
Becoming FATCA Compliant

Why asset managers
should prepare now

May 2011

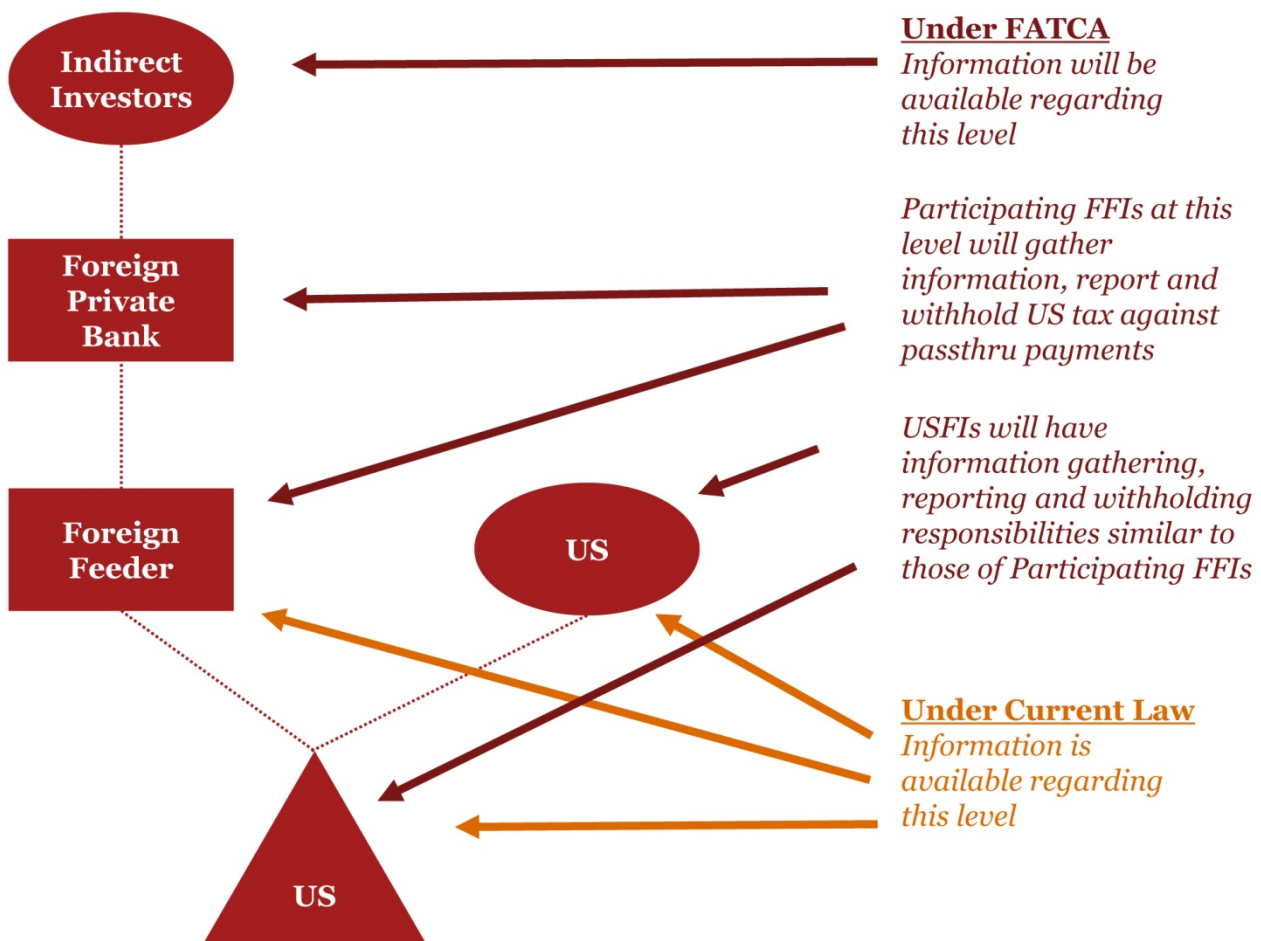


Heart of the matter

It's all about transparency!

Beginning January 1, 2013, the provisions of the Foreign Account Tax Compliance Act (FATCA) will impose a 30% US withholding tax on any US-sourced income and the gross proceeds from the sale of investments that produce US sourced interest or dividends (withholdable payments) received by any offshore fund or other foreign financial institution (FFI). This withholding tax is avoided if the FFI enters into an agreement with the US Government and agrees to comply with new documentation requirements, due diligence procedures, and reporting obligations. These new requirements are aimed at detecting US tax residents that may be evading US federal income tax by holding investments directly or indirectly through an FFI.

