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# FATCA impact on real estate industry

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## Introduction

The Foreign Account Tax Compliance Act ("FATCA") addresses perceived abuses by US taxpayers with respect to assets held offshore. Enacted in 2010, FATCA compels non-US entities to report US asset holders to the IRS beginning in 2013 and 2014 with a new, US-sourced withholding tax levied against non-cooperative foreign entities.

Specifically, the FATCA regime imposes a new 30% US withholding tax on withholdable payments made to a Non-Financial Foreign Entity ("NFFE") or a Foreign Financial Institution ("FFI").

The definition of FFI is quite broad, and appears to include virtually all non-US investment vehicles, including foreign feeder funds, foreign stand-alone funds and blocker corporations as well as foreign alternative investment vehicles, regardless of being offered or traded publicly.

US based investment vehicles, while not technically FFIs themselves, will still be considered withholding agents and have an obligation to withhold on certain payments made to foreign investors, if those partners are considered to be noncompliant FFIs or NFFEs.

To avoid FATCA withholding, foreign entities, unless otherwise exempt, must comply with FATCA by either registering with the IRS as an FFI or if the entity is an NFFE, by providing the withholding agent with either (1) certification that it does not have any substantial specified US owners or (2) information on the identities of its substantial specified US owners.

The definition of a withholdable payment is broad and includes US-source payments such as interest (including long term original issue discount), dividends, royalties, rents or any other fixed or determinable, annual or periodic ("FDAP") income.

Additionally, a withholdable payment also includes the gross proceeds from the sale or disposition of any property that could produce US source interest or dividends. Income which is "effectively connected" ("ECI") with a US trade or business is specifically exempt from FATCA withholding.

Withholdable payments made to an FFI will not be subject to withholding if the FFI enters into a formalised agreement (a "FFI Agreement") with the IRS to identify and report certain US account holders.

Withholdable payments to a NFFE will not be subject to withholding if the NFFE provides information about its substantial US owners (generally more than 10%) or is an excepted NFFE (e.g., a publicly-traded corporation or its affiliates).

Proposed regulations released in February 2012 by the US Treasury provide detailed requirements that FFIs, NFFEs and US withholding agents must comply with to avoid the withholding liability under FATCA.

The proposed regulations also provide details on exceptions, exclusions and a broader framework of international cooperation aimed at easing foreign entities' costs of FATCA compliance that was announced in a joint statement between the US and five European countries on the same day the regulations were issued.

Understanding the implications of these new rules will allow you to navigate the hurdles and seize opportunities to start preparing your processes, systems, and business relationships for a smooth transition to the new, more transparent international business environment that FATCA attempts to create.

## Industry impact

For the real estate industry, the new FATCA rules will impose additional challenges for both US and non-US real estate funds because of the many complicated and diverse investment structures that have become common in recent years.

With respect to US real estate funds, non-US investors are less likely to own real estate directly as they are adverse to US tax compliance requirements and seek to reduce the impact of the Foreign Investment in Real Property Tax Act ("FIRPTA") on the ultimate disposition of the real estate.

Such investors have sought the use of alternative investment structures, such as investment in US real estate through US and non-US corporations, investment in US real estate through a US Real Estate Investment Trust (“REIT”), and loans by non-US investors, to shield them from direct exposure to ECI taxable income and US tax compliance requirements.

Because the FATCA legislation provides for a specific exception to ECI, however, the use of these ownership structures to avoid ECI treatment may now expose these investors to the reporting and withholding tax requirements under FATCA whether or not such income may be exempt from general gross basis US tax and withholding.

Non-US real estate funds which do not receive US source income directly may still need to comply with FATCA rules. Investments into other offshore funds or depositing funds with other entities who are themselves FFI’s will most likely require disclosure of investor information by such other funds or depositories.

In this case, a non-US real estate fund may be viewed as either a non-participating FFI or a recalcitrant account holder if it does not provide the requested information, resulting in its indirect share of US source income being subject to 30% withholding tax.

Although the effective date for withholding in general has been deferred until January 2014, the date for withholding on these indirect payments, referred to as “foreign passthru payments” has been deferred to January 2017 in recognition of the administrative complexity associated with identifying and computing the withholding on such payments.

Notwithstanding these phased in dates, time is short. FATCA is generally effective beginning in 2013.

Persons investing in US real estate funds and those who manage US real estate funds will need to understand when such investments give rise to withholdable payments and be able to analyse the application of the FATCA provisions and exemptions to the various structures used and the types of investors who are contributing their capital.

Within US and non-US real estate fund organisations, the scope of FATCA can impact investor relations, operations, legal, compliance and tax. It is not just a short term economic issue, but also the management of the perception that a fund or fund sponsor has not properly educated its investors to these new rules.

## Next steps

Real estate fund managers should analyse the impact of FATCA on their organisations by examining their structure, their investor base and their operations.

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

- Reviewing current fund structure to understand the fund’s administrative requirements and potential withholding obligations under FATCA, including classification of the fund’s legal entities into FATCA taxonomy categories, and to determine which components of existing withholding processes can be leveraged and enhanced to support FATCA reporting requirements;
- Analysing fund legal documents, including offering documents and subscription agreements to determine proper scoping and disclosure of FATCA impacts, as well as identifying investors’ rights and obligations under FATCA;
- Communicating with business partners and service providers to determine division of responsibilities, develop a ‘FATCA readiness plan’, and consider whether service provider agreements may also need be modified to require associates to be FATCA compliant;
- Managing impact on investor relations processes, including updating processes for new investor onboarding, and developing a plan and approach for reaching out to existing investors to determine FATCA classification of each investor, determine the roles and responsibilities of the fund and each investor, obtain waivers and/or additional information required under

FATCA, and to understand foreign investor’s plans for becoming FATCA compliant;

- Analysing current KYC and AML practices both internally and externally with fund administrators, distributors, and other third party intermediaries to determine if any expansion or enhancements are required to these practices;
- Coordinating communications with investors and managing the various vendor communications to maintain a consistent and cohesive client experience;
- Managing the process for identifying, recording, reconciling, and reporting the new withholding information to the IRS;
- Educating cross departmental fund manager teams on the impact to their business units or functions, and appropriately identifying the impact to existing processes or technology platforms; and
- Reviewing and updating internal policies and procedures to help monitor FATCA compliance, and establishing controls and governance structure to monitor and resolve FATCA issues (e.g., non-FATCA compliant investors).

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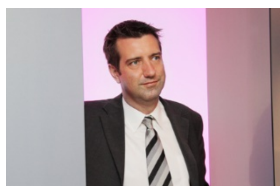

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