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# Tax Group Client Alert

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March 2, 2012

# FATCA 2.0 FOR FUNDS AND SECURITIZATION VEHICLES

## Introduction

On February 8, 2012, the United States Internal Revenue Service ("IRS") and Department of the Treasury ("Treasury") issued long awaited proposed regulations under the so-called "FATCA" provisions in sections 1471 through 1474 of the Internal Revenue Code. The proposed regulations and a number of prior IRS notices have clarified many, although not all, uncertainties about how FATCA will apply in practice. At the same time as it issued the proposed regulations, Treasury released a joint statement along with France, Germany, Italy, Spain and the United Kingdom announcing an agreement to explore an intergovernmental approach to FATCA implementation that would allow affected foreign financial institutions in each country to provide the information required under FATCA to that country's tax authorities rather than to the IRS.

Despite some helpful guidance in the notices and proposed regulations (click here to view), the implementation of FATCA raises significant concerns, particularly for offshore investment funds, such as hedge and private equity funds, and for securitization vehicles, like collateralized loan obligation ("CLO") and collateralized debt obligation ("CDO") issuers. We generally refer in this Client Alert to all of these entities collectively as "Funds." This Client Alert describes the proposed regulations, focusing on FATCA's implications for Funds.

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## FATCA Background

The purpose of FATCA is make it more difficult for U.S. taxpayers to use foreign accounts and intermediaries to conceal their taxable income from the IRS. FATCA seeks to achieve this by requiring that a 30 percent tax be withheld from any "withholdable payment" made to a "foreign financial institution" ("FFI") unless the FFI has entered into an agreement with the IRS (an "FFI Agreement") to:

- Obtain information from each "account holder" necessary to determine if an account of such FFI is a "U.S. account";
- Comply with verification and due diligence procedures required to identify U.S. accounts;
- Report certain information with respect to U.S. accounts on an annual basis;
- Comply with requests by the IRS for additional information with respect to any U.S. account;
- Attempt to obtain a waiver in any case where foreign law would prevent the reporting of information required with respect to any U.S. account, and close the account if the waiver cannot be obtained; and
- Deduct and withhold 30 percent on any "passthru payment" made by the FFI to a "recalcitrant holder" who does not provide the required information, or another FFI that has not entered into an FFI Agreement or that elects withholding in lieu of compliance with the information reporting regime.

FATCA does not apply only to traditional financial institutions. FFI is very broadly defined (effectively including most offshore Funds), and FATCA also requires 30 percent withholding on payments to certain "non-financial foreign entities" ("NFFEs"). Generally, NFFEs must certify they have no significant U.S. owners or disclose those owners to avoid withholding. However, NFFEs are subject to less onerous information reporting than FFIs and will not be treated as paying passthru payments subject to withholding. The general provisions of FATCA are discussed in more detail in a previous Milbank client alert, "*HIRE ACT*" *Gives Effect to FATCA Provisions, Imposing Withholding and Reporting Requirements to Combat Offshore Tax Evasion*, published March 23, 2010 (click here to view).

## Highlights of the Proposed Regulations Affecting Funds

The proposed regulations expand upon and clarify the FATCA regime in a number of respects:

- ***Expanded Scope of Grandfathered Obligations***. Under FATCA, payments with respect to obligations that are issued or held by funds and were issued and outstanding on or before March 18, 2012, are permanently exempt from the FATCA withholding regime. The proposed regulations extend this relief to obligations issued and outstanding on January 1, 2013. In either case, however, material modifications to an instrument's terms after the relevant date may result in a deemed exchange of the grandfathered instrument for a newly issued instrument that would not be grandfathered.

- ***Extension of the Transition Period for Scope of Information Reporting***. The proposed regulations extend various deadlines by which FFIs must perform various types of information reporting.

- ***Expanded Categories of Foreign Financial Institutions Deemed Compliant.*** The proposed regulations provide an expanded list of categories of deemed-compliant institutions that are not likely to have U.S. owners or account holders and that therefore are not required to enter into a formal FFI Agreement,

including certain local banks, collective investment funds and affiliates of participating FFIs that register with the IRS and satisfy various requirements. The collective investment fund category is very limited, however. To be deemed compliant under this category, the proposed regulations require that the collective fund be subject to regulation in its (foreign) country of formation and limit its investor base to participating or deemed compliant FFIs and certain limited classes of U.S. investors, rendering the special status inapplicable to most Funds of the types discussed in this Client Alert.

