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# FATCA impact on private equity and hedge funds industry

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## Introduction

The U.S Foreign Account Tax Compliance Act ("FATCA") addresses perceived abuses by US taxpayers with respect to assets held offshore and will require virtually all private equity and hedge funds to be capable of implementing its requirements in 2013.

Enacted in 2010, FATCA compels non-US entities to report US account holders to the Internal Revenue Service ("IRS") by otherwise imposing a new withholding tax levied against non-cooperative foreign entities.

FATCA reporting will be enforced by requiring payors of US source income and gross proceeds to withhold 30% on payments to non-US entities that do not certify their compliance with FATCA.

The new rules will have a significant impact on all private equity and hedge funds which generate US source income because they will likely be considered either a US Withholding Agent or a Foreign Financial Institutions ("FFIs") under these rules.

Proposed regulations released in February 2012 by the US Treasury and the IRS provide detailed requirements with which FFIs, US Withholding Agents, and other non-US entities must comply to avoid withholding.

The proposal also details exceptions, exclusions, reporting and withholding requirements.

Simultaneously with the release of the proposal, a broader framework for international cooperation aimed at easing privacy concerns was announced in a Joint Statement between the US and five major European countries.

Understanding the implications of these new rules will allow for a well-scheduled and well-planned implementation.

## Industry impact

The most significant impact of FATCA for the private equity and hedge fund industry will be on non-US funds.

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.

It is expected that FATCA compliant counterparties (banks, broker/dealers, custodians, etc.) are unlikely to transact with non-FATCA compliant funds. As such, these funds should consider becoming participating FFIs by entering into an FFI Agreement with the IRS.

FATCA also has an impact on non-US funds which do not have either US investors or US investments. Funds with no US investors must determine the status of direct investors and those who are non-US fund intermediaries (e.g. distributors and nominees) to determine if there are any indirect US investors. However, that information may not be easily obtainable.

Funds with no US investments will need to be aware of the eventual implementation of the foreign passthru payment requirements (i.e., a portion of payments from a non-US entity could be treated as US source), as well as any future changes in investment strategy by their investment managers.

The impact to US domiciled Private equity and hedge funds are limited. However, US funds are required to identify their investors, obtain necessary documentation or FFI registration information to confirm compliance of those shareholders, and develop a program for withholding and reporting for any non-cooperative or recalcitrant shareholders.

In cases where the fund has outsourced their transfer agency/administration functions to a third party service provider, these FATCA compliance activities can be outsourced as well, however the responsibility and liability for compliance remains with the fund.

Compliance for private equity and hedge funds will require assistance from outside of the tax department. Legal, compliance, technology, operations, and external service providers will need to be involved in preparation activities, as well as the execution of an ongoing FATCA compliance program.

## Next steps

FATCA preparation and compliance can represent a multi-year process for many fund managers, so it is important to begin preparation activities in the near term for future compliance requirements.

Fund managers should assess the impact on their organisations by examining organisational structure, their investors and distributors, third-party service providers and counterparties.

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

- Analyse current fund and organisation structures to determine each entities' classification under the FATCA categories;
- Determine whether entities classified as FFIs need to register with the IRS;
  **Note:** The proposed regulations expanded the definitions of deemed compliant entities which might include certain types of funds, though these remain restrictive.
- Classify investor accounts into FATCA categories;
- Remediate investor information as required for pre-existing accounts
  **Note:** Similar considerations apply to counterparties and third party service providers;
- Conduct reviews of investor onboarding processes to identify where additional data is required to be collected for new accounts;
  **Note:** The proposed regulations modified due diligence procedures to rely more on current AML/KYC procedures, increased de minimis thresholds for individual and entities, and, in certain cases, permits reliance on existing Form W-8 and W-9.
- Analyse AML/KYC programs performed internally and by third party service providers to confirm compliance with FATCA requirements;
- Develop a governance structure for implementation and identify "Responsible Officer(s)" who are required to certify compliance;
- Update fund documents, such as offering documents and subscription documents, to incorporate language that outline the FATCA requirements, indicate whether the funds' plans to register as an FFI, and the implications of non-compliance;
- Outline a solution for supporting the FATCA withholding and reporting requirements which are phased in from 2014 to 2017 or later;
- Analyse current fund and organisation structures to determine whether any modifications can be made to reduce the impact of FATCA;
- Develop communication strategies for investors, counterparties, and third party service providers; and
- Educate investor relations personnel and distributors about the impact to their business or functions, and identify the impact to existing processes or technology platforms.

Along with the above, it is important that fund organisations keep current on developments.

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