# How does the recent FATCA guidance affect asset managers?

*April 10, 2014*

## In brief

On February 20, 2014, the US Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued extensive temporary regulations that (1) amend the existing final Treasury regulations implementing the Foreign Account Tax Compliance Act (FATCA) and (2) provide guidance to harmonize the FATCA rules with the existing US information reporting and withholding rules. Since February 20, the Treasury and IRS have also released the final W-8BEN-E (for foreign entities), guidance on certain intergovernmental agreement (IGA) jurisdictions, and the deferral of certain key registration dates.

Asset managers who have already begun their FATCA implementation activities should find these changes provide some welcomed relief and clarification. For many managers, however, who were waiting on the additional guidance to move forward, these regulations represent the final significant pieces of guidance to be issued. If a manager has not started preparing for FATCA already, now is the time to begin preparation to 'go live' with FATCA by July 1, 2014. Time is short until July 1, so managers should review their FATCA implementation plans and make sure that they will be ready by July 1.

## In detail

The guidance provided by the Treasury and IRS have specific impacts to the asset management industry. The key areas of impact and their consequences are highlighted below.

### 1. *Investment managers and advisors*

The prior final FATCA regulations had expanded the definition of 'investment entities' that are treated as foreign financial institutions (FFIs) under FATCA to include most asset managers' management companies. To address concerns raised by the asset management industry, a new certified deemed compliant status has been added in the temporary regulations for investment advisors and managers who do not maintain financial accounts. This means that where an asset management group has separate advisory entities which act solely in an advisory capacity and, for example, are not custodians, the management entities will not be required to register.

***Observation:*** *This rule was intended to provide welcomed relief for asset managers from having to register their 'pure' investment advisor entities. The rule, however is a little ambiguous about what it means to 'maintain' financial accounts – all investment entities issue at least a class of equity (e.g. partnership interests or common stock), although not all of those are necessarily 'financial accounts' from a FATCA perspective. It is clear, however, that the drafters intended to cover investment advisors that provide pure management services and do not 'hold' assets for others. Thus, the new deemed compliant status clearly extends to management companies that receive only advisor fees, and may also extend to management*

*companies that hold general partner interests for their own account (so long as the management company activities do not rise to the level of an investment fund itself).*

### 2. *Custodian as a financial institution*

The determination of whether an entity (including, potentially, an investment advisor) represents a 'financial institution' by reason of holding financial assets for others is based on a quantitative analysis of the entity's income. The definition of 'custodial' types of income includes fees for providing financial advice. This raised the concern that an entity that did not serve as a custodian of assets at all for clients, but that did provide investment advice, could be classified as a custodial institution. The new temporary regulations limit, for purposes of this test, the fees taken into account to fees earned for advice related to financial assets held or potentially to be held in custody by the entity.

***Observation:*** *This change clarified that investment management activities themselves do not cause an entity to be classified as a 'custodian.' Asset managers that do, in fact, hold assets on behalf of clients (including through separately managed account relationships) should still run the quantitative analysis to confirm that their activities do not rise to the level of a 'custodian.' For example, an investment manager that custodies separately managed account assets directly (rather than using a third party custodian) would still need to assess whether its activities rise to the level of a custodian.*

### 3. *Limited life debt investment entities (i.e., CLOs and CDOs)*

The final FATCA regulations provided certified deemed compliant status to certain CLOs and CDOs that had particular organizational features that made compliance with the FATCA regulations impossible. The temporary regulations significantly change the various criteria for qualifying for this status to address concerns raised by the industry that the definitions were too limited to provide significant relief. The intention of the changes was to broaden the base of CLO and CDO entities eligible for deemed compliant status. The significant changes to the categories of CLOs and CDOs eligible for this deemed compliance status are:

- Permitting the entity to qualify for relief so long as the trustee or fiduciary is not authorized through a fiduciary duty or otherwise to fulfill the obligations of a participating FFI (PFFI) and no other person has the authority to fulfill the obligation of a PFFI on behalf of the FFI;
- Removing the requirement that the organizational documents cannot be amended without the consent of all of the investors;
- Allowing the vehicle to qualify until it liquidates according to its terms (rather than just merely extending the transition relief to 2017);
- Applying the status to any entity in existence on January 17, 2013 (the date of the final regulations); and
- Allowing de minimis interests not to be held in clearing organizations.

