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FATCA

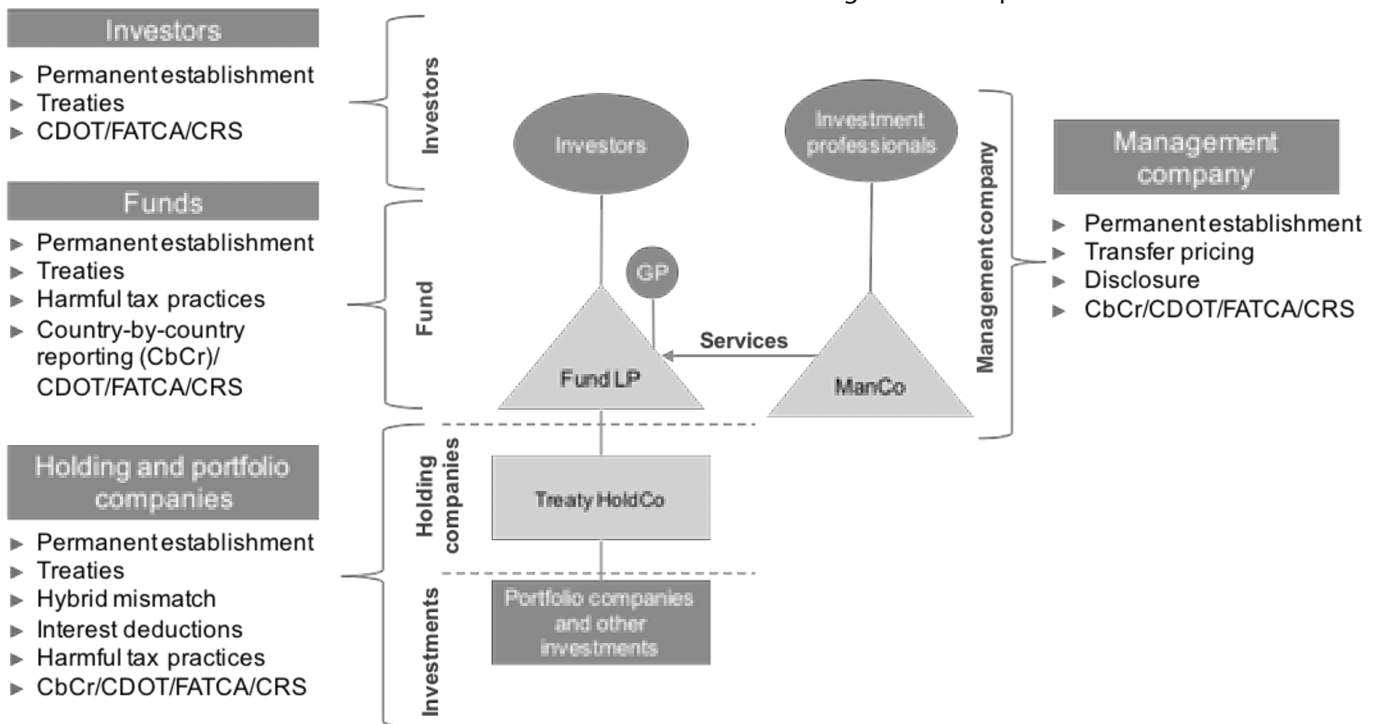
Steps That Alternative Investment Fund Managers Need to Take Today to Comply With the Global Trend Toward Tax Transparency (Part One of Two)

By Dmitri Semenov, Jun Li, Lucas Rachuba and Carter Vinson

Ernst & Young LLP

If one word can describe the focus of international tax policy today, that word is transparency. Taxing authorities around the world continue to demand increased levels of transparency and reporting from alternative investment funds (AIFs) and other financial institutions with respect to their investors, business operations and transactions. Tax planning is no longer limited to discussions between tax lawyers and accountants. It is making its way to the forefront of the national media.

