July 2011

Reprinted from the
***Journal of International Taxation* Vol. 22, Num. 7**
(with permission from
Thomson Reuters/Warren, Gorham & Lamont)

FATCA's impact on the asset management industry

by Dmitri V. Semenov, Howard Leventhal, Maria Murphy and Jun Li

The authors are all with Ernst & Young LLP. Dmitri V. Semenov is a partner, International Tax Services, Financial Services Office, New York; Howard Leventhal is Co-National Director, Asset Management Tax practice, Financial Services Office, New York; Maria Murphy is executive director, Information Reporting and Withholding, Washington, D.C.; and Jun Li is a partner, Asset Management Tax practice, Financial Services Office, New York. The authors thank Jeeyoung Shin, Sebastian Grimm, Ann Fisher and Julia Tonkovich, who provided comments and helped draft this article. The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.

The Foreign Account Tax Compliance Act (FATCA), which became law as part of the Hiring Incentives to Restore Employment (HIRE) Act on 18 March 2010 (P.L. 111-147), introduced expansive new withholding and information reporting rules aimed at ensuring that US persons with financial assets outside the US are paying US tax. While FATCA applies to certain payments made on or after 1 January 2013, alternative fund managers and their service providers are already taking active steps related to evaluation of its impact.

The IRS has already published two notices[1] that provide the Government's preliminary thoughts on how FATCA will be administered while it works on Proposed Regulations. There are no indications that the FATCA provisions will be repealed or postponed, so timely assessment of the fund entities, investors and processes is necessary to meet the FATCA implementation deadline. This article evaluates the impact of FATCA's technical provisions on the asset management industry and suggests preparatory actions to be considered now to better assess the effect that FATCA will have on the organization.

General background

The primary aim of FATCA is to provide organizational transparency to offshore entities so that US persons who are the beneficial owners[2] in these entities are identified and disclosed to the IRS. FATCA essentially provides the IRS with the arsenal to police tax evasion by US taxpayers who invest offshore.

When effective, FATCA will require US financial institutions (USFIs) (e.g., US or onshore funds), foreign financial institutions (FFIs)[3] (e.g., non-US or offshore funds) and any other withholding agent not falling within those classifications[4] to withhold 30% on withholdable payments to other FFIs or non-financial foreign entities (NFFEs). The 30% withholding can be avoided if the recipient FFI enters into an agreement with the IRS (FFI Agreement) to comply with certain conditions (discussed below) or the NFFE provides certain required information regarding its owners.[5] In addition to FATCA withholding, Section 1441 and 1442 withholding may apply to such payments. However, the overall amount of taxes imposed on these payments should be coordinated, e.g., providing for credits.[6]

A non-US fund (as FFI) will wear two hats under FATCA with distinct responsibilities — as the payor (withholding agent) of withholdable payments and as the payee (recipient) of withholdable

Ernst & Young
Quality In Everything We Do

payments. The responsibilities of a US fund (as USFI) are solely those as a payor. USFIs and FFIs will apply the FATCA withholding and due diligence procedures to a US account, which broadly means a US investor in a fund that is a specified US person[7] or is a substantial US owner because it either owns 10% or more in an NFFE or has an ownership interest (of any amount) in an FFI. A "specified US person" is any US person other than a publicly traded corporation; a corporation that is a member of the same expanded affiliated group of a publicly traded entity; a tax-exempt entity or individual retirement plan; the United States or any wholly owned agency or instrumentality thereof; any state, including the District of Columbia and US possessions, or political subdivision or wholly owned agencies or instrumentalities of any of the foregoing; US-regulated banks; real estate investment trusts (REITs); regulated investment companies (RICs); common trust funds; and trusts that are tax exempt or are charitable trusts.

