



Global Information Exchange for Investment Funds: Common Reporting Standard Enters Into Effect

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Introduction

On January 1, 2016, the Common Reporting Standard (CRS) issued by the Organisation for Economic Cooperation and Development (OECD) entered into effect in certain key investment fund jurisdictions, marking a significant step toward a global system of automatic exchange of information among participating jurisdictions. In general, the CRS requires that participating jurisdictions annually exchange certain information obtained from financial institutions and investment funds that have cross-border customer or investor relationships or participate in cross-border financial transactions or investments.

The CRS in a Nutshell

The CRS imposes a variety of diligence and reporting requirements on “financial institutions,” broadly defined to include banks and depository institutions, custodial institutions, insurance companies and also investment entities. The definition of an “investment entity,” in turn, is very broad

and includes entities that primarily conduct investment management activity on behalf of other persons, or entities that are managed by such entities (or by other financial institutions). Most collective investment vehicles (including private equity funds, hedge funds and mutual funds) and their sponsors that are resident in a CRS participating jurisdiction are likely to be subject to the CRS regime.¹

Under the CRS, investment funds will be required to provide annual reports to their local governments showing certain investor and financial account information. The local governments will then transmit the relevant information to the governments of other jurisdictions participating in the CRS regime. The information that is required to be reported generally includes an investor’s identifying information and tax residence, as well as the value of the relevant fund interest as of the end of the prior calendar year (or, if earlier, the withdrawal or transfer date of an investor). As discussed below, special rules apply for investors that are “passive nonfinancial entities” for CRS purposes.

1. A comprehensive overview of the jurisdictions participating in the CRS, the status of CRS implementation under local law and the initial reporting deadlines in each participating jurisdiction is available on the OECD website. <http://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/>

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Although the CRS is expected to be phased in the next few years across nearly 100 participating jurisdictions, a subset consisting of 56 countries is part of an “Early Adopters Group” that has agreed to apply the CRS beginning on January 1, 2016. Many jurisdictions that are typically utilized for establishing investment funds and holding companies are included in this Early Adopters Group, such as Bermuda, the British Virgin Islands, the Cayman Islands, Ireland, Luxembourg and the Netherlands. Although the United States has decided not to participate in the CRS regime, U.S. fund managers should consider whether potential CRS compliance requirements are triggered when utilizing non-U.S. alternative investment vehicles and special-purpose vehicles.

The CRS follows the introduction of other regimes for the automatic exchange of information in recent years, most notably the regime introduced by the United States under legislation commonly known as the U.S. Foreign Account Tax Compliance Act (FATCA) and the regime in place between the United Kingdom and its Crown Dependencies and Overseas Territories (often referred to as the “UK CDOT” regime). The CRS borrows heavily from the operative provisions in the intergovernmental agreements that the United States has entered into with many jurisdictions for purposes of facilitating FATCA compliance. Investment funds that seek to comply with the CRS should therefore be able to find synergies within their existing investor diligence procedures that are designed to be compliant with FATCA. There are, however, some notable distinctions between the CRS and FATCA regimes, which include the focus of the CRS on the “tax residence” of investors (as opposed to the search for U.S. citizens or U.S. persons under FATCA), the treatment of investment funds in nonparticipating jurisdictions as so-called “passive nonfinancial entities” (discussed further below), the absence of a withholding tax to enforce CRS compliance and the multilateral nature of the reporting under the CRS. It should be noted, however, that the CRS requires participating jurisdictions to adopt a framework under local law to enforce compliance with the obligations under the CRS (including anti-abuse rules and penalties for noncompliance).

“Pre-Existing” vs. “New” Investors

Under the CRS, investment funds are required to adopt diligence procedures to collect information with respect to “financial accounts,” which generally include all equity and

debt instruments issued to investors. Similar to the rollout process under FATCA, investment funds will need to separate “pre-existing” from “new” investors by reference to the acquisition date of the relevant fund interests. The cutoff date for “new investors” in Early Adopter Group jurisdictions is January 1, 2016.

With respect to pre-existing investors, due diligence procedures for investment funds in the Early Adopters Group will, very generally, be required to be completed (i) for pre-existing individual investors by December 31, 2016, and (ii) for pre-existing entity investors by December 31, 2017. A relaxed time schedule applies for completing due diligence with respect to certain specific investor categories. Procedures for pre-existing investors include a search for certain “indicia” of tax residence on the basis of electronic and potentially also paper records. Indicia of residence with respect to individual investors include, inter alia, a current mailing address, a telephone number or a power of attorney with standing instructions in a particular jurisdiction. Indicia of residence with respect to entity investors include a current address or a certificate of organization or incorporation. If indicia are found, a “self-certification” of the tax residence of the investor must generally be obtained to avoid having to treat the investor as a reportable account.

