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PRIVATE EQUITY AND  
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ALTERNATIVE TYPES  
OF FINANCING –  
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## FATCA – Consequences of US Regulations for German Private Equity Companies

By the so-called Foreign Account Tax Compliance Act (FATCA), the US tax authority IRS (Internal Revenue Service) is intervening directly in all transactions with origins in the US. Thus, presumably by the middle of 2013, inter alia, all PE companies that earn any proceeds from US sources must conclude an agreement with the IRS and report the participating US persons, as well as certain related data or, respectively, make a corresponding negative declaration.

Otherwise, according to the current status, as of 1 January 2015 a 30% “(penalty) withholding tax” shall then be assessed on cash flows from US sources (not only on revenues, but also on interest and dividends as well as sales proceeds). According to currently available information, these may not be subsequently reimbursed. This would entail a definitive taxation that may even affect all shareholders of the respective PE company, regardless of whether persons or entities subject to US tax were participants or not.

FATCA's intention is the complete assessment of US taxpayers and, in particular, their worldwide, foreign income. In the future, reporting all accounts and securities that are indirectly held by US citizens, as well as all investments, including the resulting sales proceeds, shall be required, regardless of whether these are maintained or, respectively, held in the US or elsewhere.

The so-called qualified intermediary (QI) regime, which has existed since 2001, has proven to be insufficient in this regard. According to this regime, banks were until now required to report US revenues (interest and dividends, but not sales proceeds or profits) that were realized by US citizens. A separate report on revenues from non-US sources, as well as assets that were merely indirectly held by US citizens in, for instance, structures that were not transparent, were not required until now.



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## **Origins**

In spring 2010, the US government adopted certain tax incentives designed to revive the employment market within the scope of the Hiring Incentives to Restore Employment Act (HIRE Act). The so-called Foreign Account Tax Compliance Act (FATCA) was then also enacted as partial offset financing of the HIRE Act. Such compensatory measures are certainly customary and are also often seen in Germany. The distinctive feature of FATCA is, however, that not only US taxpayers are affected, but also all other investors with US investments.

The catalysts for the introduction of FATCA were numerous cases of tax evasion, in which capital was invested outside the US by US taxpayers, but the resulting proceeds were not declared in the USA.

Therefore, FACTA enjoins all investment structures that generate revenues from US sources, in particular all private equity companies, to meet extensive administrative requirements in the USA. Failure to fulfill these obligations shall entail significant financial burdens for all investors.

## **Which transactions/proceeds are included in the FATCA regulations?**

For certain dividend-equivalent payments, retention of 30% withholding tax (if applicable, reduced according to the provisions of the respective double taxation treaty with the USA) was to be implemented as of October 2010; this regulation applies to all dividend-equivalent payments as of March 2012.

If the specified documentation and reporting requirements according to FATCA are not fulfilled, as of 2015 all revenues from US sources (withholdable payments) will be subject to withholding tax in the amount of 30% of the respective revenues. In this, the respective payment that triggers withholding tax need not necessarily be made by a US legal entity. The regulations shall also be

implemented when a transaction is carried out between two non-US taxpayers (e.g. a Swiss entity sells a US investment to a German entity) regarding assets that generate payments from US sources.

According to FATCA, not only the revenues from US sources such as, in particular, interest and dividends shall be called upon as the assessment basis for possible withholding tax. Rather, the FATCA provisions provide for retention of withholding tax already on sales proceeds from the sale of assets, from which interest or dividends from US sources can be realized. Explicitly, this shall comprise sales proceeds from the sale of US shares or holdings in other US corporations, as well as revenues from US bonded debt claims or debenture bonds.

This separation of evaluation basis from revenue components may lead to an asset taxation.

Example: <i>Acquisition costs:</i>	USD	100
<i>Sales price:</i>	USD	100
<i>Profit:</i>	USD	0
<i>Evaluation basis pursuant to FATCA:</i>	USD	100
<i>Withholding tax pursuant to FATCA (30%):</i>	USD	30
<i>Remaining cashflow after FACTA withholding tax:</i>	USD	70
<i>Resulting loss from transaction:</i>	USD	30

Pursuant to this example, according to FATCA, a withholding tax of 30% would be assessed on the sale of a US participation for the price of the initial acquisition costs, i.e. there is neither profit nor loss; this tax may not be reimbursed upon request and would therefore be definitive. Therefore, a definitive tax rate of 30% of the realized sales proceeds would be assessed in the case of an overall neutral transaction, with no profit previously realized from the transaction.

FATCA does not, however, include initial commercial income from permanent establishments, so-called effectively connected income (ECI), since in this regard, a limited obligation to make a statement and tax liability already exists in the USA.