***Observation:*** *These provisions should make it easier for CLO and similar securitization vehicles to qualify for certified deemed compliant status. That being said, in order to qualify for this status, it must be confirmed that the trustee or fiduciary cannot comply with the obligations of a PFFI. This analysis may still be time consuming, and requires coordination between the trustee/fiduciary, the sponsor and other affected stakeholders (such as the directors and the collateral manager). Ultimately, affected stakeholders need a plan for (1) assessing the importance of FATCA compliance and pursuing compliance if the certified deemed compliant status does not apply and (2) ensuring that new CLO/CDO vehicles are FATCA compliant (as the certified deemed compliant status is only effective for pre-existing vehicles).*

### 4. *Disregarded entities*

Under the prior final regulations, it was not entirely clear whether disregarded entities were, in all cases, treated in the same manner as branches, given that both structures yield the same result from a US federal income tax perspective. The temporary regulations clarify that disregarded entities are treated in the same manner as branches.

***Observation:*** *This change is helpful in clarifying the treatment of disregarded entities under the FATCA regulations themselves. Disregarded entities in Model 1 IGA jurisdictions, however, should review the applicable FATCA implementation rules to determine their status for local reporting purposes because it is expected that a disregarded entity still be treated as a juridical entity in the IGA jurisdiction.*

### 5. *Expanded affiliated group definition*

The expanded affiliated group (EAG) rules have raised concerns in the asset management industry because, unlike other sectors in the financial services industry, overlapping ownership structures can cause funds not managed by the same manager potentially to affect each other's FATCA compliance status. (If one member of an EAG is not FATCA compliant, the entire group is

'tainted,' even if not managed by the same manager.) Although the new temporary regulations do not address this issue head-on, they do make changes intended to simplify the application of these rules. The changes include:

- Exempt beneficial owners (EBOs), for example, pension funds or sovereign wealth funds that meet certain criteria, that are EAG members (implying that an EBO could be a member of an EAG) are not required to register with the IRS (although no exception is provided for entities in the EBO's group unless they themselves are EBOs).
- The temporary regulations clarify that the EAG will generally have a common parent that is a corporation, but that an entity other than a corporation (such as a trust or partnership) may elect to be treated as the common parent.
- Members of the EAG include any corporation or non-corporate entity meeting the ownership requirements irrespective of whether the entity is a US person or a foreign person (excluding only certain types of entities that are listed in the affiliated group rules of Section 1504 of the Internal Revenue Code). In addition, the temporary regulations clarify that the qualifying interest can be owned by any member entity so that partnerships will not break the ownership chain for the group.
- The standard to be part of an EAG for a partnership was clarified to require more than 50% by value of the capital or profits interest to be held directly by one or more members of the group (including the common parent). A similar rule applies to the beneficial interest in a trust.
- A limited life debt investment entity will not be considered a member of any EAG.

***Observation:*** *Although the new regulations are helpful, they leave open the key topic that has been troubling the asset management industry; that is, how an asset manager should deal with a fund that is owned by a single majority owner, making it a member of investor's EAG. The regulations also do not address how the EAG rules interact with the sponsored entity rules in that situation. In addition, guidance is still awaited on how to handle and report changes in an EAG if ownership changes above and below 50% (for example, partners enter or leave a fund).*

### 6. *Direct reporting non-financial foreign entities (NFFEs)*

As promised, the temporary regulations permit NFFEs to report their substantial US owners directly to the IRS, rather than listing such owners on a properly completed Form W-8BEN-E. A direct reporting NFFE registers with, and reports to, the IRS (similar to an FFI), and receives a global intermediary identification number (GIIN). The regulations also create a 'sponsored direct reporting NFFE' status to permit a sponsoring entity to register and report on behalf of the NFFE (similar to sponsored investment entities).

***Observation:*** *This change is significant to asset managers in circumstances in which the investor did not want to make its substantial US owners directly known to the manager (and, presumably, where such information was not otherwise available through the manager's anti-money laundering/know your customer process). These additional statuses add additional complexity to the tracking and validation of FATCA status for investors. The Model 1 and 2 IGAs have not been updated for this status, pending further guidance.*

### 7. *Sponsored entities*

The rules clarify that sponsoring entities are not jointly and severally liable for failures to report or withhold by the members of their sponsored group unless the sponsoring entity is acting as a withholding agent with respect to the payment in question (for example, a withholding partnership as the sponsor).