FATCA: What will the IRS be looking for?



In general, the new 30% withholding tax will apply to any withholdable payment received by an FFI after December 31, 2012, unless the FFI has entered into an agreement (FFI agreement) with the Internal Revenue Service (IRS). An FFI agreement will obligate the FFI to:

- **Obtain information** on each investor (account holder) that holds the FFI's equity or debt (accounts) **necessary to determine** which accounts are **US accounts** (i.e., accounts held, directly or indirectly, by certain US individuals or foreign entities with substantial US owners).
- Perform required **due diligence/verification procedures**, including searching its files for indicia of US status of the account holders (e.g., a US address associated with the account holder's account).
- **Seek waivers from its US account holders for any applicable bank secrecy, confidentiality, data privacy**, or other information disclosure restrictions that would otherwise limit the FFI's ability to share information with the IRS regarding its US account holders.

- **In some instances, close accounts** when it is not able to obtain these waivers.
- **Report** information on US accounts.
- **Deduct and withhold a 30% tax** on any passthru payment to any recalcitrant account holders or non-compliant FFIs.
- **Comply** with IRS information requests.

FATCA has important implications for the asset management industry.

FATCA carries important implications for the asset management industry by:

- Significantly increasing the types of payments that could be subject to US withholding tax, such as direct or indirect payments of gross proceeds, or payments on certain swaps, and the number of entities that could have liability for US tax on such payments, including offshore funds and offshore distribution channel intermediaries that hold, or through which others hold, direct or indirect interests in US investments
- Expanding the population of entities that will have US tax information gathering, withholding, and reporting responsibilities and potential financial exposures for non-compliance
- Increasing the business risks arising from relationships with third-party distribution intermediaries, through which indirect investors hold interests in funds, and with service providers upon which funds may rely for compliance
- Imposing US tax documentation requirements on direct and indirect US and non-US investors
- Forcing many in the industry to modify internal systems, control frameworks, processes, and procedures to meet FATCA compliance requirements, costing asset managers significant time and money

As a business matter, FATCA's tax provisions will compel most offshore funds that have meaningful direct or indirect US investments, including certain synthetic investments (e.g., through equity derivatives), to enter into FFI agreements. Otherwise, the 30% tax on gross proceeds from the disposition of investments, regardless of whether received directly through withholdable payments or deemed to have been received indirectly through passthru payments, will make most US investments uneconomical. If a fund has any material turnover, the tax could readily exceed the fund's net asset value.

Asset managers should consider several important elements relating to FATCA.

- FATCA generally will require funds (generally through their asset managers, administrators and/or other service providers) to search for specific investor attributes within their information repositories - and assign tentative FATCA-relevant classifications. Since many of the data attributes are likely to be new to many offshore funds, many will require changes to both data management systems and client on-boarding processes. Moreover, searching and aggregating information across multiple repositories may be an extremely complex exercise given the various operating models involving service providers and functional utilities.
- FATCA may require asset managers to contact existing clients to request additional information. This process will require careful coordination and tracking.
- New withholding responsibilities require additional systems capabilities and infrastructure to track for transactions producing withholdable or passthru payments and ensure necessary business rules for withholding are applied.
- Additional reporting requirements will require up-front information gathering and tracing various data elements and business rules.
- The Notices define various new or modified roles and responsibilities within the organization that may trigger changes to policies, procedures, and governance structure and processes.

As IRS and Treasury continue to issue additional guidance, the process for interpreting the guidance needs to be deliberately managed. Timely translation of additional guidance to business, operational, and technology implications will mitigate the risk of running out of time to implement changes necessary to comply by January 1, 2013.

Asset managers should not delay in assessing FATCA's impacts on their fund entities and operational functions.

FATCA compliance, particularly by offshore funds focused on alternative investments, will present substantial business and operational challenges, from the identification and documentation of investors, to the fund's portfolio and IT systems, which may affect multiple functions (tax, legal, back-office administration, operations, IT, etc.) and take substantial time and resources to address. Asset managers that complete a timely assessment of the critical business, tax, and operational impacts to their funds and operational functions arising from FATCA increase their opportunity to address the issues through a complete, effective, timely, and cost-efficient FATCA implementation program. Thus, offshore funds with long or synthetic, direct or indirect, exposures to US capital markets should begin to prepare for FATCA as soon as possible.

