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FATCA Due Diligence & Compliance for Family Offices & Personal Investment Companies

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Statutory Overview of FATCA

- FATCA (Foreign Account Tax Compliance Act) added new chapter 4 to the US Internal Revenue Code in March 2010
  - Addresses US tax non-compliance by providing transparency with respect to assets and investments held offshore
  - Intended to provide increased reporting, not collect tax, but the “hammer” is a new 30% withholding tax
  - Requires non-US entities to provide information regarding their specified US owners to the Internal Revenue Service, the payer of the income or to the taxing authorities in the country in which the non-US entity is resident.

Duties Imposed on Non-US Financial Institutions

- Broadly, FATCA imposes three obligations on Foreign Financial Institutions ("FFIs"):
    - Conduct due diligence on their account holders to ferret out US individuals who have not been reporting non-US income to the Internal Revenue Service (IRS);
    - Disclose the identity of such persons to the IRS; and
    - Withhold on persons who refuse to provide information about their US owners to the FFI.
- FFIs must also respond to IRS requests for additional information & attempt to obtain waivers of local law prohibitions against reporting.

How Does FATCA Work?

- If an FFI does not comply with FATCA, payers of items of certain types of US-source income must withhold US tax on such items when paid to the FFI for its own account and for the account of its customers.
- The most common types of income that are affected by potential FATCA withholding are interest and dividends, but other types of income can be affected as well.
- If the tax is withheld for the account of the FFI, it cannot obtain a refund. If the tax is withheld on behalf of a client, the client can obtain a refund.
- FFIs that choose not to be FATCA-compliant are referred to as Non-Participating FFIs or NPFFIs.

Will My Account Be Subject to FATCA Due Diligence Even I Don't Earn US-Source Income?

- In order for an FFI to be FATCA-compliant, it must conduct due diligence on *all* of its accounts opened after July 1, 2014.
- Accounts opened before July 1, 2014 are also subject to due diligence, but the due diligence is postponed, depending on the amount in the account.
- Due diligence requires the FFI to obtain certain information about the owners of the account or if the account is held by an entity, the owners of the entity.
- The FFI must report the information on specified US owners to the IRS in 2015.

Institutions Treated as FFIs

- Depository Institutions
- Holds financial assets for clients. Owners of Personal Investment Companies (PICs) should not be treated clients under this definition.
- Investment Entities.
- Insurance Companies that write variable policies.
- Holding companies or treasury centers that are part of a group of companies that include an FI.

Investment Entities

- Investment entities must conduct one or more of the following activities *for or on behalf of a customer*:
  - Trading in money market instruments, foreign currency, transferable securities and futures contracts
  - Portfolio management
  - Investing or managing funds on behalf of other persons
- Investment Entities also include entities whose gross income is primarily attributable to investing or trading in financial assets if the entity is managed by another entity.
- Investment Entities also include collective investment vehicles, private equity funds, hedge funds venture capital funds & similar investment vehicles.

Passive Non-Financial Foreign Entities ("NFFEs")

- Passive NFFEs are Non-Financial Entities, that is, not FFIs and do *not* fall into one of the following categories:
  - Publicly-traded corporations or an affiliate thereof
  - Engaged in the conduct of an active trade or business
  - Organized in a US territory

Requirements for FFIs and Passive NFFEs

- FFIs must register with the IRS and obtain a Global Intermediary Identification Number (a “GIIN”)
- FFIs must be open to IRS inspection and conduct due diligence on their account holders
- FFIs must withhold US tax against payees who are not FATCA-compliant
- Passive NFFEs are not required to obtain a GIIN
- Passive NFFEs must provide information on their specified US persons to FFIs and other payers of US-source income

Treatment of PICs, Family Offices & Trusts

- Externally managed PICs, family offices and trusts are likely to be treated as FFIs
- Internally managed PICs, family offices and trusts are likely to be treated as NFFEs
- Canada has taken an outlier approach and will not characterize trusts are FFIs even if they are externally managed.
- Other countries may follow the Canadian approach.

Intergovernmental Agreements

- Intergovernmental Agreements ("IGAs") are Tax Treaties.
- Under a Model 1 IGA, an FFI reports directly on its US owners to the tax authorities in the country in which it is resident.
- Under a Model 2 IGA, the country provides an exemption from bank secrecy laws to allow FFIs to report information on their US owners to the IRS.
- FFIs in both Model 1 and Model 2 IGAs must obtain GIINs.
- Due diligence requirements under a IGA and under FARCA rules are similar, but FFIs in IGA jurisdictions are not subject to withholding.