"Withholdable payment" is broadly defined to include US-source fixed or determinable annual or periodical (FDAP) income (e.g., US-source interest, including portfolio interest, and dividends) and gross proceeds from the sale of property that can produce interest or dividends from sources within the US. However, income effectively connected with a US trade or business is excluded from the definition of withholdable payment. "Withholdable payment" also includes substitute interest and dividend equivalent payments on securities, loans, repos and similar transactions on US equities or debt instruments. Depending on the rules that the IRS may promulgate under Section 871(m), FATCA withholding may apply to equity swap transactions.[8]

FFI Agreement

If an FFI (e.g., an offshore fund) is the payee of withholdable payments, it must enter into an FFI Agreement with the IRS to avoid FATCA withholding unless it is treated as a deemed-compliant FFI.[9] The specific terms of the FFI Agreement are unknown at this time, but Section 1471(b) states generally that the participating FFI (PFFI) must agree to all of the following:

1. Obtain information regarding each accountholder maintained by the FFI to determine which accounts, if any, are US accounts[10]
2. Comply with verification and due diligence procedures as the secretary may require with respect to the identification of US accounts
3. Report specified information about US accounts annually
4. Withhold 30% on any passthru payment to (1) a recalcitrant accountholder[11] or non-PFFI; or (2) a PFFI to the extent allocable to its recalcitrant accountholders or non-PFFIs
5. Obtain a waiver from bank secrecy or other disclosure limitations from any US account or, if the waiver is not obtained, close the US account
6. Comply with any requests from the IRS for additional information

Investor due diligence

Under Notice 2010-60, USFIs are required to apply FATCA only with respect to payments to non-US entity accountholders. However, FFIs must apply FATCA provisions with respect to all owners (i.e., owners that are individuals and entities).

USFIs must categorize institutional investors as follows: US persons, PFFIs, deemed-compliant FFIs, non-PFFIs, entities posing a low risk of tax evasion (as defined in Section 1471(f)), excepted NFFEs or other NFFEs. Notice 2010-60 and Notice 2011-34 provide specific rules on timing of the various determinations and follow-up steps related to the pre-existing accountholders. No guidance is provided on the timing of account due diligence procedures related to the new accountholders.

Under Notice 2010-60, a PFFI applies investor due diligence procedures to owners that are non-US entities under rules similar to those that apply to a USFI. For withholdable payments to non-US individual accountholders, the PFFI will classify the accountholders as US persons or other than US accounts.

Notice 2010-60 provides preliminary procedures and a timeline for determining whether pre-existing US accounts are US accounts for FATCA purposes. Notice 2011-34 replaces the rules for FFIs to apply when identifying pre-existing individual accounts (i.e., accounts opened prior to 1 January 2013), and distinguishes the following types of pre-existing individual accounts:

- Documented US accounts
- Accounts of $50,000 or less
- Private banking accounts[12]
- Accounts with US indicia with electronically searchable account information
- Non-private banking accounts of $500,000 or more (high-value accounts)

For individual accounts other than private banking accounts, the FFI must review its electronically searchable information for the following US indicia:

- Identification of the accountholder as a US citizen or US resident.
- US place of birth for the accountholder.
- US residence or US correspondence address (including a US P.O. box address).
- Standing instructions to transfer funds to an account maintained in the US
- A "hold mail" or "in care of" address as the sole address shown in the FFI's records.
- Power of attorney or signatory authority granted to a person with a US address.

If an account has US indicia, the FFI must request documentary confirmation of US or non-US status within a year of the effective date of the FFI's FFI Agreement. Accountholders have two years from that effective date to provide appropriate documentation; after that, they will be treated as recalcitrant until documentation is provided.

High-value accounts are accounts that are not private banking accounts and have no US indicia on electronic search, but have a value or balance of $500,000 or more at the end of the year before the FFI's FFI Agreement comes into effect. For these accounts, the FFI must perform a "diligent review of the account files associated with the account" for US indicia (not limited to electronically searchable information). If US indicia are found, the FFI must obtain documentary confirmation of US or non-US status within two years from the effective date of the FFI's FFI Agreement. If the accountholder does not provide the documentation by that date, the account must be treated as recalcitrant until documentation is provided.

Expanded affiliated group rules

An affiliated fund complex will need to consider the impact of the expanded affiliated group rules[13] on its structure. "Affiliated group" includes non-US corporations based on more than 50% ownership by vote and value, and non-US partnerships or any other non-US entity based on more than 50% beneficial interest by value. The Government intends to require each FFI in an affiliated group to become a PFFI unless it is a deemed-compliant FFI. This will allow one lead FFI to execute an FFI Agreement covering all of the other FFIs in the structure. However, each PFFI in an affiliated group will be responsible for its own account due diligence, withholding and reporting obligations. Further, each FFI affiliate will have its own FFI Agreement and will be issued its own FFI entity identification number from the IRS.

