August 2014

FATCA for Private Funds: Key Considerations

Although the Foreign Account Tax Compliance Act (FATCA) went "live" July 1, 2014, guidance continues to fall into place. On July 16, the IRS issued instructions for the requester of various Forms W-8 and continues to update its FAQ website. The Cayman Islands Tax Information Authority issued regulations effective July 4, 2014 addressing the implementation of the Cayman IGA, and on July 22 issued the first official version of its FATCA Guidance Notes.

Against this backdrop, private equity and hedge funds must keep their foot on the gas towards FATCA implementation. This bulletin discusses high-level FATCA compliance considerations for a "typical" fund structure involving either a U.S. fund as the sole vehicle, or a U.S. fund coupled with one or more master or feeder funds formed in the Cayman Islands. Non-U.S. funds formed in other jurisdictions may have different considerations.

Background

FATCA imposes a 30% withholding tax on U.S. source payments to "foreign financial institutions" (FFIs) that do not comply with requirements to identify their U.S. account holders, as well as to non-financial foreign entities that do not identify their substantial U.S. owners, unless an exception applies. Many countries, including the Cayman Islands, have entered into an intergovernmental agreement (IGA) with the United States, which sets forth the requirements for FATCA compliance for financial institutions located in that country. The Cayman IGA is a "Model 1 IGA," under which Cayman Islands institutions report information regarding their U.S. account holders directly to the Cayman Islands Tax Information Authority (rather than to the IRS). Other countries have entered into a "Model 2 IGA," under which resident FFIs report this information directly to the IRS. FFIs not located in either a Model 1 or Model 2 jurisdiction can comply with FATCA by entering into an "FFI agreement" with the IRS.

For U.S. funds, FATCA compliance means complying with due diligence, withholding and reporting requirements. For Cayman funds, FATCA compliance generally means registering with the IRS, performing required due diligence on investors and reporting investor information to the Cayman Islands Tax Information Authority.

Identify and Register Foreign Fund Vehicles

To comply with FATCA, Cayman funds must register with the IRS to be "registered deemed-compliant" (as a reporting Model 1 FFI) unless an exception applies. Thus, fund groups should review their structure charts to identify their non-U.S. vehicles, such as foreign master funds, feeder funds and management companies.

Most Cayman master and feeder funds will be considered "investment entities" under the Cayman IGA and therefore must register with the IRS. Investment management companies formed in the Cayman Islands are exempt from registration, as long as the company is within the scope of FATCA registration solely because it provides investment advice or portfolio management services, and the fund being managed is FATCA-compliant. Other limited categories of Cayman investment vehicles (described in Annex II to the Cayman IGA) are exempt from registration. Thus, funds should review their structure specifics.

Unless exempt, each Cayman investment entity should register on the IRS website to receive a global intermediary identification number (GIIN). A paper registration using Form 8957 is also permissible. The GIIN will be provided to U.S. payors (withholding agents) to establish that the Cayman fund is FATCA-compliant. Existing Cayman funds (and other reporting Model 1 FFIs) must obtain a GIIN by January 1, 2015.

As part of the registration process, a non-U.S. fund must determine whether it is part of an "expanded affiliated group" (EAG), generally meaning a chain of entities connected by more than 50% equity ownership. For example, a Cayman feeder and master fund would be part of the same EAG if the feeder owns more than 50% of the capital or profits interests of the master. Although the EAG concept is not included in the Cayman IGA, the IRS registration process contemplates that one member of the EAG be designated as the "lead financial institution," and this member will initiate registration for the other EAG members.

As part of registration, non-U.S. funds must designate a "responsible officer" (RO). For Cayman funds, the duties of an RO are to submit the FATCA registration for purposes of obtaining a GIIN and to authorize one or more points of contact to receive information related to registration. A U.S. citizen or resident serving as an RO should consider its potential obligation to file Form 5471. In general, a Form 5471 must be filed by a U.S. citizen or resident who is an officer or director of a non-U.S. corporation, if a U.S. investor acquires at least 10% (or an additional 10%) of the corporation's stock (by vote or value). Although (for Cayman funds) an RO need only be an individual and thus not necessarily an officer, ROs should review the specifics of their authorizations to determine whether Form 5471 filings would be advisable.

