Understanding the complexities, risk and exposure associated with global tax reporting and withholding requirements

Private equity (PE) funds and venture capitalists have long recognized opportunities for growth and generation of capital through non-U.S. (foreign) investors. With more U.S. funds engaging in cross-border transactions, the frequency of payments to foreign investors has also increased along with regulatory enforcement efforts in this area including increased penalties, improved systems for tracking reportable income, more examinations and a plethora of regulations. Additionally, new changes in withholding and reporting requirements set forth under the 2017 Tax Cuts and Jobs Act (TCJA) will affect funds going forward. Fund managers will therefore need to become familiar with the complex U.S. reporting and withholding requirements that apply to payments made to non-U.S. (foreign) investors. Failure to consider these requirements can result in significant assessments of taxes, penalties and interest and may have reputational implications that ultimately affect the funds' bottom line.

In today’s fast-paced marketplace and complicated regulatory environment, internationally active funds face a number of challenges.

Background

Under current U.S. tax laws, a non-U.S person with an interest in a U.S. fund is generally subject to tax on income that is either:

1. Fixed, determinable, annual or periodical (FDAP) income (such as interest, dividends or royalties) derived from U.S. sources, or
2. Effectively connected with a U.S. trade or business (ECI).

PE funds largely generate gains from the sale of portfolio companies and, to a lesser extent, dividends and interest which may be considered FDAP. However, certain common activities of PE funds can result in ECI, such as investments in U.S. operating businesses structured as partnerships or limited liability companies, and investments in U.S. real estate or U.S. corporations with substantial U.S. real estate holdings.

Non-U.S. investors that are engaged in a trade or business in the United States are taxed on their income that is “effectively connected” with that business. Equally as important, foreign investors engaged in a U.S. trade or business are required to file U.S. tax returns. Therefore, U.S. funds withholding taxes from and reporting income to foreign investors should manage risk by making every effort to ensure the accuracy and completeness of the information they provide since their investors will rely on this information to prepare their tax filings. Funds should also ensure that they have sufficient policies, procedures, systems and internal controls for managing risk associated with noncompliance with these rules.

Key requirements

Chapters 3 and 4 of the U.S. Internal Revenue Code (the tax code) generally require withholding agents, including U.S. PE funds, to report information on certain payments and distributions made to foreign investors to the IRS and to withhold taxes on these payments at a specified rate. Specifically:

Chapter 3

Section 1441—Generally requires 30 percent nonresident alien (NRA) withholding and reporting on IRS Forms 1042 and 1042–S of certain FDAP income (such as interest, dividends and royalties) derived from sources within the United States that is paid to foreign persons. While certain payments (such as portfolio interest) are exempt from NRA withholding and
others may be eligible for a reduced rate of withholding under provisions of various tax treaties, but the payments are still subject to reporting on Forms 1042 and 1042-S.

Section 1446 — Requires withholding at the highest graduated tax rate and reporting on Forms 8804 and 8805 of income effectively connected with a U.S. trade or business. Notably, the TCJA reduced the withholding rates on ECI under section 1446 from 35 percent to 21 percent for corporate partners and from 39.6 percent to 37 percent for individuals and other noncorporate partners, effective Jan. 1, 2018. Systems will therefore need to be updated to reflect the new withholding rates and to incorporate new logic. Other new requirements under TCJA for funds to consider are:

- The TCJA added new code section 864(c)(8), which treats gain or loss from the sale of an interest in a partnership that is engaged in a U.S. trade or business as ECI to a foreign partner, to the extent the partner would receive a distributive share of the gain or loss on a hypothetical sale of the partnership’s assets at fair market value.
- The TCJA introduced new section 1446(f) which imposes a flat 10 percent withholding tax on the amount realized by a foreign partner on the sale of an interest in a partnership engaged in a U.S. trade or business if any portion of the gain would be taxable under new section 864(c)(8). Pending further guidance, reporting of section 1446(f) withholding is required on IRS Form 8288 and 8288-A. Notably, the IRS has temporarily suspended section 1446(f) withholding on sales or transfers of interests in publicly traded partnerships. (See IRS Notice 2018–08 and 2018–29). Formal regulations are expected soon, but funds should begin modifying their systems and procedures and developing investor communication plans, new disclosures and subscription agreements now to address new requirements under section 1446(f) as needed.
- The TCJA also reduced the withholding rate on capital gain distributions from real estate investment trusts (REITs) or other qualified investment entities (QIEs) from 35 percent to 21 percent, effective Jan. 1, 2018. A distribution by a REIT or other QIE to a foreign person attributable to gain recognized by the QIE on the sale or exchange of U.S. real property interests (USRPIs) may be considered a “look-through” distribution under section 897(h) and subject to withholding under section 1445(e)(6). The rate of withholding follows the new 21 percent corporate tax rate.