Latin American & Caribbean Countries with IGAs

- Bermuda (Model 2)
- Brazil (Negotiating Model 1)
- British Virgin Islands (Negotiating Model 1)
- Cayman Islands (Model 1)
- Chile (Model 2)
- Costa Rica (Model 1)
- Honduras (Model 1)
- Jamaica (Negotiating Model 1)
- Mexico (Model 1)

US Real Estate Investments

CATEGORIES OF US TAX ISSUES POSED BY OWNERSHIP OF U.S. REAL PROPERTY BY FOREIGN PERSONS

- US Income Tax imposed on rents received and other income derived from the ownership of US real property
- US Income Tax on distributions by the US entity owning the US real property
- US Income Tax on dispositions of the interest in the US real property and the interests in the vehicle owning the US real property
- US estate tax considerations applicable to the ownership of US real property and interests in entities holding US real property

US Income Tax

Persons Engaged in a US Trade or Business Are Subject to Net US Federal Income Tax

Passive Investment or Active Trade or Business?

If property is going to be owned through a foreign partnership or foreign corporation it must be determined whether the entity will be carrying on an active trade or business in the U.S.

i. **This determination is made based on the level of activity of the partnership or the corporation.**

ii. **If it is determined that the foreign entity is *not* carrying on a U.S. trade or business, the rental income paid by the U.S. lessee will be considered passive investment income subject to 30% withholding tax imposed on a gross basis (i.e., no deductions are allowed).**

iii. **If gross basis taxation is less desirable than net basis taxation, the foreign entity can elect to have its income treated as business income taxable on a net basis (this election generally is made, so the remainder of the outline assumes net basis taxation applies).**

Tax & Reporting on Non-US Persons Engaged in a US Trade or Business

Rents & Current Income From Property

a) The partners, not the partnership, are subject to U.S. income tax on a net basis (i.e., associated depreciation and expenses are allowed as deductions).

b) Applicable maximum tax rate is 35% regardless of whether the investor is an individual or corporation

c) A "branch profits tax" may be imposed on the income earned by a foreign *corporation* (but not individuals).

   i. The BPT is 30% (or lower treaty rate) of after tax income that is not reinvested in the property.

   ii. It is a viewed as a substitute for the withholding tax imposed on dividends paid by a U.S. subsidiary to its foreign owner; however, it is imposed on an annual basis regardless of whether actual distributions are made.

d) Each partner as well as the partnership will be required to file U.S. Federal income tax returns annually. Non-US corporations would be required to file a US tax return.

Tax & Reporting on Non-US Persons Engaged in a US Trade or Business

Gains from Sale of Property

a) Gains from sales are subject to the "Foreign Investment in Real Property Tax Act" ("FIRPTA").

b) Gains are subject to U.S. tax at the regular capital gains rates applicable to individuals or corporations, depending on whether the partner is an individual or corporation.

   i. The capital gains rate applicable to individuals currently is 15% (25% if the gain represents certain depreciation recapture).

   ii. The capital gains rate applicable to corporations currently is graduated to 35%.

   iii. There is a 10% withholding tax on the gross sales price (unless a withholding certificate is obtained certifying that no gain is being recognized); the withheld tax is applied to the seller's U.S. income tax liability.

c) No branch profits tax should apply.

The Branch Profits Tax Attempts to Mimic the Tax That Would Have Been Imposed on Dividends Paid by a US Corporation

To the extent that the Non-US Corporation has US-connected earnings and profits (“E&P”), actual or deemed distributions constitute dividends which, if paid to non-U.S. investors, would be subject to U.S. withholding tax at the rate of 30% (or lower treaty rate).