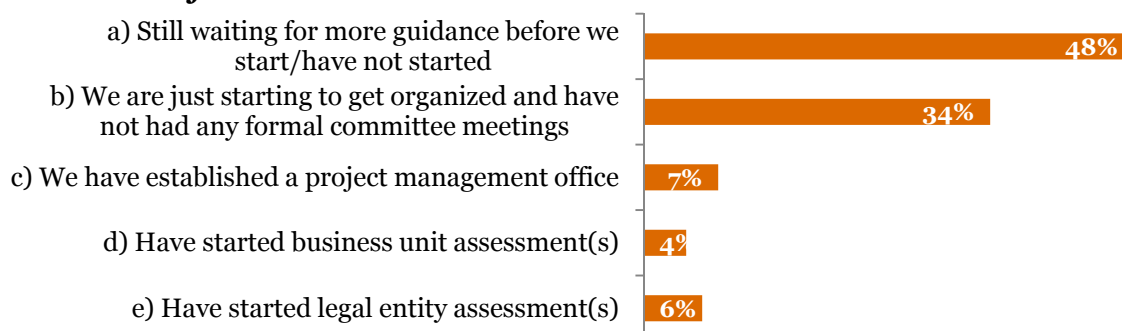
Some managers of fund groups (particularly small to mid-sized fund groups) had been waiting for additional guidance before preparing for FATCA. To date, US Department of Treasury (Treasury) and IRS have published two notices (the Notices) which set forth preliminary guidance with respect to certain priority issues involving the implementation of FATCA.¹ Treasury and the IRS intend to issue proposed regulations and related guidance incorporating the principles contained in the Notices and addressing other matters necessary to implement FATCA; however, it is unclear how soon such proposed regulations will be published.

In brief, based on the Notices, it generally appears likely that, under the proposed or final regulations, most private investment funds will be required to come within full compliance with FATCA in order to avoid suffering the 30% tax on all withholdable payments (e.g., US sourced dividends and interest and gross proceeds from the sale of US securities) and passthru payments. The Notices provide that Treasury and IRS intend to issue guidance under which certain offshore funds will be treated as "deemed-compliant" with FATCA if they comply with standards and procedures prescribed in final regulations which will be designed to ensure that such funds do not have direct or indirect US investors. However, even funds that qualify as deemed-compliant will be subject to certain obligations which will likely necessitate changes to their marketing and on-boarding, accounting and reporting policies and processes. Therefore, all fund managers, regardless of the size of their fund groups, should begin to assess FATCA's impacts on their funds and management company affiliates without delay.

FATCA poll results

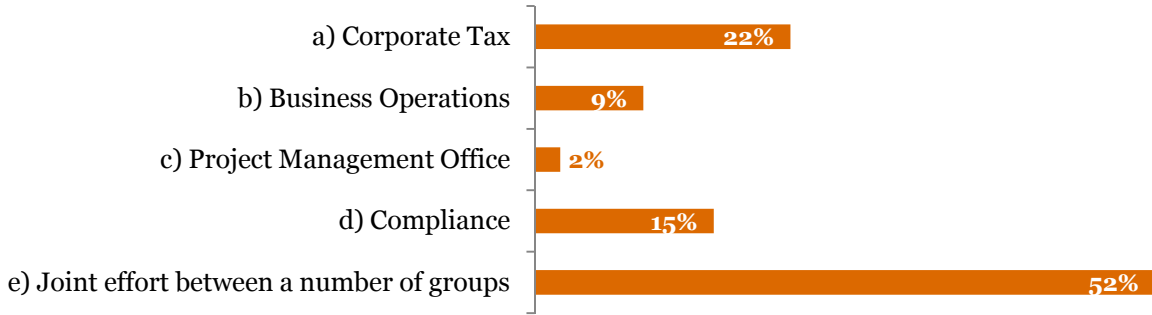
Prudent sponsors and managers of offshore funds have already begun analyzing the business impacts that FATCA will have on their funds and operational functions. In a recent webcast, PwC polled banks, mutual funds, insurance companies, broker dealers, and alternative investment firms likely to be affected by the new rules and asked, "How would you classify your company's progress in preparing for FATCA?" Of the mutual fund and alternative investment fund respondents, 48% said they were still waiting for more guidance before they would start preparing or had not begun preparations. Another 34% said they were just starting to get organized and had not had any formal committee meetings. Only 16% said they had completed a Phase 1 assessment. However, 62% said they plan to perform a Phase 1 scoping assessment over the next few months.

