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PRACTITIONERS' CORNER

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David Neuenhaus is with World Tax Service U.S. in Morristown, New Jersey.

Fund structures are often developed with a goal of accommodating favorable tax treatment for various types of investors (for example, pensions and individuals) from multiple jurisdictions. This requires satisfying often inconsistent statutory requirements, leading to the complexity inherent in many investment fund structures. When funds confront the practical difficulties of satisfying competing requirements, pragmatic approaches are sometimes adopted. For U.S. withholding taxes and U.S. tax reporting obligations, those approaches can result in overwithholding for investors and penalties for funds. For inbound funds (that is, non-U.S. investment funds investing into the U.S.), the risks and inefficiencies can be particularly acute.

This article addresses the practical difficulties often confronted by inbound funds and offers possible solutions. Section I provides an overview of the general U.S. withholding and reporting requirements. Section II describes some approaches that are often considered by funds to address the U.S. requirements, including hybrid and blocker arrangements. Section III describes the potential withholding foreign partnership (WFP) solution. The potential benefits of WFP status can be significant, such that close consideration of the WFP rules — including the requirements inherent in WFP status — should be carefully considered.

I. Overview of U.S. Requirements

Foreign investment funds use numerous arrangements, often with the common characteristic of passthrough foreign and U.S. tax treatment. Passthrough status may be beneficial for a number of reasons, including reduced entity-level taxation, access

to treaty benefits, and favorable capital gains treatment for investors in some jurisdictions. To achieve the benefits related to U.S. income earned with a passthrough investment vehicle, several requirements must be satisfied.

A. General U.S. Requirements

A fund that receives income from a U.S. investment is generally a withholding agent for U.S. tax purposes.¹ As a withholding agent, the fund must ensure that two primary obligations are satisfied:

- adequate withholding tax has been applied to certain U.S.-source income; and
- appropriate U.S. tax reporting has been completed.²

1. U.S. Withholding Tax

Typically, when a payment is made to a foreign fund by a U.S. payer, the payer must withhold U.S. tax from the payment at the rate of 30 percent. The 30

¹Significant withholding and reporting obligations are imposed on withholding agents. *See generally* Treas. regs. 1.1441 and 1.1461 et seq. A withholding agent is broadly defined to include any person that has control, receipt, or custody of an item of income of a foreign person that is subject to U.S. withholding. Treas. reg. 1.1441-7(a)(1). A withholding agent can be a U.S. or non-U.S. person and can be a partnership or other flow-through entity.

²These general requirements are based on a fund's status as a nonwithholding foreign partnership. The requirements applicable to a WFP are described in greater detail below.

percent withholding tax is subject to important exceptions.³ Generally, if reduced withholding tax rates are to be obtained, documentation on each beneficial owner (for example, each of a fund's foreign investors) must be obtained. Because the fund stands between its investors and the U.S. investment (that is, the U.S. payer), it is usually incumbent on the fund to collect the documentation from its investors and to provide the documentation to the U.S. payer in accordance with specific requirements.⁴

2. U.S. Reporting

A fund must also ensure that the information it has provided to the U.S. payer is sufficient to allow the U.S. payer to complete the required U.S. reporting. To the extent the fund does not provide sufficient information to complete the U.S. tax reporting (or otherwise has reason to know the U.S. tax reporting was not completed), the fund must report the U.S. income itself.⁵ Reporting is required even if, for example, a treaty is applicable such that no tax is withheld on the income.

B. Base Case

To observe these seemingly simple requirements in context, assume the following base case.

A foreign investment fund will raise capital from non-U.S. investors, including individual investors and foreign pension funds. The fund will use the capital to invest (at least in part) in U.S. private equity assets. Assume the investors are not subject to tax on capital gains in their home country and are potentially eligible for benefits (reduced withholding tax rates) under an applicable tax treaty with the U.S.