U.S. Funds—Key Compliance Considerations

U.S. funds are not required to register with the IRS except in limited circumstances, such as when a U.S. fund serves as a "sponsoring entity" for a non-U.S. fund. However, U.S. funds are subject to due diligence, withholding and reporting obligations under FATCA.

Withholding Certificates

To comply with their withholding and other obligations, U.S. funds must ascertain the FATCA status of their investors. This is generally done by obtaining a Form W-9 from U.S. investors and the applicable Form W-8 from foreign investors. From August 2013 through June 2014, the IRS released updated versions of these forms and instructions (including a new Form W-8BEN-E for entities) to incorporate the documentation requirements of FATCA.

Following is a summary of when U.S. funds should obtain these new withholding certificates. In some cases, a fund may rely upon a pre-FATCA Form W-8 instead of the updated version; however, the fund may be required to obtain additional information or be allowed to rely upon the form for only a limited period. Although these alternatives sometimes may be desirable, the following discussion generally assumes that the fund will request the updated Forms W-8 from all non-U.S. investors.

New Investors

For persons becoming investors on or after July 1, 2014, U.S. funds should collect the new (FATCA-modified) Forms W-8 and W-9, as applicable, to establish each investor's FATCA status. Prior to January 1, 2015, funds may treat a new entity (as opposed to individual) investor as a preexisting investor, discussed below, and obtain a pre-FATCA Form W-8.

Preexisting Investors

U.S. funds must also determine the FATCA status of their current investors, even if they subscribed before FATCA's effective date. However, relaxed procedures apply to persons who were investors as of June 30, 2014 for individuals and December 31, 2014 for entities ("preexisting investors"). With certain exceptions, U.S. funds must document the FATCA status of these investors by June 30, 2016. Beginning July 1, 2016, the regular FATCA withholding rules apply to such investors.

A U.S. fund may treat a preexisting investor as a U.S. person if there is a notation in the fund's files that a Form W-9 was previously reviewed to establish that the investor is a U.S. person and the investor's taxpayer ID number was retained. For such investors, U.S. funds need not obtain a new Form W-9 to establish the investor's status as a U.S. person.

For other preexisting investors, U.S. funds should obtain new Forms W-8 or W-9 by June 30, 2016. However, if the investor is considered a "prima facie FFI," then the investor's FATCA status must be determined by December 31, 2014 to avoid withholding beginning January 1, 2015. An investor is a prima facie FFI if (a) the withholding agent has electronically searchable information designating the investor as a qualified intermediary or nonqualified intermediary, or (b) the investor is presumed or documented as foreign, and the withholding agent has recorded in its electronically searchable information a SIC code enumerated in the regulations indicating that the payee is a financial institution.

Preexisting Investors—New Investment

If a preexisting investor (described above) in a fund makes an additional capital contribution, the June 30, 2016 deadline discussed above generally does not accelerate. For this rule to apply, the new investment itself must qualify as a "preexisting obligation." A preexisting obligation includes a new investment made by an investor if the investor held an investment (equity interest) in the fund as of June 30, 2014 (December 31, 2014 for entity investors). Moreover, the fund must treat the new investment and the prior investment as one obligation for purposes of applying AML due diligence, aggregating balances and applying the standards of knowledge for FATCA purposes. Investments in fund entities that belong to the same EAG can be aggregated for these purposes.

Even though U.S. funds generally have until June 30, 2016 to document preexisting investors, withholding begins immediately if the fund has documentation indicating that an investor is either a "nonparticipating FFI," or a "passive NFFE" that did not provide the required owner certification.[1] Thus, U.S. funds should be prepared to implement withholding (and reporting) procedures immediately for such investors.

Due Diligence Procedures

A U.S. fund's FATCA responsibilities extend beyond just "getting the forms." A fund must perform specified due diligence to validate its withholding certificates to avoid potential liability for tax, interest and penalties resulting from the failure to perform FATCA withholding. Following is a brief overview of some of these procedures.

