PROPOSED FATCA REGULATIONS—CONSIDERATIONS RELATING TO PRIVATE INVESTMENT FUNDS

February 16, 2012

To Our Clients and Friends:

On February 8, 2012, the IRS issued long-awaited proposed regulations under the FATCA (Foreign Account Tax Compliance Act) withholding and reporting regime. The FATCA rules are relevant to both foreign and U.S. private investment funds: foreign funds generally will be treated as foreign financial institutions ("FFIs"), and both foreign and U.S. funds that invest in the United States will need to contend with the FATCA withholding rules.

This Client Update describes features of the proposed regulations that are of particular relevance to private investment funds.

Foreign funds

- In order for a foreign fund to avoid 30% U.S. withholding tax on payments to the fund of U.S. source income, gross proceeds from the sale or disposition of U.S. debt instruments and stock and so-called "foreign passthru payments," the fund will need to participate in the FATCA program by entering into an agreement with the IRS (an "FFI Agreement") in which the fund agrees to report certain information regarding its investors to the IRS and comply with the FFI withholding regime.

- To ensure that a foreign fund is participating in the FATCA program when the withholding regime goes into effect for U.S. source income on January 1, 2014, the fund must enter into its FFI Agreement prior to July 1, 2013.

- A foreign fund that enters into an FFI Agreement will be required to withhold on certain distributions of U.S. source income (beginning January 1, 2014) and gross proceeds from the sale or disposition of U.S. debt instruments and stock (beginning January 1, 2015) that the fund pays to investors that are "nonparticipating FFIs" and investors that are "recalcitrant accountholders." Withholding with respect to "foreign passthru payments" will not begin earlier than January 1, 2017.

- A foreign fund will need to liaise with its investors to obtain information and certifications required under the new rules in order to comply with its FFI Agreement and to avoid withholding on distributions to investors.
- The United States has announced that it has agreed to explore entering into bilateral agreements with France, Germany, Italy, Spain and the United Kingdom providing for the reciprocal automatic exchange of information on financial accounts. Foreign funds in these countries would not be required to enter into FFI Agreements and would be excused from passthru payment withholding in certain circumstances. Instead, these funds would be required to identify U.S. accounts and report the information regarding such accounts to the government of their home country, which would transfer the information to the United States.

U.S. funds

- A U.S. fund will not be required to enter into an FFI Agreement with the IRS.
- A U.S. fund will be a withholding agent for purposes of FATCA. The fund will be required to withhold on distributions to investors that are "nonparticipating FFIs" and to certain intermediaries and pass-through entities through which nonparticipating FFIs invest. In addition, a U.S. fund will be required to withhold on "non-financial foreign entities" ("NFFEs") that do not identify their substantial U.S. owners or otherwise qualify for an exemption. As a result, like foreign funds, U.S. funds will need to liaise with their investors to obtain information and certifications required under the new rules to avoid withholding on distributions to investors.

BACKGROUND

The FATCA rules are designed to identify U.S. persons who fail to report their foreign assets and income. The rules implement an enhanced reporting regime that requires FFIs to disclose information relating to financial accounts owned by U.S. persons. For purposes of FATCA, a foreign fund (including a private equity or hedge fund) that primarily invests or trades in securities, partnership interests or commodities is treated as an FFI, and any equity or debt interest in the foreign fund that is not regularly traded on an established securities market is treated as a financial account in such fund. The FATCA rules also require certain NFFEs to disclose information relating to their substantial U.S. owners.

The mechanism for the IRS to enforce compliance with the FATCA reporting rules is a new 30% U.S. withholding tax that applies to "withholdable payments" made to (i) FFIs that do not

enter into an FFI Agreement ("nonparticipating FFIs") and (ii) NFFEs that do not provide information regarding their substantial U.S. owners. Generally, "withholdable payments" include certain U.S. source income (such as interest, dividends and rents) and gross proceeds from the sale or other disposition of property that can produce U.S. source interest or dividends. In addition, FFIs that enter into FFI Agreements are required to withhold 30% U.S. tax on "passthru payments" (generally withholdable payments and payments that are attributable to withholdable payments) that such participating FFIs make to "recalcitrant accountholders" (generally account holders that do not provide information that the FFI requests to comply with its reporting obligations or that do not provide waivers of foreign law to permit such reporting) and to nonparticipating FFIs.

FFI AGREEMENT

In order to participate in the FFI program, a foreign fund generally must enter into an FFI Agreement. In the case of a foreign fund that invests in the United States, the fund will need to enter into its FFI Agreement no later than July 1, 2013 to be in compliance with FATCA when the withholding rules applicable to U.S. source income become effective on January 1, 2014. Under the proposed regulations, withholding on "foreign passthru payments" (passthru payments that do not consist of U.S. source income or gross proceeds from the sale or disposition of property that can produce U.S. source interest or dividends) will begin no earlier than January 1, 2017 rather than on January 1, 2015, as provided in previous IRS guidance. As a result, foreign funds that do not intend to invest in the United States may be able to defer entering into an FFI Agreement.

