

## Global Financial Services

### The implications of the Foreign Account Tax Compliance Act of 2009 (FATCA) for the investment management industry

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On March 18, 2010 the final version of the Foreign Account Tax Compliance Act of 2009 ("FATCA") became law. It will dramatically change the current system of U.S. tax withholding and has significant implications for all financial services institutions. The new withholding rules will apply to payments made on or after January 1, 2013, allowing time for Treasury to issue guidance, and affected funds the time to adjust their operating procedures to accommodate the new rules. Highlighted below are specific observations on how this wide-reaching legislation will impact the investment management industry.

#### Who in the investment management industry will be affected?

Subject to certain exceptions in the statute or which are anticipated to be prescribed in future regulations, FATCA will impose new or additional information reporting and withholding requirements on foreign funds, including both non-regulated funds and those subject to regulation such as Undertakings for Collective Investment in Transferable Securities ("UCITS") and other non-U.S. regulated investment funds, including their service providers and intermediaries in the chain of distribution.

In general, FATCA will subject certain payments (including gross proceeds from the sale of securities that produce U.S. source dividends or interest) to any "foreign financial institution" ("FFI") to U.S. withholding tax unless the FFI satisfies certain information gathering, verification, due diligence, reporting and withholding requirements (the "Reporting Requirements") with respect to persons that hold "financial accounts" maintained by such FFI, or is exempted from the requirements under the regulations to be issued<sup>1</sup>. The FATCA requirements could extend to every type of foreign investment entity used in the investment management industry, including:

- any fund invested in U.S. capital markets,
- any fund using an intermediary which has exposure to U.S. capital markets, and
- any fund which may have a U.S. taxpayer as an investor (note that a U.S. investor is defined differently for Federal and State tax purposes)

as well as in the alternatives industry such as:

- Foreign master trading entities,
- Offshore feeder fund vehicles,
- Foreign private equity investment funds,
- SPV's, and
- Securitization vehicles

if they invest in the U.S. capital markets.

In summary, any fund based outside of the U.S. may face potential implications from FATCA.

Any equity or debt interest in the FFI is treated as a "financial account" unless the interest is regularly traded on an established securities market.

The new law authorizes the Secretary of the U.S. Treasury (the "Secretary") to treat an FFI as meeting the Reporting Requirements if "such institution is a member of a class of institutions with respect to which the Secretary has determined that the application of this section is not necessary to carry out the purposes of this section". By giving the Secretary this unusually open-ended discretion, it is clear that policy makers understood from day one that the

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<sup>1</sup> Any entity that is engaged, or holds itself out as engaged, primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in securities, partnership interests or commodities, is treated as an FFI.

literal application of the statute could be disastrous. The legislative history provides that regulations are expected to provide rules that would permit certain classes of widely held and other low risk investment vehicles and, to a limited extent, entities providing administration, distribution and payment services to such entities, to be deemed to meet the Reporting Requirements.

### What obligations does FATCA impose on investment funds and their service providers?

The principal objective of FATCA is to ensure that all financial institutions, wherever based, operate a system that produces information to enable the U.S. to impose its tax laws on U.S. persons who otherwise would use foreign investments and foreign accounts to hide their income and assets offshore, and thus evade their U.S. tax filing and payment obligations.

In general, FATCA will require a U.S. withholding agent to deduct and withhold a 30% tax from any "withholdable payment" to an FFI unless the FFI satisfies the Reporting Requirements with respect to persons that hold financial accounts maintained by such FFI. As a result, the new regime imposes requirements and sanctions on FFIs (including UCITS and other investment funds) that previously were not within the scope of the U.S. Qualified Intermediary (QI) regime. Prime brokers that service the investment management industry will also be subject to additional reporting and withholding requirements. These new reporting and withholding provisions generally are effective for payments made on or after January 1, 2013.

Under a separate provision of FATCA many investors who are U.S. individuals will be required to do additional reporting with respect to their foreign investments or face penalties for failure to disclose this information. The additional reporting obligation will require the U.S. individual to attach a list of foreign assets in which they have an interest, either directly or through a depository or custodial account, to such individual's U.S. federal tax return if the aggregate value of all such assets exceeds \$50,000 (or such higher amount as the Secretary may prescribe). These heightened reporting requirements on individual U.S. investors could become an added burden on

some funds (if the investment in the fund is considered a custodial or depository account) which, without regulatory guidance to the contrary, may be compelled to implement their own costly reporting and disclosure systems to fulfil their investors expectations and remain competitive in the marketplace. Unlike the general FATCA provisions, this requirement is effective for tax years beginning after March 18, 2010 (i.e., January 1, 2011 for calendar year funds).

