



LINE OF  
**SIGHT**

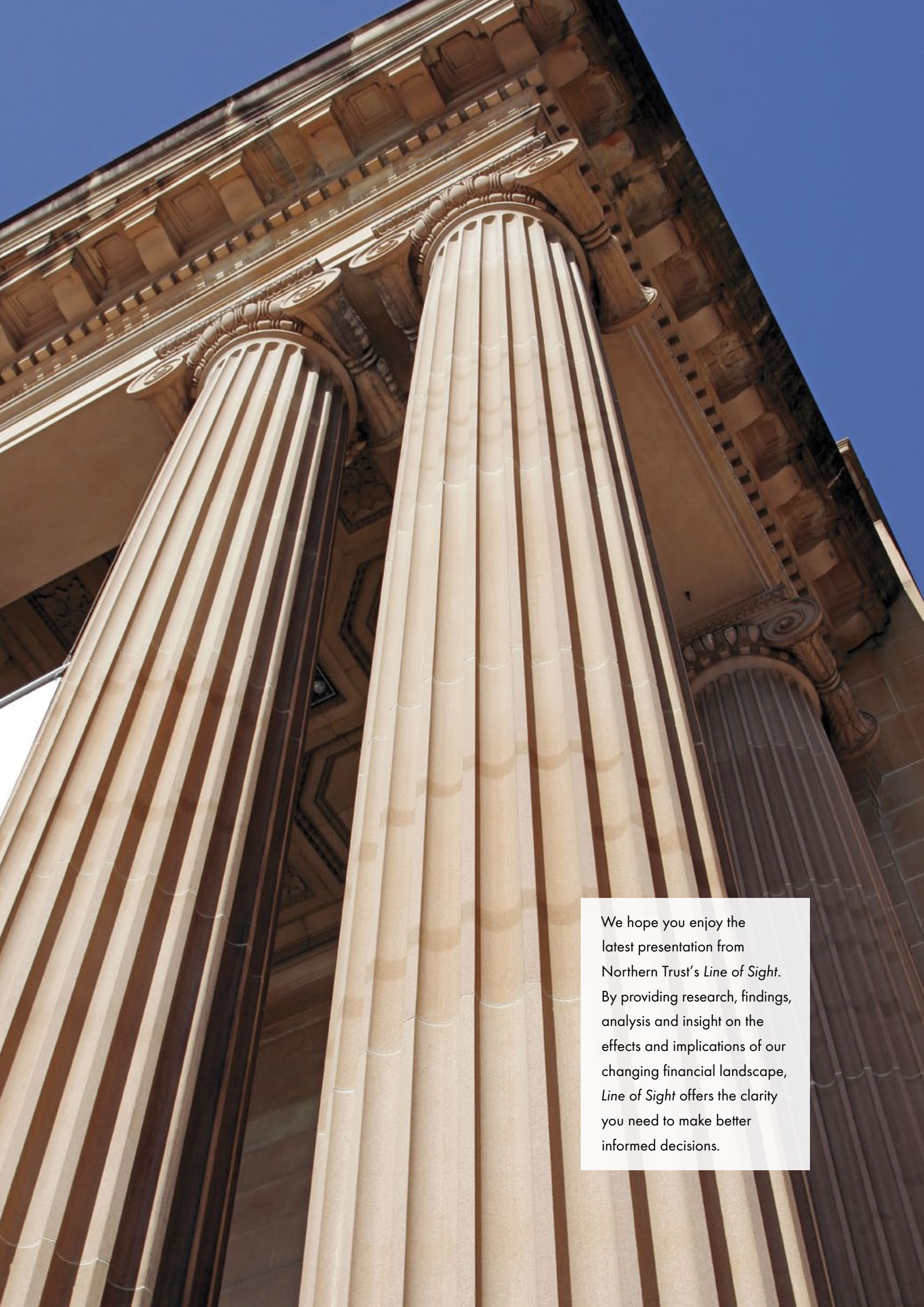
Investment  
Management  
Regulation

---

**FATCA Is Coming:  
Will You Be Ready?**



**Northern Trust**



We hope you enjoy the latest presentation from Northern Trust's *Line of Sight*. By providing research, findings, analysis and insight on the effects and implications of our changing financial landscape, *Line of Sight* offers the clarity you need to make better informed decisions.

