

# Alert

## FATCA Registration and Compliance Requirements for Hedge Funds

April 8, 2014

The Foreign Account Tax Compliance Act (“FATCA”) generally imposes registration, due diligence, withholding and reporting obligations on certain investment funds and investment fund managers. Under the U.S. Treasury regulations, foreign financial institutions (“FFIs”), including investment funds and investment managers that are organized outside of the U.S., would be required to register and enter into an agreement (an “FFI Agreement”) with the U.S. Internal Revenue Service (“IRS”) in order to ensure compliance with FATCA. In an effort to streamline these requirements, the U.S. has entered into Model 1 intergovernmental agreements (“IGAs”) with several jurisdictions, including the U.K. and the Cayman Islands. Under a Model 1 IGA, investment funds must register with the IRS, but will not be required to enter into an FFI Agreement. Instead, they will be obligated to comply with the local rules issued by the IGA partner country for the implementation of FATCA.

### **Cayman Islands Hedge Funds**

The standard Cayman Islands hedge fund structure generally includes one or more Cayman Islands entities, which will likely benefit from the Cayman IGA. The Cayman IGA describes the due diligence and reporting requirements for Cayman Islands financial entities. The details and procedures for satisfying such requirements will be clarified once the Cayman Islands government issues rules and regulations enabling the Cayman IGA. However, it is clear that almost all hedge fund entities located in the Cayman Islands will be required to register with the IRS in order to obtain a Global Intermediary Identification Number (a “GIIN”). The fund entities will then provide their GIIN on their respective Forms W-8 to indicate to their counterparties that they are compliant with FATCA. In certain limited circumstances, even investment management entities will be required to register and obtain a GIIN.

### *U.S.-Based Investment Managers*

Exhibit 1 depicts a common hedge fund structure for a U.S.-based investment manager (with certain SPVs included for illustrative purposes) and includes the entities that will be required to register with the IRS. Entities described as “FFIs” generally will be required to register with the IRS, unless they satisfy one of the limited exceptions contained in the Cayman IGA. The term “FFI” generally includes a Cayman Islands Master Fund, Cayman Islands Intermediate Fund and Cayman Islands Offshore Fund. It would also include any trading vehicles owned by these entities, including any Irish, Dutch or Luxembourg entities set up for specific investments, even if the trading vehicle is disregarded for U.S. tax purposes.<sup>1</sup> Based upon current U.S. Treasury regulations, any Cayman Islands subsidiary trading vehicle treated as a disregarded entity for U.S. tax purposes generally would not be required to register with the IRS, if its

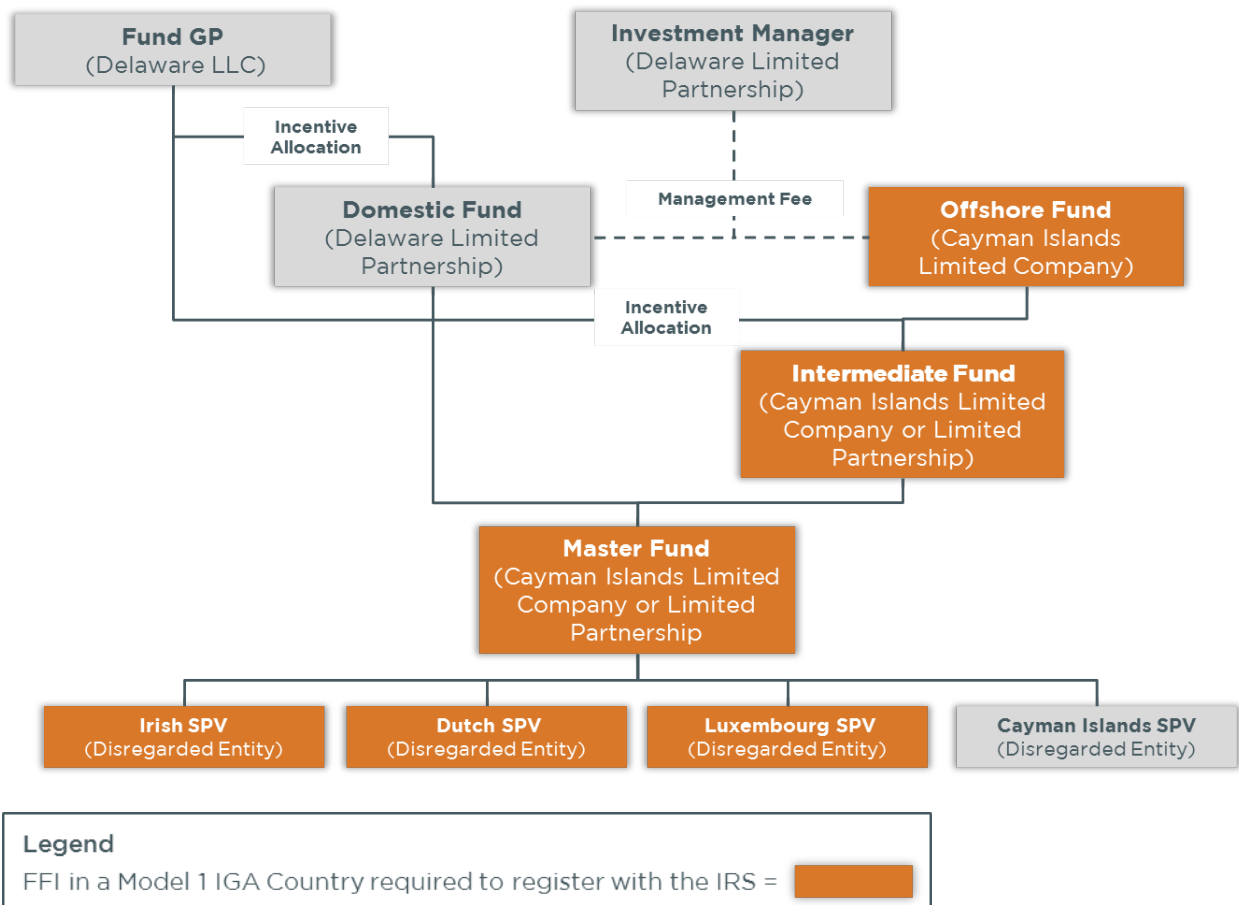
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<sup>1</sup> Ireland, the Netherlands and Luxembourg have each entered into a Model 1 IGA with the U.S.

