

Upcoming FATCA - CRS Issues: What the Alternative Fund Industry Needs to Know



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The world of alternative investment funds was not the primary target of the Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standard (CRS) norms. These regulations were aimed rather at the “wealth planning” industry, cross-border wealth management and the “offshore” economy. However, the widespread success of this type of investment fund along with the complexity and the number of structures put in place by industry actors have led alternative investment funds to be significantly impacted by these rules.

The Luxembourg tax administration has been increasingly monitoring the proper application of these rules, especially as regards financial penalties in the event of confirmed violations. In the last few months, we have witnessed exponential fines applied to late filings or the absence of FATCA and CRS reports. The amounts of the fines have become discouraging and have even captured the attention of industries which generate substantial cash flow such as alternative investment funds. Ensuring compliance with these rules is therefore a major reputational and financial issue for alternative investment funds managers.

Yet, despite the fact that these rules have been in place for many years, they still present certain “challenges” for managers, technical challenges but especially educational challenges towards clients and investors who do not always have a perfect understanding in terms of how the regulatory landscape is evolving.

The “due diligence” obligations of FATCA and CRS require financial institutions to have their clients complete self-certification forms. This seemingly simple task requires, from investors, the in-depth understanding of technical concepts as held by financial institutions or non-financial entities. The jargon used and relayed to investors makes this self-certification exercise complex, and often “laborious”, for non-initiates.

In terms of reporting, FATCA and CRS rules require financial institutions to provide reports to the

tax authorities. This implies having usable and accurate data on investment flows and on the investors concerned at their disposal. In our experience, the production of these reports is a real “stress test” for funds managers’ organisational skills. Firms and institutions that are late in collecting the subscription documents may therefore find themselves in a difficult situation if they have not made the necessary provisions.

These rules were instituted between 2014 and 2015 in Luxembourg. Today, we have certain insights into the practical difficulties experienced by actors of the alternative investment funds industry. In a standard structure, the difficulties and the issues differ according to the entities and the level of the structure concerned.

Specific issues for financial institutions “General Partner” and “Funds”

In practice, most “holding” companies of alternative investment funds are considered financial institutions within the meaning of FATCA and CRS. General Partners of funds and the funds themselves are most often subject to all the requirements imposed by Luxembourg laws, in matters of reporting (i.e. all the mechanisms used to transmit information to foreign administrations adhering to AEI) and of “due diligence” (i.e. all the information collected on investors by financial institutions).

Difficulties encountered during the gathering of due diligence documents

In our experience, the mere gathering of self-certification documents (W-8, W-9 forms and forms based on models developed by the ABBL – Associations des Banques et Banquiers, Luxembourg – and the ALFI – Association of the Luxembourg Fund Industry–) by managers can be difficult.

These forms are filled in by investors who only have limited knowledge of the regulations. In our alternative investment fund advisory business, we frequently notice that a significant amount of the forms sent by fund investors are incomplete. The models developed by the ABBL and ALFI are clear and easy to use, translated into several languages and often include a glossary, but the US forms W-8BEN, W-8BEN(E) and W-8IMY are rather bewildering for the uninitiated. Their complexity is strengthened by the fact that they are used to manage issues other than FATCA, especially the granting of treaty benefits under double tax treaties between the United States and the countries that have signed this type of agreement.

The management companies generally carry out a primary verification of the documents transmitted, checking for constancy and accuracy. Within depositary banks, transfer agents working for alternative investment funds carry out a secondary check of these documents with the support of their internal tax teams. Despite this process, the number of inaccurate forms remains significant. Many are sent back to the funds and to investors to be amended. The

difficulty of the process lies in the fact that neither the investors, nor the agents carrying out these checks are tax advisers specialised in these issues.

In addition, in case of doubts surrounding the accuracy of the forms, the management companies must determine the level of verification that they need to adopt in this process, especially as to their obligation to challenge a self-certification document provided by a client. Such a challenge causes real conflicts...

Beyond the commercial and relational problems caused, there is the issue of the legitimacy of the questions addressed by the management company or by the transfer agent to the investors. Neither the managers, nor the depositary bank are supposed to provide tax advice to third parties to improve the quality of transmitted documents.

Often, the management teams do not have the necessary technical background. Depositary banks cannot provide tax advice as it is not in line with their core business.

To avoid these difficulties, fund managers frequently organise the due diligence work at two levels:

- Before the AML/KYC process, by having their clients perform their own analysis of the qualification of their investment vehicles and by submitting the self-certification forms to a specialised adviser for a secondary review;
- After this process and throughout the life of the funds, by regularly reviewing the document. This review is often performed on an annual basis, before the annual reports are submitted to the tax authorities.

It may be appropriate to use third party tax advice to carry out necessary analyses that are not limited by the qualification of the entities used by the clients.

The assistance required also concerns the production of the self-certification forms and the management of related issues (such as foreign withholding tax). In the case of investments in the United States by a fund, it may be necessary to grant the applicable double tax treaty benefits to the vehicles that were set up.

In case of tax transparent vehicles, this analysis must be carried out up to the ultimate investors, via the now well-known US forms W-8BEN, W-8BEN(E), W-8IMY and W-8ECI. Such requests can be very complex. They require specific expertise in US tax matters and a deep analysis of the famous "limitation on benefits clause" included in the tax treaties signed by the United States.

What is often perceived as a simple gathering of documents equated with the obligations of KYC can be actually a full tax analysis performed by AEI and/or US tax specialists.

Also, there is potential that the analysis carried out by the investors differs from the one carried out by alternative investment fund teams or the one made by the depositary bank. In such a

case, the question our clients often ask themselves is: how far should they go in their investigations with their counterparts?

