Clients&FriendsMemo

The Final FATCA Regulations: Applications to Foreign Investment Vehicles

January 31, 2013

I. Introduction

On January 17, 2013, the Internal Revenue Service issued final regulations that provide guidance on the "Foreign Account Tax Compliance Act" ("FATCA") provisions contained in sections 1471-1474 of the Internal Revenue Code.[1]

The final regulations retain the basic withholding and reporting requirements that were adopted under the proposed FATCA regulations.[2] However, the final regulations contain several significant differences from the proposed regulations. In particular, the final regulations:

- Implement Announcement 2012-42, and extend the effective date for withholding on the gross proceeds of sales of assets that produce U.S.-source income (and on the payment of principal on those assets) from 2015 to 2017.

- Extend the deadline for grandfathered obligations until 2014, and expand the scope of "grandfathered obligations" that are not subject to withholding under FATCA to include obligations that give rise to foreign-source income, obligations that produce U.S.-source dividend equivalent payments, and certain collateral arrangements. The grandfather provision for collateral arrangements is much broader (and more helpful) than the one in Announcement 2012-42.

- Extend the due diligence deadlines applicable to foreign financial institutions that elect to comply with FATCA.

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[1] The Foreign Account Tax Compliance Act of 2009 was the bill that first proposed adding sections 1471-1474. The sections ultimately were enacted in the Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147).

All references to section numbers are to the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder.

[2] We discussed the proposed regulations in a previous Clients & Friends Memo, which is available at http://www.cadwalader.com/assets/client_friend/021712ApplicationProposedFATCARegulations.pdf.

- Exclude holding companies and treasury centers that are members of nonfinancial groups from the definition of "foreign financial institution."

- Exclude "home offices," personal investment companies, and family trusts that are not professionally managed by foreign financial institutions from the definition of foreign financial institution.

- Create a new category of "deemed compliant" foreign financial institutions for "vintage" collateralized loan obligation issuers ("CLOs").

In addition, the preamble to the final regulations describes the online registration process that will apply to foreign financial institutions that intend to comply with FATCA's reporting requirements.

This memorandum summarizes the aspects of the final regulations that are most relevant to foreign hedge funds and their foreign "blockers," foreign private equity funds, foreign "collateralized loan obligation" issuers, and foreign "catastrophe bond" issuers (collectively, "foreign funds"). Many of these vehicles are foreign financial institutions that will be required to report information about U.S. holders of their non-publicly traded debt and equity and their other "financial accounts" under FATCA or under an intergovernmental agreement, or else will be subject to withholding.[3] Part II provides a general overview of the FATCA regime. Part III discusses the extension of the effective date for gross proceeds withholding, certain due diligence deadlines, and the "grandfathering" rule under the final regulations. Part IV discusses certain other significant differences between the proposed regulations and the final regulations that are relevant to foreign funds.

II. Overview of FATCA Regime

The purpose of FATCA is to reduce U.S. tax evasion by requiring "foreign financial institutions" (i) to enter into an agreement with the U.S. Treasury Department (an "FFI agreement") to report information to the IRS about U.S. holders of their non-publicly traded debt and equity interests and other "financial accounts," and (ii) to withhold 30% on certain payments (referred to as "passthru payments") attributable to U.S. assets that are made to holders who do not provide the required information or to foreign financial institutions that have not themselves entered into an FFI agreement.[4] A foreign financial institution that does not enter into an FFI agreement (i.e., a "non-

[3] It is unclear if catastrophe bond issuers are foreign financial institutions under the final regulations. In general, a catastrophe bond issuer will be treated as a foreign financial institution under the final regulations if (i) it is treated as being "managed by" an investment manager, or (ii) holds itself out as an investment vehicle that is "similar to" a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, or leveraged buyout fund. Because the investment activities of catastrophe bond issuers generally are static and not actively managed, some practitioners may take the position that a catastrophe bond issuer is not a foreign financial institution.

[4] FATCA also imposes information reporting requirements on non-financial foreign entities. This memorandum does not address those rules.

participating" foreign financial institution)—will be subject to a 30% withholding tax on (i) U.S.-source income, (ii) gross proceeds from its sale of assets that produce U.S.-source income and from its receipt of principal on those assets, and (iii) passthru payments from other foreign financial institutions.