How would you classify your company's progress in preparing for FATCA?

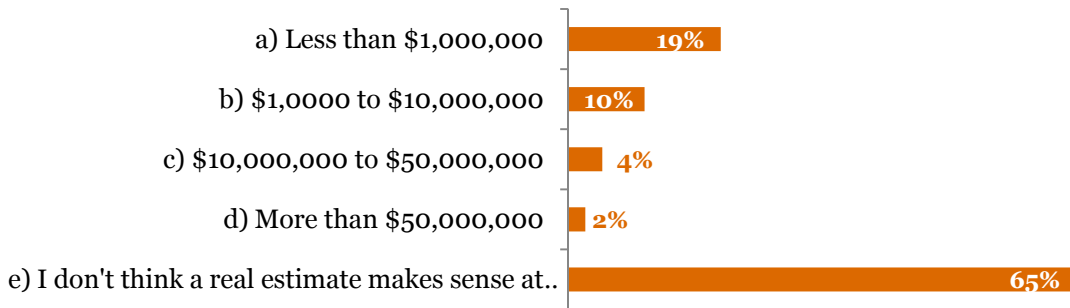


¹ Treasury and IRS issued Notice 2010-60 and Notice 2011-34 on August 27, 2010 and April 8, 2010, respectively.

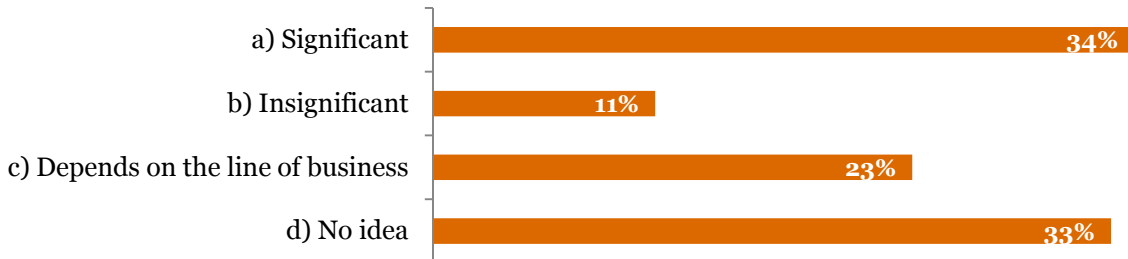
Who in your organization is primarily responsible for implementing FATCA?



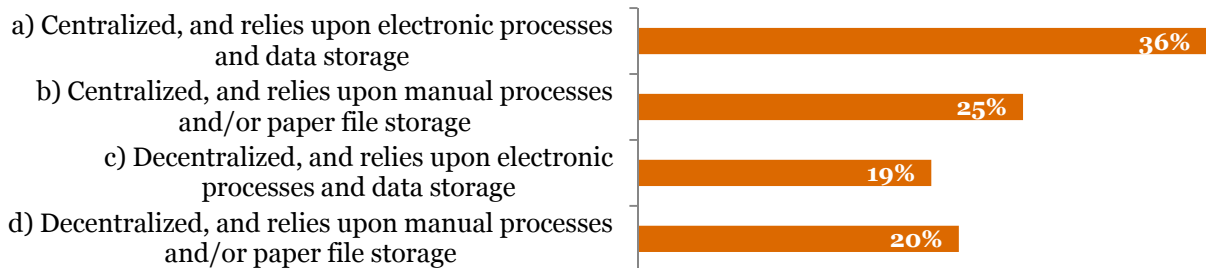
Have you estimated the cost to implement FATCA?



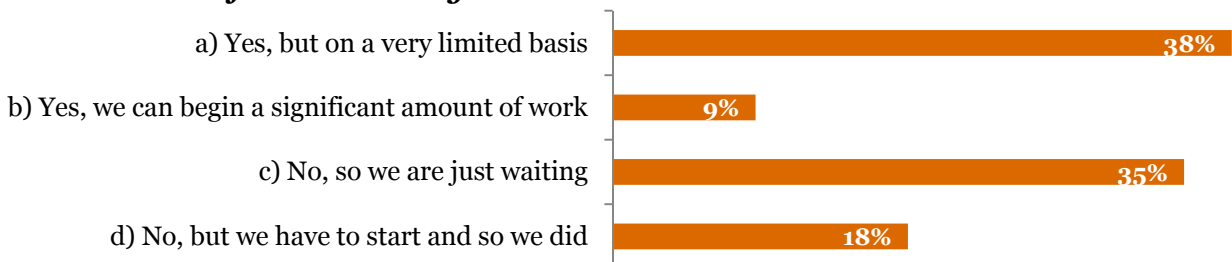
The amount of information that will reside solely in paper documentation is:



