How do the final FATCA regulations affect asset managers?

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In brief

The long-awaited final Foreign Account Tax Compliance Act (FATCA) regulations have arrived and, while much analysis still needs to be done, the US Department of the Treasury and the Internal Revenue Service (IRS) provided welcome relief on a number of key issues for the asset management industry.

That being said, significant implementation challenges still remain for the asset management industry and substantial work must be undertaken through the course of 2013 in order for asset managers to be FATCA compliant by January 1, 2014. Failure to undertake the necessary tasks in 2013 could expose investment managers to a variety of business and investor relation risks.

This Newsbrief highlights key areas for consideration for asset managers (including notable changes from the proposed FATCA regulations) as they set their FATCA implementation agenda for 2013 and beyond. For an overview of the final FATCA regulations, see Global IRW Newsbrief, *Final FATCA regulations issued: Let the compliance begin*.

Key considerations

FATCA creates a new US information reporting regime that is globally enforced through a 30% withholding tax on certain direct and indirect payments of US source periodic income and gross proceeds. In order to comply with FATCA and avoid being subject to the 30% withholding tax on amounts received, FATCA requires a broad range of investment entities to (1) register with the IRS, (2) review their investor base, (3) gather certain documentation, (4) conduct due diligence on their investors, and (5) implement new tax information reporting and withholding procedures.

The impact on the asset management industry is profound. Proposed regulations published last year set forth a framework for compliance, but many asset managers held off moving into implementation or even beginning an assessment until final regulations were issued. With the publication of the final regulations on January 17, 2013, it is now time for these efforts to begin in full.

Guidance is still forthcoming on intergovernmental agreements (IGAs), whereby certain FATCA responsibilities may be discharged locally rather than requiring interaction with the IRS by non-US financial institutions (commonly known as foreign financial institutions or FFIs). The issuance of the final FATCA regulations and the prior release of model IGAs, however, means that substantial implementation efforts must be undertaken by asset managers.

The principal tasks for asset managers include the following:

- determine the 'final' FATCA characterization of each of their investment entities, including whether they are permitted, and choose to take advantage of the expanded scope of reduced compliance statuses now available under the final regulations
- prepare to register a non-US fund by October 25, 2013 (if the asset manager intends for the fund to be included on the first list of FFIs that have registered)
- move forward with updates to the investor onboarding process
- review existing investor data in light of the due diligence standards in the final regulations, including several new provisions which may permit reliance on existing documentation in certain circumstances
- given that the final regulations explicitly permit the use of third party service providers for certain tasks required under FATCA, consider the allocation of responsibilities between investment managers and their service providers
- formulate a plan to update critical legal documents, including service level agreements, offering documents, partnership agreements, etc.
- identify which payments may give rise to withholding so that steps can be taken to comply with the documentation requirements and avoid unnecessary liability.

There are a number of changes provided in the final FATCA regulations that will affect, and in many cases simplify, the manner in which the above tasks are completed. The balance of this Newsbrief identifies these changes and highlights the impacts for asset managers on their implementation efforts.

In detail

Scope of FATCA for asset managers

The key starting point for any FATCA analysis is whether an entity meets the definition of an investment entity, which is included in the definition of 'financial institution.' The final FATCA regulations both address key definitions that expand the scope of the application of FATCA to asset managers and provide a number of exceptions that temper this effect. It is the characterization of an entity as an FFI that gives rise to the requirements around registration, due diligence, withholding, and the reporting of certain information on 'financial accounts,' which include debt and equity interests in the FFI (except for interests regularly traded on an established exchange). Although FATCA's provisions are mainly targeted towards FFIs, it should be noted that US funds, investment managers, and service providers also are impacted.

Impact on management companies

The definition of 'financial institution' in the proposed regulations included entities that invest in financial assets. This definition in the final FATCA regulations has been expanded to include entities that provide investment management services on behalf of customers, which is similar to the concept of 'investment entity' used in the model IGAs. This means that foreign organized investment managers that receive fees for investment management services now will be treated as FFIs absent an applicable exception. There is no modification to the treatment of US organized investment managers (i.e., no requirement to register). Moreover, the final regulations provide that an entity that does not have professional managers will not be treated as a financial institution (which is expected to be utilized by small family trusts and personal investment corporations set up solely for estate tax purposes).

Further, the definition of a financial account has been modified so that interests in an investment manager are not financial accounts, unless the value is linked to assets that give rise to withholdable payments or were created to avoid FATCA withholding or reporting. Thus, principals in a management company are not treated as holding financial accounts in the management company except in circumstances in which the share carry is linked to withholdable payments. Asset managers, however, will have to certify that they do not facilitate investors in their funds in avoiding FATCA.