A foreign government may enter into an "intergovernmental agreement" with the United States.[5] If the intergovernmental agreement is a "model 1" agreement, it will require the foreign government to enact legislation under which resident foreign financial institutions will report information to the foreign government instead of directly to the IRS about U.S. holders of their non-publicly traded equity and debt and their other "financial accounts," and the foreign government will forward the information to the IRS.[6] Accordingly, foreign financial institutions that are resident in a country that enters into a model 1 agreement may avoid entering into an FFI agreement with the U.S. Treasury Department and instead comply with local law to avoid FATCA withholding.[7]

By contrast, the "model 2" intergovernmental agreement will require the foreign government to enact legislation that permits resident financial institutions to comply with FATCA and to report information directly to the IRS, notwithstanding bank secrecy laws and other potential legal impediments to FATCA compliance.[8] Financial institutions that are resident in a country that enters into a model 2 intergovernmental agreement will be required to enter into an FFI agreement with the U.S. Treasury Department.

III. Extension of Effective Dates, Due Diligence Deadlines, and "Grandfathering" Rule

- **Two-year delay of gross proceeds withholding.** Consistent with Announcement 2012-42, which the IRS released in October,[9] the final regulations extend the effective date for

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[5] We discussed the intergovernmental agreements in a previous Clients & Friends Memo, available at http://www.cadwalader.com/assets/client_friend/081012USTreasuryDeptReleasesFATCAAgreements.pdf. We also discussed the intergovernmental agreement signed by the United States and the United Kingdom in September in a previous Clients & Friends Memo, available at http://www.cadwalader.com/assets/client_friend/092012USandUKSignIntergovernmentalAgreementUnderFATCA.pdf.

[6] There are two types of model 1 agreements. One is "reciprocal"—that is, each country exchanges information with the other; the other is "nonreciprocal"—that is, only the foreign country provides information.

[7] The U.S. Treasury Department has reported that it has entered into model 1 agreements with Denmark, Ireland, Mexico, and the United Kingdom.

[8] The U.S. Treasury Department has not yet reported having entered into any model 2 agreements.

The U.S. Treasury Department has also announced that it is currently negotiating intergovernmental agreements with over 50 countries, including the Cayman Islands.

[9] We discussed Announcement 2012-42 in a previous Clients & Friends Memo, available at http://www.cadwalader.com/assets/client_friend/110212FATCA_Transitional_Relief.pdf.

withholding on the gross proceeds of sales of assets that produce U.S.-source income (and on the payment of principal on those assets) from 2015 to 2017. The final regulations do not extend the effective date for withholding on US.-source income that does not constitute gross proceeds. Therefore, a nonparticipating foreign fund will be subject to FATCA withholding on U.S.-source income beginning in 2014, but will not be subject to FATCA withholding on gross proceeds from its sale of assets that produce U.S.-source income or from its receipt of principal on those assets until 2017.

- **Extension and expansion of grandfathering rule.** The final regulations extend the FATCA "grandfathering" rule for one year. Therefore, under the final regulations, FATCA withholding will not be required on any debt or derivative that has a stated maturity and is issued or entered into before 2014 (and is not significantly modified after 2013).[10] In addition, the final regulations add a grandfathering rule for three types of instruments:

  - Obligations that give rise only to foreign-source income: As mentioned above, a foreign financial institution that has entered into an FFI agreement will be required to withhold 30% on foreign-source "passthru payments" that it makes to holders of its non-publicly traded debt and equity interests and its other "financial accounts" if the holders are nonparticipating foreign financial institutions or do not provide sufficient information for the participating foreign financial institution to determine whether the holders are U.S. persons.

    The final regulations, like the proposed regulations, do not define foreign-source passthru payments,[11] and provide that withholding on foreign-source passthru payments will begin no earlier than 2017. Thus, a nonparticipating foreign fund could be subject to 30% withholding on any foreign-source passthru payments that it receives from a participating foreign financial institution beginning in 2017.

    Consistent with Announcement 2012-42, the final regulations grandfather obligations that give rise only to foreign-source passthru payments and are executed no later than six months after the publication of final regulations that define the scope of passthru payment withholding, even if the obligations mature after 2016. Therefore, a nonparticipating foreign fund will not be subject to FATCA withholding on debt obligations, swaps, and other derivative contracts that were entered into

[10] Financial instruments that constitute equity for U.S. federal income tax purposes are not grandfathered.

