

The Foreign Fund's FATCA Dilemma: Meeting Your Responsibility by Coordinating with Third Party Service Providers

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I. INTRODUCTION

Since 2009 and UBS's deferred prosecution agreement, the U.S. Government has shown that it is taking offshore tax evasion very seriously. To date, there have been approximately 150 grand jury investigations of offshore bank account holders initiated, 30 of which resulted in charges of tax fraud, as well as grand jury investigations initiated against eight other offshore banks across the world.¹ One of the most powerful tools the U.S. Government will have in its arsenal as it continues to fight offshore tax evasion is the Foreign Account Tax Compliance Act ("FATCA"). Among other things, FATCA generally mandates that for a participating foreign financial institution ("FFI") to continue to remit and receive the full value of all of its transfers and conduct its worldwide operations with limited impact by FATCA, it must identify to the IRS its U.S. accounts. The penalty for non-compliance is steep: a 30% withholding tax on certain withholdable and passthrough payments.²

II. IMPACT ON FOREIGN FUNDS

FATCA will impact most offshore mutual funds, hedge funds, private equity funds and other types of funds (collectively referred to as "Foreign Funds") as they will be classified as FFIs. Accordingly, they will have to meet the requirements of FATCA to avoid the 30% withholding.³ For Foreign Funds the implementation of FATCA will be particularly difficult, as most funds utilize different parties to collect account holder data, make decisions on investments, hold assets and make payments that may be withheld and on which should be reported. As such, the implementation of FATCA may force Foreign Funds to change their operating models so it is important for Foreign Funds to conduct impact assessments as soon as possible to determine if and how their custodians, fund administrators, transfer agents and distributors (collectively referred to as "third party service providers") are planning to comply with FATCA.

For example, assume the Foreign Fund does become FATCA compliant, but does not coordinate its compliance with its custodian or outsourced transfer agent service provider. The impact to the Foreign Fund and its clients or subscribers in this situation could be disastrous. There could be a withholding of 30% of certain payments made to the custodian

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¹ http://www.justice.gov/tax/offshore_compliance_initiative.htm

² A withholdable payment is any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the U.S. and any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States. Internal Revenue Code ("IRC") § 1473(1)(A). A passthrough payment is defined as any withholdable payment or other payment to the extent attributable to a withholdable payment. IRC § 1471(d)(7).

³ According to FATCA, an FFI is a foreign entity that: (1) accepts deposits in the ordinary course of a banking or similar business, (2) as a substantial portion of its business, holds financial assets for the account of others, or (3) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading securities, partnership interests, commodities, or any interest in these mentioned items. IRC § 1471(d)(5).



for the benefit of the Foreign Fund simply because the custodian is not FATCA compliant. Additionally, clients or subscribers of the Foreign Fund may also suffer from 30% withholding if the outsourced transfer agent does not appropriately update on-boarding procedures to ensure adequate documentation and information is collected on the client or subscriber. Using these stark examples, one can see why coordination is a key to building a strong FATCA compliance program for a Foreign Fund.

This paper is divided into three sections: (1) a brief background of FATCA; (2) coordinating FATCA compliance with the Foreign Fund's third party service providers and (3) working with third party service providers to determine whether Foreign Funds can meet the deemed compliant status requirements.

III. BRIEF BACKGROUND OF FATCA

On March 18, 2010, FATCA was signed into law as part of the Hiring Incentives to Restore Employment Act. FATCA generally goes into effect on July 1, 2013 and provides the Treasury and the IRS with oversight responsibility. In general, FATCA requires FFIs to put processes in place to identify and report their U.S. Accounts to the IRS or suffer a withholding tax. Participating FFIs will be required to enter into an agreement with the IRS (the "FFI Agreement") to report certain information regarding account holders and withhold on certain payments, if necessary. The first stage of withholding goes into effect on January 1, 2014.

To help put FATCA into a working framework, the Government has issued three Notices: (1) Notice 2010-60 on August 27, 2010; (2) Notice 2011-34 on April 8, 2011 and (3) Notice 2011-53 on July 15, 2011. The first two Notices provide much needed detail to allow FFIs to start to create their FATCA compliance systems, although to have a fully operational system more guidance or proposed regulations are needed. The third Notice gives FFIs some breathing room on the completion of different tasks. The Government is expected to issue proposed regulations in December 2011 and final regulations in the summer of 2012.