Under these facts, the fund will typically be formed as a local passthrough entity, such as a Dutch CV, Danish K/S, German GmbH & Co., or one of myriad potential passthrough entities with the anticipation that the fund's passthrough status will permit the investors

to achieve home-country tax-free capital gains treatment. Further, it is anticipated that the structure will permit each investor to qualify for the reduced U.S. withholding tax rates under an applicable U.S. tax treaty.⁶

For the investors to realize the treaty benefits relating to the U.S. investment, the fund must generally collect U.S. tax documentation (for example, a Form W-8BEN) from each investor⁷ and provide the U.S. payer (for example, the U.S. portfolio company) with the investor documentation, plus the fund's own tax information (a Form W-8IMY and withholding statement). Assuming that all information is collected and provided to the U.S. payer and that the U.S. tax reporting is completed, the tax objectives should be achieved.

However, when there are multiple tiers of investment funds (for example, if an investor in the fund was itself a fund, such as a fund-of-funds), there is a dynamic investor base, or there are a large number of investors, the documentation administration and investor-specific reporting may become impractical to the fund or U.S. payer. Under those facts, the fund may not be able to (or may decide not to) collect U.S. tax documentation from its investor base. Accordingly, no reduction in U.S. withholding tax will be available and a 30 percent withholding tax will apply to some U.S.-source payments, such as dividends. This may be unwelcome news for the investors, as they are subject to excessive amounts of U.S. taxation that may not be creditable against the investors' local taxes.⁸

There is also bad news for the fund, which is likely unexpected. That is, most funds expect that full or overwithholding imposed on an investor base nullifies the failure to report to the IRS. In fact, the reporting requirements remain, and the fund is obligated to complete the beneficial owner (investor-level) reporting because it is the fund that failed to provide appropriate U.S. tax documentation to the U.S. payer.⁹ If the fund fails to file the necessary U.S. returns, it will be subject to penalties, potentially including an increased penalty for an intentional failure to comply with the reporting

³Treas. reg. 1.1441-1(b). See also IRC section 871. All citations herein are to the U.S. Internal Revenue Code of 1986 as amended and the Treasury regulations promulgated thereunder.

⁴The documentation is provided to the U.S. payer with the fund's own documentation (for example, a Form W-8IMY indicating the fund's status as a foreign partnership) and a withholding statement. A withholding statement is a document that accompanies the investor documentation and provides significant additional information, including the name, address, type of documentation received from each investor; an allocation of each payment to every payee; the withholding tax rate applicable to each payee; and other information requested by the U.S. payer. The withholding statement must be updated as often as necessary to ensure that the information is correct. Treas. reg. 1.1441-1(e)(3)(iv).

⁵When the fund collects valid documentation from each of its investors and transfers it to the U.S. payer, the fund generally should not be required to complete the reporting under the multiple withholding agent rule. Treas. reg. 1.1461-1(c)(4)(iv).

⁶IRC section 894.

⁷Because the investments are private equity assets, each investor must generally obtain an EIN from the IRS via an application process and include the EIN on the Form W-8BEN for the form to be valid.

⁸Many countries have rules similar to those in the U.S. that do not allow foreign taxes to be credited against home-country taxes when the foreign taxes could have been reduced under an applicable tax treaty.

⁹Treas. reg. 1.1461-1(c)(4)(iv). Even if the fund provides all the documentation necessary for full and accurate withholding and reporting, a fund's obligations to the IRS may not be satisfied (and penalties can arise) if the fund knows (or has reason to know) that the appropriate IRS withholding or reporting was not completed by the U.S. payer.

requirements.¹⁰ In addition, when full withholding is not applied, the fund may be liable for U.S. taxes and penalties relating to the underwithholding, including interest, failure-to-deposit penalties, and failure-to-collect penalties.¹¹

II. Possible Solutions

Funds and their advisers often consider various structural arrangements to address reporting and documentation burdens. These arrangements frequently include the use of hybrid and blocker entities. These approaches and their limitations when used for these purposes are briefly described below.

