

Client Memo

FATCA for Private Equity and Hedge Funds: Getting Started

Background

Back in 2010, Congress adopted several pieces of legislation designed to ferret out US investors hiding their money offshore. A portion of that legislation is known as the Foreign Account Tax Compliance Act, or FATCA. In essence, FATCA imposes a new 30% withholding tax on certain payments to foreign persons.

The withholding tax was adopted with a delayed effective date. In the last few months, final regulations were published by the Treasury Department implementing FATCA. In addition, the US government has signed FATCA-related agreements with several countries in order to coordinate mechanisms for information reporting. As 2014 approaches, it is clearly time to get ready for FATCA.

Whom will it impact?

FATCA will impact both offshore and onshore private equity and hedge funds, in different ways. The tax is imposed on withholdable payments made to foreign financial institutions (FFIs) and foreign non-financial institutions (NFFIs). The prerequisites for avoiding the tax are greater for FFIs than for NFFIs. Unfortunately, the revised definition of FFIs contained in the final regulations is broad enough to cover investment funds and their sponsors. Therefore, it appears that offshore management companies, offshore funds (including master, feeder and other funds), offshore alternative investment vehicles and the like may all be considered FFIs. These offshore entities will need to comply with rigorous rules in order to avoid the tax being imposed on payments made to them. Onshore funds, even if they have no related foreign entities, will also be impacted by FATCA to the extent they are required to withhold from payments made to offshore investors.

What is the impact?

The 30% tax will apply to withholdable payments. Withholdable payments are (a) fixed, determinable, annual and periodical payments such as dividends, interest and royalties received from US sources and (b) proceeds from the sale of property that generates income described in (a) above.

When will it apply?

The effective dates for the withholding tax have been delayed by the regulations. For certain US source payments, FATCA applies as early as January 2014. The obligation to withhold with respect to proceeds does not begin until January 2017. There are also generous “grandfather” provisions for certain existing obligations.

How do I comply and avoid withholding?

The rules are quite complex, with numerous exceptions. Broadly speaking, assuming the specific exceptions are not available, there are two general approaches available to avoid the withholding taxes applicable on payments to an FFI. The first approach involves a formal agreement with the IRS. The FFI can enter into an agreement with the IRS and become a participating FFI (PFFI). Under that IRS arrangement, the PFFI must, among other things, (a) withhold on payments to others who don’t comply with the FATCA rules, (b) perform due diligence regarding its account holders and investors, (c) make annual reports to the IRS regarding its account holders and investors, (d) arrange for any affiliates to register with the IRS in order to avoid “cherry picking” and (e) close accounts for those account holders and investors who will not waive bank secrecy laws preventing compliance with the FATCA rules. The second approach involves arrangements by FFIs with their local governments, rather than the IRS. Over the last few months, the US has entered into intergovernmental agreements (IGAs) regarding FATCA with several countries. Under some of these IGAs, a foreign entity located in that jurisdiction can provide information to its local government and avoid dealing directly with the IRS. Under other, more limited IGAs, the FATCA rules are simply modified with respect to the information required to be provided by the FFIs to the IRS.

Where do I go from here?

The details of the process for registering with the IRS are still in flux. The IRS expects to open a web portal for registration by mid-July. A sample registration form has been published by the IRS (a copy of which is attached). Ultimately, when FFIs register, they will be given special identification numbers and the IRS will begin publishing a list of registered FFIs, to be updated monthly.

Despite the missing pieces to the FATCA puzzle, it would be prudent for fund sponsors to begin the process of registering for FATCA. Some first steps might include (a) identifying offshore entities within the fund and sponsor structure (including vehicles used for offshore investments by domestic funds), (b) identifying offshore entities that are likely to receive US source income or to generate gains from assets generating US source income, (c) distinguishing offshore from onshore account holders and investors and (d) interacting with account holders and investors regarding their own plans for compliance with FATCA.

If you have any questions concerning FATCA, or any other tax-related inquiries, please feel free to contact the Morrison Cohen attorneys named below (or your usual Morrison Cohen contact):

Isaac Grossman
Partner & Chair, Tax
212-735-8720
igrossman@morrisoncohen.com

Michael Weinstein
Partner, Tax
212-735-8736
mweinstein@morrisoncohen.com

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