- ***Expanded Categories of Non-Financial Foreign Entities Exempt from FATCA.*** The proposed regulations expand the types of NFFEs that are exempt from withholding tax and information reporting under FATCA, including certain publicly traded companies and their affiliates, NFFEs predominantly engaged in active businesses, and nonfinancial holding companies. This expansion is potentially applicable to Funds to the extent these entities may be part of the Fund's investor base.

- ***Modification of Due Diligence and Verification Procedures.*** Under FATCA, participating FFIs are required to perform due diligence on accounts to identify indicia of U.S. ownership. The proposed regulations permit greater reliance on FFIs' existing anti-money laundering and know your customer procedures. The proposed regulations provide that third-party audits of participating FFIs' FATCA compliance will not be required, and that a responsible officer of an FFI can certify its compliance with the terms of its FFI Agreement.

- ***Redefined Definition of "Financial Account."*** FATCA broadly defines "financial accounts" to include not only deposits and custodial accounts but also debt and equity obligations issued by an FFI that are not regularly traded on an established securities market. The proposed regulations modify the definition of "financial account" to focus on what would more ordinarily be considered an "account" with a bank, brokerage or money market. Excluded from this revised definition of "financial accounts" are most debt and equity securities issued by banks and brokerage firms (e.g., medium term notes), subject to an anti-abuse rule. However, debt and equity issued by non-bank FFIs like Funds are not exempted under the proposed rules and will be "financial accounts" unless regularly traded on an established securities market. For this purpose, mere listing (e.g, on the Irish Stock Exchange) is not sufficient, and specific trading activity requirements must be met.

- ***Passthru Payments.*** A prior notice defined passthru payments to mean that percentage of any payment by an FFI equal to the ratio of the aggregate withholdable U.S. income received by the FFI to its total income (click here to view). The proposed regulations provide that, with certain exceptions, withholding generally will not be required with respect to foreign passthru payments paid to nonparticipating FFIs and recalcitrant account holders before January 1, 2017. The proposed regulations reserve on detailed rules for imposing withholding tax on foreign passthru payments made after that date. This is a welcome delay, as the passthru payment regime is likely to be among the more difficult aspects of FACTA to implement.

## Specific Considerations for Offshore Funds

### Treatment as an FFI

"Financial institution" is broadly defined by FATCA to include, among other categories, any entity engaged (or holding itself out as engaged) in the business of investing, reinvesting or trading in securities, commodities, partnership interests, certain derivatives or other interests in these kinds of assets. Accordingly, most Funds, including most hedge funds, private equity funds, CLOs and CDOs are "financial institutions" for FATCA purposes. Any vehicle like this organized outside the United States will, in most cases, be an FFI. In most cases, unless a Fund expects to have minimal income subject to FATCA withholding (i.e., the Fund effectively plans to avoid investing in assets that produce U.S.-source income, it will have little option but to enter into an FFI Agreement to avoid an uneconomic tax burden.

**Income from the Investment Portfolio Potentially Subject to Withholding**

As an FFI, all U.S.-source income (and proceeds from disposing of debt or equity that generates U.S.-source income) earned by a Fund would be subject to the 30 percent FATCA withholding tax unless the Fund enters into a FFI Agreement with the IRS and becomes a so-called "participating" FFI. Because of the passthru payment rules, even instruments that do not appear to produce U.S.-source income could attract withholding. An example is a hedge fund that acquires debt issued by a Cayman Islands CLO vehicle that invests in U.S. loans and debt. The hedge fund could discover that the CLO is required to treat all or a portion of payments on its debt as passthru payments potentially subject to withholding unless the hedge fund has itself become a participating FFI.

In theory, if all of a Fund's assets were "grandfathered," entering into an FFI Agreement would not be necessary. However, grandfathering applies only to "obligations" issued and outstanding on March 18, 2012 (or under the proposed regulations, January 1, 2013). Equity securities are not grandfathered "obligations" and payments on securities that are in form "obligations" but present some uncertainty as to their proper characterization for U.S. federal income tax purposes may also be subject to withholding by withholding agents, who will understandably want to avoid the risk of U.S. tax liability for failing to withhold correctly. Moreover, material amendments to an obligation after the grandfathering date may result in the deemed exchange of the obligation for a new obligation for tax purposes that is not grandfathered. Consequently, a CLO that has passed its reinvestment period, for example, could attract FATCA withholding on assets in its loan portfolio if the assets are deemed to be exchanged for new loans in an "amend and extend"transaction, or if the CLO receives newly originated loans or equity assets in exchange for a "grandfathered"loan in the context of a restructuring.

Under the transition rules provided in the proposed regulations, withholding generally will not commence even with respect to assets that are not grandfathered until January 1, 2014. Accordingly, there remains some time for Fund managers to assess their position, and if they decide to have the Funds they manage become participating FFIs, to enter into an appropriate FFI Agreement.

