PwC Asset Management Alert

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How do the proposed FATCA regulations impact Asset Managers?

On 8 February, the long-awaited proposed regulations providing guidance on the various provisions under the Foreign Account Tax Compliance Act ("FATCA"), which was enacted as part of the Hiring Incentives to Restore Employment Act of 2010, were issued. The proposed regulations provide guidance on a number of specific implementation issues relevant to the asset management industry, and it is clear that a number of comments received from the industry were incorporated into the regulations. The proposed regulations generally do not, however, delay the existing effective dates for FATCA compliance.

> **PwC Observation:** *Although these regulations are only proposed, they appear to provide sufficient guidance for fund managers to begin assessing what information gaps exist, determining what systems changes will need to be made, and communicating with their third-party service providers in order to address the looming effective dates of these rules.*
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> *Among the concerns addressed by the proposed regulations were the treatment of local distributors, the treatment of funds that prohibit sale to US persons, and the application to foreign partnerships. In many cases, the proposed regulations reduce the overall burden imposed on foreign funds; however, FATCA will still significantly affect business practices, policies and procedures for many in the asset management industry.*
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> *Although the proposed regulations provide a great deal of detailed guidance relative to the prior guidance, there is still a good deal of guidance to come in the form of the draft documents, i.e., FFI Agreement, modified withholding certificates (e.g., Forms W-8) and modified information returns (e.g., Forms 1042-S).*
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> *Further, the proposed regulations still leave some open questions regarding the treatment of certain foreign pension funds, the scope of the "deemed compliant" rules, and other items for asset managers.*

Simultaneously with the issuance of the proposed regulations, the governments of the United States, France, Germany, Italy, Spain, and the United Kingdom released a joint statement providing that they are exploring a common approach to FATCA implementation through foreign financial institutions disclosing their FATCA information to the tax authority in their country of residence (rather than directly to the U.S. government). The joint statement also emphasises the willingness of the United States to reciprocate by automatically collecting and exchanging information on accounts held in U.S. Financial Institutions by residents of each of the respective countries.

> **PwC Observation:** *The joint statement addresses many of the prviacy law concerns raised by asset managers. It does not, however, necessarily reduce the amount of information that must be gathered from a FATCA perspective, and may in some cases ultimately increase the reporting costs for a global asset manager.*

Key Provisions of the Proposed Regulations

1. **Additional categories of deemed-compliant FFIs.** The proposed regulations expand the categories of deemed-compliant foreign financial institutions to reduce the compliance burdens on entities for whom entering into an FFI agreement is not necessary to carry out the provisions of FATCA. The categories of deemed-compliant FFIs are broader than those described in previous guidance, and include "certain qualified investment vehicles" and "restricted funds." These specific rules focus on the nature of the investors (e.g., participating FFIs or exempt beneficial owners), as well as the nature of the distribution relationship (e.g., limited to local banks or distributors restricted from distribution outside of the country of residence).

   PwC observation: *Deemed-compliant" status has been an alternative that the IRS and Treasury have offered for certain funds presenting a low risk of tax evasion, rather than exemption from FATCA altogether. Although these rules may make it easier for certain funds to be deemed-compliant, they will not eliminate the administrative burden associated with FATCA. For example, a deemed-compliant fund will still have to perform certain due diligence on direct investors and change how they do business with their distributors before registering with the IRS. If the distributor's status were to change, the fund will need to take remedial actions. Finally, a deemed-compliant fund will still have certain on-going information gathering and monitoring procedures it must follow in order to certify its "deemed-compliant" status every three years.*

   Even with the broader categories of "deemed-compliant" funds, there still may be a significant number of funds that do not qualify for this status and must comply with the full FATCA reporting and withholding regime.