A. Hybrid and Reverse Hybrids

An almost unlimited combination of hybrid and reverse hybrid structures has been considered to achieve passthrough status with simplified withholding tax and reporting requirements. In most instances, however, improved treaty withholding rates and reduced reporting obligations generally cannot be obtained by using check-the-box alchemy. This is due in large part to the comprehensive and complex U.S. tax rules regarding permissible treaty benefit claimants.

For instance, generally only the taxpayer that derives the income (that is, the taxpayer that is subject to tax on the income for home-country purposes) may claim U.S. treaty benefits. For most funds, two alternatives may exist:

- the fund entity may itself claim U.S. treaty benefits if the fund entity is not fiscally transparent¹² under the laws of its jurisdiction (and, of course, the entity otherwise satisfies the applicable treaty requirements); or
- an investor (that is not itself fiscally transparent) may claim treaty benefits if the fund entity is fiscally transparent in the investor's tax jurisdiction (and, of course, the investor otherwise satisfies applicable treaty requirements).¹³

Applying these principles to hybrid structures (that is, structures using one or more entities that are treated as fiscally transparent in the U.S. but are taxed as corporates/entities outside of the U.S., such as a GmbH or BV for which a U.S. check-the-box election has been made to obtain passthrough treatment for the entity), treaty benefits can be claimed only at the entity

level and not by the investors. This is because the U.S. tax election has no effect on local taxation, such that the entity, rather than the foreign investors, is viewed as the taxpayer for purposes of claiming treaty benefit. For many funds, applicable limitation on benefits provisions cannot be satisfied at the entity level.

Similarly, applying these principles to reverse hybrid structures (that is, structures in which the fund entity is viewed as a corporate for U.S. tax purposes but is viewed as fiscally transparent for local tax purposes, such as a GmbH & Co KG, K/S, or CV for which a U.S. check-the-box election has been made to obtain nonpassthrough treatment for the entity), treaty benefits may generally be claimed by investors and not the entity. Again, because the U.S. tax election has no effect on local tax treatment, the foreign investors, not the entity, are viewed as the taxpayers for purposes of claiming treaty benefit.

The use of a blocker generally eliminates the investor's ability to access local favorable capital gains taxation.

Thus, hybrid and reverse hybrid arrangements on their own generally will not achieve the desired access to treaty benefits with reduced investor-level U.S. tax documentation and reporting burdens.

B. Blocker Entities

Blocker entities (typically corporations for both local and U.S. tax purposes) are frequently used in fund structures when special investor considerations are present. In the context of planning for U.S. treaty benefits and U.S. reporting, the use of a blocker generally eliminates the investor's ability to access local favorable capital gains taxation. It may also be difficult for the blocker entity to qualify for treaty benefits because of, for example, limitation on benefits considerations at the blocker level. Further, blockers are frequently formed in jurisdictions without access to a U.S. tax treaty.

III. WFP Status as a Solution

For some funds, WFP status can be the solution to obtaining investor-level treaty benefits with vastly reduced U.S. tax reporting obligations. However, there are burdens and obligations inherent in WFP status. Each fund must independently determine whether the anticipated benefits of WFP status outweigh the burdens associated with WFP status. To date, some funds have opted for the approach of liberally interpreting

¹⁰See, e.g., IRC sections 6721 and 6722.

¹¹See, e.g., IRC sections 1461, 6656, and 6672.

¹²For these purposes, a fund is fiscally transparent to the extent an item of income retains its character and source and flows through to the investor on a current basis, whether or not distributed.

¹³In some situations benefits can be claimed by both the fund and its investors. Further, some treaties specify the treatment of particular vehicles.

the technical reporting obligations described above. The IRS's renewed interest in cross-border investor withholding and reporting, however, will likely result in greater scrutiny, and WFP status will become a more compelling alternative for many funds.¹⁴ Newly proposed withholding and reporting obligations will likely serve to further attract consideration of WFP status.¹⁵ Below is a general overview of the benefits and burdens that may result from WFP status, as well as a description of the procedural steps involved in obtaining WFP status.

