Treasury Department Issues Proposed Regulations Under FATCA and Unveils Bilateral Agreements for Partner Countries With Respect to Financial Account Information Exchange

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Questions Still Remain for Foreign Investment Funds

This update is a follow-up to our May 6, 2010 publication, *HIRE Act of 2010 - Increases Need for International Tax Compliance*, with respect to the new information reporting obligations for foreign financial institutions (FFI), including pooled investment vehicles.

General Considerations

On February 8, 2012, the Treasury Department and the IRS issued proposed regulations ("Proposed Regulations") under Sections 1471 through 1474 of the Internal Revenue Code of 1986 (as amended)(the "Code"), enacted as part of the Foreign Account Tax Compliance Act (FATCA) provisions of the Hiring Incentives to Restore Employment Act of 2010 (the "HIRE Act"). In general, the Proposed Regulations:

- Extend the date (now January 1, 2014) beginning on which U.S. withholding agents will have to withhold the 30% tax with respect to certain payments of U.S. source income such as dividends and interest to FFIs;
- Extend the date on which "Participating FFIs" must withhold tax on certain "passthru payments" until January 1, 2017; and
- Provide a simplified approach for FFIs in countries ("FATCA Partners") that would agree to collect U.S. account information from FFIs and automatically transfer the information to the IRS.

France, Germany, Spain, Italy and the United Kingdom, all of whom have bilateral tax treaties in effect with the United States, agreed to cooperate in forging an approach toward adopting a common model for automatic information exchange, including the development of reporting and due diligence standards. With respect to France, Germany, Spain, Italy and the United Kingdom, the information exchange will be mutual; therefore, U.S. financial institutions will be required to collect and remit data on their customers who are citizens of, or resident in, those countries.

In order for an FFI to avoid the 30% withholding tax, the FFI must enter into an "FFI Agreement" with the IRS in which it agrees to collect and transmit information about U.S. accounts to the IRS and to collect withholding tax on U.S. source income paid to account holders who will not provide certain identifying information and to collect withholding tax from Non-participating FFIs. Absent from the regulation package were copies of a proposed form of "FFI Agreement" and the revised IRS Form W-8. It is still unclear what type of audit or verification powers the FFI Agreement will give to the IRS. The Proposed Regulations were very specific in certain areas, for example, extending the grandfather rule/exemption for certain debt obligations outstanding on January 1, 2013, but in other areas the Proposed Regulations deferred guidance to a future date. The grandfather rules that apply to debt obligations do not apply to equity interests. Therefore, FATCA will apply to outstanding equity interests in foreign investment funds beginning January 1, 2013.

Foreign Investment Funds

Code Section 1471(d)(5) defines a financial institution as, except to the extent provided by the Secretary of the Treasury, any entity that: (i) accepts deposits in the ordinary course of a banking or similar business; (ii) as a substantial portion of its business, holds financial assets for the account of others: or (iii) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests or commodities ("Foreign Investment Funds").

Foreign investment funds, organized in the Cayman Islands for example, that invest in U.S. stocks and bonds, will be subject to the 30% withholding tax unless they enter into FFI Agreements. Once they are Participating FFIs, they must in turn report information on U.S. account holders to the IRS, and after a certain date, begin to withhold tax on passthru payments of U.S. source income distributed to "recalcitrant accountholders" and "Non-Participating FFIs."

Although certain nonfinancial holding companies are exempted from FATCA, the Proposed Regulations make clear that the exemption does not apply "if the entity functions (or holds itself out) as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund or any investment vehicle whose purpose is to acquire or fund companies and then hold interests in those companies as capital assets for investment purposes."

The Proposed Regulations make clear that the 24-month start-up exemption which applies to newly formed non-financial foreign companies does not apply to "private equity funds, venture capital funds, and leveraged buyout funds."

Certain "active" non-financial foreign entities ("NFFE") are exempt from FATCA, which are generally defined as foreign entities with a majority of income and assets that are "non-passive", i.e. do not produce dividends, interest, rents and royalties (other than rents and royalties derived in the active conduct of a trade or business conducted by the employees of the NFFE).

