How FACTA Impacts Investment Funds

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The Foreign Account Tax Compliance Act, IRS Code §§ 1471-1474, was enacted as part of the Hiring Incentives to Restore Employment Act ("HIRE Act") on March 18, 2010. FATCA is designed to prevent U.S. taxpayers from avoiding U.S. tax on their income by investing through Foreign Financial Institutions ("FFIs"), including offshore private equity, hedge or other private investment funds. For investment funds, this will translate into new withholding tax and reporting requirements, which could potentially have a dramatic impact on how funds currently operate. It will affect both U.S. and foreign-managed funds, including mutual funds, funds of funds, hedge funds, venture capital and private equity funds.

In addition to the U.S.'s efforts to combat tax evasion, a broader framework for international cooperation aimed at easing privacy concerns has resulted in the Treasury releasing a joint statement with France, Germany, Italy, Spain, the United Kingdom and Switzerland. These countries have agreed to cooperate and work toward exploring an intergovernmental approach to FATCA implementation.

Principal Provisions of FATCA

FATCA applies to FFIs and other entities that receive payments from U.S. sources, either on their own behalf or acting as intermediaries. FFIs under FATCA are defined broadly as foreign entities that: (1) accept deposits in the ordinary course of a banking or similar business; (2) hold financial assets for the accounts of others as a substantial portion of their business; or (3) are engaged (or holding themselves out as being 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 such securities, partnership interests or commodities. Based on the breadth of this definition, most non-U.S. private equity, hedge and other private investment funds constitute FFIs for the purpose of FATCA.

The mechanism for the IRS to enforce compliance with the FATCA reporting rules is a 30 percent U.S. withholding tax on all payments made to FFIs in connection with all U.S.-source "withholdable payments," including typical FDAP-type income such as interest, dividends and rents. Thus, FATCA will require payors of U.S. source income and gross proceeds to withhold from payments to FFIs that do not certify their compliance with the FATCA 30 percent of the gross payment amount. To avoid having to pay the 30 percent withholding tax, an FFI must enter into an agreement with the IRS to identify U.S. account and equity holders and comply with certain criteria, which would make it "deemed compliant" under FATCA. Alternatively, where the FFI's home country has entered into a particular model FATCA agreement with the U.S. Treasury, the foreign government would collect FATCA data from the FFIs and transmit such information to the IRS.

FATCA Compliant FFIs

After entering into an FFI agreement with the IRS, an FFI will be deemed to be "compliant" with FATCA if it: (1) obtains information regarding each holder of each account maintained by it as is necessary to determine which (if any) accounts are U.S. accounts (i.e., accounts beneficially owned by U.S. persons); (2) complete IRS-specified due diligence and verification requirements with respect to U.S. accounts; (3) report IRS-specified information to the IRS on U.S. accounts; (4) withhold a 30 percent tax on U.S. source payments made to certain recalcitrant account holders (i.e., account holders who do not provide the requisite information) and noncompliant FFIs, and other FFIs who have elected not to withhold on their own recalcitrant account holders; (5) comply with IRS requests for additional information; and (6) attempt to obtain a waiver of any foreign law that would prevent the transmission of information sought by the IRS to the IRS on the FFI's accounts; if such waiver can't be obtained, then the FFI will close the affected accounts.

More specifically, FATCA compliant FFIs will be required to report the name, address and the taxpayer identification number ("TIN"), as well as account-related information, for any "specified U.S. person" named on the account or any "substantial U.S. owner." A "specified U.S. person" is defined as any U.S. resident, with a few exceptions, including publicly traded corporations and certain banks, to name a couple. A "substantial U.S. owner" is defined as any person who owns more than a 10 percent interest in any entity, or, in cases where the payees are primarily in the business of trading, anyone who owns any interest in the entity (including a profits-only interest).

For FFIs in jurisdictions that have entered into a Model 1A FATCA Agreement with the U.S. Treasury, FFIs will be deemed compliant by providing the foregoing information to their home country. FFIs that are located in a home country that does not have a FATCA agreement with the U.S. Treasury will be able to register with the IRS as an FFI. Given the many struggles that many financial institutions have faced in implementing systems that would facilitate their reporting requirements, the IRS has delayed opening the portal from July to August of 2013. It is important for FFIs to complete their registration in order to be included in the list of compliant FFIs. If not listed as a compliant FFI by the IRS, payors to such FFIs may begin withholding the 30 percent amount described above from payments to the FFI.