**FFI Agreements, Compliance and Verification**

Assuming a Fund decides to enter into an FFI Agreement to avoid withholding on its portfolio's income, it must agree:

- to obtain information regarding Fund investors and certain others as is necessary to identify U.S. persons;
- to comply with IRS verification and due diligence procedures;
- to report annually certain identifying information to the IRS; and
- to withhold on passthru payments.

Failing to comply with any of these terms may result in termination of the FFI Agreement and expose the Fund to withholding thereafter. There has been some suggestion that after an as yet undefined period, a Fund may be required to remove a recalcitrant holder rather than merely withhold. While the proposed regulations do not directly address this idea, a Fund adviser could certainly structure Fund terms that would require a recalcitrant investor's interest to be sold.

The proposed regulations do not require annual audits to verify that the terms of an FFI Agreement have been complied with, but allow a "responsible officer" to certify as to the FFI's compliance. It is unclear who would perform that function in the case of a Fund that has an external advisor but no officers or employees. Presumably, an officer of the Fund advisor that is granted power of attorney by the Fund would qualify, however.

**Passthru Payment Withholding**

As mentioned above, after a transition period, participating FFIs are required under FFI Agreements to withhold a 30 percent tax on passthru payments that the FFI made to recalcitrant account holders or to nonparticipating FFIs. Accordingly, a Fund must be prepared to have the tax withheld on such passthru payment or the Fund (or its related withholding agent) will be liable for FATCA tax it fails to collect together with interest and possibly penalties.

Prior notices defined a passthru payment very broadly, essentially treating any payment to an "account" holder as a passthru payment in the same proportion that an FFI's aggregate U.S.-source income bears to its total income, although the proposed regulations reserve on this issue. An account holder includes a holder of debt or equity issued by an FFI, with certain exceptions. As a general matter, this will mean that after 2016, Funds may be required to withhold on payments to their recalcitrant debt or equity holders.

Debt issued before January 1, 2013, including debt issued by a Fund, would be grandfathered and therefore should never be considered a "financial account" for this purpose as long as it is not materially modified thereafter. However, the proposed regulations do not clarify the extent to which grandfathering extends to aspects of the regime other than basic FATCA withholding, such as information reporting. Debt or equity that is regularly traded on an established securities market also should be exempted. However, for most debt or equity issued by CLO, CDO or other Funds, the regularly traded exception is unlikely to apply except in certain unusual circumstances.

A participating FFI may elect not to withhold on passthru payments and instead be subject to withholding on payments it receives, to the extent those payments are "allocable" to recalcitrant account holders or nonparticipating FFIs. A participating FFI may choose to make this election if withholding on passthru payments would be particularly onerous, or if it is prohibited by local law from collecting taxes on behalf of a foreign government. However, before electing that option, a Fund advisor should carefully review applicable waterfalls, allocation provisions and tax provisions in its Fund documents (e.g., partnership agreements and indentures) to ensure that the burden of that elective withholding can be appropriately shifted to the recalcitrant investors rather than borne by all of the Fund's investors in practice.

Because the dire economic consequences of being subject to 30 percent withholding will likely compel many Funds to enter into FFI Agreements, in light of the various requirements above, fund documents (e.g., partnership agreements, subscription documents, indentures, fiscal agency agreements, withholding certificates and the like), for new Funds should now be drafted to include FATCA-related provisions. Provisions might include representations from investors as to their status (e.g., as a United States person, participating FFI, NFFE); investor covenants to provide information needed for the Fund to comply with FATCA information reporting requirements; acknowledgments that failure to comply may result in the Fund being unable to enter into or comply with an FFI Agreement or in a Fund withholding on payments to such a recalcitrant holder; and indemnities and forced sale arrangements for adverse consequences caused by a breach of these obligations. Investors should be asked to waive to the greatest extent permitted by applicable law any foreign law rights that would prevent compliance with FATCA reporting and to consent to the Fund providing information to the IRS as required.

Ideally, legacy Funds would also revise their fund documentation in a similar manner. However, amendments to include FATCA provisions like those above will generally require investor consent, which may be difficult to obtain, particularly in the case of Funds with multiple classes of investors like CLOs. At a minimum, managers of legacy Funds should review their documentation to determine how much of the necessary information the Fund may be able to obtain, and what if any remedies for non-compliance may already exist under the existing fund documentation.

