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TAX ALERT

IRS ISSUES PRELIMINARY GUIDANCE ON FATCA IMPLEMENTATION

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On March 17, 2010, as part of the Hiring Incentives to Restore Employment Act of 2010, Congress enacted—and President Obama immediately signed—the Foreign Account Tax Compliance Act (FATCA), which was designed to curb the use of foreign financial institutions, foreign trusts and foreign corporations by U.S. individuals to evade U.S. taxes. The FATCA provisions are set forth in Sections 1471 through 1474 of the Internal Revenue Code and will become effective on January 1, 2013. (See our December 16, 2009, alert announcing the enactment of the FATCA provisions for a general discussion of the provisions, "House Passes Extenders Bill That Includes Several Revenue-Raising Provisions of Note to Investment Funds and Their Sponsors.")

On August 27, 2010, the Internal Revenue Service (IRS) issued Notice 2010-60, providing preliminary guidance on the implementation of the FATCA provisions. This alert summarizes key aspects of the FATCA provisions and the Notice that are relevant to investment funds.

Generally, the FATCA provisions impose a 30 percent withholding tax on "withholdable payments" to a "foreign financial institution" (FFI), unless such FFI has entered into an agreement (an "FFI Agreement") with the IRS to comply with various administrative requirements, including—

- obtaining certain information regarding holders of accounts maintained by the FFI to determine which (if any) of such accounts are "U.S. accounts"
- complying with due diligence procedures with respect to the identification of U.S. accounts
- reporting certain information with respect to U.S. accounts maintained by the FFI
- withholding tax on certain payments made to nonparticipating FFIs and "recalcitrant account holders."

The withholding tax on payments to FFIs is not intended to be a revenue raiser in its own right; rather, it is intended as a punitive tax, in an effort to compel FFIs to enter into an FFI agreement.

The Notice provides guidance on what types of entities will be considered FFIs (including certain exceptions from that definition) and describes the information collecting/due diligence obligations that will be required of FFIs that enter into FFI Agreements. According to the Notice, the IRS will publish a draft FFI Agreement as well as draft information reporting and certification forms.

In general, most investment funds formed under the laws of a non-U.S. jurisdiction will meet the definition of an FFI. Significantly, although the Notice identifies some limited exceptions from FFI status, these exceptions are not likely to be applicable to the typical investment fund. An investment fund formed under the laws of a U.S.

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jurisdiction, of course, would not itself be an FFI. However, it still needs to be aware of the FATCA rules, since it has to determine whether it must withhold under the FATCA provisions when making withholdable payments to third parties.

The Notice describes the procedures with which participating FFIs (i.e., FFIs that have entered into FFI Agreements) must comply in identifying U.S. accounts and providing the IRS information regarding the owners of those accounts. The procedures described by the Notice distinguish between four categories of accounts: (i) pre-existing financial accounts (i.e., those accounts that are in existence at the time the FFI's FFI Agreement becomes effective) held by individuals, (ii) new financial accounts held by individuals, (iii) pre-existing financial accounts held by persons other than individuals and (iv) new financial accounts held by persons other than individuals.

There are two particularly troublesome situations that an FFI may encounter in attempting to comply with its identification obligations. The first is where an account is held by a foreign individual, many of whom have historically been reluctant to sign any form that refers in any way to U.S. taxing authorities. The second is where an account in an FFI is held by another institution. On the face of the statute, the IRS apparently could require the FFI to obtain information from the account-holder institution as to the identity of all of **its** direct and indirect investors. This is information that an institution might well consider proprietary and would likely be reluctant to provide to another institution that it might view as a competitor. The Notice provides some relief with respect to each of these situations.

Under the Notice, a participating FFI may generally treat an individual account as other than a U.S. account (and not as a recalcitrant account) if, based on the information the FFI has concerning the account holder, there are no indicia of U.S. status. In that case, the FFI need not obtain formal certification (in the form of a signed Form W-8BEN) of the owner's identity and nationality, although, in the case of new accounts, it must obtain some sort of "documentary evidence" of non-U.S. status. To determine whether an account has indicia of U.S. status, an FFI must examine information it maintains for the account holder to determine whether it includes any of the following indicia of potential U.S. status—

- identification of any account holder as a U.S. resident or U.S. citizen
- a U.S. address associated with an account holder of the account (whether a residence address or a correspondence address)
- a U.S. place of birth for an account holder of the account
- an "in care of" address, a "hold mail" address or a P.O. address that is the sole address on file with respect to the account holder
- a power of attorney or signatory authority granted to a person with a U.S. address
- standing instructions to transfer funds to an account maintained in the United States or directions received from a U.S. address.

Thus, it seems that it is theoretically possible for an investment fund to accommodate a truly foreign individual who is allergic to U.S. tax forms, provided such individual has no indicia of U.S. status and is, in the case of a new account, willing to provide "documentary evidence" in some form short of an "official" Form W-8BEN.

The Notice also provides limited relief in the second troublesome situation by providing that, when a participating FFI makes a payment to another FFI, it need not obtain documentation as to the identity of all direct and indirect owners, all the way up the chain of ownership, if the recipient FFI itself has entered into an FFI Agreement and so

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certifies to the payor FFI. For example, if a non-U.S. investment fund makes a payment to a fund-of-funds investor, it need not obtain any information about the ultimate investors in the fund-of-funds; rather, all the investment fund need do is obtain certification that the fund-of-funds is, itself, a participating FFI.

For offshore funds that are FFIs (which should be the case for most, if not all, of such funds), the crucial decision that will have to be made is whether or not to enter into an FFI Agreement. Failure to do so could have significant — possibly disastrous — effects on a fund's rate of return. In particular, because the withholding tax would be imposed on **gross proceeds** (including on gross proceeds from the sale of certain types of property), the effective rate of tax could easily exceed 100 percent of economic income. Thus, the pressure to enter into an FFI Agreement or to otherwise avoid withholding under the FATCA provisions (e.g., by not buying/selling securities of U.S. issuers) will be intense. The main obstacle to entering into an FFI Agreement is whether the offshore market will tolerate the information and certification procedures that will be required for FFIs that do enter into such an agreement. The Notice mitigates slightly the most unpalatable aspects of those procedures, but it remains to be seen how the markets will react.

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