

# Clients & Friends Memo

## Application of Proposed FATCA Regulations to Foreign Investment Vehicles

February 17, 2012

### I. Background

On February 8, the Internal Revenue Service issued [proposed regulations](#) that provide guidance on the “FATCA provisions” contained in sections 1471-1474 of the Internal Revenue Code.<sup>1</sup> The purpose of FATCA is to reduce U.S. tax evasion by requiring “foreign financial institutions” and certain other foreign entities to provide information to the IRS about U.S. holders of their debt and equity interests and other “financial accounts,” or else be subject to a 30% withholding tax.

More specifically, FATCA imposes a 30% withholding tax on payments to any foreign financial institution of (i) U.S.-source interest, dividends, rents, royalties, insurance premiums, and other “FDAP income,”<sup>2</sup> (ii) gross proceeds from the sale of “U.S. assets” that produce U.S.-source FDAP income, and (iii) foreign-source “passthru” payments from other foreign financial institutions to the extent attributable to their U.S. assets, unless the foreign financial institution enters into a “FATCA agreement” with the IRS to provide the name, address, taxpayer identification number, and certain other information with respect to its U.S. debt and equity holders and other U.S. holders of financial accounts. The FATCA agreement also requires the foreign financial institution to withhold on the passthru payments that it makes to “recalcitrant holders” that do not provide the required information and to foreign financial institutions that have not themselves entered into a FATCA agreement.

The proposed regulations extend FATCA’s “grandfathering” period, delay the effective date for withholding on foreign-source passthru payments, provide potential exemptions from FATCA, and

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<sup>1</sup> FATCA stands for the Foreign Account Tax Compliance Act of 2009, which 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 (the “HIRE Act”) (P.L. 111-147).

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

<sup>2</sup> FDAP stands for fixed or determinable annual or periodical. FDAP income also includes original issue discount on debt obligations.

provide greater detail regarding the withholding and reporting obligations that will apply to foreign financial institutions.

This memorandum discusses the aspects of the proposed regulations that are most relevant to foreign investment vehicles, such as foreign hedge funds and their foreign “blockers,” foreign private equity funds, and issuers of “collateralized loan obligations” and “catastrophe bonds.”<sup>3</sup> Many of these vehicles are foreign financial institutions that will be required to enter into a FATCA agreement, or else will be subject to FATCA withholding.<sup>4</sup> Part II discusses new rules under the proposed regulations. Part III discusses the FATCA implementation timeline under the proposed regulations.

## II. Application of the Proposed Regulations to Foreign Investment Vehicles

- **Extension of grandfathering rule.** The proposed regulations extend the “grandfather” date from March 19, 2012 until January 1, 2013. Thus, under the proposed regulations, FATCA withholding will not be required on any non-equity instrument if the instrument has a stated maturity and is issued or entered into before 2013 (and not materially modified after 2012).<sup>5</sup>
- **Postponement of foreign-source passthru payment withholding.** As mentioned above, under FATCA, foreign financial institutions that do not enter into a FATCA agreement are subject to withholding on the foreign-source “passthru” payments attributable to U.S. assets that they receive from other foreign financial institutions. In addition, foreign financial institutions that enter into a FATCA agreement must withhold 30% on the foreign-source passthru payments that they make to recalcitrant holders or to foreign financial institutions that have not entered into a FATCA agreement. Under the proposed regulations, foreign-source passthru payment withholding will not begin before 2017. Previous guidance had indicated that foreign-source passthru payment withholding would not begin before 2015. Therefore, until at least 2017, (i) foreign financial institutions will not be subject to withholding on income and gain from non-U.S. assets (even if they do not

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<sup>3</sup> This memorandum does not discuss the rules applicable to non-financial foreign entities.

<sup>4</sup> It is unclear if catastrophe bond issuers are foreign financial institutions under the proposed regulations. In general, a catastrophe bond issuer may be treated as a foreign financial institution under the proposed regulations unless (i) more than half of its business during the calendar year is issuing, being obligated to make payments with respect to, or reinsuring the underlying policies, and (ii) the underlying policies are insurance, are not treated as having cash value, and are not securities for U.S. tax purposes.

<sup>5</sup> The proposed regulations explicitly state that swaps may be grandfathered. In addition, the IRS is considering whether equity interests in securitization vehicles that invest only in debt and liquidate within a specified time frame should be grandfathered.

enter into a FATCA agreement) and (ii) foreign financial institutions that enter into a FATCA agreement will not be required to withhold on payments attributable to non-U.S. assets.<sup>6</sup>