### What are the potential impacts on the investment management industry?

Over the past several years, press accounts have suggested that U.S. investors have avoided U.S. income tax through investments in foreign entities and offshore accounts. The legislation, however, goes far beyond traditional financial institutions and covers institutions within the investment management industry, which has also received criticism for helping to facilitate some investors' desire to avoid U.S. taxation. FATCA may be viewed as an expansive response to counter this purported behavior.

The enactment of FATCA could potentially have adverse effects on investment in U.S. markets, foreign funds, and any funds using intermediaries with a U.S. presence otherwise wishing to access U.S. investments and even bank deposits. The industry potentially could be negatively impacted by FATCA's additional compliance burden and the lack of certainty surrounding its technical application, even in advance of the January 1, 2013 effective date. The specific application of these rules is highly dependent on future guidance to be issued by Treasury in the form of regulations.

At a minimum, impacts on the investment management industry may include the following:

1. There could be additional compliance burdens for many funds in gathering information on U.S. ownership from investors, drafting withholding agreements with the Internal Revenue Service ("IRS") and ongoing maintenance of agreements - including IRS audits of the overall withholding processes. Depending on the regulations to be issued, the expansive definition of a FFI may require some organizations to make substantial changes to their

processes, technology, and internal governance to handle the expected increase in due diligence procedures and compliance.

2. Some funds may have the added burden of providing information to their U.S. investors on the fund's foreign investments in order for the investors to be able to meet their reporting requirement for specified foreign financial assets. Such requirement is imposed on any individual who holds more than \$50,000 in a depository or custodial account maintained by a foreign financial. Depending on the form of the fund, an investor account could be viewed as a custodial account, although we question whether this is the intent of the provision. Moreover, the \$50,000 threshold for reporting information is an aggregate calculation for all specified foreign assets, determined at the individual investor level. The extent and detail of the information that each effected fund may be required to provide to each U.S. investor could be enormous, unless otherwise limited by the Treasury regulations to be provided. While similar to the information required under the Report of Foreign Bank and Accounts ("FBAR"), it is not identical and not meant as a substitute for compliance (the FBAR reporting requirements remain unchanged by this provision). In order for U.S. investors to comply, an effected fund would need to provide each individual investor with identifying information for each asset and its maximum value during the tax year. For an account, the name, address and account number of the institution at which the account is maintained must be provided. For a stock, security, contracts, interests in foreign entities or all other instruments, all information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counter-parties.
3. Many of the provisions of FATCA will require Treasury guidance on how they will be implemented before they become effective in 2013. In the short term, the lack of guidance could impact the ability of new funds to raise capital from investors who are concerned about the potential implications of FATCA. In the longer term, funds may be limited in their

ability to raise capital from non-U.S. entities with any U.S. ownership who may not want, or may not be able, to provide the required disclosures on U.S. ownership.

4. Investment structures offered to foreign investors not wanting to be tainted by other investors subject to withholding may be limited. For example, a foreign investor may only want to invest through a wholly owned managed account rather than investing in a foreign structure open to other investors.
5. Some funds could decide that complying with FATCA's due diligence and verification provisions may not be cost effective, and consequently, for business reasons, some may not continue making U.S. investments or seeking U.S. customers. Some investors may react negatively to funds who limit their U.S. investments in order to avoid U.S. withholding and compliance obligations imposed by FATCA.
6. FATCA potentially changes the economics of many investments from which income generated qualifies as a 'withholdable payment' under the Act. Withholding on dividend equivalents would be required even when no actual payment is made to the foreign investor (i.e., the foreign investor is on the losing end of the swap). Contractual agreements and ISDAs will need to be reviewed and amended to clarify responsibilities and procedures for withholding on dividend equivalent payments. Time will be critical given the September 18, 2010 effective date for withholding on dividend equivalent payments received in connection with repos, securities loans and certain specified swaps.

### Obtaining certification from the IRS & ongoing compliance

With the imposition of a new 30% withholding tax on 'withholdable payments', most FFIs will attempt to comply with the provision and avoid being withheld upon by entering into an agreement with Treasury to report U.S. persons who are account holders. The certification and withholding requirements under FATCA may create a significant burden on a much larger group of effected entities than the current QI regime.