sole owner is a Cayman Islands entity that has registered with the IRS.<sup>2</sup> However, this could change if the Cayman Islands rules enabling the IGA require all Cayman Islands financial institutions to register, regardless of whether they are disregarded entities for U.S. tax purposes, as other jurisdictions (such as the U.K. and Ireland) have done. Unfortunately, this is likely to be the case.

For U.S.-based investment managers with a non-U.S. affiliate, such as a U.K. sub-adviser, see the discussion below on U.K. and other non-U.S. based investment managers.

**Exhibit 1: Common Hedge Fund Structure with a U.S.-Based Investment Manager**

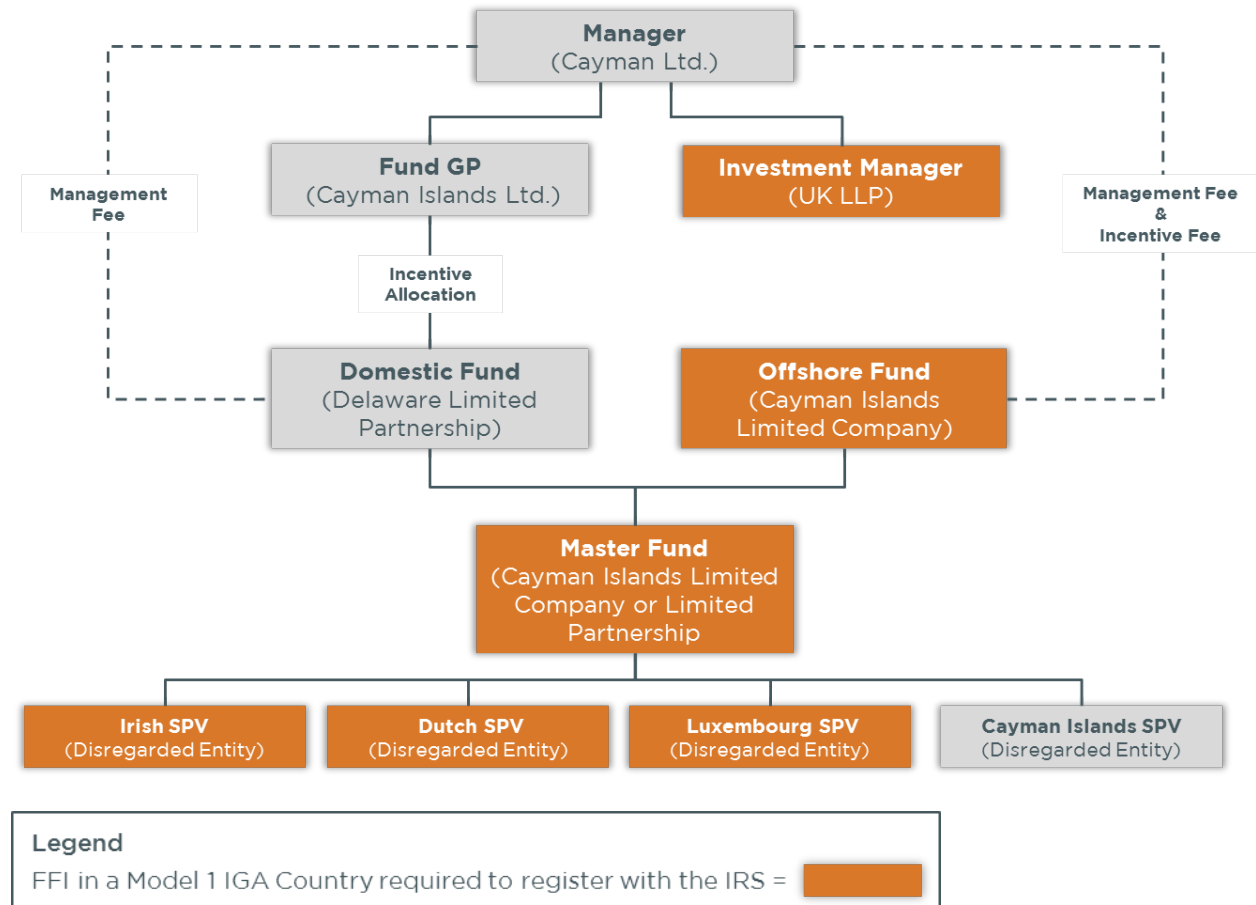


<sup>2</sup> The same would be true of Dutch or Luxembourg disregarded subsidiaries of a Dutch or Luxembourg entity, respectively, except to the extent that the Netherlands or Luxembourg issues rules to the contrary.

*U.K.-Based Investment Managers*

Exhibit 2 depicts a common hedge fund structure with a U.K.-based investment manager (with certain SPVs included for illustrative purposes) and includes the entities that will be required to register with the IRS. In addition to the fund entities described previously, certain investment manager entities might be required to register as well, unless they satisfy one of the exceptions contained in the U.S. Treasury regulations or an applicable IGA (or enabling regulations issued thereunder).

**Exhibit 2: Common Hedge Fund Structure with a U.K.-Based Investment Manager**



*U.K. Investment Managers:* The U.K. has agreed to a Model 1 IGA and Her Majesty's Revenue & Customs ("HMRC") has already issued enabling regulations under the IGA. The U.K. regulations provide a very narrow exception from registration for "investment advisers," i.e., advisers that cannot undertake transactions on the portfolio of assets without the agreement of the customer. Where the entity is an "investment