Impact on real estate funds

The final FATCA regulations provide an example where an investment fund consisting solely of non-debt, direct interests in real property located within and without the United States does not meet the definition of a 'financial institution' (even if professionally managed). This exception, however, is limited to investment funds solely holding physical real property and does not include investments in mortgages, derivatives over real property or real property holding companies, derivatives over real estate indices, and other indirect investments in real property.

The final FATCA regulations provide a quantitative test consistent with the proposed regulations to assess whether a fund that invests in both real property and indirect investments in real property is within the scope of the definition of a 'financial institution.' Accordingly, many foreign real estate funds that derive value indirectly from real property investments may still be within scope for FATCA depending on the percentage of gross income attributable to investing, reinvesting, or trading in these financial assets. As such, investment managers of real property funds will need to carefully review each fund to determine the application of the 'financial institution' concept.

Expansion and clarification of deemed-compliant and excepted categories

Consistent with the proposed FATCA regulations, there are two deemed-compliant categories in the final regulations. FFIs that qualify either for a registered or certified deemed-compliant status are provided reduced reporting and account due diligence obligations under FATCA. The first, called a 'registered deemed-compliant FFI,' does not need to enter into an agreement with the IRS, but is still required to register with the IRS, agree to deemed-compliant criteria, and certify every three years to its compliance. The second category, called a 'certified deemed-compliant FFI,' does not need to either register with the IRS or enter into an agreement with the IRS, but just certify to a withholding agent that it meets the requirements on a Form W-8 and provide any other required documentation.

The final FATCA regulations expand the scope of investment entities that qualify for such reduced obligations. The most significant new category is that of sponsored FFIs which, at its broadest, allows an FFI to engage a third party to perform all of its FATCA obligations. For many entities which employ administrators to perform a broad range of onboarding and similar services already, this is a welcome addition to the regulatory framework.

Note that eligibility for reliance on certain registered deemed-compliant statuses is still fairly restrictive and requires continual monitoring. For example, certain statuses require a fund to restrict its investors to certain FATCA-compliant categories (such as participating FFIs and deemed-compliant FFIs).

Key highlights relating to these categories include the following.

Sponsored entities

The final regulations provide three new types of deemed-compliant sponsored FFIs. Entities that qualify for such status can rely on the sponsor's identifying number (a global intermediary identification number or GIIN) until 2016 to allow the sponsored entity more time to register with the IRS.

- *Sponsored investment entities*. This category applies to investment entities that have contracted with a registered sponsoring entity (such as an investment manager) to comply with FATCA on their behalf. While this category is very useful for consolidating FATCA compliance within a fund group, it also allows investment vehicles to engage third party sponsors to deal with FATCA on their behalf. Further, it clarifies that a third party sponsor (such as an investment manager, collateral manager, trustee, or similar sponsor) can comply with FATCA without modifying the terms of the sponsored entities organizational documents, which is important for many securitization vehicles.
- *Sponsored controlled foreign corporations (CFCs)*. This category applies to CFCs that are wholly owned by a US financial institution that agrees to act as the sponsoring entity. This category also includes blocker corporations owned by US regulated investment companies.
- *Sponsored closely held investment vehicles*. These entities qualify as certified deemed-compliant FFIs, but the category is limited to sponsored vehicles that do not hold themselves out as investment vehicles for unrelated parties. The sponsoring entity has to be a participating FFI, a reporting Model 1 FFI (under an IGA), or a US financial institution.

Limited life debt investment entities

This certified deemed-compliant category appears to be specifically created for collateralized loan obligation and collateral mortgage obligation securitizations that do not permit either active investment or management (for example, so called brain dead entities). FFIs formed prior to 2012 pursuant to a trust indenture or similar instrument where

its organizational documents require it to liquidate on a set date and do not permit amendment without consent of all of its investors are eligible for this certified deemed compliant status. The FFIs must be formed for the purpose of acquiring certain types of debt, and payments must be cleared through a clearing organization or trustee that itself is a participating FFI, a reporting Model 1 FFI, or a US financial institution. The status is applicable only until 2017 (by which time the FFI must have found a way to comply with FATCA more broadly or have liquidated).

Excepted inter-affiliate FFI

Foreign entities that are members of participating FFI groups that have no accounts or interests held outside their expanded affiliated group (EAG) and do not act as an agent for another entity for FATCA purposes can qualify as excepted inter-affiliate FFIs. This category seems to cover intermediate foreign blockers in private equity structures, therefore reducing the total number of entities that need to register separately for FATCA purposes.