The identification of U.S. accounts is divided into different processes for individual and entity account holders. In attempting to identify U.S. accounts among the FFI's individual account population, there are three classifications for individual accounts that will trigger different actions by the FFI. The account can be classified as: (1) a U.S. account, which triggers a reporting requirement; (2) a non-U.S. account, which does not trigger any further reporting or withholding obligation or (3) a recalcitrant account holder,⁴ which triggers a withholding and reporting requirement. For pre-existing private banking accounts, as defined by FATCA, and for accounts with balances or values of \$500,000 or more, an FFI must conduct a diligent review of all electronic and paper files of an account holder. For all remaining pre-existing individual accounts with a balance or value of \$50,000 or greater, a FFI only has to conduct a review of electronically searchable information⁵ for indicia of a U.S. account.⁶ The analysis of entity accounts is more cumbersome, but

⁴ A recalcitrant account holder is an account holder who does not comply with a request for information or a waiver from the FFI within a set period of time, usually one year. IRC § 1471(d)(6).

⁵ Electronically searchable information refers to information that an FFI maintains in its tax reporting files, or customer master files or similar files that is stored in the form of an electronic database against which standard queries in programming languages, such as Structured Query Language, may be used. Customer master files include an FFI's primary files for maintaining account holder information, such as information used for contacting account holders and for satisfying AML/KYC requirements. Information, data, or files are not electronically searchable merely because they are stored in an image retrieval system (such as .pdf files or scanned documents). Notice 2011-34, pp. 14-15.

⁶ According to Notice 2011-34, indicia of a U.S. account for individual accounts includes:

(1) U.S. citizenship or lawful permanent resident (green card) status;

(2) U.S. birthplace;

(3) U.S. residence address or a U.S. correspondence address (including a U.S. Post office box);

(4) Standing instructions to transfer funds to an account maintained in the U.S., or directions regularly received from a U.S. address (only accounts fitting the definition of a private banking account under FATCA need to be searched for directions regularly received from a U.S. address);

(5) "In care of" address or "hold mail" address that is the sole address with respect to the client; or

(6) Power of attorney or signatory authority granted to a person with a U.S. address.

If one or more of the above indicia is identified, the FFI has to request additional documentation and/or information from the account holder.

has similar goals: identifying U.S. accounts and determining if there should be reporting and/or withholding for their entity account holders.⁷

After analyzing their accounts, FFIs will have to report U.S. Accounts to the IRS and withhold on non-participating FFIs and recalcitrant account holders.

Under FATCA, Foreign Funds are responsible for compliance, as Notice 2011-34 explicitly states that "a participating FFI is liable for the performance of its obligations under its FFI Agreement, but may use an agent to perform those obligations on its behalf."⁸

IV. COORDINATING FATCA COMPLIANCE

A. Foreign Funds Need to Perform Their Impact Assessment

FATCA will be particularly complex as each Foreign Fund that desires to become a participating FFI will need to coordinate with its third party service providers to fulfill its obligations. Foreign Funds have to determine which of their third party service providers will comply with FATCA and what steps the third party service providers are taking to comply with FATCA. Working with a non-compliant third party service provider, which may be an FFI, may not be a realistic option for Foreign Funds as the potential penalty of 30% withholding is too great a risk and could have a negative impact on the cash flow of the fund. Moreover, even if the Foreign Fund's third party service providers will be FATCA compliant, a Foreign Fund may have to reorganize its distribution system and create new workflows of collecting, distributing

and reporting information. Participating Foreign Funds will be a withholding agent for FATCA purposes,⁹ so strict coordination with its third party service providers is necessary to ensure the correct parties are being withheld upon, if required.

Because of all of these uncertainties, each Foreign Fund should start their impact assessment now. The Foreign Fund's impact assessment should cover, among other things, coordination with third party service providers to discover their plans for FATCA compliance.

B. The FATCA Compliance Program is Only as Strong as its Weakest Link

A Foreign Fund that outsources some or all of its asset custody, compliance and regulatory functions, transfer agency services and distribution will be dependent on its third party service providers to meet its FATCA compliance goals. Because of this reliance on third parties, the results of the impact assessment could lead to an augmentation of the Foreign Fund's business model and its operations.

A Foreign Fund that wants to be a participating FFI will need to work with third party service providers that also become FATCA compliant, or are willing to assist participating FFIs in becoming compliant. For example, if the Foreign Fund's custodian is not planning on becoming FATCA compliant (not a likely option for most custodians), the Foreign Fund may want to change custodians so there is no withholding on transfers to the custodian (a non-participating FFI) for the benefit of the Foreign Fund. Moreover other third party service providers, such as transfer agents, will most likely need to update procedures to ensure they are requesting and

⁷ Under FATCA, an entity account holder can be classified as one of the following:

- (1) Participating FFI;
- (2) Deemed compliant FFI, as described in section V;
- (3) Non-participating FFI;
- (4) Non-Financial Foreign Entity ("NFFE");
- (5) Excepted NFFE (i.e. an NFFE that operates an active trade or business);
- (6) Excepted entity under FACTA § 1471(f) (an excepted entity according to the statute);
- (7) Recalcitrant account holder; or
- (8) U.S. account.

