insights

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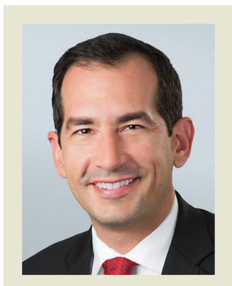
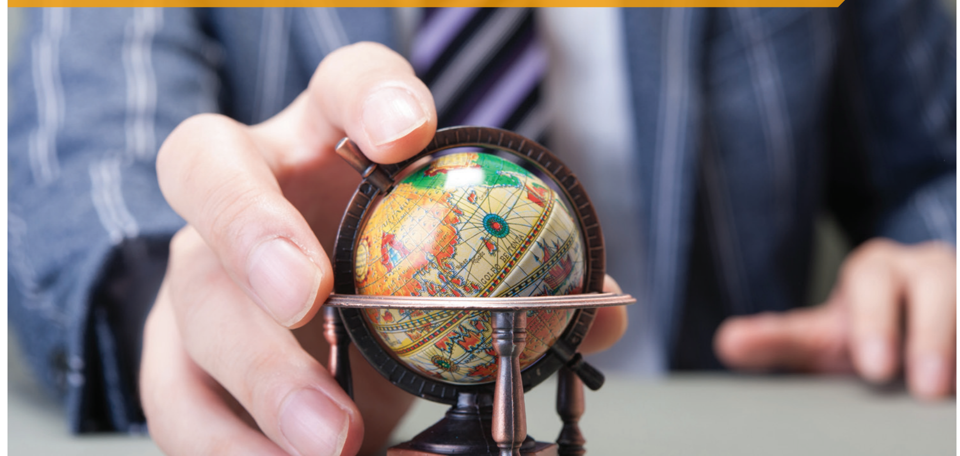
FATCA Compliance:

Documentation for an Investment Fund

In the Fall 2012 issue of *insights*, Tom Cotter (then a Shumaker attorney) discussed the proposed Foreign Account Tax Compliance Act ("FATCA") documentation requirements that were to begin phasing in January 1, 2013. The goal of FATCA is to increase federal tax revenue and penalties from a wider global population of newly discovered U.S. persons, their accounts, and any advisors or representatives who help them evade U.S. tax laws. As explained in the Fall 2012 article, since the U.S. does not have direct jurisdiction over foreign recipients of U.S.-sourced income, FATCA encourages compliance by requiring U.S. persons that make payments overseas to comply with documentation requirements and withhold a 30% penalty tax from the payment, unless an exemption applies. A failure to comply can lead to penalties against the U.S. person.



by John P. Dombrowski



FATCA requires withholding agents to document each recipient of a payment that leaves the U.S.

Shumaker recently represented a domestic hedge fund that added European investors. The fund was setup as a domestic limited partnership designed to purchase and hold a domestic operating target corporation. Although both the limited partnership and operating corporation are based in the U.S., since the fund is designed to eventually send gains offshore, FATCA required the firm to identify, classify and report all investors in the fund.

FATCA requires withholding agents to document each recipient of a payment that leaves the U.S. A "withholding agent" is defined as "all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment." A "withholdable payment" is defined as "any payment of interest (including any original issue discount), 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 United States, 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."

In the context of an investment fund, this means any person or entity that anticipates transferring money from the U.S. must determine who the ultimate

beneficiary of those funds will be, both for reporting purposes and for withholding purposes. Whereas Form W-9 is used to obtain the necessary reporting information for payments made to U.S. persons, W-8 forms are used to obtain the necessary information from foreign individuals and entities. Unlike the W-9 regime which utilizes a single form, however, the W-8 offers five different forms to choose from depending on the identity of the foreign recipient receiving the income (i.e. individual, corporation, partnership, trust, or foreign government or organization) and the type of income being earned.

The following is a step-by-step guide for withholding agents to follow to comply with FATCA reporting requirements as they pertain to foreign investors:

1. **Determine if the payment is derived from effectively connected income ("ECI") or not.**

   If the withholdable payment emanates from ECI, the foreign taxpayer must submit a Form W-8ECI to the withholding agent, in addition to being subject to other U.S. tax reporting requirements. If the payment is not from ECI, then go to step 2 below for advice on the appropriate W-8 form.

   A foreign individual or entity must first have a U.S. trade or business in order to have effectively connected income. According to Field Service Advisory 199909004, the active trade of securities is considered a U.S. trade or business, whereas the mere investment in securities will not be classified as such. While no bright line test exists to distinguish an investor from an active trader, courts have stated that the relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions. Whereas an investor is primarily interested in the long-term growth potential of stocks, an active trader purchases and sells securities with reasonable frequency in an endeavor to catch the swings in the daily market movements.

   In the context of Shumaker's recent representation of the hedge fund, this required us to examine the activities of the limited partnership itself, since determination of whether or not each nonresident partner investor will be engaged in a U.S. trade or business is made at the partnership, rather than the partner, level. Since the partnership aims to purchase and hold the shares of the operating entity target, we determined the partnership's activities will not rise to the level of active trading, and therefore the nonresident partner investors will not be engaged in a U.S. trade or business. Because the investor partners will not be engaged in a U.S. trade or business, they were required to submit a W-8 form aside from Form W-8ECI.