***Observation:*** *This provision should provide some comfort to asset managers who were planning on acting as sponsors for funds under their management. It does, however, remind asset managers that an error with respect to their undertakings as a sponsor creates a direct liability at the fund level (rather than a liability that falls primarily at the sponsor level).*

### 8. *Changes relevant for holding companies*

A number of changes in the temporary regulations will affect intermediate holding companies such as blocker vehicles set up for private equity investments:

- Acquired holding companies. If a private equity or venture capital fund purchases a target whose group contains holding companies, investment managers worried that the prior final regulations would 'taint' those holding companies as investment entities not eligible for the 'holding company' exception for non-financial groups. The temporary regulations provide that any entity that existed six months prior to its acquisition by the investment vehicle and that, prior to its acquisition, regularly conducted activities in the ordinary course of business would generally

not be treated as 'formed or availed of' for these purposes. The portfolio company (together with its owners) would still need to test whether it is a non-financial group under the quantitative requirements, including all members of its EAG (which could include some or all of its private equity/venture capital owners).

- Excepted intermediate entities. The final FATCA regulations provided an exception for so-called 'excepted inter-affiliate FFIs,' which was basically an exception for intermediate holding company entities that did not admit outside investors directly. The original definition, which was targeted at ensuring that related parties owned its debt and equity, did not permit the entity to have any financial accounts outside its EAG. The definition has been amended to allow such entities to hold a depository account with a local financial institution in the country in which it is operating to pay for expenses in that country.

***Observation:*** *These enhancements to the definitions make it easier for asset managers especially in the private equity space to 'carve out' some entities from full FATCA compliance.*

### *9. Events of default*

The failure to reduce significantly the number of nonparticipating FFIs (NPFFIs) or recalcitrant account holders over time is an event of default under the final FATCA regulations. The temporary regulations clarify that this provision applies only if the failure is a result of the PFFI failing to comply with required due diligence procedures.

***Observation:*** *The FATCA regulations had long ago abandoned the concept that a PFFI had an obligation to 'kick out' all non-compliant investors as long as it otherwise complied with all of its reporting and withholding obligations under the rules. This change helps clarify that the goals of FATCA center on appropriate reporting.*

### *10. Grandfathered obligations*

If a grandfathered obligation is materially modified after June 30, 2014, it loses its status as grandfathered – meaning that non-FATCA compliant holders will suffer 30% FATCA withholding. The final FATCA regulations provided that a withholding agent would be required to withhold if it had reason to know that the obligation had been modified. This provision has been changed in the temporary regulations to require the withholding agent to have actual knowledge. Disclosure by the issuer is given as an example of actual knowledge in the temporary regulations. (The issuer and its agents will still be held to the reason to know standard.)

***Observation:*** *Although the changes are generally helpful, the temporary regulations leave open other situations that might create actual knowledge by a withholding agent or would be held to a 'reason to know' standard. For example, if a transfer agent is also a withholding agent on the debt, the 'reason to know' standard still applies. Funds that determine whether significant modifications occurred in their portfolio as part of their year-end compliance still may be blindsided by FATCA withholding even under the relaxed standard.*

### *11. 'Normal' US withholding and FATCA harmonization rules*

Extensive and detailed changes were also made to the various reporting and withholding regimes. A few highlights likely to assist asset managers are as follows:

- The expiration dates for existing withholding certificates (i.e., Forms W-8) has been extended to the end of 2014 to allow withholding agents even more time to collect new forms with respect to preexisting obligations.
- For preexisting obligations, the rules allow a withholding agent to treat a payee as a US person for FATCA purposes if it has previously reviewed a Form W-9 or equivalent documentation or previously categorized the payee as a US person using the Section 6049 'eyeball test.' This extension of the rules provides relief for brokers and other counterparties so long as the asset manager is comfortable that the existing requirements for the test have been met.
- The rules for indefinite validity of Forms W-8 have been enhanced but do not apply when the Form W-8 is also being relied upon for a claim of a reduced rate of withholding under a treaty. As a result, the Form W-8 for any investor claiming treaty benefits will still be required to be updated every three years. In addition, an investor no longer needs a US tax identification number (TIN) to complete a Form W-8; a foreign TIN will suffice.
- Consistent with guidance previously provided, the regulations clarify that a withholding agent may rely on a signed form or a document received by facsimile or scanned and sent by e-mail unless the withholding agent knows that the person transmitting the form or

document is not authorized to do so.