manager," i.e., it has discretion on behalf of the customer to make decisions in respect of asset selection, asset sales and purchases and the selection of appropriate dealing venues, the entity will not be able to benefit from the "investment advisers" exception and, as such, will be required to register with the IRS. Unless HMRC revises its regulations, UK investment management entities should expect to register with the IRS.

*Cayman Islands Managers/General Partners:* The Cayman IGA contains an exception from registration for an investment management entity established in the Cayman Islands that is within the scope of FATCA registration solely because it renders investment advice to, or manages portfolios for, a customer's investments so long as the investment fund being managed is compliant with FATCA. Based on this exception, so long as managers ensure that their fund vehicles achieve a compliant status under FATCA, then Cayman manager/general partner entities should not be required to register with the IRS.

#### *Non-Model 1 IGA-Based Investment Managers*

Investment managers may also establish investment management and sub-advisory entities in various countries, some of which have agreed to Model 1 IGAs. However, other jurisdictions have agreed to Model 2 IGAs (including Bermuda and Switzerland) or have not yet entered into an IGA (such as Singapore and China). As a result, investment management and sub-advisory entities organized in those jurisdictions will have more onerous FATCA obligations than entities organized in Model 1 IGA jurisdictions, unless they satisfy an exception from registration.

An investment manager, including a sub-adviser, that does not fall under a Model 1 IGA can benefit from an exception to registration and compliance with an FFI Agreement, if: (1) it is within the scope of FATCA registration solely because it is an investment advisor/manager; and (2) it does not maintain "financial accounts."