The lead FFI will have to identify the name and country of incorporation of each member of the affiliated group that is not an FFI. The lead FFI will serve as a central contact for the IRS. Treasury and the IRS are considering whether an administrator of the funds, or an investment manager, as agent, could perform the necessary due diligence and take any required action associated with maintaining compliant status for the FFIs. However, this does not relieve the respective FFIs in the structure of responsibility for their own participating or deemed-compliant status.[14]

Passthru payments[15]

Notice 2011-34 addresses the concept of "passthru payments." Withholding is required on passthru payments by participating FFIs to recalcitrant accountholders and noncompliant FFIs to the extent that the payments are attributable to a withholdable payment. The new passthru payment rules will have a significant impact on the asset management industries since all offshore funds that are considered PFFIs will now need to publish and calculate their passthru payment percentage (PP%), which will require quarterly analysis of the underlying assets. The PP% corresponds to a percentage of the FFI's assets that could give rise to a withholdable payment (US assets over total assets).

An FFI payment will be a passthru payment to the extent of (1) the amount of the payment that is a withholdable payment, plus (2) the amount of the payment that is not a withholdable payment, times (A) PP% of the entity that issued the security for custodial payments; or (B) PP% of the payor FFI for noncustodial payments. A custodial payment is a payment in which an FFI acts as a custodian, broker, nominee or otherwise as an agent for another person.

An FFI is required to determine its PP% quarterly (based on FFI's fiscal year), which must be published on a website or database readily searchable by the public within three months after the quarterly test date. Further, all values must be translated into a single currency, not necessarily into US dollars. If the PP% is not calculated and published, it is deemed to be 100%. In the FFI's first year of its Agreement, the PP% is calculated as:

- First quarter — FFI assets on a single testing date (Initial Testing Date).

Exhibit 1. Notice 2011-34 example of passthru payment rules

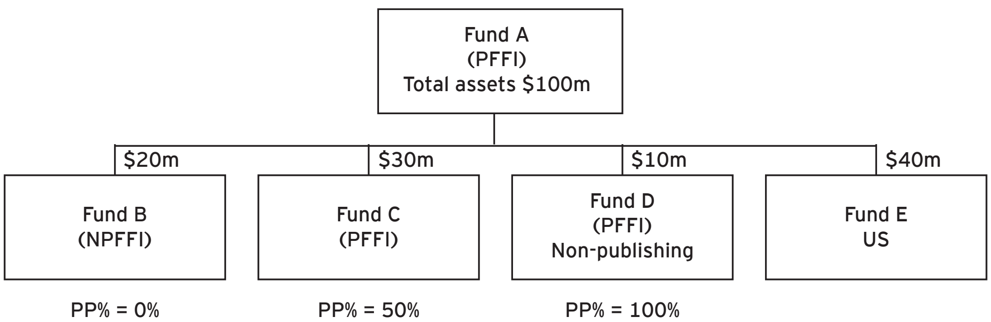
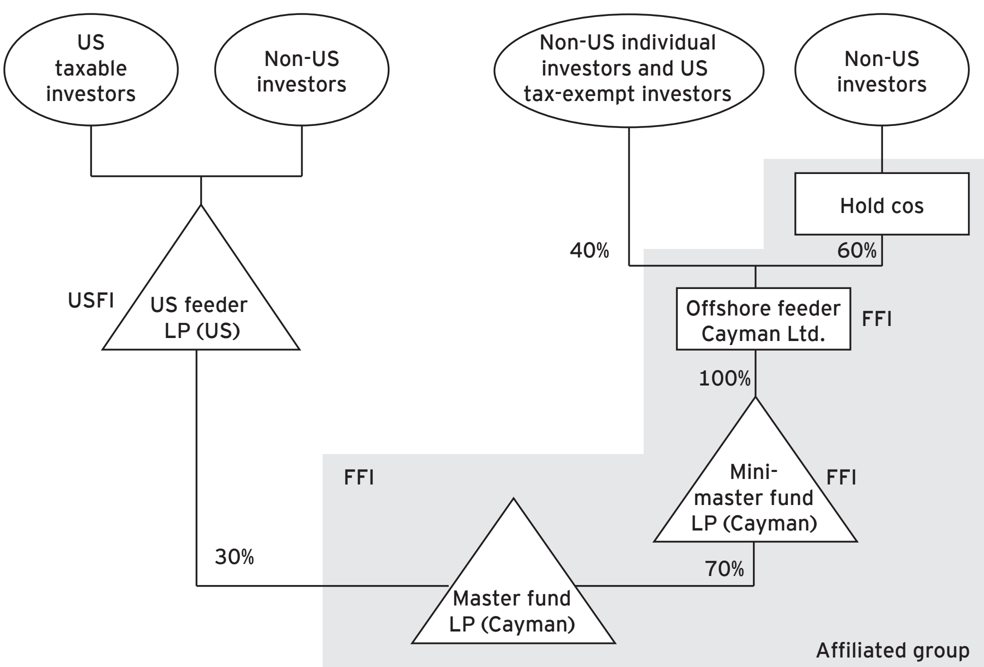