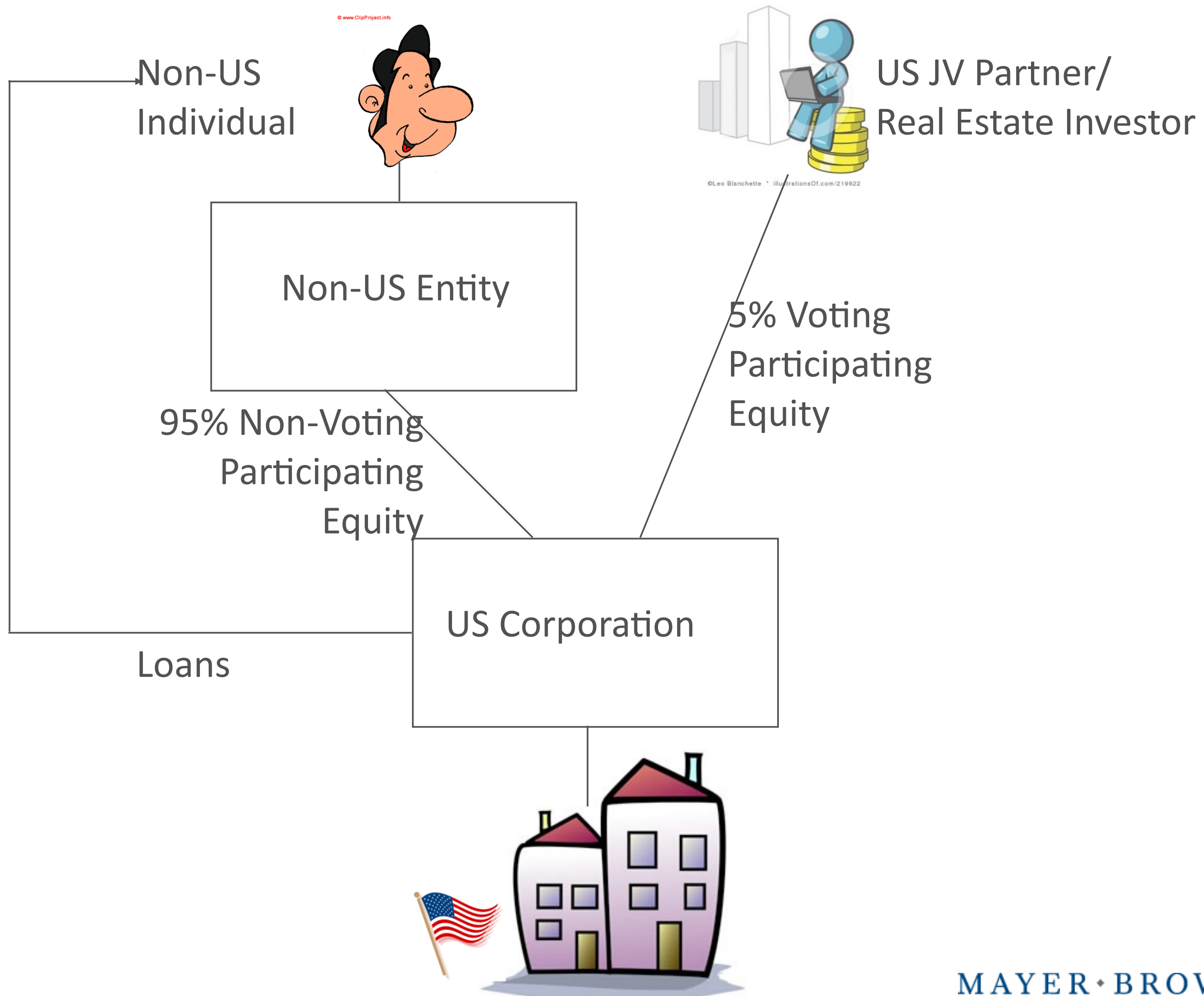
Distributions to non-U.S. investors in excess of the non-US corporation’s E&P generally should be treated as a tax free return of capital to the extent of the investors’ basis in the Equity Interests and should not be subject to tax.

Distributions in excess of E&P and basis generally should be treated as capital gain from the sale of the investors’ Equity Interests and would be subject to FIRPTA.

Main differences between owning US Realty through a Partnership or Corporation

- Partners in a foreign partnership have to file U.S. tax returns; shareholders in a foreign corporation do not.
- The branch profits tax applies to foreign corporations (including corporate partners in foreign partnerships), but not to individuals.
- The capital gains rate applicable to foreign corporations (including corporate partners in foreign partnerships) is 35%, whereas the rate applicable to individuals is 15% (going to 20%); therefore, individuals can obtain more favorable rates by investing through a partnership.
- However, the U.S. estate tax could apply to individual partners of a foreign partnership, but would not apply to individuals who are shareholders of a foreign corporation.
- A sale of shares in a foreign corporation that owns U.S. realty are not subject to U.S. tax, whereas a sale of interests in a foreign partnership that owns U.S. realty is subject to U.S. tax.