A. General Benefits of WFP Status

WFP status is obtained under an application process with the IRS, as further described below. Upon approval of a fund's application for WFP status, the IRS and the fund enter into an agreement (WFP agreement), setting forth terms and conditions of WFP status. The IRS has issued a draft form WFP agreement.¹⁶ Detailed WFP requirements are set forth in the Treasury regulations.¹⁷ Many WFP concepts and the WFP agreement terms are similar to, and included by cross-reference to, the standard qualified intermediary agreement. The QI rules apply to financial institutions, whereas the WFP rules generally apply to foreign passthrough entities.¹⁸ WFP status can provide many benefits:

- Investor documentation is confidential. As a WFP, documentation collected from non-U.S. investors is retained and does not get transferred by the WFP to other funds, portfolio companies, upstream withholding agents, or the IRS.
- U.S. tax filings are reduced. A WFP can elect pooled reporting; that is, it may elect to file a single Form 1042-S for an entire pool of similarly situated investors without disclosing any investor-specific information to the IRS. In the base case example, if 3,000 fund investors qualify for the 15 percent withholding tax rate on dividends, a single Form 1042-S can be filed by the WFP for the investor pool. In comparison, as a non-WFP, 3,000 Forms 1042-S would have to be filed. WFP status can therefore significantly reduce administrative burdens.
- There are treaty benefits for investors. A fund that is a WFP reviews the investor documentation collected and applies withholding tax rates as appropriate. When there are many investors with small percentage interests, the benefits of reduced withholding may be immaterial on an individual investor level, but in the aggregate, savings may be significant, provide a commercial advantage, and improve a fund's reported returns. For instance, assume that in the example a \$3 million dividend is paid by a U.S. portfolio company to the fund with 3,000 treaty-eligible investors. Absent treaty relief, the amount withheld would be \$900,000, or 30 percent of the dividend. If WFP status is in place so that a reduced withholding tax rate of 15 percent can be claimed, the amount withheld would be \$450,000. Of course, when investors are eligible for a 0 percent withholding tax rate (such as pension funds), the savings to the investors can be greater.
- Refunds may be claimed by a WFP on behalf of investors. A WFP may complete IRS refund claims on behalf of its investors and, in some circumstances, may directly obtain an effective refund through setoff or reimbursement procedures.
- The need for EINs on W-8BENs may be eliminated. Typically, a W-8BEN provided by a foreign individual must contain an employer identification number to obtain treaty benefits relating to payment on U.S. private securities (for example, investment portfolio companies held by private equity funds). Obtaining an EIN can be difficult for some investors, especially non-English speakers, and uncomfortable for investors not otherwise obligated to interact with the IRS. For WFPs, the

¹⁴The IRS has recently raised cross-border investment (withholding and reporting) to a Tier I audit issue. This means that increased focus and resources will be allocated to these matters by the IRS, in turn prompting U.S. withholding agents to pay greater attention to the documentation they are receiving from non-U.S. investors. Funds with foreign investors are in fact beginning to experience much greater scrutiny from their U.S. payers.

¹⁵The Foreign Account Tax Compliance (FATC) provisions of the recently enacted HIRE Act (H.R. 2847) generally impose a 30 percent withholding tax on any withholdable payments (generally U.S.-source payments and gross proceeds on U.S. debt and equity) made to some foreign financial and nonfinancial institutions. The FATC rules are generally intended to root out undisclosed U.S. taxpayers, but the rules may motivate funds to seek WFP status. More guidance can be expected regarding coordinating the FATC rules and the existing U.S. withholding tax rules.

¹⁶Rev. Proc. 2003-64, 2003-2 C.B. 306 (Aug. 11, 2003), as amended in subtle but important ways in Rev. Procs. 2005-77 and 2004-21 (each discussed in greater detail below).

¹⁷Treas. reg. 1.1441-5(c) et seq.

¹⁸It is possible to obtain QI status for partnerships, but to do so the partnership must essentially be structured so that each partner has a segregated account with independent control/investment decision-making (similar to a segregated investment account at a bank or brokerage firm). For private equity funds, partners generally are viewed as having a combined interest in the aggregate portfolio of the fund, and as such, QI status is generally not available. A main benefit of obtaining QI status versus WFP status is that the investors can be confirmed with local country know-your-customer documentation and obtain treaty

(Footnote continued in next column.)

benefits, whereas investors in a WFP must generally be documented with, for example, a Form W-8, as described herein.