Industry Impact

The implementation of FATCA in the private equity and hedge fund industry will have the most significant impact on non-U.S. funds, since the definition of an FFI is broad and appears to include nearly all non-U.S. investment vehicles (including foreign stand-alone funds and blocker corporations, foreign feeder funds and foreign alternative investment vehicles) regardless of whether they are being offered or traded publicly.

Even if a non-U.S. fund doesn't have any U.S. investors and/or investments, it will likely find itself needing to comply with FATCA because so many of its counterparties (such as banks, brokers/dealers, custodians, etc.) will need to be FATCA compliant or need to ensure that the FFI is FATCA compliant before making payments to the FFI. In addition, the non-U.S. fund will also need to be aware of the eventual implementation of the foreign pass-through payment requirements and take into consideration that a portion of foreign-sourced payments from a non-U.S. entity could be treated as a U.S. source.

Since FATCA implementation has been delayed six months until July 1, 2014, fund managers now have additional time to ensure their funds are properly registered as FFIs and that all reporting requirements are in place. Offshore funds that are FFIs will now have until April 24, 2014, to register as an FFI and they will not have to file their first report until March 31, 2015.

FATCA implementation will be challenging for investment funds given the fact that the current model of the investment fund industry is based on the premise that various operators and agents make U.S. investments via non-U.S. funds. The current FATCA implementation proposals operate on a different premise whereby the FFI that is holding the U.S. investments maintains all of the information necessary, on a stand-alone basis, to comply with the FATCA requirements.

Such a discrepancy in the fundamental premises of the models presents a challenge because the industry does not have the necessary experience in taking responsibility for operational tax matters required by FATCA (such as withholding taxes and individual tax reporting). As a result, fund managers are going to need to adapt their processes to ensure that relevant information is being collected at the onset for all new clients and that the investment fund's systems are able to capture and store information in a manner which can be used to comply with FATCA requirements.

It is common practice for an FFI to outsource some if not all of its asset custody, compliance and regulatory functions, transfer agency services and/or distribution. For this reason, FFIs should look towards implementing a FATCA task force headed by a FATCA officer who can coordinate and ensure that all relevant operators and agents working with the FFI are in compliance with FATCA. It is important that the FFI take the lead on compliance since FATCA compliance failure on behalf of an agent or operator can be construed as failure by the FFI itself.

Fund managers should contact legal and tax counsel as soon as possible to ensure that they begin compliance with FATCA at the earliest possible opportunity. Otherwise, the fund managers' offshore funds could be subject to significant withholding on payments from U.S. entities.

Additional FACTA Provisions

In addition to the withholding and disclosure regime, FATCA includes other provisions geared toward improving tax compliance on issues related to foreign accounts. Certain U.S. taxpayers holding specified foreign financial assets with an aggregate value exceeding $50,000 will report information about those assets on the new Form 8938, which must be attached to the taxpayer's annual income-tax return.

The Form 8938 supplements current Report of Foreign Bank and Financial Accounts ("FBAR") requirements. If an individual fails to comply with this specific reporting requirement, there are penalties ranging from $10,000 to $50,000. FATCA also extends the statute of limitations to three years after the taxpayer files Form 8938 for an individual who fails to report income from foreign assets (the extended three year statute applies to the taxpayer's entire return, not just to foreign assets).

Conclusion

With the implementation of FATCA, the IRS will possess much more information about U.S. account holders than it has ever received. The enhanced penalties and extended statute of limitation will lead to the eventual diminishment of bank secrecy for Americans worldwide and the enforcement of the foreign accounts arena for years to come.

Currently, Americans around the world are beginning to receive letters from their non-U.S. banks requesting information, and are being requested to file a Form W-9, Request for Taxpayer Identification Number and Certification, which provides the account holder's social security number. If the taxpayer does not file a W-9, then they may be asked to close their account and take their money elsewhere.

With the passage of time, it is expected that FACTA will allow the IRS to easily match tax information received from various disclosure requirements and the required tax filings. With the information gathered through FACTA compliance the IRS will be able to easily compare data received from FFIs about their U.S. account holders against tax returns that may or may not have a Form 8938. If the taxpayer has not complied for a multiyear period, then he or she could be at serious risk for civil examination or criminal investigation.

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