Moreover, the verification procedures, although not yet fully defined, are expected to increase the costs of compliance for many FFIs regardless of whether they are done internally (i.e., through internal audit or confirmations) or through an external resource (i.e., using an outside firm to opine).

Many of the implementation aspects of the certification process have been reserved for the Secretary to develop via Treasury regulations. However, it is not too early to identify some of the specific challenges to obtaining and complying with the certification process including the following:

- In a typical master-feeder structure with a foreign master fund and at least one foreign feeder, two outcomes can result with respect to withholding under the Act. First, if the master fund does not enter into an agreement with Treasury (and is not exempted from the Chapter 4 compliance rules), payments made to the master fund from the U.S. broker-dealer would be subject to the 30-percent withholding under the new Chapter 4. In addition, Treasury will also deny a credit or refund to a FFI that is the beneficial owner of a payment except to the extent that the firm is eligible for a reduced treaty rate of withholding. Second, if the master fund enters into an agreement with Treasury and maintains compliance with the provisions of this agreement or is exempted from Chapter 4 compliance, payments made to the master fund from the U.S. broker-dealer would not be subject to withholding added by FATCA (but would be subject to the customary Chapter 3 (Section 1441) withholding that applies under pre-FATCA law and continues to apply where Chapter 4 withholding is not imposed). In order to receive this certification, each entity in the ownership chain would ultimately have to provide to the master fund owner information (likely to consist of information on U.S. persons or proof of entering into an agreement with the IRS if the account holder is an FFI). The likelihood that all entities in a large structure will be able to provide the complete, required information to obtain certification appears to be slim.
- Obtaining ownership information may be particularly difficult in a fund-of-funds structure whereby funds with other FFI's as investors might need to gather information from third-party investors. If the master fund cannot obtain the necessary certifications from all account holders, withholdable

payments to the FFI allocable to "pass thru payments" made to these non-compliant account holders or non participating FFI's would be subject to 30% withholding. Non-compliant account holders are defined as those account holders who fail to provide the required information regarding U.S. ownership.

- In a multi-tiered structure, it could be difficult and impractical for these foreign entities to gather information on all U.S. investors or to obtain confirmation from their direct investors that there are no U.S. account holders within the entire chain of ownership. While a foreign entity might be able to satisfy this requirement by getting confirmation that its direct investors have themselves entered into an agreement with the IRS, as a practical matter, obtaining confirmations all the way up the ownership chain may be impossible to obtain, thus resulting in additional withholding on the income allocated to those account holders missing the required information.
- Even if a fund is able to obtain information about its U.S. investors all the way up the chain, it is unclear what it will be required to monitor if there are ownership changes and an introduction of a U.S. investor or a non-compliant holder in the chain. Presumably the Treasury will address this in order to avoid imposing, on multiple tiers of FFI's, the requirement to engage in due diligence each time a payment subject to withholding is received.
- There will be potential FIN 48 and FAS 5 implications due to potential exposures for non-compliance with FATCA (for example, failure to meet withholding obligations for payments to an investor who refuses to provide the required information to identify U.S. account holders). In addition, there could be penalties for providing inaccurate or insufficient information to a withholding agent (e.g., a U.S. bank) to enable them to determine the appropriate amount to withhold with respect to a payment that is allocable to recalcitrant account holder. There could also be exposures for failure to meet additional information reporting obligations that may be imposed on a fund so that U.S. investors can meet their increased reporting obligations of foreign accounts and investments. Note that the International Accounting Standards Board ("IASB") has drafted similar provisions that address FIN 48 concerns as described above.

## Final comments

The investment management industry will have unique challenges in complying with FATCA. Much will depend on Treasury regulations which are expected to be issued before the extended effective date of the legislation. PwC will continue to monitor these developments and evaluate best practices for preparing for implementation.

### Contacts

If you would like further advice in relation to the issues outline above, please call your local PwC contact or alternatively any of the people listed below:

Patrick Wall	Partner	+353 1 792 8602	patrick.wall@ie.pwc.com
Pat Convery	Director	+353 1 792 8687	pat.convery@ie.pwc.com
Rosaleen Carey	Senior Manager	+353 1 792 8756	rosaleen.carey@ie.pwc.com
John Perry	Manager	+353 1 792 8859	john.b.perry@ie.pwc.com

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