## **FATCA IS COMING: WILL YOU BE READY?**

---

*The scope of the Foreign Account Tax Compliance Act is extremely broad and fund managers will be significantly affected.*

Primarily, the Foreign Account Tax Compliance Act (FATCA) is aimed at identifying and penalising U.S. tax avoidance – but goes far beyond what might typically be thought of as an operational issue. In fact, FATCA's scale and scope have the potential to affect the products managers offer – from product promotion and distribution to administration and risk profile. It is a fundamentally important strategic business issue that demands managers' attention now.

While implementation details are not finalised, funds that are unprepared for FATCA could well find themselves at a disadvantage. There is no time to lose.

November 2011

**Lorraine White**  
Tax Specialist  
Northern Trust  
+44 (0) 207 982 2949  
lw42@ntrs.com

**Kathleen Dugan**  
Senior Product Manager  
for FATCA  
Northern Trust  
(00) 1 312 630 0625  
kd18@ntrs.com

FATCA requirements may cause fund managers to adjust their business models – the nature of their investments, the type of investors allowed and the choice of distribution channels.

## BACKGROUND

FATCA, a component of the Hiring Incentives to Restore Employment Act (the HIRE Act), was enacted by the U.S. Congress to combat tax evasion. FATCA requires foreign financial institutions to report on U.S. investors with overseas financial assets.

U.S. citizens and permanent residents are subject to federal tax on their worldwide income, regardless of source. Driving FATCA is the presumption that there are significant numbers of tax evaders holding assets outside of the United States.

FATCA creates incentives for foreign financial institutions (FFIs) to provide information to the U.S. Internal Revenue Service (IRS) on any accounts held directly or indirectly by 'U.S. persons'; the IRS would use this information to penalise evasion more effectively.

Noncompliant foreign financial institutions will face harsh penalties on the proceeds of any transactions involving U.S. assets. Fund managers who plan to comply face operational challenges that will necessitate changes in subscription, documentation, recordkeeping, payment and reporting procedures. Investment in technology will likely be needed to accommodate these requirements.

The obligations FATCA introduces are new and quite different from those of the IRS's existing Qualified Intermediary tax regime — the process financial institutions use to withhold and report on U.S. sourced income based on the client's status (i.e., documented, undocumented, U.S. or foreign, treaty-eligible or not). It is also important to note that while jurisdictions outside the U.S. usually apply taxes based on residency, the United States applies taxes based on citizenship or legal permanent residency (holders of U.S. 'green cards').

FATCA will have broad effects throughout the global financial system. Organisations such as Northern Trust are working to clarify their obligations ahead of implementation. FATCA also presents institutions with areas of ambiguity, and possible legal conflicts. For example, the United States requires reporting on U.S. account-holders, but the country in which the fund is regulated may impose strict investor privacy laws that preclude such reporting. Currently no guidance is available to address how any legal tensions may be resolved.

Yet, with phased implementation beginning in less than 18 months, managers can take steps now to prepare beginning with an understanding of their legal and fiduciary obligations and how these may affect their business model, operations and marketing.

## OBLIGATIONS UNDER FATCA

FATCA classifies foreign institutions into FFIs and nonfinancial foreign entities (NFFE)<sup>1</sup>. Foreign (non-U.S.) investment funds will be classified as FFIs. To be treated as a 'participating FFI,' funds will need to enter into an agreement with the IRS (an FFI agreement) whereby they agree to undertake certain duties (see box to the right).

Non-U.S. funds are not compelled to participate in FATCA. However, if they do not enter into an FFI agreement they will be subject to a 30% withholding tax on income they receive from sources within the United States.

If they invest in U.S. asset classes, managers that do not participate in FATCA will therefore be at a significant disadvantage.

### FATCA WILL BE IMPLEMENTED IN PHASES BEGINNING 1 JANUARY 2013 AND IS LIKELY TO REQUIRE FUND MANAGERS TO:

- Evaluate exposure to U.S.-sourced income
- Evaluate new FATCA legal and fiduciary responsibilities
- Perform enhanced due diligence on account holders
- Create new withholding and reporting processes
- Communicate with account holders on FATCA

*FATCA makes foreign financial institutions responsible for reporting to the IRS and withholding payments to noncompliant account holders. For asset managers who invest in the United States, the penalty for noncompliance is intended to be so prohibitively expensive that it is simply not an option.*

### KEY OBLIGATIONS FOR FOREIGN INVESTMENT FUNDS UNDER FATCA INCLUDE:

- Entering into an FFI agreement with the IRS
- Identification and classification of all investors based on their FATCA status
- Reporting to the IRS on U.S. individuals and U.S. institutions
- Application of 30% FATCA withholding to passthru payments made to noncompliant account holders

<sup>1</sup> An NFFE is any foreign entity that is not a financial institution; under FATCA there is a requirement for USFIs and FFIs to report on any substantial US owners of NFFE account holders.