In this respect, it should be noted that the IGA (Intergovernmental agreement) signed by Luxembourg explicitly requires financial institutions to call into question the documents provided by their clients should the institutions doubt the quality of foresaid documents. De facto, the scope of this obligation goes beyond the mere obligation of means. Fund managers cannot hide behind their ignorance of a law which they are expected to master in terms of Luxembourg rules.

Nevertheless, in practice, there are many tricky situations. A frequently encountered case with regard to FATCA for individuals concerns cases of investors born in the United States. This investor is as a principle a US citizen taxable in the United States. He or she is a “US person”, and therefore required to provide a W-9 form to financial institutions whose services he or she solicits.

Some clients are not aware of their “US person” status and provide an inappropriate type of form. It may also occur that, having renounced to his/her American nationality, the client legitimately provides other certificates. These situations give rise to numerous exchanges between the investor and the promoters of the funds who question the nature of the documents to collect.

When it comes to corporate investors, they are often themselves funds or institutional investors whose qualification can be more complex than in standard cases. There are many overriding qualifications in FATCA, some of which derive from US law and require, for their proper application, an in-depth knowledge of the FATCA regulation in the United States. Alternative investment funds, like every financial institution, must identify all qualifications of their investors and apply these regulations in all their complexity.

Concerning the world of alternative investment funds, some vehicles are exempt from their registration obligations with the US tax authorities (IRS) and do not need to obtain a FATCA identification number (GIIN) because of inherent overriding provisions of this regulation. This is the case for some General Partners who benefit from the “Luxembourg investment advisor / Investment manager” status or for some investment funds which benefit from the “collective investment vehicle” status. Particular attention must be paid to the fact that these vehicles meet all the conditions allowing them to benefit from these overriding provisions.

Many management teams are unsure of the attitude to adopt and, when the client provides satisfactory explanations, which documents to collect to justify this “unusual” situation.

It is essential that financial institutions comply with their due diligence obligations, not only because breaches may be sanctioned and punished by fines, but also because this information is the basis for the production of FATCA and CRS reports.

Main difficulties relating to the production of FATCA and CRS reports

FATCA and CRS reports are the result of the gathering of information during the due diligence process. The accuracy of these reports depends on the quality of the information collected and the effective monitoring of the flow of payments to investors. If the documents are properly gathered and if the flows are precisely identified, the production of FATCA and CRS reports becomes “trivial”. For FATCA, the obligation to produce reports stems solely from their “financial institution” status, which leads these institutions to limit their production of blank reports. However, regarding CRS, in addition to its status of “financial institution”, the financial institution must have reportable accounts in its client portfolio (i.e. individual investors who are resident in CRS countries) to produce a report.

A typical alternative investment fund structure involves many entities: one or more General Partner(s), one or more funds, intermediate holding companies and investment vehicles. It is necessary for the management teams to map out all the vehicles of their groups. Our experience has shown that managers have registered entities with IRS, qualifying de facto this entity as a reporting financial institution. If a FATCA report is not produced for these reporting financial institutions, they may be subject to fines of up to several tens of thousands of Euros. It is essential for management teams to clearly identify the obligations of the companies within its group and manage this subject meticulously.

The General Partners and some employees frequently serve on the board of directors or the board of management of the companies in the group. They are responsible for ensuring compliance with these standards, both on the “due diligence” and the “reporting” fronts. They will have to monitor the issue for each managed company, whether it is located in Luxembourg or abroad.

Specific concerns for non-financial entities, intermediate holding companies and target entities

Holding companies and target companies set up by alternative investment funds constitute, by default, financial institutions. However, they can be qualified as non-financial entities if certain conditions are met. Intermediate holding companies can most often be described as passive non-financial entities. Target entities may be either passive or active non-financial entities.

FATCA and CRS obligations applicable to these entities are limited to identifying their beneficial owners and collecting personal data specific to FATCA and CRS from them. In the end, this exercise is similar to the work that is required to report the necessary information to the register of beneficial owners. There is no self-standing definition of “beneficial owner” for FATCA and CRS purposes and the concepts used are the same as in AML (Anti Money Laundering) matters.

Based on this identification and analysis, each company in question will have to be able to fill in the self-certification forms which will be requested by the banks with which they work.

These entities are therefore subject to a level of FATCA/CRS obligations which is much lower than the one applicable to funds and their General Partners. Nevertheless, filling in the self-certification forms remains tricky, especially when it comes to US forms and involves a request to benefit from double tax treaties.

What future challenges do these regulations cover?

The AEI is at the heart of regulators' concerns in most developed countries. The network of CRS countries is projected to expand and FATCA and CRS regulations are vowed to strengthen.

The sustainability of the measure has been confirmed by the inclusion of subjects related to AEI in the DAC 6 directive. In particular, this directive states that the transactions which allow AEI to be circumvented must be reported by the financial intermediaries involved in their implementation. It is therefore necessary for alternative investment funds to master the qualification rules to maintain the quality of the information transmitted. It is also key to document the decisions taken in terms of qualification to preserve consistency among analyses and avoid any misunderstandings.

The trend is toward reinforcing the exchange of information rules, even if they create via DAC 6 a double system of sanctions within the scope of this directive. It is even more crucial for the alternative investment fund industry to acquire a certain mastery of these different regulations, hoping that, one day, US regulators and the OECD will agree on one single and standard AEI format.

This article originally appeared in the October 2019 issue of AGEFI Luxembourg (in French). Read it [here](#).