- **Possible exemption for foreign financial institutions in jurisdictions that enter into information-sharing agreements with the United States.** On the same day that the IRS released the proposed FATCA regulations, the U.S. Treasury Department issued a [joint statement](#) with France, Germany, Italy, Spain, and the United Kingdom proposing that, if a jurisdiction enters into an information-sharing agreement with the United States, then foreign financial institutions organized under the laws of that jurisdiction will not be required to enter into a FATCA agreement and will not be subject to FATCA withholding.<sup>7</sup>
- **Exemption for certain “restricted” foreign investment funds.** The proposed regulations provide an exemption from FATCA for any entity that certifies to the IRS that:
  - It is organized in a jurisdiction that has adopted and sufficiently implemented policies against anti-money laundering and combating the financing of terrorism;<sup>8</sup>
  - It is regulated as an investment fund by the jurisdiction in which it is organized;<sup>9</sup>
  - Its underwriter and any other distributor of its interests have entered into a FATCA agreement (or are otherwise exempt from FATCA);
  - Its interests can be held only by non-U.S. individuals, foreign financial institutions that have entered into a FATCA agreement (or are otherwise exempt from FATCA), publicly traded non-financial foreign entities, non-publicly traded foreign financial entities with no significant U.S. holders, governmental instrumentalities (such as sovereign wealth funds), and certain retirement funds.
- **Absence of a rule requiring termination of FATCA agreement.** Notice 2011-34 suggested that a foreign financial institution’s FATCA agreement may be terminated if the

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<sup>6</sup> The proposed regulations reserve on the definition of foreign-source passthru payments and request comments on how to implement passthru payment withholding.

<sup>7</sup> The joint statement also provides that if the United States and another jurisdiction enter into the information-sharing agreement, then foreign financial institutions in the jurisdiction will not be required to “terminate the account of a recalcitrant account holder.”

<sup>8</sup> Generally, the jurisdiction must not have been identified by the Financial Action Task Force as being at-risk with respect to its anti-money laundering and combating the financing of terrorism regime. Currently, there are no European Union members on this [“at-risk” list](#). Bermuda, the British Virgin Islands, and the Cayman Islands also are not on the list.

<sup>9</sup> It is unclear what it means for a foreign financial institution to be “regulated as an investment fund.”

foreign financial institution fails to cancel a recalcitrant holder's account.<sup>10</sup> The proposed regulations do not include such a provision, but do indicate that a FATCA agreement may be cancelled as a result of certain (unspecified) compliance failures. The preamble to the proposed regulations provides that the IRS intends to release a draft model FATCA agreement early this year.

### III. FATCA Withholding and Information Reporting Timeline

#### Beginning in 2014

- **Withholding.** Foreign financial institutions that do not enter into a FATCA agreement will be subject to 30% withholding on U.S.-source FDAP income.<sup>11</sup>
- **Information reporting.** Each foreign financial institution that enters into a FATCA agreement will be required to report the name, address, and taxpayer identification number of each person that, during the preceding calendar year,<sup>12</sup> owned an interest in the foreign financial institution and was either (i) a U.S. person<sup>13</sup> or (ii) a non-financial foreign entity in which any U.S. person owned more than 10% of the voting power or value of the stock or capital or profits interests.<sup>14</sup> The foreign financial institution generally must also report the value of the debt or equity interests that each of these holders owned,<sup>15</sup> and the number and value of interests held by recalcitrant holders.<sup>16</sup>

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<sup>10</sup> Notice 2011-34, part I.C., 2011-19 IRB 765.

<sup>11</sup> The preamble to the proposed regulations provides that Form W-8 will be amended to indicate whether a payee is a foreign financial institution and, if so, whether the payee has entered into a FATCA agreement.

<sup>12</sup> With respect to 2013, the foreign financial institution will be required to report only with respect to persons that are also holders on June 30, 2014. For subsequent years, the foreign financial institution will be required to report with respect to persons that were holders during the preceding calendar year.

<sup>13</sup> The foreign financial institution generally is not required to report information about U.S. persons that are publicly traded corporations, affiliates of publicly traded corporations, tax-exempt organizations, mutual funds, real estate investment trusts, individual retirement plans, common trust funds, or securities, commodities, or swap brokers or dealers.

<sup>14</sup> If the foreign financial institution reports a non-financial foreign entity under this rule, it must also report the name, address, and taxpayer identification number of each U.S. person that owned more than 10% of the voting power or value of the stock or capital or profits interests in the entity.

<sup>15</sup> The proposed regulations provide that the reported value of an equity or debt interest in a foreign financial institution is the value "as determined for the purpose that requires the most frequent determination of value."

<sup>16</sup> The IRS intends to release a new form for purposes of FATCA reporting.

**Beginning in 2015**

- **Withholding.** Foreign financial institutions that do not enter into a FATCA agreement will also be subject to 30% withholding on gross proceeds from the sale of U.S. assets.

**Beginning in 2016**

- **Information reporting.** Each foreign financial institution that enters into a FATCA agreement will also be required to report the aggregate gross amount of income and gain credited or paid during the preceding calendar year to any holder that was either (i) a U.S. person or (ii) a non-financial foreign entity in which any U.S. person owned more than 10% of the voting power or value of the stock or capital or profits interests.
- In 2016 and 2017, each foreign financial institution that enters into a FATCA agreement will also be required to report information about foreign-source FDAP payments it makes to any foreign financial institution that has not entered into a FATCA agreement.

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If you have any questions about this memorandum, please contact David S. Miller, Shlomo Boehm, Jason Schwartz, or any other member of our [Tax Department](#).