

The Impact of FATCA on U.S. and Non-U.S. Real Estate Funds

Closing the distance

Global Financial Services Industry



Overview

The Foreign Account Tax Compliance Act (“FATCA”) is one of the most extensive and complex tax information reporting regimes created by the Internal Revenue Service (“IRS”) and U.S. Treasury. The reach of FATCA will most likely require nearly every business with an international footprint or conducting business outside the U.S. to confront new compliance realities. Core objective of FATCA is to address perceived abuses by U.S. taxpayers with respect to their offshore accounts and indirect investment income through non-U.S. entities. The regulations impose significant compliance burdens on payors making cross-border payments and liability for any under withholding. FATCA will have a significant impact on funds that directly, indirectly or through certain investment vehicles trade or invest in U.S. assets.

The FATCA withholding tax will be imposed in a similar manner to the existing withholding tax on U.S. source income under Chapter 3 (sections 1441 and 1442) of the Internal Revenue Code by requiring payors (or withholding agents) of U.S. sourced income and gross proceeds to withhold 30% on payments to non-U.S. entities that do not certify their compliance with FATCA or disclose their substantial U.S. owners. However, FATCA withholding, which is applied before any Chapter 3 withholding, does not allow tax treaty based exemptions or other reductions of the withholding tax rate. To avoid the tax, Foreign Financial Institutions (“FFIs”) must generally enter into an FFI agreement with the IRS to share the identities of U.S. account and asset holders, if subject to a model 1 Intergovernmental agreements (“IGA”), register with the IRS as a reporting model 1 IGA FFI, or fall within one of the exempt, certified or deemed compliant categories. The IGAs are bi-

lateral 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. Other affected non-financial foreign entities seeking to avoid the tax will be required to provide appropriate information to the withholding agents relating to any of their substantial U.S. owners or certify to a particular excepted status.

The definition of a withholdable payment is broad and includes U.S.-source payments such as interest (including original issue discount), dividends, 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 U.S. source interest or dividends. Income which is “effectively connected” (“ECI”) with a U.S. trade or business is specifically exempt from FATCA withholding. As discussed above, withholdable payments made to a FFI will generally not be subject to withholding if the FFI enters into an FFI Agreement with the IRS to identify and report certain U.S. account holders, complies with an applicable IGA, meets a deemed compliant category, or is considered exempt. Withholdable payments to a NFFE will not be subject to withholding if the NFFE provides information about its substantial U.S. owners (generally more than 10%) or is an excepted NFFE (e.g., a publicly-traded corporation or its affiliates).

Industry Impact

The new FATCA rules may impose additional challenges for both U.S. and non-U.S. real estate funds given the many complicated and diverse investment structures that have become common in recent years. With respect to U.S. real estate, non-U.S. investors may be less likely to own real estate directly for numerous reasons, including an unwillingness to address U.S. tax compliance requirements and pay tax under 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 U.S. real estate through U.S. and non-U.S. corporations, as opposed to partnerships, to avoid treatment as effectively connected income (“ECI”), or investment through a U.S. real estate investment trust (“REIT”) to avoid FIRPTA. However, the use of these ownership structures to avoid ECI or FIRPTA 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 U.S. tax and withholding. In contrast, payments subject to FIRPTA or considered effectively connected with a trade or business in the United States are not considered withholdable payments, and therefore not subject to FATCA.

Non-U.S. real estate funds that do not receive U.S. 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 FFIs will most likely require disclosure of investor information by such other funds or depositories. In this case a non-U.S. real estate fund may be viewed as either a nonparticipating FFI or a recalcitrant account holder if it does not provide the requested information, resulting in its indirect share of U.S. source income being subject to 30% withholding tax. Although the effective date for withholding in general has been deferred until July 1st, 2014, the date for withholding on these indirect payments, referred to as “foreign pass-through payments” has been deferred to January 2017 in recognition of the administrative complexity associated with identifying and computing the withholding on such payments. The final regulations reserved the definition of foreign pass-through payments for future guidance. However, previous guidance noted that this could include non-US source payments from a non-US corporation if a portion of the payment is treated as attributable to a US source withholdable payment received by the non-US corporation.

Persons investing in U.S. real estate funds and those who manage U.S. real estate funds will need to understand when such investments give rise to withholdable payments and be able to analyze the application of the FATCA provisions and exemptions to the various structures used and the types of investors who are contributing their capital. Within U.S. and non-U.S. real estate fund organizations, 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 a possible perception that a fund or fund sponsor may not have properly educated its investors to these new rules.

Foreign entities not meeting the definition of an FFI who hold real estate may be classified as nonfinancial foreign entities (“NFFEs”) subject to the withholding and reporting requirements of FATCA. As the nature of the income received by such foreign entities is generally “passive”, such entities will generally be treated as “passive NFFEs” and required to comply with FATCA.

Next Steps

Real estate fund managers should analyze the impact of FATCA on their organizations by examining their structure, their investor base and their operations. Some of the specific action items to consider when developing FATCA compliance programs are:

- Reviewing current fund structure to understand the fund’s administrative requirements, product portfolio, 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;
- Analyzing 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;
- Analyzing current KYC and AML procedures both internally and externally with fund administrators, distributors, and other third party intermediaries to determine if any expansion or enhancements are required to these procedures;
- 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).