### **Which persons / legal entities are subject to the FATCA provisions?**

The intention of FATCA is the complete assessment of foreign income from (specified) US persons. As such, according to FATCA, this shall concern, not solely US citizens but also, for example, persons with dual citizenship, green card holders, formerly taxable US entities (10 years), as well as persons with a certain average stay in the USA (>183 days within the last three years or >31 days in the current year, "substantial presence test"). In particular, such persons can thus become considered US persons in terms of FATCA, who have relocated to the USA during the term of the PE company. In order to guarantee the assessment of US persons, all foreign institutions in which US persons may participate shall be obliged by FATCA to report these persons, as well as certain related data.

The legal entities, which are obliged to report, are divided into foreign financial institutions (FFI) and non-financial foreign entities (NFFE). All banks (including savings and loan associations and credit unions) and institutions that hold and administer financial investments for third parties (brokers, depository banks) qualify as FFIs.

Furthermore, the definition of an FFI also includes all foreign companies that invest, reinvest or deal in securities, participations in partnerships, goods/commodities as well as related derivative instruments. Thus, it includes private equity and venture capital companies (fund of funds and direct funds), mutual funds and insurance companies.

If a foreign entity does not fulfill the above-mentioned criteria, it is considered a non-financial foreign entity (NFFE). The latter include all foreign companies that allow US taxpayers to participate as shareholders or investors. Generally, this includes all corporations – with the exception of stock corporations, whose stocks are regularly traded on a public stock exchange – as well as partnerships. Since PE companies generally qualify as FFIs, the further implications of FATCA on NFFEs will not be discussed here.

In addition, foreign governments and their public agencies and authorities, primarily operational subsidiaries or affiliates of holding companies (as far as they

themselves qualify as FFI), as well as commercially active start-up companies for a period of two years after their founding, are generally excluded from the scope of application.

### ■ Administrative requirements of FATCA

In order to avoid the described (penalty) withholding tax in the amount of 30% of revenues from US sources, the represented legal entities – and therefore also all PE companies involved in US investments – must conclude an agreement with the US tax authority, the IRS, by 30 June 2013, according to current information. A draft of this standardized, electronic or Web-based agreement is currently expected by the middle of 2012.

The institutions undertake to either

- make complete reports on (FFIs are then considered participating FFIs, respectively PFFIs) or
- to completely avoid (so-called deemed compliant FFIs) so-called US accounts.

In this context, a US account is any so-called financial account held by a US person. This shall in turn include all monetary and depository accounts, as well as all equity participations or shares in other financial instruments of the shareholders of the FFI. The share of a US person in a PE company, which holds US participations in its portfolio, shall thereby be qualified as a financial and US account.

### ■ Participating FFI (PFFI)

In order to become a PFFI and thereby avoid the obligation to retain (penalty) withholding tax, a PE company investing in the USA must conclude an agreement with the IRS.

According to information currently available, the yearly reporting obligation includes name, address, US taxpayer identification number (TIN), account balance (value of the account), as well as gross deposits (interest and dividends, as well as the gross sales profits from the disposal of participations or other assets) and gross withdrawals that were credited or charged to the respective US account.

If the PE company is structured as a direct fund, it is furthermore a withholding agent in the purchase of direct participations. Regardless of whether the vendor is subject to US tax or is a foreign (legal) entity, it is thereby obligated as party liable to retain and pay withholding tax that may be due pursuant to FATCA.

With regard to US enterprises in which shares are held, the PE company must establish its status as PFFI in order to collect possible interest or dividends paid out by these participations without deduction of the 30% withholding tax pursuant to FATCA.

If the PE company operates as a fund of fund, it must confirm its conformity with FATCA regulations, since otherwise the US target funds would have to undertake a separate retention of 30% of all payments to the fund of fund.

If, in principle, the foreign institution fulfills the required documentation and reporting obligations pursuant to FATCA, withholding tax on gross revenues from US sources must only be retained if the payments are transferred to so-called uncooperative (limited) partners that refuse to disclose their data (recalcitrant account holders) or if a transfer of payments is made to an FFI that has not concluded an FFI agreement (non-participating FFIs, NPFFIs). For such pass-thru payments, the FFI making the payment is considered a withholding agent and is obligated to retain withholding tax (which in this case may not be retained directly from the US source).

If the documentation and reporting obligations are not completely fulfilled, the agreement with the FFI may be cancelled, although the related conditions have not yet been conclusively determined. The question of how incomplete fulfillment of contractual obligations, which is caused by individual uncooperative US persons (recalcitrant account holders), shall affect the status of the FFI has also not yet been determined.

Since US taxpayers who refuse to provide the necessary details about themselves (recalcitrant account holders) might permanently elude possibly higher US taxation via the penalty taxation to be assessed from the PE company (or another FFI), the FFI is obligated to urge these persons to fulfill the requirements or, alterna-

tively, within an appropriate period of time, the length of which has not yet been determined, to preclude them or cancel their accounts.

However, should it come to a disqualification of PFFI status (= cancellation of the agreement with the IRS), a general retention of 30% (penalty) withholding tax shall be assessed on the total revenues attributable to the FFI, thus also on the percentage attributable to non-US or cooperative US persons.