A U.S. fund receiving a Form W-8 must review whether the certificate is incomplete or contains information that is inconsistent with the investor's claims, whether the fund has other account information that conflicts with the investor's claims, and whether the withholding certificate lacks information necessary to establish entitlement to an exemption from FATCA withholding. In other words, funds must know the forms (including countless defined terms) so they can assess whether they are filled out correctly, and must cross-check other information maintained by the fund against the forms.

If an investor claims foreign status (e.g., by proving a Form W-8BEN or W-8BEN-E), then except in certain cases in which a GIIN is provided, the fund must scrub its files for specified U.S. indicia (such as a U.S. address) and, if necessary, obtain follow-up information to establish foreign status. A withholding agent must also confirm that a GIIN is provided if required,[2] and that the GIIN and investor's name appear on the IRS website within 90 days. (However, reporting Model 1 FFIs have until January 1, 2015 to obtain a GIIN.) If an investor provides a GIIN, the fund must also confirm, at least annually, that the GIIN has not been removed from the IRS list. Additional due diligence may be required depending on the particular type of FATCA status claimed, and relaxed due diligence procedures are available for certain preexisting obligations (investors).

Withholding and Reporting

U.S. funds must establish procedures to identify amounts subject to FATCA withholding, and to withhold and pay the IRS as required. Generally, withholding and deposit requirements are triggered when an investor receives a distribution of income subject to withholding, but no later than the delivery date (or due date, if earlier) of the investor's Schedule K-1.

U.S. funds have additional reporting obligations under FATCA. Funds must use Form 1042-S to report payments to non-U.S. investors that are subject to FATCA withholding, even if no amounts were required to be withheld. Such

[1] A "nonparticipating FFI" generally means an FFI that is not compliant with FATCA and is not otherwise exempt, and a "passive NFFE" generally means a foreign entity that is not an FFI and does not qualify for an exemption from such status.

[2] For example, a GIIN is required if the investor claims status as a participating FFI (including a reporting Model 2 FFI), a registered deemed-complaint FFI (including a reporting Model 1 FF1) or a direct reporting NFFE, as those terms are defined in the FATCA regulations.

funds must also file an annual Form 1042. In addition, U.S. funds are required to file Form 8966 to report the substantial U.S. owners of investors who are passive NFFEs.

Cayman Funds—Post-Registration Compliance

For Cayman funds, registering with the IRS and obtaining a GIIN is merely the first step towards FATCA compliance. Under the Cayman IGA, Cayman funds are required to identify "U.S. Reportable Accounts," which include investments held by U.S. persons, or by non-U.S. entities with controlling U.S. persons, who are not exempt from reporting. Cayman funds will report information regarding these investors directly to the Cayman Islands Tax Information Authority rather than to the IRS. Cayman funds must also report payments made to FFIs that are not FATCA-compliant.

Cayman funds are required to identify their account holders (investors) by applying due diligence procedures set forth in Annex 1 to the Cayman IGA, as expanded by the Cayman Islands regulations (effective July 4, 2014) and FATCA guidance notes (issued July 22, 2014). The procedures depend, in part, on whether the investor is a new investor or a preexisting investor and are briefly summarized below.

For investors joining on or after July 1, 2014, Cayman funds must collect self-certifications (although a GIIN or other information can sometimes suffice). Forms W-8 and W-9 can generally be used for this purpose. Cayman funds should make sure to capture the information required under the definitions in the Cayman IGA and associated rules, which do not always match the definitions in the U.S. regulations. To this end, Cayman funds using Form W-8BEN-E are permitted to request alternate certifications in accordance with definitions used in the Cayman IGA, instead of the certifications contained in Parts IV through XXVIII of the Form. A similar rule applies to Form W-8IMY. Also, the Cayman Islands Tax Information Authority has recently circulated two self-certification forms that can be used under the U.S.-Cayman IGA (as well as the U.K.-Cayman IGA): one for individuals and one for entities.

Cayman funds that "know or have reason to know" that certifications or documents received are incorrect or unreliable cannot rely on them. Also, for new individual investors, Cayman funds must confirm the reasonableness of self-certifications against other account information obtained, including AML/KYC documentation.

