



The Impact of FATCA on Mutual Funds and other Regulated, Open-ended Funds

Closing the distance

Global Financial Services Industry



Overview

The Treasury Department and the Internal Revenue Service (“IRS”) issued the final regulations on the set of statutory rules commonly referred to as Foreign Account Tax Compliance Act (“FATCA”). The new information reporting and withholding regime signifies the U.S. government’s effort to encourage foreign financial institutions (“FFIs”), including non-U.S mutual funds and other regulated open-ended funds, to report U.S. taxpayers holding assets offshore.

Generally, FATCA requires payors of U.S. source income and gross proceeds to apply 30% withholding on such payments to non-U.S. entities that do not comply with FATCA. To avoid FATCA withholding, FFIs that are not exempted or “deemed-compliant” must generally enter into FFI agreements with the IRS or, if subject to a model 1 intergovernmental agreement (“IGA”), register with the IRS as a reporting model 1 IGA FFI. The IGAs are agreements between the U.S. and foreign jurisdictions to implement FATCA compliance. FFIs that register with the IRS will obtain a Global Intermediary Identification Number (GIIN) to identify themselves as FATCA compliant to other withholding agents. To avoid the withholding tax, non-financial foreign entities

(“NFFEs”) that are not exempted in the final regulations will be required to provide information to the withholding agents relating to their U.S. owners who have a substantial ownership stake.

Implications to Mutual Funds and Regulated Open-ended Funds

FATCA will have significant impact on both U.S. and non-U.S. domiciled mutual funds and in many cases FATCA preparation and ongoing compliance activities will require close coordination and oversight of third party transfer agents, distributors, and other intermediaries.

U.S. Domiciled Mutual Funds – U.S. Withholding Agents (USWAs)

U.S. funds registered under the Investment Company Act of 1940 and treated as Regulated Investment Companies (“RICs”) are generally USWAs under the FATCA provisions. These funds must withhold on certain distributions to foreign shareholders who are not FATCA compliant. To determine if their foreign shareholders are FATCA compliant, RICs will be required to perform enhanced due diligence to identify their shareholders, obtain the necessary documentation or FFI registration information to confirm FATCA compliance by those shareholders, develop a program for withholding on any non-participating or non-compliant shareholders, conduct enhanced 1042-S reporting on certain FATCA withholdable payments, and conduct new Form 8966 reporting on certain U.S. owners of certain non-U.S. entity shareholders. In cases where the RIC has outsourced its transfer agency function to a third party service provider; these FATCA compliance activities may reside with the transfer agent. However, the RIC remains responsible for ensuring its FATCA obligations are satisfied, and any financial liability for non-compliance remains with the RIC. Therefore, it is imperative the RIC closely coordinates with any transfer agents to ensure FATCA compliance and monitor compliance activities.

Non-U.S. Domiciled Funds- FFI

The final regulations modify the definition of an “investment entity” found in the proposed regulations to more closely align with the definition provided in the IGAs. Specifically, the definition has been modified by excluding passive, non-commercial investment vehicles, including trusts, from the definition. The final regulations define an investment entity as any entity that:

- Is professionally managed by a depository institution, custodial institution, specified insurance company or another investment entity;
- Functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets; or
- Primarily engages in a business of trading financial products for customers, performing portfolio management, or investing, administering, or managing funds, money, or financial assets on behalf of customers.

Another key difference in this new investment entity definition is that it captures many investment management companies, investment advisors, and fund administrators along with the funds in the definition of an FFI.

Non-U.S. funds will need to be analyzed under the regulations to determine whether they fall under the FFI definition. Generally, non U.S. funds will be FFIs and will need to enter into FFI agreements unless they qualify as deemed-compliant FFIs, or, should an IGA be in place, they comply with their local country IGA. There is a much broader scope of compliance activities applicable to non-U.S. mutual funds such as UCITs, OEIC, SICAVs that have U.S. sourced income and/or U.S. investors within their funds.

The considerations required of these FFIs can include the following (among others):

- Entering into an FFI Agreement with the IRS or registering with the IRS;
- Reviewing pre-existing shareholder accounts and classifying shareholder accounts into FATCA categories;
- Analyzing AML/KYC programs performed internally and by third party service providers to confirm compliance with FATCA requirements;
- Updating shareholder onboarding procedures to comply with FATCA requirements;
- Developing a governance structure for implementation and electing “Responsible Officer(s)” (RO) who are required to certify compliance;
- Creating a FATCA compliance program that contains the policies, procedures, controls and internal audit procedures required to comply with an FFI agreement; and
- Identifying, reporting, and withholding on certain payments on redemption, certain foreign pass-through payments etc.

Deemed-compliant Status

In assessing the impact of FATCA on an individual fund or other investment entity, much of the analysis will involve determining whether any exceptions apply and whether the requirements are mitigated by various exceptions in the final regulations. The final regulations introduced new deemed-compliant categories that will be of particular interest to non-U.S. mutual funds and regulated open-ended funds seeking to reduce the burden of FATCA. For example, the category known as the “**sponsored investment entity**” allows a sponsoring entity to register with the IRS to undertake the FATCA responsibilities on behalf of sponsored entities. As the sponsoring entity, it registers the sponsored investment entity FFI, registers itself as a sponsoring entity, and generally fulfills the FATCA requirements of the sponsored investment entity FFI. This new category will provide certain fund managers the option to consolidate FATCA compliance for multiple funds under management. Although this registered deemed-compliant category still requires registration with the IRS and responsible officer certifications among other procedural requirements, it will help certain funds reduce their compliance burden.

