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M E M O R A N D U M

To: Clients & Friends
From: Armin Gray
Re: Technical Correction to F.A.T.C.A. Regulations Clarifies Example Regarding Investment Advice
Date: October 8, 2013

[Announcement 2013-41](#)¹ (the “Announcement”), recently released by the I.R.S., provides correcting amendments to the Foreign Tax Account Compliance Act (“F.A.T.C.A.”) final regulations that were issued on January 17, 2013. One important clarification that we would like to highlight for our clients relates to an example that explains the application of the rules with respect to foreign financial institutions (“F.F.I.s”) classified as such under the final regulations as foreign “investment entities.” The clarification of the example is helpful in avoiding F.F.I. classification in respect of family owned trusts and other foreign entities that solicit advice or receive fees for providing such services in respect of the entities’ investments.

¹ 2013-40 I.R.B. 322 (Released September 30, 2013).

Background

F.A.T.C.A. imposes a 30% withholding tax on payments made to foreign entities if the payments have a jurisdictional nexus to the United States. Under F.A.T.C.A. final regulations,² a foreign entity that is classified as an F.F.I. rather than a non-financial foreign entity is subject to more onerous obligations in order to avoid the withholding tax. More specifically, a foreign entity classified as an F.F.I. will be required to enter into an agreement and register with the I.R.S. or be subject to an Inter-Governmental Agreement relating to F.A.T.C.A. compliance.³ The agreement will require the F.F.I. to, among other things, undertake (i) a due diligence operation to identify its U.S. accounts, (ii) certain withholding obligations on payments it makes to those who are not in compliance with F.A.T.C.A., and (iii) certain other documentation and information reporting obligations.

A foreign entity is classified as an F.F.I. under the final regulations under five categories.⁴ In general, the five categories of the test include as F.F.I.s the following entities:

- Banks,
- Custodial institutions,
- Investment entities,
- Certain insurance companies, and
- Certain holding companies that hold interests in other F.F.I.s, and certain treasury centers.⁵

² All section references are to the Internal Revenue Code of 1986 (the “Code”), as amended, and to the regulations as promulgated thereunder.

³ Those who enter into an agreement are referred to as a “participating F.F.I.” or “P.F.F.I.”. The registration portal was opened on August 19, 2013. For further discussion, see, *e.g.*, our prior client alerts, such as “[F.A.T.C.A. Update: Registration Portal Opens](#)” (August 21, 2013), or “[Notice 2013-43 – Revised Timeline and Other Guidance Regarding the Implementation of F.A.T.C.A.](#)” (July 18, 2013).

⁴ Treas. Reg. §1.1471-5(e).

⁵ Treas. Reg. §1.1471-5(e)(1).

The third category, investment entities, is quite broad. Under this category, a foreign investment entity is an F.F.I. under one of three tests:

- The entity primarily conducts as a business one or more of the following activities or operations (“Listed Activities”) for or on behalf of a customer:
 - Trading in money market instruments (checks, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures;
 - Individual or collective portfolio management; or
 - Otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons.⁶
- The entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets and the entity is managed by another F.F.I. such as a bank, custodial institution, insurance company, or investment entity under the first investment entity test discussed above.⁷
- The entity functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.⁸

For these purposes:

- An entity is managed by another entity if the managing entity performs, either directly or through another third-party service provider, any of the Listed Activities described above on behalf of the managed entity;⁹ and

⁶ Treas. Reg. §1.1471-5(e)(4)(i)(A).

⁷ Treas. Reg. §1.1471-5(e)(4)(i)(B).

⁸ Treas. Reg. §1.1471-5(e)(4)(i)(C).

⁹ Treas. Reg. §1.1471-5(e)(4)(i)(B).

- The term financial assets include shares of stock in a corporation, partnership interest, note, bond, debenture, or other evidence of indebtedness, notional principal and derivative contracts, and various other types of financial instruments.¹⁰

The final regulations, as issued on January 17, 2013, provide eight examples on the application of these rules to investment entities. The Announcement provides a technical correction to example 1 ("Example 1") of those examples.