2. **Foreign partnerships and trusts.** The proposed regulations provide some clarity regarding the treatment of U.S. source payments received by foreign flow-through entities (including partnerships and simple trusts). For partnerships that are not FFIs (and not certain NFFEs, withholding partnerships and withholding trusts) and for participating FFIs receiving payments of U.S. source FDAP, the proposed regulations state that the amount of U.S. source fixed or determinable annual or periodic ("FDAP") (e.g., interest, dividends, etc.) income paid to the flow-through entity is treated as paid to its partners under the existing withholding principles or, for partnerships and trusts that have not elected to be withholding agents for their partners, the U.S. source FDAP income is treated as paid to the partners at the time the income is paid to the partnership or trust. For either a non-participating FFI or a participating FFI with respect to payments other than U.S. source FDAP, generally the foreign fund is treated as the recipient (i.e., the "payee") with respect to a U.S. source FDAP payment (and subject to the normally applicable FATCA rules).

   PwC observation: *These proposed regulations provide some clarification regarding the application of the FATCA rules for foreign partnerships. The regulations clarify when a foreign fund is treated as a "payee" under the FATCA withholding rules, and when a "look-thru" approach to the fund is appropriate. The regulations do not address other related issues, such as the computation of passthru payment percentage.*

3. **Modification of Due Diligence procedures for the identification of accounts.** The proposed regulations reduce the burden associated with reviewing records of pre-existing accounts to determine U.S. status by:

   a. Increasing the threshold for manual reviews to US$1,000,000 for pre-existing individual accounts (a "high value account").

   b. Providing guidance on the scope of a "diligent review" of paper account records (e.g., paper search).

   c. Providing a US$250,000 de minimis rule for pre-existing entity accounts, and extending the reliance on information collected during a "know your customer" or "anti-money laundering" process (KYC/AML).

   d. Eliminating the special rules in the prior guidance for so-called "private banking accounts" and replacing this concept with the "high value" account concept listed above.

   PwC observation: *For asset managers that use different processes for assessing FATCA compliance for pre-existing and new accounts, these rules provide additional clarification on the information and diligence necessary for these pre-existing accounts. The prior guidance required a private banking relationship manager to identify any client where he had actual knowledge that the client is a U.S. person and request a Form W-9 from such person, with commentators noting that the definition of a private banking was fairly broad and subjective. The proposed regulations simplify the requirement so that the participating FFI must only identify all high-value accounts for which a relationship manager has actual knowledge that the account holder is a U.S. person and obtain from such account holder a Form W-9, and a valid and effective waiver, if necessary. The regulations also do not clarify how "accounts" are measured in the fund context -- for example, does an increase in capital subscription by an individual investor constitute a "new account" or an increase in an "existing account"?*

4. **Temporary safe harbor for funds with legal prohibitions from FATCA compliance.** Prior to the proposed regulations, a single non-compliant fund in a fund complex could affect the ability of any fund in the complex to qualify as a participating FFI. The proposed regulations provide a two-year transition rule (until 1 January 2016) for certain members of an expanded affiliated group to become a participating or deemed-compliant FFI. The transition period, which only applies to FFIs located in jurisdictions that have laws that prohibit the tax withholding or reporting required under FATCA, provides such FFIs with additional time to fully implement FATCA, without preventing other FFIs within the same expanded affiliated group from entering into an FFI agreement. An FFI still will need to agree to perform due diligence to identify U.S. accounts and maintain certain records during this transition period.

   PwC observation: *This limited deferred effective date rule not only provides additional time for funds that have local law conflicts to assess their legal options, but also permits the possibility that additional governments might reach an agreement with the U.S. government regarding exchanging FATCA-relevant information. During this two-year transition period, an FFI member of an expanded affiliated group that does not enter into an FFI agreement will be subject to FATCA withholding on withholdable payments that it receives. Thus, any fund in a complex that is legally prohibited from FATCA compliance will still face 30 percent withholding on any US-source income payments, starting in 2014.*

5. **Extended compliance date for passthru payments.** The proposed regulations extend the date on which FATCA withholding and reporting begins on foreign passthru payments (i.e., passthru payments that are not withholdable payments) from 1 January 2015 to 1 January 2017. During this interim period, however, an FFI must report the aggregate amount of certain payments to each non-participating FFI as a means to reduce the incentive for non-participating FFIs to use participating FFIs to block the application of the FATCA rules.