Most investment managers are expected to meet the first requirement of this two-prong test. However, determining whether an investment management entity maintains "financial accounts" is quite complex. Under the U.S. Treasury regulations, an equity interest in an investment management entity generally will be considered a financial account if the return earned on such equity interest (including upon sale of such interest) is determined primarily by reference to the profits or assets of a U.S. person (or equity interests in a U.S. person). For instance, if an investment manager earns a majority of its management fees and incentive compensation (fees or allocations) from a U.S. feeder fund, then under these regulations, the equity interests held by the principals in the investment manager would be considered financial accounts. If an equity interest in an investment management entity is thereby considered a financial account, the investment manager would be required to register and enter into with an FFI Agreement. Investment managers with entities in non-Model 1 IGA jurisdictions should discuss with their tax advisers whether the above exception is applicable to them.

#### **Responsible Officers: Who Signs/Submits the Fund's Registration**

Each fund must appoint an individual as its responsible officer authorized to register the fund with the IRS. This responsible officer could be an employee of the investment manager, an independent director or an individual from the fund's administrator. This individual must be an officer of the fund entity itself

with authority under local law to submit information about the fund to the IRS and make the following certifications to the IRS upon completion of the registration process:

- That to the best of his or her knowledge the information provided is accurate and complete; and
- That he or she is authorized to represent that the entity will comply with its FATCA obligations in accordance with the terms and conditions reflected in regulations, IGAs and other administrative guidance to the extent applicable to the entity based on its status in each jurisdiction in which it operates.

Although a fund director (or other authorized signatory) might have the requisite level of authority over the fund to register on its behalf, the IRS registration system requires that the individual registering the fund be an “officer” of the fund. To that end, non-U.S. funds should appoint the individual designated as the responsible officer as an officer of the fund through a board resolution or other legal mechanism.

U.S. citizens or residents appointed as the responsible officer for a non-U.S. fund treated as a corporation for U.S. tax purposes should be aware that, under certain circumstances, they will be required to file (with their personal income tax return) a Form 5471 information return with the IRS as a “Category 2 Filer.”<sup>3</sup> The officer would generally file this form for each year during which any U.S. person acquired (in one or more transactions) at least 10 percent of the vote or value of such fund or acquired an additional 10 percent (vote or value) of such fund. Any U.S. person appointed as the responsible officer should consult the fund’s accountants to determine if this filing is necessary.

A responsible officer of an entity located in a Model 2 IGA jurisdiction or in a jurisdiction that does not have an IGA will have additional obligations, including oversight and periodic certification requirements, in accordance with the terms of that entity’s FFI Agreement.

### **When to Register**

For entities located in Model 1 IGA jurisdictions, such as the U.K. and the Cayman Islands, the deadline for registration is Dec. 31, 2014. For all other entities, the deadline for registration and entering into an FFI Agreement is June 30, 2014. The IRS will publish a monthly list of FATCA compliant entities and their GIINs. The first list will be published on June 2, 2014.

Despite the above deadlines, some managers have decided that it is prudent to have the funds they advise registered by May 5, 2014 in order for their GIINs to appear on the June 2 list of published GIINs or, alternatively, by June 3, 2014, in order for their GIINs to appear on the July 1 list.<sup>4</sup> This appears (at least in part) to be based on a concern that, given FATCA’s complexity, some counterparties may mistakenly withhold on funds that do not have GIINs published on either of these lists. Others just want to get the FATCA registration done and over with.

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<sup>3</sup> The same filing requirement already exists for U.S. citizens or residents who are directors of non-U.S. entities that are treated as corporations for U.S. tax purposes.

<sup>4</sup> Previously the IRS had recommended registration by April 25, 2014 in order for an entity’s GIIN to appear on the first list of GIINs that will be published on June 2, 2014. On April 2, 2014, the IRS issued Announcement 2014-17 that, among other things, pushed off this date from April 25, 2014 to May 5, 2014 for the June 2, 2014 list and added that registrations submitted after May 5, 2014 but by June 3, 2014 will have their GIINs appear on the July 1, 2014 list of GIINs.

Notwithstanding these concerns, fund managers should be aware that, until Jan. 1, 2015, there is no legal requirement for a counterparty to withhold on payments to a Cayman Islands investment fund so long as the investment fund provides its counterparty with the proper certifications on its Form W-8, even without listing a GIIN.

Investment fund managers should consult their tax advisors to determine the appropriate time to register each of their funds and any management entities required to register with the IRS. While many funds will want to register by May 5 or June 3, certain lingering uncertainties in the law, such as the requirement to register, and the proper method of registering, disregarded entities, might militate for applying a “wait and see” approach to registration in order to provide the U.S. Treasury department and the IRS additional time to hopefully clarify these issues.