Exhibit 2. FATCA impact on typical master-feeder fund structure



- Second, third, fourth quarters — FFI's US assets held on the initial testing date and each of the quarterly testing dates divided by FFI's total assets held on the initial testing date and each of the quarterly testing dates

The initial testing date is any date in the six months preceding the effective date of the FFI Agreement.

Notice 2011-34 provides a specific example illustrating the application of passthru payment rules.

Example — Fund A (PFFI) has total assets of $100m comprising an interest in (1) Fund B, a non-PFFI; (2) Fund C, a PFFI with PP% of 50%; (3) Fund D, a PFFI that does not calculate its PP%; and (4) Fund E, a domestic corporation. With that, Fund A's US assets equals $65m [(Fund B: $20m × 0%) + (Fund C: $30m × 50%) + (Fund D: $10m × 100%) + (Fund E: $40m × 100%)]. For Fund B, the PP% is deemed to be zero as it is a non-PFFI. For Fund D, the PP% is deemed to be 100% as it does not calculate its PP% (a disincentive to encourage PFFIs to publish PP%). If there are any redemption proceeds paid to a recalcitrant accountholder in Fund A, Fund A will be required to apply passthru withholding on 65% of that payment (see Exhibit 1).

Certification requirement of responsible officer

The chief compliance officer or another equivalent-level officer of the FFI must certify to the IRS that the FFI has timely completed procedures for identification of pre-existing individual accounts. The certification must confirm that between the official publication date of Notice 2011-34 and the effective date of the FFI Agreement, FFI management did not engage in any activities, policies or procedures, formal or otherwise, directing, encouraging or assisting accountholders to avoid identification of their accounts as US accounts. The responsible officer is further required to certify that the FFI had written policies and procedures in place as of the effective date of the FFI Agreement.

Responsible party for FATCA compliance

Alternative investment fund clients typically engage third parties to perform administrative tasks such as collecting subscription documents and other relevant paperwork to comply with the know-your-customer (KYC) or anti-money laundering (AML) requirements, managing the fund's assets, distributing and marketing the fund, redeeming or selling assets, calculating net asset value and other tasks. While it is clear that an alternative investment fund itself is an FI for FATCA purposes, it is not clear what happens when the funds have one or more other parties perform some or all of their tasks.

The question seems to be not whether third-party service providers automatically step into the shoes of the USFI/FFI, but whether the service provider responsible for redeeming or selling fund assets is responsible for collecting the subscription/AML/KYC documents. Also, it is not clear how broadly the IRS and Treasury will expand the application of FATCA duties for financial accounts.

Clearly, investment funds want to make sure that the FATCA compliance process is managed properly, as failure to do so will have a detrimental impact on the business. Parties involved in executing FATCA compliance-related issues for alternative investment funds would likely also be affected (even though they do not meet the precise definition of the FFI or USFI).