[11] As a result of the absence of a definition of passthru payment, it is unclear whether the calculation of passthru payments will reflect a "tracing" approach that attempts to determine which payments by a foreign financial institution are attributable to U.S. assets, a "percentage" approach that treats a portion of each payment by a foreign financial institution as being attributable to U.S. assets, or a hybrid or other approach.

with foreign counterparties, give rise only to foreign-source income, and are entered into no later than six months after the passthru payment regulations are finalized.[12]

- Obligations that produce U.S.-source dividend equivalent payments. Under section 871(m), payments on certain equity swaps, securities loans, and securities repurchase transactions are treated as U.S.-source dividends and subject to 30% withholding tax if the payments are "dividend equivalent payments"—that is, if the payments are contingent upon, or determined by reference to, U.S.-source dividends. In addition, beginning in 2014, dividend equivalent payments on all equity swaps and other financial instruments will be treated as U.S.-source dividends and subject to the 30% withholding tax unless regulations are issued that exempt the payments from this treatment.[13]

  Consistent with Announcement 2012-42, the final regulations provide that the extended grandfathering date described above for obligations that produce only foreign-source passthru payments also will apply to obligations that produce U.S.-source income solely by reason of section 871(m), so long as the obligations are entered into no later than six months after the effective date of any regulations that cause the payments to be treated as U.S.-source dividends.

  Certain collateral arrangements. As mentioned above, FATCA withholding will not be required on payments of U.S.-source income on any debt or derivative that has a stated maturity and is issued or entered into before 2014 (and is not significantly modified after 2013), or on gross proceeds from the disposition of the obligation (or on the payment of principal on the obligation). Some practitioners have raised concerns that, because collateral arrangements typically do not have stated maturities, a counterparty may be required to withhold under FATCA when it repays collateral or passes an income payment through on any securities posted as collateral (even if the securities were issued before 2014).

  Announcement 2012-42 provided that a collateral arrangement would be grandfathered, and the posting of collateral after 2013 would not itself give rise to withholding under FATCA, so long as the collateral secured only "notional principal

[12] Likewise, a participating foreign fund will not be required to withhold on passthru payments that it makes under debt obligations, swaps, and other derivative contracts issued or entered into earlier than six months after passthru payment regulations are finalized, even if the instruments mature after 2016 and the counterparties fail to provide required FATCA certifications or are nonparticipating foreign financial institutions.

[13] We discussed section 871(m) and the temporary and proposed regulations thereunder in a previous Clients & Friends Memo, available at http://www.cadwalader.com/assets/client_friend/012512ProposedRegsAddressUSTaxOnCBEquityDerivatives.pdf.

contracts" that were, themselves, grandfathered from FATCA withholding.[14] This grandfather provision was extremely narrow, because it applied only to collateral arrangements that secured only grandfathered notional principal contracts. Thus, if a collateral agreement served as security for a single instrument that was not a notional principal contract (or was not grandfathered), then the collateral agreement would not have been grandfathered.

The final regulations expand this grandfathering rule by providing that a collateral arrangement is treated as a grandfathered obligation to the extent that it secures grandfathered obligations.[15]

- **Extension of due diligence deadlines.** Consistent with Announcement 2012-42, the final regulations extend the time that a participating foreign financial institution has to determine the FATCA status of a holder that purchased a non-publicly traded debt or equity interest in the foreign financial institution or that otherwise was treated as opening a "financial account" at the foreign financial institution before the foreign financial institution became a participating foreign financial institution.[16] A participating foreign fund will not be required to report information about these "preexisting" account holders until after the due diligence deadlines, unless the foreign fund completes its due diligence before the deadlines and discovers a noncompliant holder. In this case, immediate reporting is required. These changes generally are intended to conform the timeline to that contained in the intergovernmental agreements.

  Very generally, the revised deadlines for preexisting accounts are:

  Entities:

  For any holder that is a "prima facie FFI," six months after the effective date of the FFI agreement. In general, a "prima facie" FFI is an account holder that the foreign

[14] Very generally, a notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by multiplying a notional principal amount by (i) a fixed rate (e.g., LIBOR) or (ii) an index that is based on current, objectively determinable financial or economic information that is not within the control of either of the parties to the contract and is not unique to one of the parties' circumstances (such as the party's dividends or profits, or the value of its stock), in exchange for specified consideration or an obligation to pay similar amounts. Notional principal contracts may include interest rate swaps, caps, and floors, and commodity swaps.