Whatever an investment manager decides to do, it should inform its prime brokers and counterparties of the anticipated FATCA registration and compliance timeline, to ensure a smooth transition once FATCA diligence and withholding commence on July 1, 2014.

The online FATCA Registration System can be found on the IRS website at:  
<https://sa1.www4.irs.gov/fatca-rup/>.

#### **Due Diligence/Compliance Preparations**

Regardless of whether an investment fund is a U.S. or non-U.S. entity and regardless of whether it registers by June 30, 2014 or by Dec. 31, 2014, its obligation to collect identifying information from its investors generally begins on July 1, 2014. Each fund should review its investor base and be in a position to request updated IRS tax forms from its investors.

Funds should ensure that they have valid Forms W-9 for all U.S. investors on file. It is of particular importance that non-U.S. funds receive updated Forms W-9 (published in August 2013) from their tax-exempt U.S. investors so that tax-exempt U.S. investors can certify that they are exempt from FATCA reporting. This would eliminate the need for the fund to report on that tax-exempt U.S. investor’s interest in the fund to the IRS or to the local tax authority in the case of entities located in Model 1 IGA jurisdictions.

Funds should also ensure that they have valid Forms W-8 (including appropriate certifications about the investor’s FATCA status and GIIN, if applicable) from their non-U.S. investors. While the IRS has already issued several of the new IRS forms required for FATCA certification, including Forms W-9 and W-8BEN (for individuals) and the new Form W-8BEN-E (for entities),<sup>5</sup> additional forms are still forthcoming, including the new W-8IMY.

The new Form W-8BEN-E can be found on the IRS website at: <http://www.irs.gov/pub/irs-pdf/fw8bene.pdf>.

Additionally, each non-U.S. fund should ensure that, in the coming months, it establishes the appropriate compliance mechanisms so that by July 1, 2014 it is in a position to perform the due diligence needed to properly determine the FATCA status of existing investors and to determine the

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<sup>5</sup> The IRS also has not yet published the instructions to the new Form W-8BEN-E, without which it might be difficult for certain taxpayers to complete the Form W-8BEN-E correctly.

FATCA status of new investors upon subscription to the fund on or after July 1. The bulk of the due diligence will surround scrubbing for “U.S. indicia,” i.e., ensuring that nothing in the fund’s electronic and paper files indicates that an existing investor claiming to be a non-U.S. individual is in fact a U.S. individual. For funds benefitting from Model 1 IGAs, each Model 1 IGA jurisdiction will issue its own rules, which are expected to track the due diligence guidelines contained in Annex I to the Model 1 IGA. Investment funds not covered by a Model 1 IGA should ensure that they can be in compliance with the terms of the FFI Agreement that will be effective July 1, 2014.

U.S. funds will be required to have validly completed U.S. tax forms for all of their investors by July 1, 2014 and as such should request updated forms from their investors in May-June of this year, to the extent necessary. For most U.S. funds, this will require reviewing their investor files to ensure that they have valid Forms W-9 on file for each investor. If U.S. funds have any non-U.S. investors, including any investors that invest through a non-U.S. nominee, they should ensure that they have collected new Forms W-8 on which each non-U.S. entity investor and nominee has certified to a FATCA-compliant status.

Best practices for non-U.S. funds would be to ensure that they have collected validly completed U.S. tax forms for all of their investors by the end of 2014, although in most instances non-U.S. funds have until June 30, 2015 to complete due diligence on their individual investors and June 30, 2016 to complete due diligence on their entity investors. However, if any investors subscribe to a non-U.S. fund on or after July 1, 2014, such fund should ensure that it collects the correct tax form upon subscription.

A copy of Annex I for a Model 1 IGA can be found on the U.S. Treasury department’s website at: <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Annex-I-to-Model-1-Agreement-11-4-13.pdf>.

In addition, with respect to Cayman Islands entities, Annex I of the U.S.-Cayman IGA can be found beginning on page 16 of such IGA at: <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FINAL%20US%20-%20Cayman%20Islands%20-%20Cayman%20alternat.pdf>.

The list of countries that have entered into IGAs, or for which there are agreements in substance with respect to IGAs, can also be found on the U.S. Treasury department’s website at: <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx>.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel LLP or one of the following attorneys: [Philippe Benedict](#), [Nicholas Fagge](#), [Shlomo C. Twerski](#), [Steven Whittaker](#), [David S. Griffel](#) and [David S. Wermuth](#).

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