Exhibit 2 illustrates the impact of FATCA on a typical master-feeder fund structure, which consists of a Cayman Islands limited partnership fund (master fund), owned by the US feeder limited partnership (onshore fund) and a Cayman Islands corporate feeder (offshore fund). The offshore fund invests through a Cayman Islands partnership fund (mini-master). The exhibit shows that several related entities are subject to the FATCA withholding and reporting regime.

First, there must be an analysis of how each fund in which the master fund has an interest should be classified under the FATCA guidelines. The master fund, which conducts investment activities, is subject to FATCA because it meets the definition of FFI (since it conducts investment activities), although exceptions may apply under future IRS guidance, and must enter into an FFI Agreement with the IRS. To the extent that the master fund receives payments from US sources, it will need to provide evidence of its PFFI status to the withholding agents. Further, since the master fund will be making payments to the mini-master, it will then need to obtain information on the mini-master's status as a PFFI. Otherwise, it may be required to withhold 30% on US withholdable payments to the mini-master.

Similar analysis applies to payments from the mini-master to the offshore fund. On payments from the offshore fund, 30% withholding will be required if payment is to its investors that are not FATCA compliant. Currently, it is not clear how the overlap of resulting reporting requirements will be addressed. US entities (the onshore fund) in the structure will be considered US withholding agents and will need to comply with FATCA withholding obligations on payments to certain non-US investors.

Implementation challenges

While many funds are currently subject to global regulatory and compliance challenges, there are new implementation issues as a result of FATCA. It is important to be cognizant of the aggressive FATCA implementation date of January 2013, as well as the responsible officer certification, which is the first FATCA compliance provision that is in effect now. Exhibit 3 summarizes potential

Exhibit 3. FATCA implementation challenges/approaches

Challenge	Description
1. Program governance/ownership	The enterprise-level effort requires allocation of people, budget and project ownership across the businesses, operations, compliance and tax.
2. Legal-entity analysis	Determining the status of each XYZ entity for FATCA purposes may be challenging because information about the various entities included within the expanded affiliated group may not be readily available.
3. Existing account information	Existing KYC information may not be readily available and/or could not be leveraged on.
4. Lack of central customer data	Very few organizations have a single source of necessary information to readily make the required determinations with respect to accountholders.
5. Timing	The short time frame for implementation requires immediate focus on key start-up tasks while the Treasury Department and the IRS develop additional guidance.
6. Technology	Numerous unrelated systems must be assessed and modified to enable new required information reporting and witholding at the FFI and USFI levels.
7. Education	Generally, there is not a full awareness of FATCA, its requirements and resulting impact to the businesses, which will necessitate early, senior-level commitment and communication.
8. Vendors	Vendors' FATCA readiness and capabilities will need to be assessed.
9. Passthru payments	FFIs will need to identify where income is earned and sourced on a quarterly basis.
10. Private banking relationships	FFIs will need to identify private banking relationships and educate relationship managers.
11. 9 May 2011 account governance	First step to FATCA compliance is to have a responsible officer to ensure governance and control over guidance given to US accountholders as of 9 May 2011.

challenges and approaches that should be considered.

Other impact areas

While FATCA applies to certain payments made starting on 1 January 2013, the fund managers and other service teams need to timely assess their fund entities and investor information and put together a process to meet the FATCA implementation deadline. Implementing FATCA compliance within an entity requires education and cooperation not only of the tax department, but also of other functions with the group, including legal, operations and central management. The tax team should support regulatory interpretation and education and consider proactive engagement with US Government officials preparing Proposed Regulations. It also should provide continuing support and guidance to all workstreams and processes at all levels. The legal and business development teams need to assess legal-entity structure and identify where FATCA may be applicable in the organizational chart, where the FFIs are located, and what type of income is earned by the respective entities. The operation team needs to assess existing and new accounts and manage relationships with prospective investors. It should also assist with processing and documenting investors' information.

Fund-raising considerations

Implementation and ongoing compliance regarding FATCA provisions will require cooperation and agreement from existing and prospective investors. Below are some of the fund-raising issues that the fund manager should consider with respect to raising capital for the funds in light of FATCA:

- Fund sponsors will need to educate their potential investors as to the disclosure requirements. Subscription documents and private placement memoranda need to be modified to account for the additional disclosure requirements.
- Partnership/LLC agreements need to be drafted and modified to deal with non-PFFIs and recalcitrant accountholders (e.g., withholding and potential closing of accounts).
- Future failure to comply could result in account closure. This presents a liquidity issue to the fund as it would need to return the capital of the investor.
- FATCA is far broader in terms of information disclosure than any other country's rules. Will other markets have a competitive advantage as a result?