Technical Correction

Example 1, as provided for on the final regulations, as issued on January 17, 2013, provided that an investment advisor (a foreign entity), which was hired by a fund manager to provide advice to a fund in respect of the fund's investments was an F.F.I. because it "primarily conducts as a business providing investment advice on behalf of clients."¹¹ The example did not mention any discretionary management of a portion of the fund assets in the coming to the example's conclusion that the investment advisor was an F.F.I. under the final regulations.

The Announcement revises Example 1. Example 1 now provides for the same facts as above, except that the investment advisor was hired to provide advice and discretionary management of a portion of the financial assets held by the fund. The example goes on to provide that the investment advisor is an investment entity because it "primarily conducts as a business of managing financial assets" on behalf of clients.

For the reader's convenience, the chart entitled "Comparison of Example 1, Final Regulations v. Technical Correction" provides a side by side comparison of the rules under the final regulations and as corrected.

¹⁰ Treas. Reg. §1.1471-5(e)(4)(ii); Code §475(c)(2).

¹¹ The example states that the F.F.I. was classified as an F.F.I. under the first test applicable to investment entities as discussed above.

Conclusion

The technical correction to example 1 of the final regulations is a welcome clarification. It appears that family owned trusts and other foreign entities can be assured that merely soliciting investment advice, or receiving fees from those services, without something more, should not cause F.F.I. status in respect of F.A.T.C.A. under the investment entity prong of the test. However, due to the highly complex nature of F.A.T.C.A., you should consult your tax advisor if you believe F.A.T.C.A. is applicable to you.

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Comparison of Example 1, Final Regulations v. Technical Correction

<i>Final Regulations</i>	<i>Technical Correction</i>	<i>Comparison</i>
<p>Example (1). Investment advisor. Fund Manager is an investment entity within the meaning of paragraph (e)(4)(i)(A) of this section. Fund Manager, among its various business operations, organizes and manages a variety of funds, including Fund A, a fund that invests primarily in equities. Fund Manager hires Investment Advisor, a foreign entity, to provide advice about the financial assets in which Fund A invests. Investment Advisor earned more than 50% of its gross income for the last three years from providing services as an investment advisor. Because Investment Adviser primarily conducts as a business providing investment advice on behalf of clients, Investment Advisor is an investment entity under paragraph (e)(4)(i)(A) of this section and an F.F.I. under</p>	<p>Example (1). Investment advisor. Fund Manager is an investment entity within the meaning of paragraph (e)(4)(i)(A) of this section. Fund Manager, among its various business operations, organizes and manages a variety of funds, including Fund A, a fund that invests primarily in equities. Fund Manager hires Investment Advisor, a foreign entity, to provide advice and discretionary management of a portion of the financial assets held by Fund A. Investment Advisor earned more than 50% of its gross income for the last three years from providing similar services. Because Investment Advisor primarily conducts a business of managing financial assets on behalf of clients, Investment Advisor is an investment entity under paragraph (e)(4)(i)(A) of this</p>	<p>Example (1). Investment advisor. Fund Manager is an investment entity within the meaning of paragraph (e)(4)(i)(A) of this section. Fund Manager, among its various business operations, organizes and manages a variety of funds, including Fund A, a fund that invests primarily in equities. Fund Manager hires Investment Advisor, a foreign entity, to provide advice <u>about and discretionary management of a portion of</u> the financial assets <u>in which held by</u> Fund A—<u>invests</u>. Investment Advisor earned more than 50% of its gross income for the last three years from providing <u>similar</u> services—<u>as an investment advisor</u>. Because Investment Adviser<u>Advisor</u> primarily conducts <u>as a business providing investment advice of managing financial assets</u> on behalf of</p>

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paragraph (e)(1)(iii) of this section.	section and an F.F.I. under paragraph (e)(1)(iii) of this section.	clients, Investment Advisor is an investment entity under paragraph (e)(4)(i)(A) of this section and an F.F.I. under paragraph (e)(1)(iii) of this section.
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Contacts

If you have any questions about this alert, you may contact the principal of our law firm, Stanley C. Ruchelman, or the author of this client alert, Armin Gray, or Philip Hirschfeld, whose practice includes international tax matters such as F.A.T.C.A.

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