A similar more restrictive category was added to the certified deemed-compliant category. That is, the “**sponsored, closely held investment vehicles**” where certain sponsoring entities can likewise register themselves to perform all of the FFI agreement requirements on behalf of its sponsored entities. The key difference with this category (aside from the stricter requirements), is that the sponsoring entity does not need to register the individual sponsored funds for a GIIN.

Other registered deemed-compliant categories that provide some relief are the qualified collective investment vehicle and restricted fund deemed-compliant status. However, the requirements to comply under these categories are fairly restrictive. The “**qualified collective investment vehicles**” category generally applies to a regulated investment entity FFI in a FATCA-compliant expanded affiliated group (e.g., participating FFIs, deemed-compliant FFIs, etc.), but certain restrictions apply to direct debt interests in excess of \$50,000. The “**restricted fund**” category generally applies to a regulated investment entity FFI in a Financial Action Task Force (“FATF”)-compliant jurisdiction that generally redeems or transfers interests in the fund itself (other than bearer obligations issued prior to 1/1/2013) or through participating FFIs, registered deemed-compliant FFIs, nonregistering local banks, or restricted distributors. Restricted distributors have additional strict guidelines to meet.

Fund Managers, Investment Advisors, and Fund Administrators

As noted above, the new investment entity definition generally includes fund managers, investment advisors, and fund administrators. Therefore, non-U.S. fund managers and fund

administrators will have to either enter into an FFI agreement with the IRS or otherwise register with the IRS if IGA or deemed-compliant status applies.

Grandfathered Obligations - Derivatives and Related Transactions

The final regulations define grandfathered obligations as any obligation outstanding on January 1, 2014, that is not significantly modified on or after that date. This provision covers most financial instruments, except, notably, those that are treated as equity for U.S. tax purposes or that lack a stated expiration or term. The final regulations exempt grandfathered obligations from FATCA withholding, but not reporting. The final regulations extend and describe the grandfathering rule by clarifying the term “obligation” as any legally binding agreement or instrument including (i) certain derivatives transactions entered between counterparties under an ISDA master agreement that is evidenced by a confirmation by December 31st, 2013, (ii) certain obligations that may give rise to withholdable payments through future regulations under section 871(m) (relating to dividend equivalent payments) or to foreign passthru payments under the chapter 4 foreign passthru payment rules, and (iii) collateral obligations that secures the grandfathered derivative or other obligation.

Next Steps

The impact for global mutual funds goes beyond tax and requires extensive efforts throughout an organization including legal, compliance, technology, and operations. It is likely that service providers will also need to be involved in tax compliance preparation activities, including executing an ongoing FATCA compliance program.

FATCA preparation and compliance can represent a multi-year process for many global fund managers, and although the program can be broken down into manageable steps, preparation activities must begin now. Fund managers should assess the impact on their organization by examining their organizational structure, shareholder base, and operations. Once fund managers understand their structure and current state, they can begin to target the impacted areas and move forward to become FATCA compliant.

Some of the specific action items for fund managers to consider when developing their FATCA compliance programs are:

- Identifying organizational legal entities and funds or products that will be classified as an FFI under the FATCA regime;
- Updating fund documents, such as offering documents and subscription documents to incorporate FATCA specific language, indicate that the funds plan to register as an FFI, and the implications of non-compliance;
- Reviewing and updating legal agreements with third party service providers;
- Reviewing existing shareholder onboarding to identify where additional data is required for new accounts, and remediating shareholder/investor information as required for pre-existing accounts, counterparties;
- Developing communication strategies for shareholders, investors, counterparties, and third party service providers;
- Analyzing current fund and organizational structures to determine whether any modifications can be made to reduce the impact of FATCA;
- Educating shareholder/investor relations personnel and distributors about the impact to their business or functions;

- Identifying the impact to existing processes or technology platforms; and
- Outlining a solution for supporting the FATCA withholding and reporting requirements which are phased in from 2014 to 2017.

These requirements can be complex for a large mutual fund organization with a global network of transfer agents, distributors, and other third party intermediaries. To closely monitor activities of multiple third parties, a fund manager should develop a broad based program management office to review the FATCA client communications and preparation programs in place at each transfer agent, distributor, and intermediary.

Important FATCA dates in 2013 and 2014

2013

July 15	FATCA registration portal will be accessible for registration
October 15	IRS to start issuing FFI Global Intermediary Identification Numbers (GIINs)
October 25	Last date an FFI can register with IRS to ensure inclusion in the December 2013 IRS FFI list
December 02	IRS to publish first list of participating and registered-deemed compliant FFIs
December 31	Grandfathered obligations cutoff

2014

January 01	USWA & FFI to begin new account onboarding
January 01	Begin income withholding (excluding certain offshore payment of U.S. source income)
June 30	FFI & USWA to complete documenting/remediating preexisting accounts that are considered "prima facie FFIs"

** Other Withholding/Reporting requirements phase in from 2015 through 2018

To learn more

The final regulations are extensive and complicated, and the changes from the proposed regulations are substantial. This document attempts to highlight certain important provisions of the final regulations that generally impact U.S. and non-U.S. mutual funds and other regulated open-ended funds and do not represent a broad-based summary of all of the changes. If you are directly or indirectly affected by the compliance obligations of the final regulations, you will likely want to take affirmative steps soon with respect to FATCA implementation. If you wish to discuss the final regulations or any FATCA-related matters, please contact one of our FATCA contacts listed on the following pages.

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