## The "Intermediary" Problem

Even Funds that plan to become participating FFIs should be aware that they may encounter FATCA withholding complications as a result of intermediaries. For many purposes, the FATCA withholding regime applies by reference to the "payee" rather than the "beneficial owner" of the payment. For example, if a Fund holds a portion of its securities portfolio through a non-U.S. custodian, even if the Fund itself has entered into an FFI Agreement, paying agents that make payments to the Fund's custodial account may withhold if they cannot establish that the custodian (i.e., payee) is a participating FFI. Similarly, when a Fund employs paying agents to make payments on its debt securities it may need to ensure that the paying agent, if foreign, will be a participating FFI or the Fund may be required to withhold on the payments. More generally, Funds may not be able to identify the beneficial owner of securities held in "street name," making it impracticable for the Fund itself to comply with aspects of FATCA like the information reporting rules.

An intermediary that raises particular concerns is Euroclear, given the volume of securities held through the clearing system. As Euroclear, unlike DTC, is a foreign entity that is likely an FFI, payments to Euroclear (e.g., passthru payments on debt issued by a Cayman-based CLO) potentially will be subject to withholding unless Euroclear decides to enter into an FFI Agreement and become a participating FFI. (Euroclear has not yet publicly taken a position regarding how it will approach FATCA.) Funds also may not be able to identify the owners of securities held through the clearing system to undertake appropriate information reporting. Even if a Fund in theory were able to identify holders and undertake required FATCA withholding, Euroclear systems currently may lack the capacity to allocate withholding to the appropriate recalcitrant holder rather than investors in the security generally. Although the grandfathering and transition rules ensure a reasonable period before withholding in practice would apply, instruments that are not grandfathered (e.g., an instrument that is treated as equity for U.S. tax purposes) and have maturity date beyond the end of the applicable transition periods already raise concerns if issued through Euroclear. This uncertainty has the potential to interfere with the functioning of an important segment of the capital markets unless resolved.

Funds that interact with intermediaries in the payment process also should bear in mind that it may be the intermediary, rather than the Fund and its manager, that in practice will control decisions about the adequacy of documentation from investors and other issues relevant to the decision to withhold under FATCA.

Intermediaries that are FFIs may become qualified intermediaries ("QIs"), by entering into Qualified Intermediary Agreements ("QI Agreements"), a type of FFI Agreement which, like other FFI Agreements, requires the participating QI to submit to IRS audit, reporting and withholding as applicable. In addition, such a QI may elect to assume primary withholding responsibility. In that case, a Fund generally could make payments to the QI without doing its own withholding or information reporting, which would instead be handled by the QI or another intermediary in the chain of custody. Many intermediaries that Funds typically encounter in the payment system and custody chain will probably elect this status. However, there may be a substantial transition period before this becomes the norm.

## Considerations for U.S.-Based Funds

Generally, Funds organized as U.S. entities are not themselves FFIs. Nevertheless, these Funds will be withholding agents and, as such, subject to withholding requirements with respect to withholdable payments made to FFIs and NFFEs, and the Funds will be required to undertake appropriate information reporting. A Fund will be liable as withholding agent for FATCA tax it fails to collect together with interest and possibly penalties. To the extent current fund documentation does not provide for these considerations, a Fund will need to consider and undertake many of the same revisions to fund documentation discussed above to ensure that they do not find themselves in the awkward position of withholding on their investors or exposed to liability as a withholding agent.

# FATCA Timeline

## 2010 / 2011

**March 18, 2010**
FATCA is signed into Law.

**August 27, 2010**
The IRS issues Notice 2010-60, 2010-37 IRB 329, providing preliminary FATCA guidance.

**April 8, 2011**
The IRS issues Notice 2011-34, 2011-19 IRB 765, modifying and supplementing notice 2010-60.

**July 14, 2011**
The IRS issues Notice 2011-53, modifying Notice 2011-34 and providing timeline for phased implementation.

## 2012

**February 8, 2012**
IRS issues proposed regulations and the joint intergovernmental statement.

**Summer 2012**
IRS anticipates issuance of final FATCA regulations.

## 2013

**January 1, 2013**
Obligations that are already outstanding on this date are grandfathered and will not be subject to FATCA withholding. The FFI electronic application process begins.

**June 30, 2013**
Deadline for entering into an FFI Agreement to avoid withholding implemented January 1, 2014.

## 2014

**January 1, 2014**
FATCA withholding on U.S.-source FDAP payments begins. For reporting in 2014 and 2015 (for calendar years 2013 and 2014) participating FFIs are required to report only the name, address, TIN, account number, and account balance with respect to U.S. accounts.

## 2015

**January 1, 2015**
FATCA withholding on gross proceeds begins.

## 2017

**January 1, 2017**
FATCA withholding on foreign passthru payments begins. Full information reporting is required after this date, including information on the gross proceeds from broker transactions.

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