As illustrated in the following diagram, this increased focus on transparency will create significant implications from the planning and compliance perspectives for AIFs, their management companies and investors:



Despite the obvious challenges, taking a proactive approach to reporting and planning issues arising from recent initiatives could help better position AIFs from the competitive perspective. For instance, understanding transaction data and having better transfer pricing support could lead to more robust long-term planning solutions, and better investor data should facilitate marketing and investor relations initiatives.

In a two-part guest series, Dmitri Semenov, Jun Li, Lucas Rachuba and Carter Vinson of Ernst & Young (EY) highlight challenges and recommend steps

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for AIFs to take to meet global planning and reporting issues associated with increased transparency demands arising from global initiatives including U.S. Foreign Account Tax Compliance Act (FATCA), U.K. Crown Dependencies and Offshore Territories (CDOT), Common Reporting Standards (CRS), Base Erosion and Profit Shifting (BEPS), State Aid and the European Union anti-avoidance measures. The following diagram provides a high-level summary of some of these issues:

Reporting considerations
Immediate areas of focus

- **CRS** requires AIFs to conduct diligence (55 countries starting in 2016 and another 40 starting in 2018) and report (starting in 2017) on their investors. FATCA will continue to apply to diligence of U.S. investors as long as the U.S. does not agree to follow the CRS regime, but this may change in the future.
- **CDOT** requires diligence (starting in 2014) and reporting (due May 31, 2016) on specific U.K. persons investing in U.K. and CDOT entities. CDOT will be replaced with CRS in 2018.
- **BEPS country-by-country reporting (Action 13)** requires companies to use a consistent three-tier framework for providing information on global allocation of income, economic activity and intercompany pricing across all of a company's global operations.

Planning considerations
Long-term considerations

- **BEPS treaty access (Action 6)** aims to restrict treaty abuses and limit treaty access to qualifying persons only and/or to transactions where obtaining the benefits of the tax treaty is not a main purpose.
- **BEPS permanent establishment (Action 7)** focuses on defining the concept of permanent establishment to create key value drivers and decisions.
- **BEPS finance deductions and hybrids (Actions 2 and 4)** aim to prevent tax advantages relating to hybrid instruments or entities and excess interest deductions (relative to taxable profit) being deductible in a jurisdiction.
- **BEPS harmful tax practices (Action 5)** provides guidance on what qualifies as a ruling and best practices for cross-border rulings, as well as a framework for the compulsory spontaneous exchange of information on rulings.

This first article addresses global reporting considerations and areas on which AIFs should immediately focus. The second article will discuss planning and other long-term considerations for hedge funds and other AIFs to consider.

For more on tax transparency, see "*Understanding the Intricacies for Private Funds of Becoming and Remaining FATCA-Compliant*" (Sep. 12, 2013). For commentary from other EY professionals, see "*Critical Components of a Hedge Fund Manager Cybersecurity Program: Resources, Preparation, Coordination, Response and Mitigation*" (Jan. 15, 2015); and "*Considerations for Hedge Fund Managers Evaluating Forming Reinsurance Vehicles in the Cayman Islands*" (Sep. 4, 2014).

Global Reporting Considerations

From the reporting perspective, AIFs will need to learn how to deal with managing investor data and be able to report this data to taxing authorities around the globe on an annual basis. The U.S. FATCA, U.K. CDOT and CRS regimes are some of the examples of recent initiatives that will require additional reporting.

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TY2015 was the first year that AIF managers had to deal with reporting under U.S. FATCA rules focused on identifying certain U.S. investors and reporting them to the U.S. government and non-U.S. tax authorities in countries that concluded Model 1 FATCA intergovernmental agreements (IGAs) with the U.S. Beginning in 2016, reporting will also be required under U.K. CDOT regulations with respect to the 2014 and 2015 reporting years.[1]

In 2017, AIF managers will have to comply with CRS reporting in 55 early-adopting countries, and in 2018, compliance obligations will expand to include another 40 late-adopting countries. The early-adopting jurisdictions require onboarding processes in place effective January 1, 2016, to identify the tax residency of account holders and investors, including the mandatory gathering of tax residency self-certifications. The first reporting for CRS will be required to be filed in 2017 for the 2016 calendar year for early-adopting countries.