A U.S. Account is defined, generally, as a financial account held by a specified U.S. person or by an entity that, directly or indirectly, had one or more "substantial" U.S. owners. FATCA defines a "substantial" U.S. owner as a direct or indirect owner of: (1) more than 10% of the stock of a corporation; (2) more than 10% of the profit or capital interest in a partnership; or (3) more than 10% of the beneficial interest of a trust. Investment vehicles owned by a U.S. person must also be reported to the IRS. IRC § 1473(2) and 1473(3).

⁸ Notice 2011-34, p.33.

⁹ A withholding agent pursuant to FATCA includes a participating FFI. Notice 2011-53, p. 8.

obtaining additional information and documentation about new subscribers to the Foreign Fund as well as conducting the required analysis on pre-existing accounts in close coordination with the Foreign Fund. A Foreign Fund working towards becoming a participating FFI needs to align itself with third party service providers that are also working towards FATCA compliance.

I. Will Your Third Party Service Providers Plan To Be FATCA Compliant?

Foreign Funds not wanting to risk the 30% withholding need to ensure their third party service providers are planning on complying with FATCA as part of their impact assessment.¹⁰ The Foreign Fund should ask their third party service providers questions concerning their plans for compliance including:

- a. Does the third party service provider plan on becoming FATCA compliant?
- b. How will the third party service provider and the Foreign Fund divide the new FATCA-related responsibilities?
- c. At what stage is the third party service provider in the process of building a FATCA compliance program?
- d. How is the third party service provider going to work with its clients to ensure a smooth transition for any new FATCA-related services being offered?
- e. Does the third party service provider have suggestions for improving the business operating model?
- f. How much will the third party service provider charge for any additional FATCA-related compliance services?

- g. How can the third party service provider guarantee it will maintain its compliance with FATCA or participating FFI status?¹¹

Continued compliance by the third party service providers is a must for Foreign Funds; non-compliance could force the Foreign Fund to miss its withholding obligations and could also put the Foreign Fund's FFI Agreement at risk. Any withholding on payments for the benefit of the Foreign Fund could ultimately affect the Foreign Fund's performance, which could damage the fund's reputation and its relationship with clients.

2. What Are The Potential Changes to the Business Model?

A tougher question for Foreign Funds will be if and how to change their business model to assist in ensuring FATCA compliance. Two areas to consider include:

a. Flow of information

Foreign Funds may have to rework their internal flow of information and information from third party service providers to comply with FATCA's due diligence, reporting and withholding requirements. In addition, Foreign Funds will have to update service provider contracts and corresponding service level agreements to incorporate newly delegated activities and escalation protocols which clearly assign to each party their responsibility for implementing FATCA policies.

Because of FATCA, different third party service providers will have to share information with one another. For example, a transfer agent or other collector of client on-boarding and subscriber information will need to inform the payor of funds to withhold if an accountholder is classified as a non-participating FFI or recalcitrant accountholder.

¹⁰ Although not a focus of this whitepaper, the impact assessment should cover other topics such as:

(1) A legal entity analysis to determine whether each affiliated legal entity falls within the definition of a financial institution;

(2) An inventory of affected business lines, products and services;

(3) The identification of the types of accounts maintained, including an estimate of the number of private banking accounts (as defined by FATCA) and the type of data maintained on account holders; and

(4) The identification of affected information technology systems.

¹¹ Additionally, the Foreign Fund should request a clause for a right to an annual audit or review of FATCA-related procedures when negotiating a new or updated contract with its third party service providers.

This is made more difficult because the status of an accountholder may change from one day to the next. For instance, the accountholder could supply the requisite information to prove non-U.S. taxpayer status after already being classified as a recalcitrant accountholder; so a one-time data collection and exchange is not sufficient.

b. Distributors

Funds may want to evaluate their distribution partners. For example, it is unclear whether small distributors of a Foreign Fund will become FATCA compliant because of the potential costs of compliance.¹² It may also be difficult for Foreign Funds to ensure small distributors are FATCA compliant. Foreign Funds should have a plan with regard to small distributors prior to withholding being mandated. Potential solutions include: (1) limiting the number of distributors utilized; (2) bringing distribution in-house; (3) continuing with all distributors, but making it very clear what will happen (i.e. 30% withholding) if a FFI distributor is not FATCA compliant or (4) combining the above solutions.

