

US Tax Reporting and its Impact on the AM Industry

Foreign Account Tax Compliance (FATCA)

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New rules on withholding tax might impact performance

The United States of America (US) have on March 18, 2010, enacted new tax provisions which tighten the US tax reporting for the financial sector. Every financial intermediary will in principle be asked to sign a contract with the US tax authorities and to comply with certain reporting obligations. In case of non-compliance, expanded withholding tax might significantly impact the performance of investment products. US dividends, US interest and gross proceeds from the sale of US assets might be subject to 30% withholding tax. Although US tax reporting was until today a topic dealt with by banks, actors in the investment management industry need to be aware of the changes and potentially adapt their business model. In addition, changed withholding tax provisions regarding certain derivative transactions might also impact the product offering.

General Overview

On March 18, 2010, the final version of the highly anticipated Foreign Account Tax Compliance Act of 2009 ("FATCA") became law as part of the Hiring Incentives to Restore Employment ("HIRE") Act. The law creates a new chapter of the US tax code that is focused on strengthening information reporting and withholding compliance with respect to US persons that invest through or in non-US entities.

The most significant provisions are discussed in more detail below, but, at a high level, the main aspects cover:

- the withholding at source of payments made to either a "foreign financial institution" or a "foreign non-financial entity";
- the treatment of bearer obligations traditionally used by US borrowers to access the Eurobond market;
- the treatment of "dividend equivalents" determined by reference to US securities.

Currently, payments made to most non-US investment vehicles are subject to the following US withholding tax: 30% (or reduced rate under a double tax treaty) on US dividends, 0% (portfolio exemption) on most US interest (otherwise, 30% or reduced treaty rate), and no withholding tax on proceeds or gains on the sale of US securities.

Although this will in principle not change, the new legislation results in an unfavourable 30% withholding tax on the following income (withholdable payments) if the expanded documentation and reporting obligations are not met:

- US sourced dividends;
- US sourced interest; and
- Gross proceeds from the sale of assets which could produce US sourced interest and US sourced dividends.

Namely the 30% withholding tax on sales proceeds would in case of non-compliance impact the performance of the product and severely reduce the capital invested.

These rules will be effective for payments made on or after January 1, 2013.

Payments to Foreign Financial Institutions (“FFI”)

The definition of an FFI is expansive. It includes any foreign entity that

- (1) accepts deposits in the ordinary course of a banking or similar business,
- (2) is engaged in the business of holding financial assets for the account of others, or
- (3) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, interest in partnerships, commodities or any interest (including futures or forward contracts or options) in such securities, partnership interest or commodities.

Accordingly, the term may include a number of different entities, including investment vehicles such as hedge funds, private equity funds and certain insurance products.

FATCA requires a 30% withholding tax on any withholdable payment (ie US dividend, US interest and gross proceeds from the sale of US securities) made to an FFI, unless the FFI enters into an agreement with the US tax authorities to:

- obtain information from each account holder (and investor) as is necessary to determine which accounts are “US accounts”;
- comply with verification and due diligence procedures;
- report annually certain information (incl. name of investor, investment volume, income paid etc.) to the US tax authorities;
- provide US tax authorities with further information upon request; and
- attempt to obtain a waiver in any case in which foreign (e.g. Luxembourg) law would prevent reporting of such information.

It is important to note that the law introduces a “look-through-approach” under which not only the direct US investors but also the ultimate US investors are to be identified and disclosed to the US tax authorities.

Payments to Foreign Non-Financial Entities (“NFFE”)

In general, a withholding agent shall deduct and withhold 30% tax from withholdable payments (as defined above) made to entities other than FFI. A withholding agent is however not required to do so if:

- the NFFE discloses the name, address and US tax identification number of any substantial US owner or certifies the absence thereof;
- the withholding agent has no reason to know that such certification is incorrect; and
- the withholding agent reports the name, address and tax identification number of such owner to the US tax authorities.

As applicable for FFIs, the identification of substantial US owners follows again a “look-through-approach”. Ultimate US beneficial owners need to be identified even in case of tiered structures.

Interest on Bearer Debt

Prior to the effective date of the HIRE Act, the law provided favourable tax treatment for interest on certain bearer debt to issuers and non-US beneficial owners if the bearer debt is issued under arrangements reasonably designed to ensure sale only to non-US persons ("foreign-targeted") and certain other requirements are met. Simplified speaking, the HIRE eliminates certain foreign-targeted exceptions. The main feature impacting the non-US fund industry is the elimination of the exemption from withholding tax on interest ("portfolio exemption") in case of interest on registration-required bearer debt that is foreign-targeted. As a result, many interest payments made on bearer bonds issued by a US issuer after March 18, 2012, might be subject to 30% US withholding tax.

Dividend Equivalent Payments

The HIRE Act changes the tax treatment of certain derivatives over US equities by making so-called "dividend equivalent payments" made by reference to US equity subject to gross basis tax and associated withholding tax. The HIRE Act defines "dividend equivalent" as

- (1) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction ("repo") that is contingent upon, or determined by reference to, the payment of a US source dividend;
- (2) any payment made pursuant to a "specified notional principal contract" that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a US source dividend; and
- (3) any other payment the Secretary determines is substantially similar to (1) or (2) above.

Different effective dates apply depending on the type of contract. For securities lending and repo transactions (even existing contracts), the new rules apply to dividend equivalent payments made on or after September 18, 2010 (ie 180 days after enactment).

For notional principal contracts (eg swaps), the HIRE Act has a phased effective date (ie 180 days to two years after enactment). Depending on the conditions of every single transaction, the new rules might therefore already be applicable for payments made on or after September 18, 2010. At the latest for payments made on or after March 18, 2012, the HIRE Act will apply to all such contracts.

Impact on Industry and Outstanding Questions

Although the new legislation clearly intends to identify US investors investing in non-US structures and investment vehicles, the legislative language is unclear in many aspects, out of which only some are mentioned below. The law authorizes the Secretary to issue regulations to provide guidance as well as exceptions.

One important question relates to the scope of the new law, ie whether or not and to what extent an investment vehicle is considered an FFI. Although "widely held investment trusts" and investments in vehicles which are "regularly traded on an established securities market" are meant to be excluded, the definition of such vehicles and the conditions under which they are carved out are unclear.

FFI as well as NFFE will be required to identify and potentially disclose the identity of their ultimate beneficial owners and investors. Professional confidentiality (eg banking secrecy) might force FFI to close accounts with such account holders and

investors who do not agree to being disclosed. In addition, problems occur in practice depending on the product and the distribution channels if ultimate investors are not or only partially known to the FFI. In theory, the FFI has to apply the withholding tax only on the percentage of its investors which are undisclosed US persons or unknown. In this respect, legislative language is however unclear and withholding agents and depositary banks would in practice need to agree to such procedure.

In addition, all actors in the financial services industry will need to carefully analyze the service providers they are dealing with. As soon as there is one non-compliant FFI in the chain of payments, withholding tax is withheld at this level. This might significantly impact the performance as refund of taxes overwithheld is almost impossible. This is an aspect to be also analysed from a risk management perspective.

As conclusion, FATCA and the other provisions of the HIRE Act are likely to change the financial services landscape. They are in line with the international trend towards more transparency. Significant operational changes might be required and the related cost important. Although many open questions exist, namely regarding the investment management industry, the impact needs to be analysed on a case-by-case basis, resulting in important reflexions on the current business model and product offering.

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