Important FATCA dates in 2013 and 2014

2013

August 19 FATCA registration portal will be accessible for registration

2014

April 25 Last date an FFI can register with IRS to ensure inclusion in the June 2, 2014 IRS FFI list

June 02 IRS scheduled to publish first "GIIN" list

July 01 Grandfathered obligations cutoff

July 01 USWA & FFI to begin new account onboarding

July 01 Begin income withholding (excluding certain offshore payment of U.S. source income)

December 31 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 real estate funds and do not represent a broad-based summary of all of the changes. If you are or suspect that you are directly or indirectly affected by the compliance obligations of the final regulations, you should take affirmative steps soon with respect to FATCA compliance. If you wish to discuss the final regulations or any FATCA-related matters, please contact one of our FATCA contacts listed below.

For more information please [click here](#) or please contact:

Denise Hintzke
Director, Global FATCA Tax Leader
Deloitte Tax LLP
+1 212 436 4792
dhintzke@deloitte.com

Anne Mericle
Global FATCA PMO Manager
Deloitte Tax LLP
+1 212 436 3908
americle@deloitte.com

Americas

John Rieger
Partner, National Tax Financial
Services Industry
Deloitte Tax LLP
+1 212 436 6934
jrieger@deloitte.com

John Kocjan
Partner, FATCA Consulting Leader,
U.S.
Deloitte Consulting LLP
+1 212 618 4181
jkocjan@deloitte.com

Jon Watts
Director, FATCA Enterprise Risk
Services Leader, U.S.
Deloitte & Touche LLP
+1 212 436 6561
jonwatts@deloitte.com

Dennis Metzler
FATCA Leader, Canada
Deloitte & Touche LLP
+ 1 416 601 6144
dmetzler@deloitte.ca

Mike Wade
Director, FATCA Enterprise Risk
Services Leader, U.S.
Deloitte & Touche LLP
+1 804 697 1537
miwade@deloitte.com

Greg Thomas
Principal, FATCA Enterprise Risk
Services Leader, U.S.
Deloitte & Touche LLP
+1 415 783 5211
grethomas@deloitte.com

Helda Rock
Director, FATCA Enterprise Risk
Services Leader, U.S.
Deloitte & Touche LLP
+1 973 602 6052
hrock@deloitte.com

Oscar Ortiz
FATCA Leader, LatAm
Deloitte Mexico
+52 55 5080 6513 x6513
oortiz@deloittemx.com

Michael Shepard
Principal, U.S. FATCA Financial
Advisory Services Leader, Deloitte
Financial Advisory Services LLP
+1 215 299 5260
mshepard@deloitte.com

Patty Florness
Partner, Global Information
Reporting
Deloitte Tax LLP
+1 212 436 7413
pflorness@deloitte.com

Stephen Cryer
FATCA Consulting Leader, Canada
Deloitte & Touche LLP
+ 1 416 874 3169
scryer@deloitte.ca

James Dockeray
FATCA Leader,
Caribbean/Bermuda
Deloitte & Touche Ltd.
+1 441 299 1399
james.dockeray@deloitte.bm

Europe, Middle East & Africa**Piero Molinario**

FATCA FAS Leader, Europe
Deloitte & Touche, S.p.A
+39 02 8332 5102
pimolinario@deloitte.it

Nick Sandall

FATCA Consulting Leader, EMEA
Deloitte LLP
+ 44 20 7007 1850
nsandall@deloitte.co.uk

Chris Tragheim

FATCA Tax Leader, EMEA
Deloitte LLP
+ 44 20 7303 2848
ctragheim@deloitte.co.uk

David Fidan

FATCA Corporate Finance Leader, Switzerland
Deloitte AG
+41 58 279 6750
mailto:dfidan@deloitte.ch

Umair Hameed

FATCA FAS Leader, Middle East
Deloitte Corporate Finance Ltd
+971 50 658 4486
uhameed@deloitte.com

Humphry Hatton

FATCA Co-Leader, Middle East
Deloitte LLP
+971 (0) 4 506 4730
huhatton@deloitte.com

Ali Kazimi

FATCA Tax Leader, Middle East
Deloitte LLP
+971 (0) 4 5064910
alikazimi@deloitte.com

Mark Pegram

FATCA Co-Leader, Middle East
Deloitte LLP
+971 (0) 4 506 4902
mapegram@deloitte.com

Asia-Pacific**Jim Calvin**

FATCA Leader, Asia-Pacific
Deloitte & Touche LLP
+65 6224 8288
jimcalvin@deloitte.com

Anna Bleazard

FATCA FAS Leader, Asia-Pacific
Deloitte & Touche Financial Advisory Services
+65 6216 3277
ableazard@deloitte.com

Karon Wan

FATCA Consulting Leader, Asia-Pacific (excl. Japan)
Deloitte Touche Tohmatsu
+852 28526562
karonwan@deloitte.com.hk

Patrick Yip

FATCA Country Leader, China/Hong Kong
Deloitte Touche Tohmatsu
+852 28521618
patyip@deloitte.com.hk

Natalie Yu

FATCA Leader, Beijing
Deloitte Touche Tohmatsu
+86 10 85207567
natyu@deloitte.com.cn

Johnny Foun

FATCA Leader, Shanghai
Deloitte Touche Tohmatsu
+86 21 61411032
jfoun@deloitte.com.cn

Hiromi Ikuta

FATCA Leader, Japan
Deloitte Touche Tohmatsu
+036 213 1164
hiromi.ikuta@tohmatsu.co.jp

Chris Cass

FATCA Leader, Australia
Deloitte Touche Tohmatsu
+61 2 9322 7060
ccass@deloitte.com.au

Global Information Reporting & Withholding Contacts**Terence Coppinger**

+1 212 436 6412

Patty Florness

+1 212 436 7413

Denise Hintzke

+1 212 436 4792

Anthony Martirano

+1 973 602 6986

Faye Tannenbaum

+1 212 436 2968

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