As a result of the FATCA/CRS/CDOT initiatives, AIFs will have to report information with respect to virtually every investor. Some of the key differences among FATCA, CRS and CDOT are summarized in the table below:

	U.S. FATCA	U.K. CDOT	CRS
Purpose	Identify/report certain U.S. persons	Identify/report certain U.K. and CDOT tax residents	Identify/report certain tax residents in CRS jurisdictions
Withholding	30% withholding may be required for noncompliance on U.S.-source income (except in Model 1 IGA jurisdictions)	No withholding	No withholding
Penalties	The traditional IRS penalty is 30% withholding on U.S.-source income (except in Model 1 IGA jurisdictions)	Penalties may be imposed under domestic law	Penalties may be imposed under domestic law
Reporting	2016 reporting for TY 2015; reporting financial institutions (FIs) must report gross proceeds (beginning 2017 for TY 2016)	2016 reporting for TY 2014 and TY 2015; gross proceeds must be reported (beginning 2017 for TY 2016)	2017 reporting for TY 2016 (early adopters); otherwise 2018 for TY 2017; gross proceeds must be reported
Responsible officer certification	Model 1 IGA: not applicable Model 2 IGA/participating foreign financial institutions: yes	Not applicable	Not applicable
Tax documentation	U.S. and non-IGA: W-8s/W-9s IGA: W-8s/W-9s and self-certification	Self-certification	Self-certification

Significant work will be required to oversee the efforts of administrators; address technical and procedural issues; and comply with FATCA/CDOT/CRS rules. Some of the key action items are as follows:

- Develop FATCA/CDOT/CRS implementation plan;
- Review and determine whether any legal entity classification will need to be changed for purposes of CRS and CDOT;
- Document FATCA/CDOT/CRS legal entity creation and maintenance procedures;
- Identify controlling persons of passive nonfinancial entities (NFEs) to be reported on CRS self-certifications;
- Document FATCA/CDOT/CRS onboarding (investor, counterparty, vendor) procedures

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and conduct training;
- Assess quality, completeness and accessibility of data attributes relevant to FATCA/CDOT/CRS;
- Complete pre-existing investor due diligence;
- Capture and validate U.S. tax forms W-8 and W-9; and
- Develop and execute 2016 FATCA/CDOT reporting strategy.

The key reporting deadlines for FATCA, CRS and CDOT for 2016, 2017 and 2018 are as follows:

	2016 deadlines	2017 deadlines	2018 deadlines
FATCA	▸ March – TY15 reporting starts, including payments (new). ▸ June – Complete due diligence on all pre-existing existing accounts.	▸ March – TY16 reporting starts, including payments.	▸ March – TY17 reporting starts, including payments.
CDOT	▸ May – Complete investor due diligence on all accounts. ▸ 31 May – Reporting for TY14 and TY15 due.	▸ 31 May – Reporting for TY16 due.	▸ 31 May – Reporting for TY17 due.
CRS*	▸ 1 January – Investor onboarding for early adopters begins. ▸ 31 December – Complete review of "High Value" individual pre-existing accounts.	▸ 1 January – Investor onboarding for 2018 reporters begins. ▸ March – TY16 reporting starts, including gross proceeds. ▸ 31 December – Complete due diligence on all other pre-existing accounts.	▸ March – TY17 reporting for early adopters starts, including gross proceeds. ▸ March – TY17 reporting for 2018 reporters starts, including gross proceeds.

** This assumes all current proposals will be enacted*

Global Planning Considerations

BEPS Initiative Generally

From the planning perspective, AIF managers need to continue focusing on each transaction's economic substance and business purpose, which are the key focus areas of the BEPS initiative of the Organisation for Economic Co-operation and Development (OECD). Late last year, the OECD released final reports on 15 focus areas in its Action Plan[2] on BEPS, which represent a fundamental change in international tax policy and provide recommendations to improve global transparency through minimum standards, reinforcement of international standards and best practices.

Considering that BEPS represents global tax policy recommendations, tax planning must be based on how various countries implement BEPS where AIFs invest and also take into account specific organizational and business requirements. See, e.g., "Luxembourg Funds Offer Options for Hedge Fund Managers to Access European and Global Investors" (Feb. 11, 2016).