### Opting out of FATCA?

Some investment managers are reportedly assessing options for effectively ‘opting-out’ of the FATCA regime by ceasing their investment in U.S. asset classes; 6% of respondents to a recent industry survey said they would disinvest from both U.S. equity and fixed income markets as a result of FATCA, while 46% of fixed income respondents and 42% of equity funds refused to rule out the possibility of leaving the U.S. market.<sup>2</sup>

U.S. regulators are concerned that allowing funds with no direct U.S. investments to avoid FATCA reporting requirements will allow U.S. citizens and residents investing in those funds to escape reporting. They propose requiring FFIs to estimate (by calculating and publishing a ‘passthru payment percentage’) how much of their investment assets can be attributed directly or indirectly to U.S. sources. An FFI would then be required to impose withholding based on its passthru payment percentage on any payments to noncompliant account holders. The result would be that a fund’s investments in (non-U.S.) FFIs would be subject to FATCA withholding (e.g., bonds issued by a British bank that holds U.S. assets, or an interest in a Cayman fund that holds U.S. assets).

The goal of this proposal is to force even foreign financial institutions that have no direct U.S. investments to comply with FATCA requirements. Financial institutions across the globe have raised strong objections to this proposal, so the requirement may be subject to revision.

Other options reportedly under consideration include closing the accounts of existing U.S. investors and refusing to accept new ones. In fact, we have seen a series of announcements from financial institutions that have decided to close accounts held by U.S. individuals; U.S. citizens living abroad may find it increasingly difficult to open banking or investment accounts.

While excluding U.S. investors would alleviate much of the burden of FATCA reporting, managers would still be responsible for due diligence on foreign institutions and withholding on all noncompliant foreign institutions. The intention of U.S. regulators is to push FATCA obligations down the chain of investments so that all foreign financial institutions at all levels would be required to report on U.S. investors.

‘Opting-out’ may therefore be difficult to execute in practice. Managers will need to analyse their underlying client base and determine the compliance status of each account holder. Where the account holder is a foreign financial intermediary (a foreign nominee or distributor, for example), these institutions likely will be regarded as FFIs that will need to comply with FATCA or suffer FATCA withholding. It is unclear whether local distributors will be required to enter into a full FFI agreement with the IRS or will have to comply with lesser requirements.

This illustrates how far FATCA is intended to penetrate the financial system – indeed its global territorial impact has caused disquiet across the whole financial services industry.

### Few exemptions exist

Only a limited number of entities are exempt under current preliminary guidance. Among non-U.S. institutions, these include government and international organisations (such as those under the auspices of the United Nations), central banks, certain types of holding companies and insurance companies that do not issue cash value insurance or annuities. Retirement and pensions plans may also be exempt although precise clarification is required in this area; the FATCA status of charities is unclear.

#### RELIEF FROM FATCA IS LIKELY TO BE LIMITED:

- Scope of FATCA is intentionally broad
- Difficult to ‘opt-out’ from FATCA
- FFIs may need to comply if they are part of an affiliated group
- Even indirect contact with U.S. assets may fall within FATCA’s scope
- Very few types of institutions are exempted
- No country or regional exemptions likely

<sup>2</sup> FATCA and The Funds Industry: Defining the Path, KPMG, June 2011.

It is considered unlikely that any country or region will be granted specific exemptions from FATCA. U.S. officials have stated that ‘blanket exemptions’ are not possible and that whilst their primary focus remains on making use of international cooperation to implement FATCA in a ‘cooperative way’,<sup>3</sup> their intention is to affect regulations that can be applied globally and as broadly as possible.

While recent IRS guidance allows for a staged implementation throughout 2013 and 2014, the message from U.S. authorities is clear: FATCA is coming and institutions should prepare for it.