2. **If the payment is not derived from ECI, determine the right type of form.**

   If there is no effectively connected income involved, then the identity of the foreign recipient determines the appropriate W-8 form to comply with FATCA, and the following table can be used:

FOREIGN RECIPIENTS	DESIGNATED W-8 FORMS
Individuals	W-8BEN
Foreign Intermediaries, Foreign Flow-Through Entities, and certain U.S. branches of foreign entities	W-8IMY
Entities Not Taxed as Flow-Through or Disregarded Entities	W-8BEN-E
Foreign Government or Other Exempt Foreign Organization	W-8EXP

   As shown above, if the nonresident investor is an individual, Form W-8BEN is applicable. If the investor is a foreign government or other foreign exempt entity, then Form W-8EXP is the appropriate form. If neither of the preceding applies, FATCA requires the withholding agent to determine if the entity is taxed as a flow-through entity or as a corporation in that entity's relevant tax jurisdiction.

   Considering the synonyms for "corporation" or "disregarded entity" that exist around the world, a withholding agent would be well advised to confirm the relevant entity's tax treatment with that entity's legal counsel since the forms that apply to flow-through entities and corporate-like entities are substantially similar.

3. **Common issues related to all W-8 forms.**

   Although the withholding agent is charged with reporting under FATCA, the recipient of the payments is responsible for filling out the form and returning it to the agent. Upon receipt, there are some common issues the withholding agent should review before accepting the form.

   First, each form requires the foreign individual or entity to provide a taxpayer identification ("ID") number. This ID number could be a U.S. taxpayer ID number (social security number or international taxpayer ID number ("ITIN")), a foreign tax identifying number ("FTIN"), or even a global intermediary ID number ("GIIN") in limited circumstances. From past experience, foreign taxpayers often neglect to provide this number; however, it is crucial to provide as each form requires an ID number except under a very limited set of circumstances.

Second, a part of the form often overlooked is the "Claim of Tax Treaty Benefits" section. Although the taxpayer may have provided the address elsewhere on the form, if the taxpayer fails to provide the country of residence in the relevant section (by writing in the country of residence and checking the relevant few box(es), depending on the form), the taxpayer will forgo the decreased rates of withholding potentially available under the applicable treaty. Even if the parties do not foresee the need to claim treaty benefits, clients are advised to claim the benefits now to provide flexibility if circumstances change in the future, especially since there is no downside to claiming these benefits.

In Shumaker's representation of the hedge fund, over 50% of the returned forms were either lacking an ID number or failed to claim treaty benefits.

4. **Classification issues common to Forms W-8BEN-E and W-8IMY.**

On Forms W-8BEN-E and W-8IMY, a taxpayer must document both "chapter 3" and "chapter 4" status. Chapter 3 status refers to defining the type of entity receiving the payment for withholding tax purposes. On Form W-8BEN-E (used for entities taxed as corporations), the choices include many of the common business forms such as a corporation, estate, and grantor trust. On Form W-8IMY (used for entities taxed as partnerships), the choices include many common "pass-through" entity forms including a withholding foreign partnership, qualified intermediary, nonqualified intermediary, and U.S. branch of a foreign entity.

On the other hand, chapter 4 status defines the type of entity by way of activity and reporting requirements. A taxpayer must first decide whether to classify itself as a foreign financial institution ("FFI") or non-financial foreign entity ("NFFE"), as the classifications are generally divided by this determination aside from a few unique classifications such as an exempt retirement plan or international organization. Even this initial decision, however, must be approached with caution depending on an entity's investment activities. For example, in the above-described hedge fund the firm helped set up, one the investors was an Isle of Man corporation organized to acquire and hold interests in the hedge fund. Treasury Regulations define an FFI as an entity that (among other things) "is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities." Although the investor entity was organized specifically to invest in a partnership, which makes it appear analogous to an FFI, we ultimately classified the entity as an NFFE since its investment activity (i.e. one investment meant to be held for the long term) failed to rise to the level of an active investment trade or business. Unfortunately, after making this initial determination, a taxpayer is then faced with a labyrinth of regulations to come to a conclusion as to which of the 31 different FATCA classifications to choose.

Conclusion

When foreign investment comes into the U.S., the withholding agent carries the burden of compliance in both terms of reporting and withholding the correct amount for U.S. income tax purposes. For reporting purposes, the withholding agent needs to (1) know the investment (i.e will it generate ECI or not), (2) determine the right form, (3) know how to correctly fill out each form, and (4) know all of the various FATCA classifications used to identify certain entities. Due to the difficulty in understanding the FATCA regulations, withholding agents should work closely with their foreign investors to determine the right choices at each step throughout the process, since a failure to properly fill out the form could result in a loss of income tax treaty benefits for the investor.

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