Why act now?

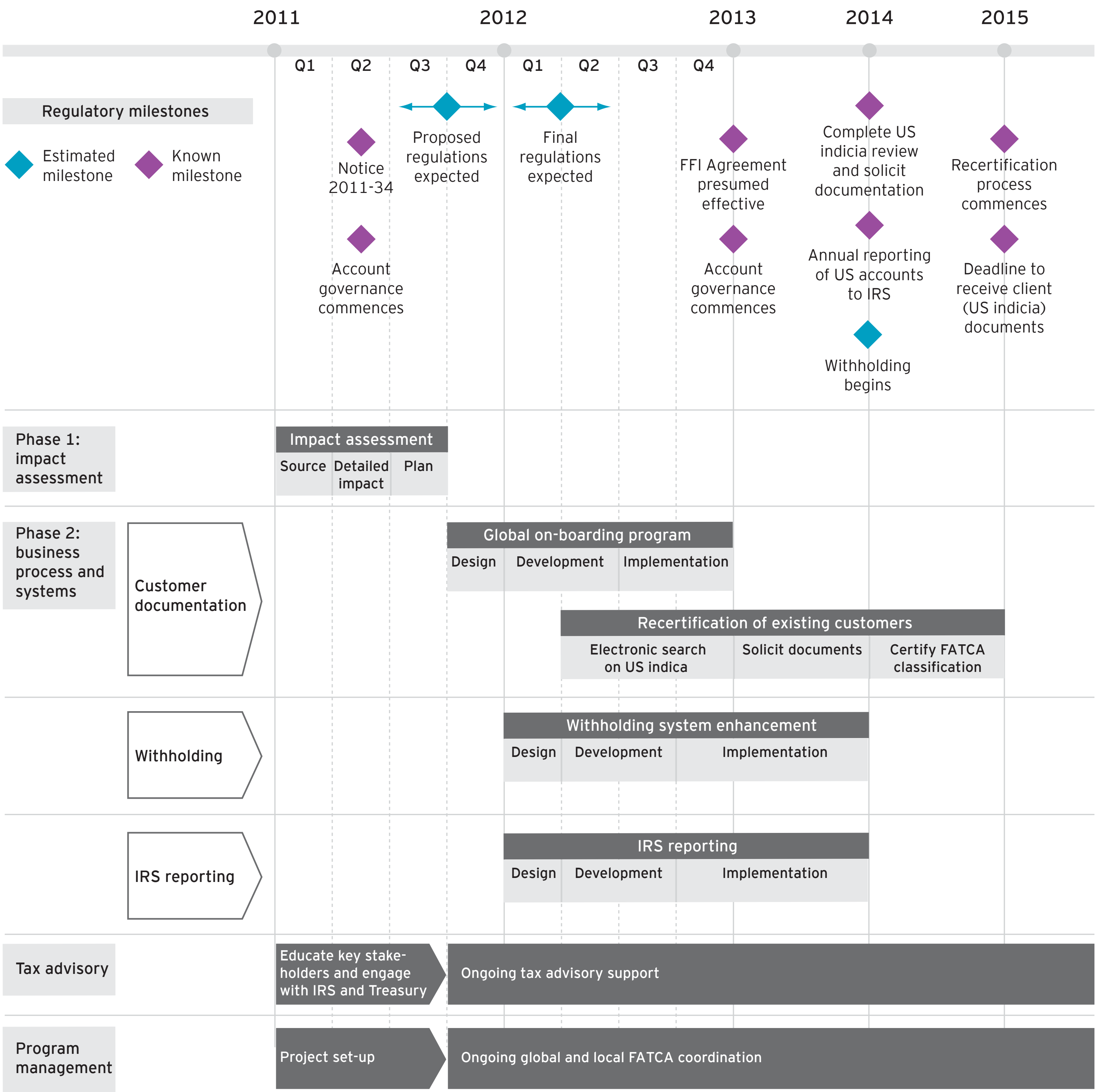
FATCA is not just a tax issue; it affects capital-raising and investor acceptance, investor relations, legal, risk management, operational processes and systems technology. Generally, substantial changes to cross-functional programs within an organization are difficult to implement; therefore, the earlier that a remediation program begins in a controlled and well-governed environment, the more likely that the implementation will run smoothly.