## DUE DILIGENCE AND REPORTING

### Classification and record-searching

FATCA defines U.S. account holders to include dual citizens with U.S. citizenship and U.S. green card holders. Therefore, foreign citizens cannot automatically be excluded from the definition of ‘U.S. persons.’

How, then, is a fund expected to identify all such account holders? The key requirement under current guidance is that institutions must perform an initial ‘sweep’ of their ‘electronically searchable’ records to identify U.S. clients, looking for indications that a client has a U.S. connection, such as a U.S. address or birthplace.

Such evidence would require further investigation to determine whether the individual meets the definition of ‘U.S. person.’ In addition, ‘high value accounts’ with a value of US\$500,000 or more are likely to require a review of all hard-copy documentation.

FATCA requires FFIs to provide names, taxpayer identification numbers and account details for all account holders identified as ‘U.S. persons’ (a category that includes all U.S. individuals and most U.S. institutions) that hold at least US\$50,000 of assets in their accounts.

The scope of this classification is potentially very broad. While FATCA is aimed at U.S. citizens and residents who knowingly hide assets overseas to escape their tax obligations, it will inevitably sweep up some individuals who carry neither a U.S. passport nor a green card. For example, someone born in the United States who has lived overseas since a child may be entirely unaware of any U.S. tax requirements, yet he or she would likely qualify as a U.S. person.

To comply with FATCA, a fund must disclose the identities of direct and indirect U.S. investors, arrange for a compliance officer sign-off on disclosures and agree to external audits by the IRS or its agents. Funds that participate in FATCA will also need to comply with IRS guidelines for proving it has no U.S. investors.

There is even a requirement that the chief compliance officer certify that the FFI management personnel have not, between April 2011 and the time of signing the FATCA agreement, advised U.S. account holders on strategies to avoid having their U.S. accounts identified.

FATCA recognises that funds may wish to delegate some of their reporting obligations to third-party transfer agents. It should be noted, however, that FATCA places the responsibility for this task with the fund even if services are outsourced, and participating institutions can expect to be audited.

### Client communication

FATCA will necessitate the collection of additional information from clients. Those managing funds who choose to participate should therefore consider revising their documentation and subscription processes to capture the information they will need to deliver to the IRS. They should also consider additional communications that may be necessary with their investors, distributors and other stakeholders.

#### FATCA AIMS TO IMPOSE IDENTIFICATION AND REPORTING ON ACCOUNTS OF MORE THAN US\$50,000 THAT ARE HELD BY:

- U.S. citizens, including dual citizens
- U.S. green card holders
- Other U.S. entities
- Nonfinancial foreign entities with substantial U.S. ownership

*To be compliant, a foreign investment fund will need to evaluate whether each of its account holders is FATCA-compliant. That said, further guidance is required on how to distinguish U.S. individuals from foreign individuals, FFIs from NFFEs, and deemed-compliant FFIs from exempt foreign institutions. Without such guidance, a detailed gap analysis is next to impossible.*

<sup>3</sup> Source: *Financial Times*, 16 June 2011.

Investors are becoming more conscious of FATCA and managers are also likely to face questions from clients regarding their potential exposure to it. In particular, because of FATCA's potential negative impact on a fund's investment return, investors will ask whether the funds in which their capital is invested are compliant. Those who engage with FATCA now will be in the strongest position to respond to any concerns raised by their stakeholders.

### FATCA WITHHOLDING

As well as reporting on U.S. account-holders, funds will be required to apply FATCA withholding of 30% on uncooperative account holders. This 30% withholding will apply not only to dividends and interest paid to investors, but also on the gross proceeds from sales. It should also be noted that withholding is to be applied on any applicable transaction before any other tax considerations are taken into account.

Suppose, for example, that a noncompliant fund sells US\$1 million of U.S. stock. Full withholding would be applied regardless of whether the transaction represented a gain or loss on the original investment. The fund's custodian is instructed under FATCA to classify the fund as a noncompliant FFI and would therefore move US\$700,000 into the fund's custody account and send US\$300,000 to the IRS. In this way, FATCA withholding is designed to be so punitive that every fund will comply.