For "preexisting" investors (investors as of June 30, 2014), Cayman funds are required to apply the due diligence procedures set forth in Annex I to the Cayman IGA, as expanded by the Cayman Islands regulations and guidance notes. The primary aim of these procedures is to identify investors that are U.S. persons, non-U.S. entities with controlling U.S. persons, or foreign financial institutions that are not FATCA-compliant. The procedures and timing for review depend, among other things, on whether the account holder is an individual or an entity and on the amount of the investment. Due diligence primarily involves searching the fund's electronic and paper records for certain U.S. indicia and, for entities, the type of investor. This generally must be completed by June 30, 2015 for individual investors (June 30, 2016 for accounts up to $1 million), and June 30, 2016 for entity investors. Cayman funds are permitted to evaluate entity investors joining prior to January 1, 2015 under the procedures for preexisting investors rather than new investors discussed above.

Cayman funds should also be prepared to perform required reporting to the Cayman Islands Tax Information Authority. Cayman funds subject to reporting must report by May 31 of each year, starting in 2015.

* * *

The above is a general summary of certain high-level action steps for U.S. and Cayman funds; however, the U.S. regulations and other authorities provide further detailed guidance on an assortment of matters. Moreover, the above discussion is limited to FATCA; other U.S. tax withholding and reporting rules continue to apply and in some cases have been modified to coordinate with FATCA.

If you have questions regarding this bulletin, please contact **Matthew P. Larvick** at +1 (312) 609 7970 or the Vedder Price attorney with whom you regularly work.

Principal Tax Group Members

Daniel T. Sherlock, *Co-Chair* .... +1 (312) 609 7551

Timothy W. O'Donnell, *Co-Chair* ..... +1 (312) 609 7683

Denise L. Blau .... +1 (212) 407 7755

Jonathan H. Bogaard...................... +1 (312) 609 7651

Matthew P. Larvick.......................... +1 (312) 609 7970

David P. Dorner .... +1 (312) 609 7764

Amy E. Lewis................................. +1 (312) 609 7837

Peter T. Wynacht .... +1 (312) 609 7965

Tax Group

The Vedder Price Tax group provides practical and creative advice to meet clients' needs for federal, state, local and international tax solutions. Our experienced tax attorneys work with a wide array of clients in many different industries to develop sound and practical advice on a variety of matters.

As part of our tax-related services, we provide comprehensive tax advice in connection with forming hedge funds, private equity funds and other private investment vehicles. We also provide tax counsel and support to private equity funds, buyers and sellers, and management teams at every point in the acquisition and investment process—from negotiating and evaluating private equity-backed acquisition and sale transactions to restructuring and selling or acquiring distressed businesses. In addition, we support a range of other matters, including portfolio company platform acquisitions and add-on transactions.

About Vedder Price

Vedder Price is a thriving general-practice law firm with a proud tradition of maintaining long-term relationships with our clients, many of whom have been with us since our founding in 1952. With approximately 300 attorneys and growing, we serve clients of all sizes and in virtually all industries from our offices in Chicago, New York, Washington, DC, London, San Francisco and Los Angeles.

VEDDER PRICE®

Chicago
222 North LaSalle Street
Chicago, IL 60601
T: +1 (312) 609 7500
F: +1 (312) 609 5005

New York
1633 Broadway, 47th Floor
New York, NY 10019
T: +1 (212) 407 7700
F: +1 (212) 407 7799

Washington, DC
1401 I Street NW, Suite 1100
Washington, DC 20005
T: +1 (202) 312 3320
F: +1 (202) 312 3322

London
4 Coleman Street
London EC2R 5AR
T: +44 (0)20 3667 2900
F: +44 (0)20 3667 2901

San Francisco
275 Battery Street, Suite 2464
San Francisco, CA 94111
T: +1 (415) 749 9500
F: +1 (415) 749 9502

Los Angeles
1925 Century Park East, Suite 1900
Los Angeles, CA 90067
T: +1 (424) 204 7700
F: +1 (424) 204 7702