IRS can grant relief and agree that investors are not required to obtain EINs for investments held by the WFP.

- The need for the preparation of U.S. Form 1065, "Partnership Return," and Schedules K-1 may be eliminated. Funds with U.S.-source income may be required to prepare a U.S. tax return and issue Schedules K-1 to investors.¹⁹ For WFPs, the IRS can grant relief so that the fund is not required to prepare the Forms 1065 and Schedules K-1 in some instances.

B. General Obligations of WFP Status

As a WFP, a fund also must agree to assume certain obligations, including:

- The WFP must apply the appropriate U.S. withholding tax amounts. A U.S. payer will generally pay all U.S.-source income to a WFP in the gross amount (that is, without reduction for any U.S. withholding taxes). A WFP fund must apply the appropriate amount of withholding tax based on the type of income received and the specific makeup of its investor base. Accordingly, a WFP and its advisers must implement systems to ensure that the necessary information is maintained and updated and that the appropriate withholding tax rates are applied. WFPs may be liable for any underwithholding.
- Amounts withheld must be remitted to the IRS in a timely manner. The amounts withheld by a WFP must be remitted (transferred) to the IRS via the electronic federal tax payment system in a timely manner. The timeliness and frequency of deposits depend upon specific facts and are determined based on specific rules in the IRC. Remittance typically must be made to the IRS from a U.S. account. One important detail to be considered by a WFP is how to ensure the remittance requirements are satisfied (for example, use of master account with fund PIN access).
- A third-party audit of WFP controls and procedures is generally required.²⁰ In some instances a WFP's procedures must be audited by a third party.²¹ The audit is not a financial audit, but rather tests the fund's WFP-related documentation and processes. The specific audit requirements are described in greater detail below.

¹⁹See IRC section 6114.

²⁰WFP agreement, section 8. See also Draft External Auditor's Audit Plan Submission on the IRS website (<http://www.irs.gov>). The IRS has issued proposed changes to the audit procedures for QIs, which may or may not be extended to WFPs. See Rev. Proc. 2008-98.

²¹The auditor must know the WFP and U.S. tax rules and must be subject to independence requirements.

C. Practical Limitations of WFP Status

WFP status can result in complexity in two scenarios. These scenarios, described below, can often be accommodated but can require further structuring efforts.

1. Limited Application for Indirect Investors

One important limitation relates to a WFP's indirect partners. Specifically, Rev. Proc. 2003-64, section 2.02, "Application to Direct Partners," provides in part that with limited exceptions a WFP may only act as a WFP for its direct partners that are not intermediaries or flow-through entities. Greater flexibility has since been adopted,²² but absent the ability to negotiate an amendment to the WFP agreement with the IRS, WFP treatment may be difficult for funds that have significant passthrough investor bases. In the situations described immediately below, relief for passthrough investors is available (assuming the WFP has elected pooled reporting). Other structural solutions can also be developed.

The first exception, referred to as "Smaller Partnerships and Trusts,"²³ applies when:

- the second-tier partnership is a foreign partnership;
- the second-tier partnership is a direct investor in the WFP; and
- none of the second-tier partnership's owners are U.S. persons or passthroughs.

Amounts includable in the distributive share of the second-tier partners must be subject to the highest rate of withholding applicable to any of the second-tier partnerships owners. Thus, this exception is beneficial when all investors in a second-tier partnership/fund-of-funds are eligible for the same treaty rate, but it generally is not available when there are multiple tiers of fund investors.

The second exception, regarding related partnerships, applies when the upper-tier partnership is:

- a foreign partnership;
- an investor in a partnership to which the WFP applies the exception; and
- the WFP is a general partner of that partnership.²⁴

Under this exception, investors of the upper-tier partnership are effectively treated as direct investors of

²²See Rev. Procs. 2005-77 and 2004-21 (regarding the related partnership and smaller partnership exceptions).

