, and (iii) certify every three years to the IRS that it satisfies the requirements for such treatment.

With respect to investment funds, the provision for deemed compliance is disappointingly narrow. Specifically, Notice 2011-34 states that, under future guidance, an investment fund will be deemed to be FATCA-compliant if (i) all holders of record of direct interests are FATCA-compliant or deemed-compliant FFIs or exempt foreign governments (or their agencies or instrumentalities), international organizations or foreign central banks, (ii) the fund prohibits subscription by persons other than those described in (i), and (iii) the fund certifies that any passthru payment percentages that it calculates and publishes will comply with the requirements of Notice 2011-34.

Furthermore, with respect to funds (such as exchange-traded funds or "ETFs"), the interests in which are regularly traded[10] on an established securities market (which interests are not considered financial "accounts" under FATCA), Notice 2011-34 states that, although such FFIs maintain no U.S. accounts, they are FFIs and therefore subject to certain obligations under FATCA to the extent that they receive passthru payments. Such funds would therefore be required to enter into FFI agreements, withhold on passthru payments made to non-compliant FFIs, and certify that any published passthru payment percentages comply with the requirements of Notice 2011-34. Rather than provide a blanket exception for such funds, Notice 2011-34 states merely that Treasury and the IRS are considering under what circumstances such funds could be deemed compliant.

Notice 2011-34 concludes its discussion of deemed-compliant investment funds by stating that Treasury and the IRS continue to consider comments received regarding whether there may be a category of funds that may be deemed compliant because (i) all direct interest holders are FATCA-compliant or deemed compliant FFIs, U.S. financial institutions, certain foreign governmental entities, international organizations or foreign central banks, or non-compliant FFIs acting as distributors, (ii) distribution agreements prohibit sales to reportable U.S. persons, non-compliant FFIs holding for their own account, and non-financial foreign entities other than certain excepted entities, and (iii) the fund satisfies other as-yet-unidentified requirements.

Regrettably, the Notice does not refer to potential exemptions, deemed compliance or other special treatment for widely held investment funds (however defined) or for funds that offer interests directly to investors (rather than through distributors or global platforms) and do not permit investment by reportable U.S. account holders.

Centralized Compliance Options

Notice 2011-34 discusses the intention of Treasury and the IRS to provide certain affiliated groups of FFIs with an option to appoint a designated FFI to assume an oversight role with respect to the FATCA compliance of some or all members of the group.

Treasury and the IRS similarly are considering whether a centralized compliance option should be provided for investment funds having a common asset manager or other agent. The Notice contemplates that such an option would permit the common asset manager or other agent to execute a single FFI agreement on behalf of each affiliated fund that contracts with the manager or other agent to perform the functions required under the FFI agreement with respect to the fund. This option would be limited to those situations in which the manager or other agent is able to monitor the fund's compliance with its FFI agreement based on its legal agreements and other arrangements with each fund.

10 Although further clarification is needed as to what constitutes "regular trading on an established securities market," mere listing of fund shares without actual trading would appear to fall short under the most liberal of interpretations.

The manager or other agent would act as the point of contact for the IRS with respect to all issues concerning the affected funds, or could designate an agent to assume this responsibility. Funds participating in such an arrangement would continue to be liable for the performance of their obligations under the FFI agreement.

Future Guidance and Next Steps

Treasury and the IRS intend to issue regulations incorporating the guidance described in Notice 2011-34 and addressing other matters necessary to implement FATCA. In addition, Treasury and the IRS intend to publish draft FFI agreements and draft information reporting and certification forms.

It is expected that various industry groups will continue to press Treasury for guidance that would alleviate the FATCA burdens imposed on widely held investment vehicles and funds that prohibit investment by reportable U.S. account holders. There can be no assurance as to whether and in what form any such guidance may issue.

In the interim, non-U.S. funds should begin to decide whether to permit reportable U.S. account holders, and determine who will be responsible for performing the due diligence required to identify U.S. account holders. Offering documents will require updating to include related risk disclosure. Subscription procedures will need to be revisited. Distribution agreements and platform arrangements may also need revisiting to ensure that such arrangements will not impede FATCA compliance.

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Practice group contacts

For more information and to learn how Dechert may help you plan for FATCA in advance of its January 1, 2013 effective date, please contact the author, one of the Dechert attorneys listed below or any Dechert attorney with whom you regularly work. Visit us at http://www.dechert.com/tax and http://www.dechert.com/financialservices.

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