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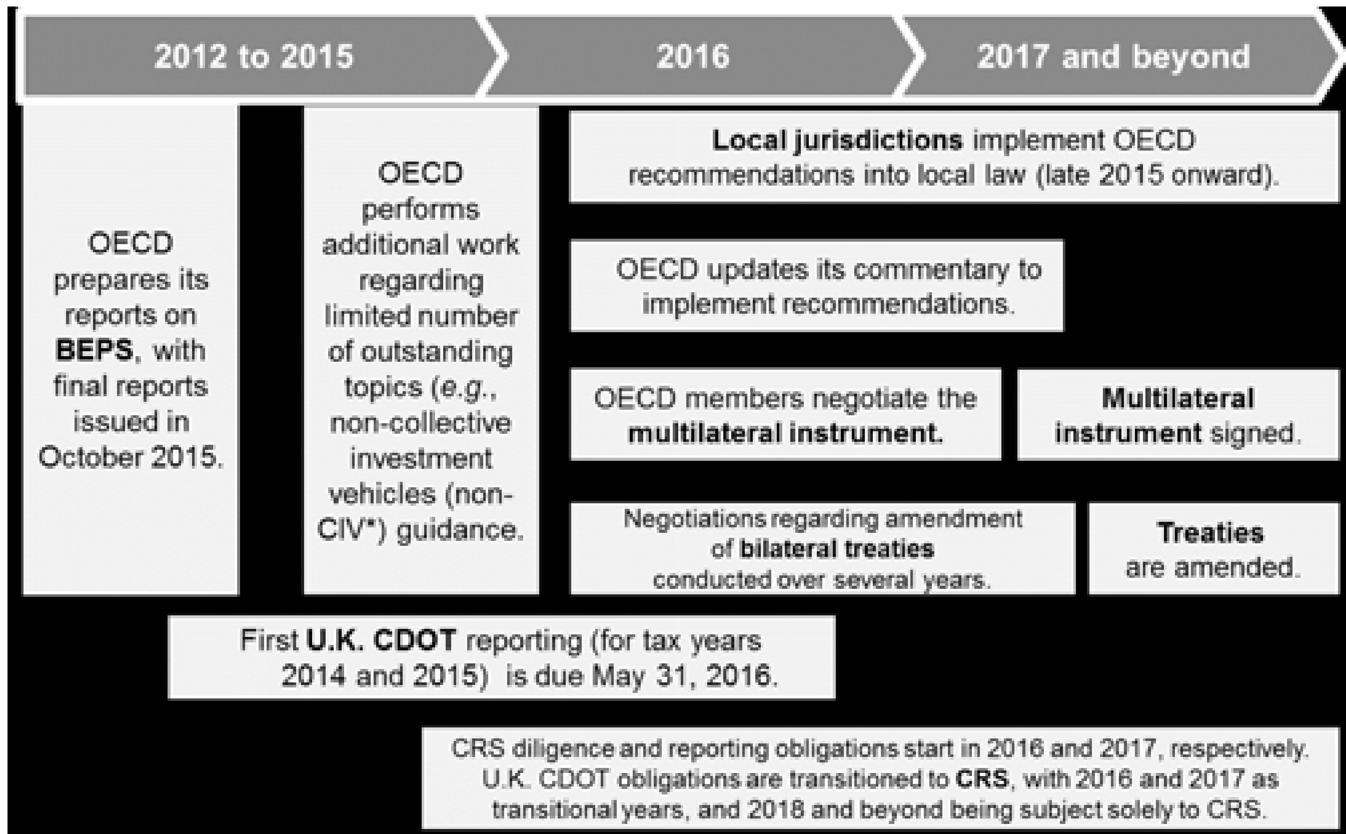
Key timing issues associated with the BEPS initiative are as follows:



Action 13: Transfer Pricing Documentation and CbCr

One of the immediate BEPS-related action items that AIFs and their managers need to focus on is the transfer pricing documentation and country-by-country reporting (CbCr) requirements of Action 13.