### Applying FATCA withholding

So how can a compliant fund apply withholding to its investors? In the case of a U.S. fund, the investor who purchases units in the fund has bought a U.S. investment, so any payment to a noncompliant investor (including both distributions and redemptions) would be a withholdable payment subject to full 30% withholding. Note that uncertainty exists at present as to how funds structured as U.S. partnerships should proceed with withholding; this is one of several areas where clarification is required.<sup>4</sup>

By contrast, how would a foreign fund apply withholding to its investors? Normally, all payments made by a foreign fund are considered non-U.S. sourced.<sup>5</sup> Here however, FATCA introduces the concept of 'passthru payments' referred to earlier. These are a source of contention, as IRS guidance broadens the scope of the tax withholding regime to effectively apply to some foreign securities as well as U.S. securities; the aim is to prevent U.S. investors from avoiding FATCA reporting simply by investing exclusively in non-U.S. securities.

### Passthru payments

The IRS proposes that all FATCA-compliant FFIs calculate a passthru payment percentage based on the percentage of U.S. investments on their balance sheet. To illustrate: Suppose a European bank decides to comply to avoid FATCA withholding, and a quarter of its total balance sheet consists of investments in U.S. securities. In this case, the bank's passthru payment percentage would be set at 25%.

The FATCA withholding rate of 30% would be multiplied by the passthru payment percentage to calculate the rate to be withheld. In this case, the bank would be required to deduct 7.5% withholding to all bond interest payments made to noncompliant investors. The diagram on page 6 shows the process through which this withholding rate is reached.

*FATCA withholding is highly controversial. For example, under current guidance, a nonparticipating fund may still suffer FATCA withholding, even if it makes no investments in the United States. This aspect of FACTA has been condemned and is among the focal points of ongoing consultation.*

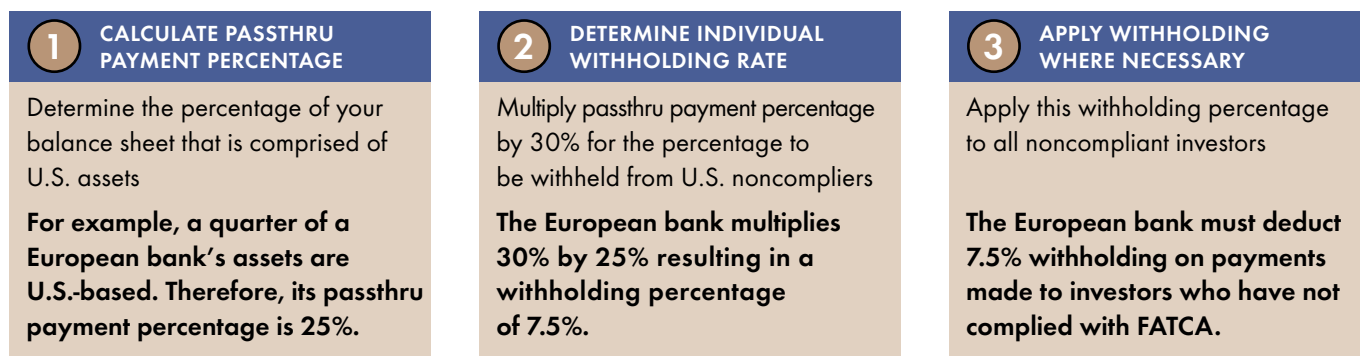
### FATCA WITHHOLDING – SUMMARY POINTS:

- U.S. institutions obliged to withhold on certain U.S.-sourced payments to noncompliant foreign entities
- FFIs required to calculate proportion of payments that are U.S.-sourced and apply 30% withholding
- Substantial technology and operations changes required by investment managers or their transfer agents
- Controversy and consultation continues over scope of passthru payment regime

<sup>4</sup> If the fund is a partnership or other flow-through entity, the application of FATCA withholding to noncompliant investors is unclear at this time. Under current tax withholding rules, a partnership determines the source of payments to its partners based on the source of the partnership's earnings on its investments.

<sup>5</sup> See note 4 above.

## PASSTHRU PAYMENTS: DETERMINING WITHHOLDING RATE TO BE APPLIED BY FFIS TO NONCOMPLIANT U.S. INVESTORS



As a second example, assume a fund consists of half U.S. securities and half non-U.S. securities. The fund would calculate its passthru payment percentage (total U.S. holdings divided by total non-U.S. holdings); in this case the passthru payment percentage would be 50%.

The fund would therefore multiply any payment due to a noncompliant investor by 50% (the passthru payment percentage) and again by 30% (the FATCA withholding rate) to yield the overall withholding rate of 15%.