For new investors, investment funds must obtain a valid self-certification form stating the tax residence of the investor to avoid being required to treat the investor as a reportable account. The CRS permits investors to provide the self-certification in any manner and any form (e.g., a scanned PDF). However, if the self-certification is provided electronically, then the systems used by the investment fund collecting the form must ensure that the authenticity of the sender and the information provided can be confirmed. Further, upon request, an investment fund must be able to provide a hard copy of any self-certifications received electronically. Thus, the systems that are used must also permit proper storing of self-certifications.

Since the CRS provides only limited exceptions from the rule that a self-certification must be obtained, the question arises whether an investment fund can accept an investor without obtaining a self-certification on the relevant closing date. In such case, local guidance implementing the CRS may permit that a self-certification is obtained as soon as possible after the closing date and, in any event, no later

than a threshold date after the acceptance of the investor in the fund (e.g., 90 days). Fund managers should also consider whether sanctions may apply under local law in case the investor is ultimately categorized as undocumented, potentially including the increased likelihood of an audit if the fund reports multiple undocumented investors.

Passive NFEs and U.S. Investment Funds

Entities that do not qualify as financial institutions for CRS purposes are generally referred to as “nonfinancial entities” (NFEs). Very generally, if substantially all of the income realized by an NFE and substantially all of its assets produce passive income, such NFE will be regarded as a “passive NFE” for CRS purposes (it is important to note that this concept does not overlap with the very similar “passive NFFE” concept under FATCA). Passive NFEs will typically include many privately held investment companies, offshore trust arrangements and family office investors.

Passive NFEs are not themselves subject to CRS diligence and reporting, but are required to disclose the tax residence of their controlling persons to investment funds in which they hold equity or debt interests. Such investment funds are then required to conduct CRS diligence and reporting with respect to such controlling persons as if they were direct investors in such funds. A “controlling person” for CRS purposes is a natural person who (i) owns more than a threshold percentage of the relevant investor entity (e.g., 25 percent); (ii) absent significant equity ownership, otherwise exercises control over such entity (e.g., via a special voting arrangement); or (iii) if control is not otherwise established, is in charge of the effective management of such entity (e.g., ignoring any nominee directors).

In addition, investment entities located in a jurisdiction that does not participate in the CRS, such as the United States, are treated as passive NFEs for CRS purposes. Thus, even though U.S.-based investment funds are not required to report information to the U.S. government under the CRS, such funds may become the subject of CRS diligence efforts with respect to their controlling persons when interacting with financial intermediaries or making investments outside the United States. However, since the United States does not require reporting of taxpayer identification numbers under the CRS, any investment funds that are passive NFEs with controlling persons who are U.S. citizens or U.S. persons should not be required to disclose any U.S. social security numbers (although disclosure of any non-U.S. taxpayer identification numbers that such persons may have is, of course, required for purposes of CRS reporting).

Practical Steps to Undertake

Initial steps that investment funds in participating jurisdictions should consider undertaking for purposes of their compliance with the CRS include the following:

- confirm that no CRS registration requirement applies under local law; if no registration requirement applies because the fund already obtained a FATCA registration number (or so-called “GIIN” number), confirm whether such number must be notified to local tax authorities
- for all open-ended and closed-end funds in their capital-raising phase, have in place updated subscription procedures requiring new investors coming into the fund as of January 1, 2016, to provide self-certifications that permit due diligence and recording of their tax residence (for investment funds in jurisdictions not in the Early Adopters Group: as of January 1, 2017)
- for existing closed-end funds, update subscription procedures with respect to secondary market transfers
- bring operations teams up to speed as to the CRS diligence and reporting processes
- request self-certifications and other information required under the CRS from existing investors to permit completion of CRS diligence before the applicable deadline
- identify the persons in charge of CRS reporting, which may include expanding existing contractual arrangements with fund administrators.

The first reporting deadline for the Early Adopters Group is expected to be in 2017 with respect to information obtained in 2016. For example, in the Cayman Islands, the first reporting deadline is expected to be May 31, 2017.

Finally, since the CRS is a new and evolving regime, local law in the relevant fund’s jurisdiction of residence should be monitored to better understand the timeline for CRS implementation and reporting, and to be aware of any rules that may be adopted to address enforcement in case of noncompliance.

About the Author



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