In the case of a private fund, an FFI Agreement generally will require the fund to (i) obtain information regarding its investors in order to determine whether the investors are subject to information reporting under the FATCA rules, (ii) report to the IRS information regarding the fund's U.S. investors and recalcitrant accountholders, (iii) comply with the FFI withholding regime (discussed below) and (iv) comply with other requirements, including due diligence and verification procedures, obtaining waivers of foreign laws that would prevent the reporting to the IRS of information regarding U.S. accounts and providing other information requested by the IRS.

The proposed regulations also provide that a responsible officer of an FFI that has entered into an FFI Agreement will be required to make certain periodic certifications to the IRS regarding the FFI's compliance with its FFI Agreement, including a certification that the FFI did not have any formal or informal practices or procedures in place from August 6, 2011 to assist account holders in avoiding the FATCA requirements.

Under the proposed regulations, the FFI Agreement reporting requirements are phased in. Beginning in 2014, a fund will be required to report certain identifying information to the IRS with respect to its U.S. investors for the calendar year ending December 31, 2013. Income reporting with respect to U.S. investors is scheduled under the proposed regulations to begin in 2016 for the calendar year ending December 31, 2015.

WITHHOLDING TAX RULES

Consistent with previous IRS guidance, the proposed regulations defer the effective date for withholding on U.S. source income until January 1, 2014 and defer the effective date for withholding on gross proceeds from the sale or disposition of property that can produce U.S. source interest or dividend income (*e.g.,* U.S. debt instruments and stock) until January 1, 2015. The proposed regulations reserve on the definition of foreign passthru payments, but provide that withholding on such payments will not apply before January 1, 2017, which represents an additional two-year grace period beyond the January 1, 2015 effective date provided in previous IRS guidance.

As discussed above, for a foreign fund to avoid being subject to U.S. withholding tax on U.S. source income, gross proceeds from the sale or disposition of property that can produce U.S. source interest or dividends and, eventually, on foreign passthru payments, the fund will be required to enter into an FFI Agreement. In addition, foreign funds that enter into FFI Agreements generally will be required to withhold on payments to (i) investors that are recalcitrant accountholders and (ii) FFIs that do not elect to participate in the FATCA program. Foreign funds will need to liaise with their investors in order to appropriately identify their investors under a series of complex procedures set forth in the proposed regulations and to obtain appropriate withholding certificates.

In the case of a U.S. fund, unless an exemption applies, the U.S. fund will be required to withhold on investors that are (i) nonparticipating FFIs and certain intermediaries and pass-through entities through which nonparticipating FFIs invest and (ii) NFFEs that do not identify their substantial U.S. owners or otherwise qualify for an exemption. Like foreign funds, U.S. funds will need to liaise with their investors in order to appropriately identify their investors under a series of complex procedures set forth in the proposed regulations and to obtain appropriate withholding certificates.

INVESTORS THAT BENEFIT FROM EXEMPTIONS

The proposed regulations expand somewhat the types of FFIs that are exempt from FATCA withholding, either because such entities qualify for a general exemption or because such entities, subject to the satisfaction of certain conditions, are deemed to comply with the FATCA rules

due to the nature of their status. Fund investors that may be exempt from FATCA withholding because of their special status include, among others, foreign governments and their wholly-owned agencies and instrumentalities, certain international organizations, certain foreign retirement and pension plans and foreign charitable organizations.

BILATERAL AGREEMENTS WITH OTHER COUNTRIES

On February 8, 2012, the United States issued a Joint Statement with France, Germany, Italy, Spain and the United Kingdom that it intends to explore entering into a bilateral agreement with each such country providing for the reciprocal automatic exchange of information on financial accounts. We understand that the U.S. Treasury is also discussing reciprocal arrangements with other foreign countries.

The Joint Statement contemplates that each of these foreign countries would implement legislation that would require FFIs in that country, including foreign funds, to undertake the necessary diligence procedures to identify U.S. accounts and to report information regarding such accounts to the government of that country, which would then transfer the information, on an automatic basis, to the United States. In consideration of this enhanced information exchange, such foreign funds would not be required to enter into an FFI Agreement or to undertake passthru payment withholding on payments to recalcitrant account holders or to other FFIs subject to a similar system.

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Please do not hesitate to call us if you have any questions.

Adele M. Karig
+1 212 909 6787
amkarig@debevoise.com

Matthew D. Saronson
+44 20 7786 9167
mdsaronson@debevoise.com

David H. Schnabel
+1 212 909 6336
dhschnabel @debevoise.com

Peter F.G. Schuur
+1 212 909 6353
pfgschuur@debevoise.com

Erin Cleary
+1 212 909 6527
ecleary@debevoise.com

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