Even if the PE company fulfills the documentation and reporting obligations pursuant to FATCA and is therefore not subject to retention of FATCA withholding tax, the previously existing withholding tax regulations (QI regime) shall continue to be applicable. Hence, for instance, the presently necessary forms to attain preferential withholding tax retention pursuant to double taxation treaties (e.g. W-8 BEN) shall in the future also be obtained and deposited with the respective withholding agent. Upon failure to comply with FATCA regulations, a withholding tax of 30% of the withholdable payments can be assessed, as well as an additional 30% cumulatively on the revenues that should be retained pursuant to double taxation treaties.

### ■ Trustees

Shares in PE companies are often indirectly held by an intermediary trustee. According to the regulations of the QI regime that were previously valid, mere trustees were considered non-qualified intermediaries (non-QI) and were not included in the respective reporting and retention obligations with regard to possible withholding tax. FATCA itself represents a further development of the QI regime. If trustees were not qualified as QIs before FATCA, the additional regulations for QIs should therefore under FATCA also not be applicable to non-QIs.

Independently of the regulations of the QI regime, respectively the additional regulations pursuant to FATCA, the names of recipients of payments from US sources had to be provided to the IRS in various forms such as W-8 BEN or W-8 IMY, in order to take advantage of a possible preferential withholding tax rate on interest and dividends pursuant to the double taxation treaty between the USA and Germany. Thus, the trustee was already seen as a pass-thru entity for



these purposes and was subject to the respective reporting obligations of the PE company.

Ultimately, the trustee must also ensure under FATCA that its trustor is not subject to the reporting obligation pursuant to FATCA, respectively provide all necessary documents and information to the PE company so that it may also fulfill its reporting obligations as a PFFI.

#### ■ Deemed compliant FFI

An FFI can also qualify as a so-called deemed compliant FFI (DCFFI) if it maintains no US accounts at all. This status is granted to the FFI by the IRS upon request and must be renewed every three years by attestation of compliance with the requirements.

The advantage of attaining the status of a DCFFI lies in the fact that no FFI agreement must be concluded with the IRS and also that the DCFFI must merely fulfill significantly reduced documentation and reporting obligations.

However, only nationally operating banks and certain investment funds, whose shareholder structure fulfills certain conditions, may attain DCFFI status. Since, for instance, the participation of natural persons is not allowed in DCFFI status, this potential relief is generally unavailable to PE companies.

#### ■ Non-participating FFI

If a PE company, which is active in the USA, does not conclude a corresponding agreement with the IRS, it is considered a non-participating FFI (NPFFI) and therefore subject to the 30% flat rate withholding tax on the revenues from US sources. This will, however, only occur in such exceptional cases in which the percentage of revenues from US sources represents only a negligible amount of the cash flow and the costs of fulfillment of the documentation and reporting obligations are disproportionate to the withholding tax to be avoided.

#### ■ Alternative: Disinvestment of US investments

Alternatively, the complete disinvestment of US investments is another way to avoid the additional administrative burdens connected with FATCA. In practice,

PE companies would either focus on or refrain completely from making investments with US sources. This alternative is only an option for the few PE companies that have focused primarily e.g. on Asia or Europe and – if at all – have only included a few US investments. Solely to avoid concluding a FATCA agreement, adjusting an existing portfolio is, however, often not practical from an economic point of view, in particular due to the limited fungibility of the investments as well as the reduced valuation of the portfolio companies or the target funds that often takes place in secondary transactions. A possibly necessary change in the investment region, which may be contractually determined and prospected, is also not deemed practicable.

### ■ Regulation and temporal application

The details regarding temporal and material application, as well as the scope of reporting and documentation obligations according to FATCA, shall be administered and published in the context of individual notices.

In the first FATCA notices, the starting date of 1 January 2013 was still designated, on which FATCA was to apply to withholdable payments normally to be assessed at PE companies. However, based on the most recent notice dated June 2011, it may be assumed that due to the many questions of interpretation, as well as the significant administrative burden on the obligated institutions and also on the US tax authorities, a transitional period until 1 January 2015 will be granted for the assessment of all withholding payments.

### Outlook

In addition to the many known cases of tax evasion by US persons abroad, the US government is getting serious and increasingly strict about its tax regulations in this respect. Thus, in the future all payments (not only profits!) from US sources may be assessed a (penalty) withholding tax in the amount of 30%, which currently takes the form of definitive taxation and which may be cumulatively raised in addition to the normal withholding tax according to double taxation treaties.

At this point in time, many details with regard to the material and temporal implementation have not yet been clarified and shall be established by the US financial and fiscal authorities in upcoming notices. The initial schedule for the implementation and establishment of the obligations of all participating parties, as well as the information and documentation which must be provided, has already been significantly deferred.

This circumstance currently impedes serious preparation for this topic and further developments should be very closely followed.

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