A key to effective risk management is identification of a leading-practice approach to obtain, maintain and manage the various forms of data (investor information, fund structures, limited partnership agreements, private placement memoranda, subscription documents). Delivering complete reporting to the IRS at a granular level of detail will be extremely complex and demand a high level of accuracy. With that, the asset managers should act now to do all of the following:

1. Educate the firm about the need to comply with FATCA
2. Conduct a high-level review of business operations and entities that may be affected by FATCA
3. Assign primary points of contact for the FATCA initiative within those operations and entities that may be affected
4. Develop an initial FATCA roadmap illustrating timeline, principal workstreams, outputs and targeted internal deadline
5. Document how entities currently keep track of customer accounts and whether the accounts are linked to one another
6. Ascertain what data is kept in paper form versus electronically
7. Identify processes, procedures and technology systems that will need to be enhanced or added

Exhibit 4 illustrates the key implementation dates related to FATCA rules.

Exhibit 4. FATCA key implementation dates



Endnotes

1. Notice 2010-60, 2010-37 IRB 329 (27 August 2010), and Notice 2011-34, 2011-19 IRB 765 (9 May 2011). On Notice 2010-60, see Nevas, "Foreign Account Tax Compliance: Initial Guidance," 22 JOIT 20 (November 2010) ; on Notice 2011-34, see Michaels and DePasquale, "IRS Issues Second Round of FATCA Guidance," 22 JOIT 18 (July 2011).
2. Although not defined in the HIRE Act, the Section 1441 Regulations generally provide that, for payments other than those for which a tax treaty benefit is claimed, a person will be treated as the beneficial owner of income to the extent that the owner is required under US tax principles to include the amount in its gross income under Section 61. Reg. 1.1441-1(c)(6)(i).
3. Section 1471(d)(4) . Under Section 1471(d)(5) , alternative investment funds are generally classified as financial institutions (FIs). Notice 2010-60, section II.A.3, identifies several fund types as FIs, including mutual funds, fund of funds, publicly traded funds, hedge funds, private equity funds, venture capital funds, other managed funds, commodity pools and other investment vehicles.
4. Section 1473(4) defines withholding agent as "all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment."
5. Sections 1471(a), 1471(b) , and 1472(a).
6. Section 1474(d).
7. Section 1473(3).
8. Regs. 1.861-2(a)(7) and 1.861-3(a)(6).
9. Certain local institutions and fully intermediated funds will be treated as deemed compliant and will not have to enter into FFI Agreements. See Notice 2011-34.
10. For investment vehicles, any ownership percentage held by a US person (directly or indirectly) is sufficient for the account to be treated as a US account under FATCA.
11. Section 1471(d)(6).
12. An account is treated as a private banking account if it is maintained with an FFI's private banking department. A private banking department (1) focuses on high net worth individuals; (2) provides personalized services to individual clients; (3) gathers information about individual clients' personal and financial histories; (4) is treated as a private banking department for know-your-customer purposes; or (5) is otherwise referred to by the FFI as a private banking, wealth management or similar department. Further, a private banking department is any part of an FFI in which an FFI employee provides personalized services or collects information about clients' personal, professional and financial histories. Arguably, the private banking account category may be less relevant for alternative investment funds. However, activities would need to be reviewed to determine whether they fall within the definition of "private banking" under Notice 2011-34.
13. Section 1471(e)(2).
14. In drafting these rules, the IRS was clearly focused on identifying a point entity in the fund structure or an affiliated FFI group that would be responsible for administration of FATCA compliance. Similarly, rules related to the certification by the chief compliance officer (CCO), discussed below, were focused on identifying a person with management capacity to be in charge of certain parts of FATCA compliance (there could be a separate CCO for each fund entity).
15. Section 1471(e).

SCORE No. CK0452
1107-1275068 NY