Bearer shares

An entity having bearer shares will no longer be disqualified under either the qualified collective investment vehicle or restricted fund deemed-compliant status. In order to qualify under these revised rules, the FFI must (1) not issue any new bearer shares after December 31, 2012, (2) retire bearer shares upon surrender, (3) establish procedures to redeem or immobilize the shares by January 1, 2017, and (4) document the actual holder at the time any distribution that is made with respect to the shares.

Seed capital

The final regulations provide a variety of exceptions for funds with seed capital provided by an investment manager:

- *Qualification as a qualified collective investment vehicle*. In general, funds with US investors cannot qualify as qualified collective investment vehicles. The regulations now ignore investments of seed capital by US investment managers subject to certain limitations (such as the investment is not intended to be held for more than three years). This means that a foreign fund capitalized with seed capital from its US investment manager may still qualify for this registered deemed-compliant status.
- *Seed capital from an FFI*. A fund formed with seed capital of an FFI will not be included in the contributing FFI's EAG. In order to qualify for this exception, the seeding FFI must be in the business of providing seed capital and cannot intend to hold the interest for more than three years.
- *Seed capital from US investment managers*. There is no specific exception from FATCA for entities formed with seed capital from US investment managers. In many circumstances, however, funds formed with seed capital provided by US management companies may qualify for the sponsored CFC exception discussed above.

Retirement funds

The retirement fund provisions in the proposed FATCA regulations provided a variety of exceptions with different statuses. These provisions have been changed and consolidated into the status of exempt beneficial owner in the final regulations. There are several different bases for the exemption. The provisions should be helpful to both in-house pension plans and investment funds that have pension plan investors.

Impact on holding companies

The definition of 'financial institution' has also been clarified specifically to include holding companies that are either part of a group that include other financial institutions (including investment funds) or are 'formed or availed of' by investment funds. This means that any foreign holding company in an investment fund structure is viewed as an FFI and needs to register with the IRS. That being said, the simplified rules applicable to wholly-owned entities (such as either excepted inter-affiliate FFIs or sponsored entities) may mitigate the impact of this rule.

Considerations for investor onboarding

The regulations set forth extensive rules for examining the accounts of new and pre-existing investors to determine whether any of them are US persons or are entities that are owned by US persons. These rules will affect the way in which investors are onboarded to funds and the due diligence required both with respect to new investors and to verify the status of pre-existing investors. In response to comments received from the investment management community, the final FATCA regulations relax certain requirements to make the rules more administrable.

Relief for investors moving to new funds within the same complex

In many cases, investment managers do not have to perform new anti-money laundering (AML) /know your customer (KYC) checks in circumstances when existing investors invest in new funds within the same complex. The final FATCA regulations acknowledge this business reality and allow the investment manager to treat such investors as 'pre-existing' investors even when they move into a new fund. This favorable rule, which can either limit the extent of the due diligence required or extend the time

to complete the due diligence process, however, is limited to circumstances in which the funds are part of the same EAG (which requires common ownership) or sponsored FFI group (which requires common reporting). These conditions may not be satisfied in many typical investment management structures. The corollary of this provision is that the investment manager must treat all of the interests held by the single investor as a single investment for purposes of (1) determining whether the fund has 'reason to know' certain information about the investor and (2) aggregating account balances to determine whether certain account thresholds are met.

Relaxation of documentation requirements

In a number of areas, withholding agents (which includes US funds) are permitted to rely on existing tests or existing documentation to document classification of their investors. These include the following:

- *Eyeball test.* Payors (such as a US fund) may rely on the 'eyeball test' to identify US exempt recipients without receiving a Form W-9. (This is critical for US funds that make payments to investors through US brokers holding shares in street name.)
- *Pre-FATCA forms for certain investors.* A withholding agent can rely on a pre-FATCA Form W-8 for individuals, foreign governments, and international organizations for the period such form is valid (in many cases, three years).
- *Pre-FATCA forms for entities.* For other entities, the pre-existing Form W-8 can be used until January 1, 2017 so long as additional documentary evidence of the payee's FATCA status is obtained. Although a fund may rely on the pre-existing Form W-8, it may still be required to gather additional FATCA-relevant information for investors prior to 2017.
- *Validity of existing forms.* There are also a number of situations where documentary evidence remains valid indefinitely unless the withholding agent has knowledge of a change in circumstances.