   PwC observation: *The preamble to the regulations notes that the extension of time was a response to comments regarding the administrative complexity and legal impediments in identifying and withholding on passthru payments. Without this additional time, many FFIs have stated it would be impossible to fulfill their commitment under FATCA. For the asset management industry, the problem is more acute because funds would need to work with their third-party service providers (administrators, custodians, etc.) to put in place systems to compute and report passthru payment percentages. Although the Treasury and the IRS requested additional comments on practical approaches to reduce the burden, the preamble also noted that for FFIs in a jurisdiction where the agreements contemplated by the intergovernmental joint statement that provide the appropriate reporting of U.S. accounts and recalcitrant account holders, the withholding on any foreign passthru payments to recalcitrant account holders may not be required.*

   Although previous guidance indicated that an FFI must enter into an FFI Agreement by June 30, 2013 to ensure that it will be identified as a participating FFI in sufficient time to allow U.S. withholding agents to refrain from withholding beginning on 1 January 2014, the proposed regulations did not provide any specific guidance. The Treasury Department and the IRS intend to publish a draft model FFI agreement in early 2012 which may provide more guidance.

6. **Grandfathered obligations.** The proposed regulations include obligations outstanding as of 1 January 2013 (the previous guidance included obligations outstanding on 18 March 2012), and identify certain obligations (such as debt instruments, revolver credit facilities, lines of credit, certain life insurance contracts, term-certain annuity contracts, and derivatives under an ISDA master agreement) as eligible for grandfathered status.

   PwC observation: *Similar to the extension of the time for reporting passthru payment percentages, this extension reduces the scope of instruments that prompt FATCA reporting and withholding. That being said, reporting on grandfathered obligations present a small piece of the overall FATCA compliance process for many asset managers.*

7. **Guidance on procedures required to verify compliance.** The proposed regulations modify the guidance provided in the previous guidance by providing that the responsible officer of an FFI will be expected to certify that the FFI complied with the terms of the FFI agreement. In addition, verification of compliance through a third-party audit is not required.

   PwC observation: *This confirms that the responsible officer at each asset manager will be ultimately responsible for FATCA compliance. As such, even if a third-party service provider performs all of the necessary due diligence, withholding and reporting functions, the responsible officer would need to be satisfied that all of the procedures are sufficient completed be providing any such certifications.*

A public hearing has been scheduled for 15 May 2012. The IRS has requested that comments be submitted by 30 April 2012.

On 21 February 2012, PwC will host a webcast on the proposed regulations in general. A link to the registration site will be open on Friday 10 February 2012, and can be found at: http://www.pwc.com/us/fatca

In addition, various PwC offices across the country will be hosting a series of roundtables and seminars over the course of the next month to discuss the implications of the regulations on the Asset Management industry.

> **PwC observation:** *It has been suggested that the proposed regulations have either delayed FATCA or that the efforts around compliance for the asset management industry have been substantially mitigated. It seems in fact there is still a substantial amount of work to be done by these asset managers to even qualify for deemed-compliant FFI status. Given that the regulations have provided details on how these rules may ultimately work, asset managers should have sufficient direction to begin assessing and developing a plan with their third-party service providers to implement the requirements of FATCA into their business processes and procedures.*

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Included below are links to the guidance released as well as the press release and the joint statement.

Link to release:
http://www.treasury.gov/press-center/press-releases/Pages/tg1412.aspx

Link to statement:
http://www.treasury.gov/press-center/press-releases/Documents/020712%20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf

Link to regulations:
http://www.ofr.gov/OFRUpload/OFRData/2012-02979_PI.pdf

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