Section 1445 — Requires withholding at a flat rate of 15 percent and reporting of dispositions of interests in U.S. real property by foreign persons on IRS Form 8288.

Chapter 4

Sections 1471 through 1474 – Requires U.S. funds to withhold 30 percent of certain payments and distributions of FDAP income (such as interest or dividends) derived from sources in the U.S. that are made to foreign investors who fail to comply with provisions of the Foreign Account Tax Compliance Act (FATCA). FATCA requires U.S. withholding agents to collect documentation (such as IRS Forms W–8 or W–9) from investors certifying their status as a U.S. or non-U.S. person and their Chapter 4 status and to report and withhold FATCA taxes from FATCA withholdable payments made to investors that fail to provide such documentation or who are otherwise FATCA noncompliant. Undocumented investors and those with a Chapter 4 status of “Nonparticipating Foreign Financial Institution” or “Passive Nonfinancial Foreign Entity” who fail to disclose their substantial (i.e., 10 percent or more) U.S. owners will be subject to 30 percent FATCA withholding.

FATCA withholdable payments and related taxes must be reported by domestic funds on IRS Forms 1042 and 1042-S due annually by March 15. Furthermore, information on FATCA noncompliant investors must be reported by U.S. funds to the IRS on Form 8966 due annually by March 31.

As discussed above, U.S. reporting and withholding requirements under Chapters 3 and 4 of the tax code are most relevant for domestic funds with foreign investors. Other reporting requirements may also be relevant, but are beyond the scope of this article. For example, reporting under the Organisation for Economic Cooperation and Development’s (OECD) Common Reporting Standard (CRS) is not relevant since the U.S. does not currently participate in CRS and U.S. funds are not currently required to file CRS reports. However, to the extent a domestic PE fund has an interest in or signature authority over a non-U.S. bank account with a value of $10,000 U.S. dollars or more, it must file a Foreign Bank Account Report (FBAR).

Why is this relevant now?

The U.S. government has increased its focus on and enforcement of compliance with tax information reporting and withholding requirements, and has in fact announced that FATCA compliance is one of its highest audit priorities. As a result, PE funds and other financial institutions have been subject to more IRS examinations and compliance checks with respect to information reporting and withholding issues in recent years.

Furthermore, besides the U.S. government, now more than ever, governments around the world have increased reporting requirements for companies doing business within their borders. Simultaneously, governments have increased enforcement with respect to these rules by conducting more audits and compliance checks and imposing higher penalties for those who are noncompliant.

Given this environment, it is imperative that PE funds evaluate whether they are properly managing risk with respect to foreign investors by prioritizing the implementation of systems and processes to ensure compliance with U.S. reporting and withholding requirements.
What is the real risk?

Penalties for noncompliance with these rules can add up quickly. For example, penalties for failing to comply with FATCA and CRS vary by jurisdiction, but can range from $250 to $250,000 U.S. dollars per instance and may include criminal sanctions. Likewise, penalties for failure to comply with NRA and ECI reporting and withholding requirements include liability for 100 percent of any underwithheld tax. Funds may also be subject to any of the following:

- Failure-to-file penalties ($260 per form for failure to issue recipient copies, and $260 per form for failure to file forms with the IRS)
- Failure-to-pay penalties (up to 25 percent of the unpaid tax liability)
- Failure-to-deposit penalties (10 percent of the tax)
- Accuracy-related penalties (20 percent) that could increase out-of-pocket exposure substantially

Finally, in the United States, there is no maximum penalty where intentional disregard of the rules (based on evidence of a pattern of noncompliance) is found. Therefore, it is imperative to manage risk in advance to avoid economic and reputational risk for the fund.

Historical reporting and withholding processes under Chapter 3 of the tax code tend to be the foundation upon which processes for complying with FATCA and other new reporting regimes are built. Penalties are significant and enforcement is expected to increase while global reporting obligations for funds become more complex. It is therefore imperative to properly manage risk associated with noncompliance now.

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