Although not expressly stated in the Proposed Regulations, it is unlikely that a private equity fund, venture capital fund, leveraged buyout fund, investment manager with an interest in a fund, or a real estate fund, could qualify as an "active" NFFE even if it had its own employees: first, because those entities would be classified as financial; and second, because the activity conducted by the employees would be viewed more as investment activity rather than business operating activity.

Qualified Collective Investment Vehicles and Restricted Funds

Qualified Collective Investment Vehicles and Restricted Funds may become "registered deemed-compliant FFIs" if they meet certain procedural requirements. The limitations on ownership are so restrictive, however, that for all practical purposes, their terms preclude most U.S. investors.

To become a Qualified Collective Investment Vehicle, the Foreign Investment Fund:

- Must be registered in its country of incorporation or organization as an investment fund;
- Each creditor with a debt interest in excess of $50,000 and each equity interest owner must be:

(i) a Participating FFI;

(ii) a registered deemed-compliant FF;

(iii) one of the following U.S. Persons:

1. a publicly-traded corporation or an affiliate,
2. a Code Section 501(a) exempt organization,
3. the United States,
4. any state, District of Columbia or possession of the United States,
5. any bank defined in Code Section 581,
6. any REIT,
7. any RIC,

8. certain brokers and dealers,

9. certain exempt trusts and common trust funds; or

(iv) one of the following exempt beneficial owners:

1. foreign governments,

2. political subdivisions of a foreign government,

3. agencies of a foreign government,

4. international organizations and wholly-owned agencies of an international organization,

5. foreign central banks of issue,

6. governments of U.S. territories, or

7. certain foreign retirement plans; and

- In the case of an FFI that is part of an expanded affiliated group, all other FFIs in the expanded affiliated group must be either Participating FFIs or registered deemed-compliant FFIs.

A Restricted Fund is an investment vehicle that trades in securities, commodities, partnership interests and derivatives that is regulated as an investment fund under the laws of its country of incorporation or organization which must comply with the rules of the Financial Action Task Force ("FATF") at the time the FFI registers for deemed-compliant status. (The FATF is an inter-government body that develops and promotes international policies to combat money laundering and terrorist financing.)

In addition, the interests in a Restricted Fund can only be sold through certain distributors or redeemed directly by the fund. Each distributor must be a Participating FFI, registered deemed-compliant FFI or otherwise FATCA compliant. Any distribution agreement must ensure, and the offering memorandum must clearly state, that no interests in the Restricted Fund may be sold to any U.S. Persons, Non-Participating FFIs, or passive NFFEs with one or more substantial U.S. owners. The Restricted Fund must conduct due diligence on existing account holders, put in place certain prospective policies to comply with FATCA, and meet certain other on-going requirements.

Both Qualified Collective Investment Vehicles and Restricted Funds must have their chief compliance officer certify that all of the requirements are met in the deemed-compliant category claimed by the FFI as of the date the FFI registers as a deemed-compliant FFI. These deemed-compliant FFIs (1) must obtain an FFI-EIN; (2) must agree that if they publish a passthru payment percentage, they will do so in accordance with the Proposed Regulations; (3) must renew their certification every three years; and (4) must agree to notify the IRS if there is a change in circumstances which would make the FFI ineligible for the deemed-compliant status for which it has registered.

Conclusion

Compliance with FATCA is effectively mandated for foreign investment funds located outside the United States that are managed from within the United States and that rely on the exemptions from U.S. federal income taxation provided in Code Sections 864(b) or 871(h) – the "trading in securities and commodities safe harbor" and the "portfolio interest exemption." Furthermore, many foreign limited companies that serve as feeder funds or investment managers will also be required to become FATCA compliant. Most of these entities are already either (1) classified as "passive foreign investment companies" or "PFICs" which make a qualified electing fund election and provide their U.S. shareholders with information necessary to complete their tax returns, or (2) partnerships that provide their U.S. partners with Forms K-1 each year. FATCA will impose the duty to police their investors and may impose an agreement to become subject to some type of audit or verification procedure by the IRS. Although the cost of compliance will be high, failure to enter into a FFI Agreement could make investing in the U.S. capital markets cost prohibitive.

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