Role of third party service providers

Many investment managers outsource transfer agent, reporting, or withholding responsibilities to one or more third parties. Prior to the issuance of the final regulations, FATCA presented the possibility for overlapping and duplicative compliance efforts for performing due diligence on accounts, allocating liability for underwithholding, and addressing other matters that arise in connection when payments are made pursuant to an agency arrangement. In order to address this ambiguity, the final FATCA regulations contain special rules for principals (e.g., funds, issuers, etc.) who use agents (e.g., transfer agents, paying agents, etc.) to make payments and/or fulfill their obligations under FATCA.

Transfer agents and paying agents

Although paying agents (including transfer agents that also act as paying agents) are typically withholding agents with respect to payments they make on behalf of a principal (such as a fund), they are permitted under the final FATCA regulations to rely on certifications from the fund to determine their FATCA withholding obligations, instead of obtaining documentation directly from account holders. A paying agent that relies on a certification from a fund in this manner will not be liable for any underwithholding that results from the principal's failure to properly document and determine the status of a payee, unless the paying agent knows or has reason to know the certification provided by the fund is inaccurate. The fund remains liable for underwithholding in all instances, whether the failure was due to its own error or that of its agent.

Common agents

The final regulations also provide rules (consistent with existing Chapter 3) with respect to sharing and relying upon documentation that has been provided by a common agent for multiple parties, including a fund advisor or principal underwriter that collects information for a family of mutual funds. This is contingent on the agent sharing information/any knowledge regarding the inaccuracy or unreliability of the FATCA status across all the withholding agents with which the agent shares the documentation.

Third party data providers

A withholding agent can rely upon documentation collected with respect to an entity by a third party data provider such as a credit bureau, subject to certain conditions. This does not relieve the withholding agent of the obligation to determine whether the documentation is reliable based on information contained in the document and other information in the files of the withholding agent.

Maintaining a financial account

Where an account could be viewed as maintained by multiple entities (such as an investment entity and a transfer agent), the regulations identify which entity will be viewed as maintaining the account in order to avoid multiple obligations with respect to the same account. For example, the final FATCA regulations acknowledge that, although a paying agent can be a withholding agent with respect to

payments it makes on behalf of a fund, the financial accounts to which it makes payments generally belongs to the fund and not the paying agent.

Thus, in many cases, the investment fund (and by extension, its investment manager) -- and not its third party service providers -- will continue to bear ultimate responsibility for FATCA compliance, even if such tasks are conducted through agents.

Withholding considerations

The final FATCA regulations clarify certain key concepts around FATCA withholding. The starting point for the withholding responsibilities is the identification of a withholding agent which is very broadly defined to include any person, whether US or non-US, making a payment that is subject to withholding. As a practical matter, as withholdable payments include US source income and the gross proceeds from the sale of property that produce certain types of US source income, most withholding agents will be in the US.

Deferral of withholding responsibilities for offshore US source fixed, determinable, annual and periodic (FDAP) payments

Several offshore funds, concerned about making withholdable payments on offshore obligations, requested guidance on the breadth of the definition of a withholding agent. The final regulations provide an exception to FATCA withholding prior to 2017 so long as the payor fund is not acting as an intermediary with respect to the payment (for example, acting as an agent for a payment by a US withholding agent) or is not a flow-through entity with withholding responsibilities. The circumstances under which an FFI could make a payment of US source FDAP are limited (such as derivatives governed by Section 871(m)), but the exception will be helpful in those instances.

Gross proceeds

Even though withholding on gross proceeds has been delayed until 2017, a number of clarifications were made to the definition of gross proceeds. The original definition included property of a type that can produce US source interest or dividends. Under the final regulations, the disposition of a contract that produces a dividend equivalent is treated as property that produces interest or dividends, and therefore the gross proceeds from such disposition could be subject to FATCA withholding. In addition, the final FATCA regulations clarify that a capital gain dividend paid by a regulated investment company is treated as gross proceeds to the extent it is attributable to property that produces interest or dividends.

The takeaway

Reaction to the final FATCA regulations from the investment management industry will develop over the coming weeks and months. In many respects, the final FATCA regulations provide relief both with respect to the scope of investment entities covered and practical implementation challenges for entities within scope. The final FATCA regulations did not, however, exempt significant portions of the industry from the application of FATCA.

Investment managers who have not done so already will still need to carefully assess the impact of FATCA on their organization. For investment complexes that have assessed the areas in which FATCA will apply, the work on implementation needs to begin. Further, investment managers now have to determine where they are willing to engage (and compensate) service providers for such tasks.

Additional background

Please see the Global IRW Newsbrief archive for other recent FATCA developments. In addition, please access our FATCA IGA Website Monitor for a high-level overview of the IGAs promulgated so far and the latest IGA developments.

Let's talk

If you would like to discuss FATCA in more detail, please call your local PwC contact or alternatively any of the FATCA team members listed below:

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