### Controversy and key challenges regarding withholding

FATCA withholding is highly controversial and potentially the most problematic aspect of the legislation for fund managers. The process of withholding client funds carries obvious potential for damaging client relationships and will require careful planning to implement. Very few fund managers, especially those outside the United States, have experience in tax withholding and reporting on selected account holders.

Such a broad application of the law would make even non-U.S. securities held by a noncompliant FFI subject to FATCA withholding. This has been heavily criticised as overly coercive and unworkable in practice, and is among the focal points of ongoing consultation.

Research among managers suggests only 19% already have processes in place to implement withholding in all countries,<sup>6</sup> and it is likely many such functions will need to be built from scratch or outsourced to external providers.

### CONFLICT OF LAW ISSUES

Perhaps the most troubling problem with FATCA implementation is the conflicts it creates with existing local regulations. In many jurisdictions, privacy laws prevent funds from disclosing information on their account holders. FATCA requires the FFI to obtain a waiver of privacy rights from each U.S. investor and to close the account if the U.S. individual refuses to provide it. But in some jurisdictions, local laws prohibit the FFI from closing the account.

Other jurisdictions forbid a financial institution to impose withholding that is not mandated by local law. Unless these conflict-of-law issues are resolved, a fund sponsor could be faced with the unpleasant choice of suffering withholding due to failure to comply with FATCA or violating the local law in the fund's jurisdiction. Resolving these issues across multiple jurisdictions is likely to take some time.

*Unless some 'conflict-of-law' issues are resolved, a fund sponsor could be faced with the unpleasant choice between suffering withholding due to failure to comply with FATCA or violating local law in the fund's jurisdiction.*

<sup>6</sup> FATCA and The Funds Industry: Defining the Path, KPMG survey, June 2011

## FATCA TIMELINE

FATCA is slated for phased implementation beginning in 2013. All FFIs that wish to avoid FATCA withholding on U.S. investments need to sign a FATCA agreement with the IRS by 30 June 2013.

Due diligence on investors is required for all new accounts opened after 1 July 2013. Due diligence on existing investors will be implemented in phases, with the first phase due to be complete on 30 June 2014.

A U.S. fund would be expected to begin withholding on distributions, but not redemptions, in January 2014; withholding on redemptions paid by a U.S. fund and on redemptions and passthru payments paid by a foreign-domiciled fund begins a year later.

It is clearly challenging that so many details of FATCA's implementation remain to be clarified. Industry bodies and affected organisations globally have called for more time to be granted before implementation and for clear guidance as soon as possible.

## FATCA DEMANDS YOUR ATTENTION

Some funds will choose to outsource their FATCA operations (due diligence, withholding, reporting) to their fund administrator; Northern Trust is preparing to assist our clients to meet their compliance obligations.

But managers cannot afford to assume their fund administrator will take care of everything for them. Nor should managers assume their tax department will take care of the problem. FATCA requirements may cause you to adjust your business model – the nature of your investments, the type of investors you will allow and your choice of distribution channels.

While it may not be possible for managers to implement practical solutions until FATCA regulations have been finalised, significant groundwork can and should be carried out now. The list below summarises key questions on FATCA – the answers to these questions may help formulate approaches to tackling FATCA.

## KEY DATES

### 30 June 2013

- Deadline for executing agreement with the IRS for FFIs

### 1 July 2013

- Due diligence required on new accounts from this date

### 1 January 2014

- U.S. institutions expected to begin withholding on distributions

### 1 January 2015

- FFIs expected to begin withholding on redemptions and passthru payments.
- U.S. institutions expected to begin withholding on redemptions

## FORMULATING YOUR RESPONSE TO FATCA – QUESTIONS AND CONSIDERATIONS INCLUDE:

- Do you understand your funds' legal obligations under FATCA?
- Will your funds choose to comply with FATCA?
- Have you identified a chief compliance officer?
- Do you have the type of investors that may present due diligence challenges?
- Are nominee companies and distributors planning to comply, or will you be forced to withhold on them?
- Will you choose to modify your agreements with distributors?
- When should you alert investors of the need to provide you with additional information?
- Do you invest in foreign-domiciled funds? Are these planning to be FATCA-compliant?
- Will you choose to change your agreements with distributors?
- Will you outsource some FATCA compliance functions to vendors?
- Are your vendors preparing for FATCA?
- Do conflict-of-law issues prevent you from complying with FATCA requirements?
- Should you establish an internal group to coordinate the FFI application process?