Action 13 aims to expand global transparency through the implementation of a new worldwide filing obligation for multinational groups with turnover in excess of €750m or $850m. Some of the key issues related to CbCr for AIFs are as follows:

CbCr for MNEs With €750m/$850m Turnover

AIFs and their management companies may have to submit CbCr to the extent there is a multinational enterprise (MNE) group (generally a chain of entities in two or more jurisdictions connected through at least 50% ownership) with a turnover of €750m/$850m. MNE groups would include many common AIF structures, such as U.S. management companies with a U.K. subsidiary or Cayman funds with a Luxembourg/Irish holding company that owns European portfolio companies or capital market investments.

Generally, management companies, funds and general partners (GPs) would be looked at as separate groups. However, the accounting consolidation rules are complex and need to be reviewed on a case-by-case basis. For instance, in certain cases, management company financial statements would include those of the funds that they manage.

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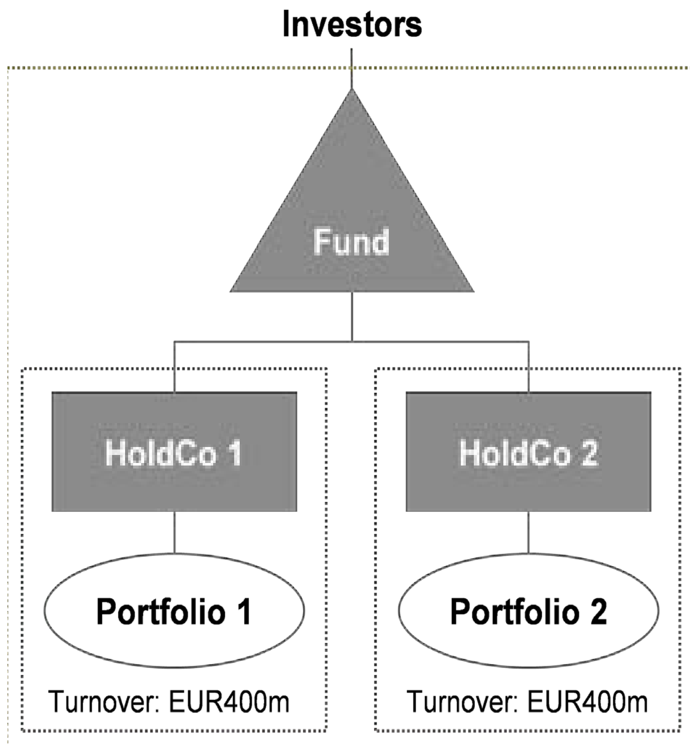

Multiple Management Company Reporting Requirements for 2016

Action 13 (as well as local country provisions implementing Action 13) generally requires country-by-country reports to be filed for the 2016 amounts in 2017, whereas the U.S. proposed regulations are expected to require filings for 2017 amounts in 2018. Due to this mismatch in timing, the U.S. management company (the parent entity) will not be required to report in 2017. However, subsidiaries in jurisdictions that do require reporting in 2017 may have to provide reports for the entire group in their respective jurisdictions. Therefore, it is important for managers to determine whether they are in scope for CbCr purposes and, if so, what they are required to report.

Fund-Reporting Structures

Cayman Islands and other common fund jurisdictions have not adopted Action 13 reporting requirements. Therefore, a special purpose vehicle (SPV) owned by an offshore feeder could be required to report for the entire group, or the group could choose a surrogate parent entity to do the reporting.

Key Planning Steps for AIF Managers

The following is a summary of the key planning steps that AIF managers should consider to address CbCr:

- Confirm Reporting Requirement: Determine whether the fund/management company constitutes an MNE group and has a turnover of €750m/$850m or more and is, therefore, required to report certain data in each jurisdiction in which it operates. This will likely require a detailed review of the structure to determine the entities that make up the group.
- Consider Availability of Data: If required, consider the steps needed to prepare for reporting, including what data is required and the proper process needed for reporting (e.g., putting systems in place). The documentation required to satisfy the CbCr obligations include:

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