²³WFP agreement, section 10.01, as amended. The term "smaller" is an anachronism. Previously, this exception applied only to passthrough partnership investors that had total reportable amounts not exceeding \$200,000. The size limitation has been eliminated.

²⁴*Id.* at section 10.02, as amended.

the WFP. This exception may be viable for multiple fund layers, but it may be difficult to implement in some instances.

2. *All Investors Must Be Documented*

The WFP rules require strict compliance with the investor documentation rules. Documentation is required from every direct investor, and, subject to cure provisions, the absence of documentation can result in the termination of the WFP agreement.²⁵ A WFP is not, however, required to act as a WFP for all payments it receives. That is, it may operate as both a WFP and a nonwithholding foreign partnership, and, depending on the structure and facts, some investors (for example, foreign investors not seeking treaty benefits) may be segregated.

D. WFP Application Process

The process to apply for WFP status is set forth in section 3 of Rev. Proc. 2003-64. The fund must submit to the IRS specific information regarding the fund, such as the entity type, composition of investor base, and size of U.S. investments. It also must identify the personnel responsible for overseeing the WFP process. Included with the information should be an IRS Form SS-4 (to request a WFP tax identification number, or EIN) and two signed forms of the WFP agreement. If the IRS accepts the application, it will countersign the agreement and return it to the fund applicant. There is some flexibility regarding the terms, and the IRS may issue riders to the agreement potentially simplifying certain requirements, so a dialogue with IRS personnel is generally beneficial before submission.

Upon issuance of the signed WFP agreement and receipt of the WFP EIN, a fund may activate its status by completing a Form W-8IMY, including its WFP EIN, and indicating that it is acting as a WFP. Importantly, WFP may continue to act as a non-WFP regarding those investments for which it has provided a Form W-8IMY.

E. WFP Operations

The main operational implications of WFP status tend to relate to the systems necessary to complete the documentation, withholding, and remittance tasks described above. Ideally, one or more of a WFP fund's personnel should be assigned to oversee the WFP requirements, and procedures should be adopted regard-

ing documentation collection, documentation review for due diligence/consistency, documentation storage, and coordination of withholding and tax remittance processes. In most instances some degree of training of the responsible personnel regarding the WFP requirements and the adoption of internal checklists help with WFP compliance.

F. Audit

As mentioned, a WFP must agree to be audited. The specific audit requirements are set forth in section 8 of the WFP agreement, and in some respects continue to evolve.²⁶ In general, the WFP's procedures, especially regarding investor documentation, tax withholding, remittance, and reporting, are subject to review by the auditor to confirm compliance with the terms of the WFP agreement. Sampling methods are permitted,²⁷ and the audit findings are submitted to the IRS without disclosure of specific investors. Depending on the findings, the IRS may request an auditor to complete further inquiries.

Audit frequency depends on the specific terms of the WFP agreement. If a WFP does not select pooled reporting, an audit is conducted only upon request by the IRS. If pooled reporting is selected, the frequency of the required audits is based on the terms of the WFP agreement.

IV. Conclusion

Fund structures frequently fail to take into account the practical limitations of obtaining favorable U.S. withholding tax treatment and the compliance burdens related to passthrough structures. The IRS has increased its focus on foreign investor withholding and reporting matters, so it is important that funds correspondingly increase their compliance efforts regarding these matters. The WFP regime can provide relief in terms of access to treaty benefits and reduced U.S. tax reporting. Inherent in WFP status are burdens that must be carefully considered, and funds that adopt WFP status must be prepared to allocate time and resources to accommodate these burdens. ◆

²⁶IRS Announcement 2009-98, discussing changes to similar audit rules for QIs.

²⁷See "IRS Draft External Auditor's Audit Plan Submission," including its reference to account sampling per Rev. Proc. 2002-55 ("Audit Guidance for External Auditors of Qualified Intermediaries").

²⁵*Id.* at section 9.04.