V. CAN THE FOREIGN FUND MEET DEEMED COMPLIANT STATUS?

Select funds may be able to become deemed-compliant FFIs, which will alleviate some of the FATCA requirements. The Government intends to issue guidance concerning Foreign Funds that will be treated as deemed-compliant, as Notice 2011-34 states:

a fund will be deemed-compliant if it meets the following three requirements: (1) all holders of record of direct interests in the fund (e.g. the holders of its units or global certificates) are participating FFIs or deemed-compliant FFIs holding on behalf of other investors, or entities described in section 1471(f) (2) the fund prohibits the subscription for or acquisition of any interests in the fund by any person that is not a participating FFI, a deemed-compliant FFI, or any entity described in 1471(f); and (3) the fund certifies that any passthru payment percentages that it calculates and publishes will be done in accordance with Section II of this Notice.¹³

Moreover, a deemed-compliant FFI will need to obtain certification status from the IRS. The Government is still considering whether other categories of funds may be treated as deemed-compliant and requested comments on such in Notice 2011-34.¹⁴ Foreign Funds should determine preliminarily whether one or more Foreign Funds within the fund family fits the conditions above and then plan their FATCA compliance accordingly. This could be another area where a Foreign Fund could work with their distributors to only take on certain types of clients or subscribers so the Foreign Fund could meet and maintain its deemed compliant status.

VI. CONCLUSION

On the road to FATCA compliance Foreign Funds have different options to consider including their relationships with their current third party service providers and their business model. Although the road forward may not be readily clear, Foreign Funds need to conduct an impact assessment soon to determine how they and their third party service providers will work together to allow each Foreign Fund to become compliant with FATCA and avoid unnecessary withholding.

¹² "Treasury and the IRS continue to consider comments received regarding whether there may be a category of funds that may be treated as deemed-compliant because: (i) all direct interest holders in the fund are participating FFIs, USFIs, deemed-compliant FFIs, entities described in section 1471(f), or non-participating FFIs acting as distributors; (ii) distribution or similar agreements prohibit the sale of interests to specified U.S. persons, NFFEs other than excepted NFFEs, and non-participating FFIs holding for their own account; (iii) each distributor agrees to enforce the sales prohibitions described in (ii) above, and (iv) the fund satisfies other requirements and meets other criteria relevant to the purposes of chapter 4." Notice 2011-34, pp. 32-33.

¹³ *Id.*, pp.31-32. Section 1471(f) is an exception to FATCA for foreign governments, international organizations, central banks of issue and any other class of persons identified by the Secretary for purposes of this subsection as posing a low risk of tax evasion. Also, for a discussion of the passthru payment percentage see Navigant's previous white paper entitled, "FATCA: Take 2, Are You Ready to Certify Compliance?" (May 2011).

¹⁴ *Id.*, pp 32-33.

BIOGRAPHIES

Ellen Zimiles is a Managing Director and Head of Global Investigations and Compliance in Navigant's Disputes & Investigations practice. She has more than 25 years of litigation and investigation experience, including 10 years as a federal prosecutor. Ms. Zimiles is a leading authority on anti-money laundering programs, corporate governance, regulatory and corporate compliance, fraud control and public corruption matters. She has worked with a multitude of financial institutions preparing for regulatory exams, developing remediation programs and assisting organizations as a regulatory liaison. Ms. Zimiles founded and served as CEO of Daylight Forensic & Advisory LLC, an international investigations and compliance consulting firm which merged with Navigant in 2010. As an assistant United States attorney in the Southern District of New York for more than 10 years, Ms. Zimiles served in the civil and criminal divisions and was chief of the forfeiture unit for more than six years. She was responsible for many high-profile money laundering, fraud and forfeiture cases.

Richard Kando is a Director in Navigant's Disputes & Investigations practice, and along with Jeffrey Locke, a leader of Navigant's FATCA Task Force. Mr. Kando primarily assists counsel with anti-money laundering and other regulatory compliance related engagements and litigation related matters. Prior to joining the consulting industry, Mr. Kando served as a special agent for the Internal Revenue Service – Criminal Investigation Division in New York City where he investigated allegations of tax evasion and other tax related criminal offenses, mail and wire fraud, embezzlement, money laundering and identity theft. In recognition of his services as a special agent, he received the U.S. Department of Justice – Tax Division Assistant Attorney General's Special Contribution Award.

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