Tax-Efficient Direct Structure for US Real Estate Investments by Non-US Individuals



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Debt-Financing the US Entity Reduces the Sting of the US Tax Bite

Payments on the Notes

a) **Repayment of principal on the Notes should not be subject to U.S. tax.**

b) **Interest paid to a foreign recipient generally is subject to U.S. withholding tax at the rate of 30% unless:**

   i. **the "portfolio interest exemption" applies; or**

   ii. **such withholding tax is eliminated or reduced by an applicable income tax treaty.**

c) **Interest on the Notes should be eligible for the portfolio interest exception if, *inter alia*,**

   i. **the note holder does not own 10% or more of the voting power of the US obligor (however, a note holder can own a greater than 10% economic interest in the US obligor);**

   ii. **the interest is not contingent (*i.e.*, is not based on income, profits or changes in value of the real estate); and**

   iii. **the investor is not a bank (or conduit thereof).**

Participation of the Unrelated Real Estate Investor Creates the Opportunity for Portfolio Interest

Who can serve as the holder of the voting stock?

- Any unrelated person, whether US or non-US.
- Sisters & brothers of the investor, as well as the investor's nieces and nephews.
- The foreign investor cannot control the third party holding the voting stock.
- The unrelated person's investment in the voting stock should not be debt-financed by the investor.
- The value of the voting stock should not be depressed to de minimis levels.
- The equity participation of the voting stock can be capped, but should provide an equity-like return.

The US Thin Cap or Earning Stripping Rules Mandate Parameters for the Debt-Financing

The US has thin capitalization rules the limit the amount of deductible interest. In the US, these rules are called "thin capitalization" or "thin cap" rules.

Thin cap rules apply if 2 conditions are met:

The debt-to-equity ratio exceeds 1.5:1. Tax basis & not fair value is used to determine value of assets.

Debtor has "excess interest expense." This exists when net interest expense exceeds 50% of adjusted taxable income of debtor.

Disallowance only applied to "disqualified interest," that is, interest not subject to US tax paid to a related person.

Structuring Dispositions of US Real Property Held Through a US Corporation

Gains from Sale of Property

a) **Income from the sale by the Fund of its real property would be includible in the Corporation's U.S. taxable income and subject to U.S. tax on a net basis at the corporate rate (*i.e.*, currently graduated to 35%).**

   i. **Such taxable income would be reduced by interest payable on the Notes and any net operating loss carryovers that may have been generated in prior years.**

b) **U.S. withholding tax on liquidating distributions by the Feeder to non-U.S. investors can be avoided if the Feeder defers liquidating until the Fund has disposed of *all* of its real estate in taxable transactions.**

   i. **Once the Fund has disposed of *all* of its real estate in taxable transactions, it is no longer a "United States Real Property Holding Company" ("USRPHC") and, therefore, is *not* subject to the FIRPTA rules.**

   ii. **Capital gain realized by a non-U.S. person on the liquidation of a U.S. corporation that is not a USRPHC is not be subject to U.S. tax.**

The Simpler Alternative of Holding US Real Estate Through an Off-shore Entity Has Advantages Too

1. Advantages of Ownership Through Foreign Partnership:
   a) **Gain allocated to a foreign investor who is an individual on a sale of the real estate should be subject to tax at the preferential capital gain rate applicable to individuals (15% - 25%, rather than the 35% capital gains rate applicable to corporations).**
   b) **Possibility of exemption from U.S. estate tax (caution is advised).**
2. **Advantages of Ownership Through Foreign Corporation:**
   a) **Sale of the foreign corporation (as opposed to the real estate) would not be subject to U.S. tax (although discounted price is likely).**
   b) **Exemption from U.S. estate tax is clear.**

Certain Considerations Relating to the Ownership of a Vacation Home in the U.S. where no Rent is Charged

- Should be owned through a foreign partnership or corporation to eliminate the risk of U.S. estate tax as discussed above.
- No existing IRS rulings that rent should be charged.
- Because it is not an investment, expenses cannot be deducted.
- Generally, no U.S. reporting requirements.
- The disposition of the vacation home will be subject to the same FIRPTA rules discussed above.