[15] If posted collateral secures both grandfathered and ungrandfathered obligations, the portion of the collateral arrangement that is grandfathered must be determined based on the proportionate value of grandfathered obligations to total obligations secured by the collateral.

[16] Consistent with these extensions, the final regulations also provide that foreign financial institutions will not be required to file their first information report under FATCA until March 31, 2015. The proposed regulations required the first information report to be filed by September 30, 2014.

financial institution has documented as an intermediary in its electronically searchable information, or has a North American Industry Classification System or Standard Industrial Classification Code indicating that the payee is a financial institution.

For any holder that is not a "prima facie FFI," two years after the effective date of the FFI agreement.

Individuals:

For an individual with an aggregate account balance in excess of $1 million, one year after the effective date of the FFI agreement.

For an individual with an aggregate account balance not in excess of $1 million, two years after the effective date of the FFI agreement.

For purposes of these provisions, an FFI agreement that is entered into before 2014 is treated as having been entered into on December 31, 2013. Thus, for example, the earliest date by which a foreign financial institution must complete its due diligence with respect to prima facie FFIs will be July 1, 2014 (i.e., six months after December 31, 2013).

- **FATCA registration portal.** The preamble to the final regulations provides that foreign financial institutions will be able to enter into FFI agreements beginning no later than July 15, 2013. The IRS will issue special "global intermediary identification numbers" ("GIINs") to each participating foreign financial institution (and to foreign financial institutions that are otherwise exempt from FATCA withholding), will post a list of these foreign financial institutions on December 2, 2013, and will update the list monthly. The last date by which a foreign financial institution can register with the IRS to ensure its inclusion on the December 2013 list is October 25, 2013.

IV. Additional Changes to the Proposed Regulations

- **"Home offices" and family trusts not treated as foreign financial institutions.** Consistent with the FATCA intergovernmental agreements, the final regulations provide that an investment entity is treated as a foreign financial institution only if the investment entity conducts investment management activities as a business for or on behalf of a customer, or is managed by an entity that conducts investment management activities for or on behalf of a customer. The final regulations also explicitly provide that collective investment vehicles, mutual funds, exchange traded funds, private equity funds, hedge

funds, venture capital funds, leveraged buyout funds, and "similar investment vehicles" are treated as foreign financial institutions.

Under this definition, so long as "home offices" and family trusts do not conduct investment management activities for or on behalf of customers, and are not managed by an entity that conducts investment management activities for or on behalf of customers, they generally will not be classified as foreign financial institutions.[17] Instead, these entities generally will be classified as "passive nonfinancial foreign entities."[18]

- **Holding companies and treasury centers not treated as foreign financial institutions.** Under the proposed regulations, a holding company or treasury center of a group of nonfinancial foreign entities was treated as a foreign financial institution unless the entity engaged primarily in financing and hedging transactions solely with respect to its affiliates, or substantially all of the entity's activities consisted of holding active subsidiaries. Thus, under the proposed regulations, if a nonfinancial foreign entity owned a hedging center that engaged primarily in proprietary trading, the hedging center would have been required to enter into an FFI agreement and to report information about the nonfinancial foreign entity.

  The final regulations provide that a holding company or treasury center is treated as a financial institution only if it is affiliated with a financial institution.[19] Thus, under the final regulations, holding companies and treasury centers that are members of a nonfinancial group generally will not be treated as foreign financial institutions.

- **New "deemed compliant" category for vintage CLOs.** The final regulations provide that a "limited life debt investment entity" will not be subject to FATCA withholding until 2017, even if the entity does not enter into an FFI agreement, so long as:

  - The entity is not a depository or custodial institution or an insurance company,

  - The entity was formed before 2012 and, pursuant to its organization documents, will liquidate on or before a set date,

[17] An investment entity may still be a foreign financial institution if it is (i) a bank or other "depository institution," (ii) a broker or other "custodial institution," or (iii) an insurance company.

[18] Passive nonfinancial foreign entities are discussed below under the heading "—Retention of the "10% U.S. owner" test for passive nonfinancial foreign entities."