***Observation:*** *These are all welcomed changes for asset managers. Asset managers do need to make sure that their process allows for periodic updates for Forms W-8 that claim treaty benefits. Similarly, the changes to rules applicable to brokers and other market counterparties are helpful, but do assume that the asset manager has engaged in a baseline level of payor due diligence. In all cases, the asset manager should work closely with its third party vendors to understand their process.*

### *12. Final Form W-8BEN-E*

On March 28, 2014, the IRS released the Form W-8BEN-E, *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)*. The Form W-8BEN-E is the most recent of the W-8 forms to be finalized by the IRS. There are no instructions, so this form should not be used until the instructions are published and clarity is provided on what constitutes a valid form. The final form, however, was released to enable recipients of the form (such as asset managers or service providers, such as administrators and transfer agents) to update their new account onboarding process and systems to accommodate FATCA.

***Observations:*** *Many asset managers were waiting on the final Form W-8BEN-E to complete their work on their new account onboarding procedures, which must be in place by July 1. This final piece of guidance clears many of the remaining impediments noted by asset managers trying to finalizing their controls and procedures around investor and third party (vendor, service provider, and counterparty) documentation.*

### *13. Extension of the registration dates and additional IGA jurisdictions*

In addition to the guidance addressed above, on April 2, 2014, the Treasury and IRS released an announcement providing additional relief in two significant areas:

*An expansion of the circumstances in which the United States will treat a jurisdiction as having an IGA in effect*. The US Treasury expanded the list of jurisdictions deemed to have an IGA in effect which provides FFIs in those jurisdictions with much needed clarity as they prepare to comply with FATCA. To be included on the Treasury's 'in effect' list (see link), the partner country must agree in substance to an IGA before July 1, 2014 and consent to have the status of its IGA disclosed. Treasury has noted on its website an additional 22 jurisdictions in which IGAs are now treated as being in effect. FFIs in these jurisdictions are permitted to register consistent with their treatment under the relevant model IGA and will be permitted to certify their status to withholding agents consistent with that treatment. Those jurisdictions that are listed on Treasury's 'in effect' list will be treated as such for a limited time through the end of 2014. By that time, jurisdictions must sign their IGAs in order for this status to continue. If the jurisdiction fails to sign its IGA by December 31, 2014, the jurisdiction will be removed from the 'in effect' list.

*Extending the time by which FFIs must register with the IRS in order to be included on the first IRS FFI list*, which is slated to be released on June 2, 2014. FFIs that must register with the IRS now have until May 5, 2014, instead of April 25, 2014 as originally announced, to register and be included on the first IRS FFI list. According to the announcement, FFIs that register by June 3, 2014 will be included on the second FFI list slated to be released on July 1, 2014.

***Observation:*** *The expansion of the countries treated as having an IGA may change the content of certain asset managers' FATCA registrations and provides welcome relief for managers with management entities or funds in those jurisdictions. The extension of the registration deadlines, while helpful, does not provide significant additional time for asset managers to develop their registration approach.*

## *The takeaway*

Broadly speaking, the recently released guidance provides clarification and relief regarding what obligations and entities are in scope for purposes of the asset management industry complying with FATCA. The regulatory changes are significant, and stakeholders should carefully review the regulations to determine their impact on specific situations.

Asset managers that have already begun their FATCA programs should revisit their legal entity analysis, implementation plans, and business requirements in order to apply these clarifying points and take full advantage of the regulatory changes. In many cases, these changes are sufficiently discrete to permit asset managers to make changes to in flight implementation projects. For asset managers that have been waiting on additional guidance to begin, these regulations provide sufficient guidance for managers to develop their legal entity registration approach, new account onboarding procedures and overall controls framework. In particular, the guidance provides a basis to finalize and agree on the allocation of FATCA-relevant responsibilities between the asset manager and its third party service providers (such as administrators). Given that asset

managers cannot outsource all of their responsibilities, the time to discuss these issues is now!

## *Let's talk*

For a deeper discussion of how this issued might affect your business, please contact:

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