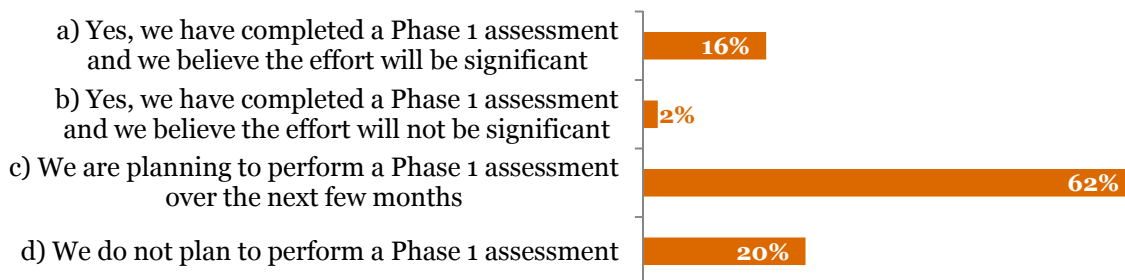
My company's account on-boarding process is:



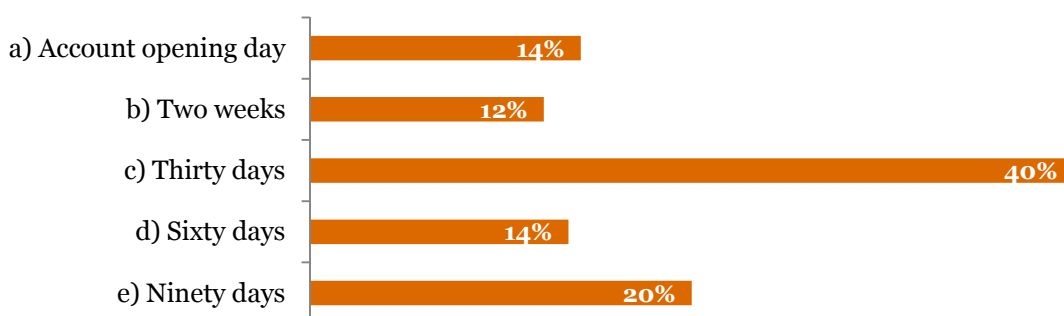
Based on current information do you believe you have enough information to begin?



Have you already or do you plan to conduct an initial assessment?



How long would you expect it take a new account to be compliant under Notice 2010-60?



Asset managers can take steps now to prepare for FATCA.

While many of the details about FATCA’s requirements remain unclear, based on what we know already there are a number of steps asset managers can and should take now to prepare for FATCA. Since FATCA will affect processes and systems, possibly throughout the organization, and require new and expanded information and reporting systems and procedures, preparing for it will require a multi-disciplinary effort. FATCA project teams of asset managers who have numerous third-party relationships, and broader and more varied distribution networks generally should include tax professionals, IT, operations, legal, and investor relations. Managers who have multiple outside service providers and distribution channels may face more complex business and implementation issues than those with fewer and less scattered third-party and distributor relationships.

Effective and timely FATCA preparation generally should start with a comprehensive impact assessment (FATCA Impact Assessment) which identifies and assesses the following based on current Treasury and IRS guidance:

- Tax issues affecting relevant fund groups and management company affiliates
- Business issues affecting internal and outsourced business functions and key business relationships, such as the adequacy of current subscription documentation, tax indemnity provisions, and service agreement provisions
- Data and operational gaps across people, process, and technology categories