*Fund managers are one of the groups on which the burden of FATCA most clearly and obviously falls and FACTA is very much an industry-wide concern.*

At Northern Trust, we are committed to sharing our best understanding of FATCA as more details emerge of how it will be implemented, and to supporting managers with their preparations for its impact.

#### FOR MORE INFORMATION

Northern Trust is preparing for FATCA and is actively engaged in industry working groups to participate in the rulemaking process, and to determine how we can help our clients meet their obligations. If you would like to talk to us regarding any of the topics covered, please contact your Northern Trust representative.

Northern Trust Corporation, Head Office: 50 South La Salle Street, Chicago, Illinois 60603 U.S.A., incorporated with limited liability in the U.S.

The Northern Trust Company, London Branch (reg. no. BR001960), Northern Trust Global Investments Limited (reg. no. 03929218) and Northern Trust Global Services Limited (reg. no. 04795756) are authorised and regulated by the Financial Services Authority.

The material within and any linked material accessed via this communication is directed to eligible counterparties and professional clients only and should not be distributed to or relied upon by retail investors. For Asia Pacific markets, it is directed to institutional investors, expert investors and professional investors only and should not be relied upon by retail investors.

Northern Trust (Guernsey) Limited, Northern Trust Fiduciary Services (Guernsey) Limited, and Northern Trust International Fund Administration Services (Guernsey) Limited are licensed by the Guernsey Financial Services Commission. Northern Trust International Fund Administrators (Jersey) Limited and Northern Trust Fiduciary Services (Jersey) Limited are regulated by the Jersey Financial Services Commission. Northern Trust International Fund Administration Services (Ireland) Limited, Northern Trust Securities Services (Ireland) Limited and Northern Trust Fiduciary Services (Ireland) Limited are regulated by the Central Bank of Ireland. Northern Trust Global Services Limited has a Luxembourg Branch, which is authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF). Northern Trust Luxembourg Management Company S.A. is regulated by the Commission de Surveillance du Secteur Financier (CSSF). Northern Trust Global Investments Limited has a Netherlands branch, which is authorised by the Financial Services Authority and subject to regulation in the Netherlands by the Autoriteit Financiële Markten. Northern Trust Global Services Limited has a Netherlands Branch, which is authorised and regulated in the Netherlands by De Nederlandsche Bank. Northern Trust Global Investments Limited has a Sweden branch, which is authorised by the Financial Services Authority and subject to regulation in Sweden by the Finansinspektionen. Northern Trust Global Services Ltd (UK) Sweden Filial is authorised by the Financial Services Authority and subject to regulation by the Finansinspektionen. Northern Trust Global Services Limited operates in Abu Dhabi as a Representative Office. Our registered office is authorised and regulated by the Central Bank of the United Arab Emirates. The Northern Trust Company operates in Australia as a foreign authorised deposit-taking institution (foreign ADI) and is regulated by the Australian Prudential Regulation Authority. The Northern Trust Company has a branch in China regulated by the China Banking Regulatory Commission. The Northern Trust Company of Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission. Northern Trust Global Investments Japan, K.K. is regulated by the Japan Financial Services Agency. The Northern Trust Company has a Singapore Branch, which is a foreign wholesale bank regulated by the Monetary Authority of Singapore. The Northern Trust Company operates in Canada as The Northern Trust Company, Canada Branch, which is an authorised foreign bank branch under the Bank Act (Canada). Trustee related services in Canada are provided by the wholly owned subsidiary The Northern Trust Company, Canada, an authorised trust company under the Trust & Loans Companies Act (Canada). Deposits with The Northern Trust Company and its affiliates and subsidiaries are not insured by the Canada Deposit Insurance Corporation.

**IRS CIRCULAR 230 NOTICE:** To the extent that this message or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. For more information about this notice, see <http://www.northerntrust.com/circular230>.

**LEGAL, INVESTMENT AND TAX NOTICE:** This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Client should under no circumstances rely upon this information as a substitute for obtaining specific legal or tax advice from their own legal or tax advisors.

All information has been obtained from sources believed to be reliable, but accuracy and interpretation are not guaranteed.



[northerntrust.com](http://northerntrust.com)



Northern Trust