[19] An "affiliate" for purposes of this rule is any entity that is connected through ownership to a common parent, if more than 50% of the voting power and value of the stock or beneficial interests in each entity within the ownership chain is owned by another entity within the chain.

- The entity was formed to purchase and hold specific types of debt, with limited reinvestment,

- All payments to investors are cleared through a clearing organization or made through a trustee that, in either case, is a participating FFI or a U.S. person, and

- The entity's organizational documents (including the indenture) cannot be amended without the agreement of all investors, and do not authorize the trustee or other fiduciary to cause the entity to comply with FATCA.

Although this rule apparently was designed to provide relief from FATCA to "vintage" CLOs and similar investment vehicles, the rule is unlikely to be of much value. First, most CLOs provide that their indenture may be amended with a majority or a supermajority of investors (instead of with the consent of all investors), and therefore most CLOs will be ineligible for the exemption. Second, even if the exemption applies to a CLO, it would only benefit the CLO if it liquidates before 2017. Otherwise, it would still be subject to 30% withholding on any interest, principal payments and other gross proceeds from U.S. debt beginning in 2017.[20]

- **Retention of the "10% U.S. owner" test for passive nonfinancial foreign entities.** The final regulations retain the rule from the proposed regulations that requires a foreign financial institution to report information about any U.S. persons who own more than 10% of the voting power or value of any non-publicly traded passive nonfinancial foreign entity (such as a foreign real estate investment trust, royalty trust, or home office) that owns a financial account in the foreign financial institution. This rule differs from the rule under the intergovernmental agreements, which replace the "10% U.S. owner" test with a "control" test that requires signatory country financial institutions to report any U.S. persons who control a nonfinancial foreign entity. As we discussed in our Clients & Friends Memo on intergovernmental agreements, "control" for this purpose is defined by reference to the "Financial Action Task Force Recommendations" for developing international standards on combating money laundering and the financing of terrorism and proliferation, and is often interpreted to mean 25% ownership.

  As a result of these different tests, passive nonfinancial foreign entities could be required to disclose their U.S. owners based on different tests depending on the status of their counterparty. For example, a non-publicly traded foreign real estate investment trust that owns a financial account in a signatory country financial institution will be required to

[20] The final regulations also provide an exemption from FATCA withholding for certain investment entities for which a manager (referred to as a "sponsoring entity") has agreed to perform all FATCA reporting and withholding obligations.

determine its controlling U.S. owners so that the signatory country financial institution can comply with its reporting requirements, but will also be required to disclose its 10% U.S. owners to a U.S. borrower so that the borrower is not required to withhold under FATCA on interest payments to the trust.

- **Retention of "tracking" stock in definition of financial accounts.** The final regulations retain the rule from the proposed regulations that "financial accounts" include any non-publicly traded equity or debt issued by a foreign depository or custodial institution if the value of the equity or debt is directly or indirectly determined primarily by reference to assets that give rise to U.S.-source income. The final regulations also provide that the value of equity or debt issued by a foreign depository or custodian institution will be treated as being determined primarily by reference to assets that give rise to U.S.-source income if the amount payable on redemption is secured primarily by reference to assets that give rise (or could give rise) to U.S.-source income. By contrast, the intergovernmental agreements provide that non-publicly traded equity or debt issued by a foreign depository or custodial institution is treated as a financial account under FATCA only if the applicable class of equity or debt is established with a purpose of avoiding FATCA reporting.[21]

  Thus, under the final regulations, if a foreign depository or custodial institution issues nonpublicly traded notes that either track the value of, or are secured by, U.S. Treasuries, and the investment bank is not resident in a country that has entered into an intergovernmental agreement with the United States, then the notes will constitute financial accounts that are subject to FATCA reporting.

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If you have any questions about the foregoing, please contact Jean Bertrand, Shlomo Boehm, Mark Howe, David Miller, Daniel Mulcahy, Jason Schwartz, or any other member of our Tax Department.

[21] Moreover, under the intergovernmental agreements, the characterization of an instrument generally is determined under local law. If a note is treated as a "forward contract," "swap," or other derivative under local law (and not equity or debt), it would not be subject to information reporting under FATCA, even if it were established with a purpose of avoiding FATCA reporting.