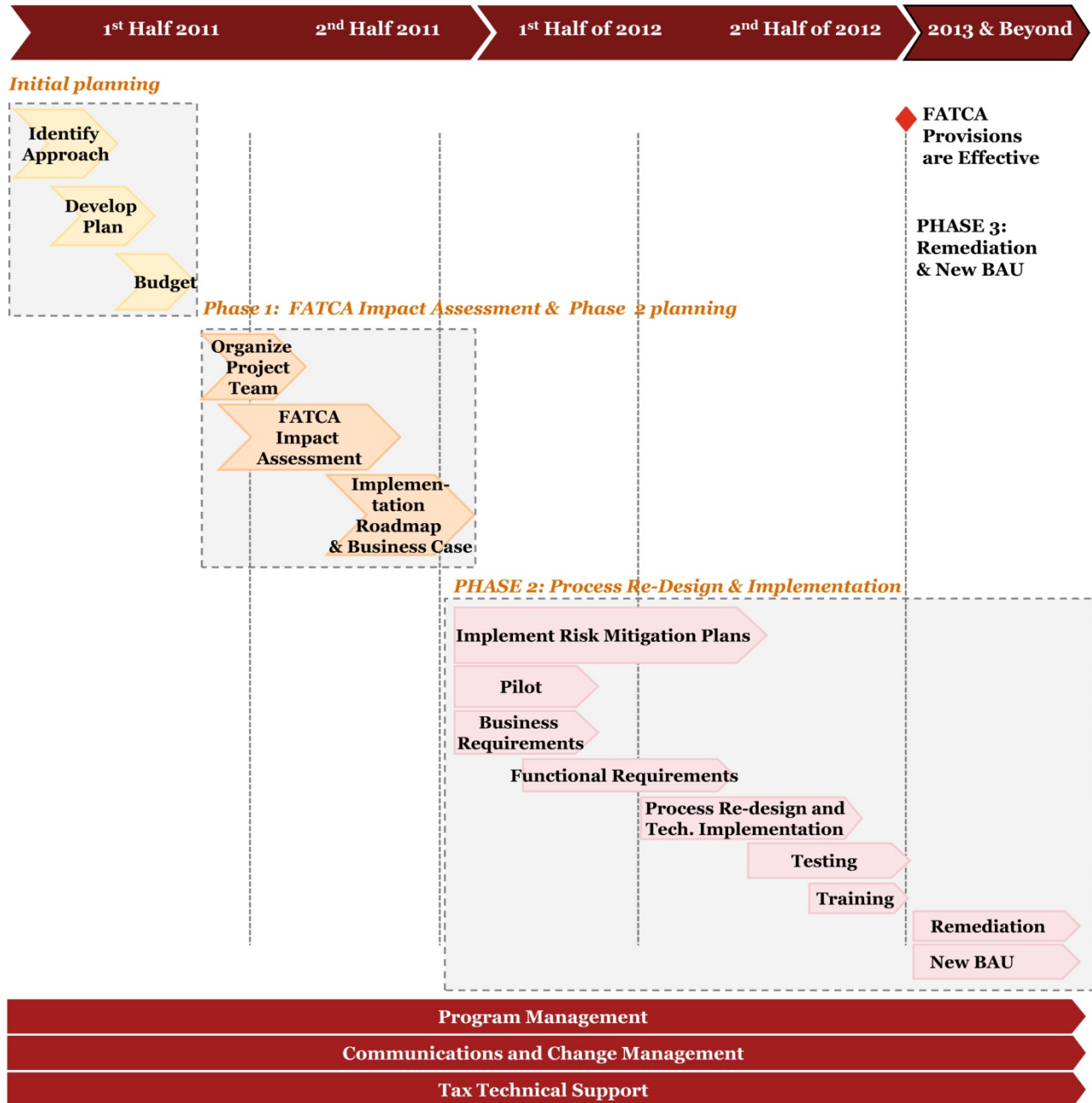
A typical FATCA Impact Assessment might include the following work-streams:

- **An investment products and services analysis.** An analysis of investment products and services designed to identify possible FFIs, USFIs, withholdable payments, passthru payments, etc., and assign risk profiles to relevant categories of funds and services.
- **A business impact analysis.** An analysis to identify likely data and operational process gaps based on internal and external on-boarding data collection and operational processes and an assessment of limitations of the existing technology to handle the additional data elements, withholding, and reporting requirements to be imposed by FATCA. This business impact assessment should also identify and analyze significant potential business and other non-tax issues relating to the channels used to distribute interests in the funds and reliance on third-party service providers, among others.

An effective FATCA preparation program should also be designed to:

- Educate internal stakeholders, including internal counsel, compliance, IT, and investor relations personnel, about FATCA's requirements
- Engage and mobilize a multidisciplinary, skilled, global FATCA team
- Develop an implementation roadmap
- Estimate funding required for implementation and remediation

Overview of FATCA implementation approach



Conclusion

Initiating a program now to identify and assess the critical business, tax, and operational impacts arising from FATCA will increase an asset manager's opportunity to address the business issues and implementation challenges through a complete, effective, and cost-efficient implementation program that will permit full compliance by January 1, 2013 (the effective date of FATCA's new documentation requirements, due diligence procedures, and reporting obligations).

To have a more in-depth conversation about any of these issues, please contact:

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