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SOUTH AFRICAN PRIVATE EQUITY FUNDS AND FATCA – NO ROOM FOR LINGERING LETHARGY

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This article describes the current legislative vacuum in which South African entities, including private equity funds, find themselves with regard to the US Foreign Account Taxation Compliance Act (FATCA). This vacuum notwithstanding, we encourage all entities:

- *to banish any temptation to think that the rules do not apply;*
- *to start preparing for the imminent introduction of the much wider ranging automatic exchange of information regime represented by the OECD's Common Reporting Standard; and*
- *to focus on the next steps to take so as to be FATCA compliant.*

The private equity industry is well within the sights of FATCA bearing in mind that collective investment vehicles and other investment entities are specifically targeted. That is not to say that all private equity investment vehicles will be classified as reporting financial Institutions (FIs) but, until the work has been done to establish that this is indeed not the case, the working assumption should be that, in any private equity structure, there will be entities that should have registered with the US Internal Revenue Service (IRS) by the end of last year and that will need to submit their first reports to SARS by 30 June 2015.

The current position - US FATCA

Along with over 100 other countries, South Africa is the signatory to an Intergovernmental Agreement (IGA) with the United States government that provides the basis for making the automatic exchange of information known as FATCA applicable to South African entities. Although the South African government has taken the necessary steps to put the IGA into effect, it would appear that the US has not completed its own ratification processes. Technically, therefore there is the small matter of the IGA currently having no legal force.

However, even if the IGA was fully in place (and this is certain to happen), it would have no direct binding effect on South African financial institutions (FIs) as they would only be legally obliged to carry out the due diligence and reporting requirements set out in the IGA once the SA government had introduced the necessary domestic regulations. It would normally be expected that, as in countries like the UK and Canada and to a lesser extent Australia, there would be a detailed set of regulations that would largely mirror the IGA. This has so far not been the case and indications are that South African FIs remain in something of a legal vacuum. However, before anyone starts to argue (or continues to argue as there were signs of such an argument in the panicked run-up to the 31 December 2014 deadline for the registration of entities with the IRS) that this means that a South African FI need do nothing until a long set of regulations is in place, the following points need to be borne in mind:

- Under the IGA, South Africa is under a duty to make sure that its FIs comply. It cannot do that until formal regulations are introduced. Thus, until that is the case, South Africa is technically in breach. If the SA government is in breach, then so are its FIs. Thus, there is no merit in an FI arguing that it is the government's problem and not the FI's. But clearly government has an important role to play in ensuring that South African FIs are compliant.

- Breach in this context means that the IGA would be ignored and the FIs would be subject to the full set of US Regulations and would be required to report directly to the IRS.

- The US government is displaying (without saying it) a remarkable degree of tolerance in not making a song and dance about IGA governments not having passed the necessary laws to make FATCA binding on their local financial community. This is perhaps because it is itself behind in its implementation processes but it is also consistent with the pragmatic line it took on getting IGAs negotiated, signed and ratified where it was prepared to accept that countries had made sufficient progress to be treated as having signed an IGA.

- In fact, the SA government, with very little fanfare, introduced two Notices in June 2014 that purport to require an SA FI to:

    - keep the necessary records to show that it has complied with the due diligence requirements under the IGA; and

    - submit to SARS a return containing the information required by the IGA.

- There may be some legitimate questions to be raised as to the legal effectiveness of these Notices. Indications are that a new set of secondary legislation is being prepared. However, the Notices comprise a clear statement of intent from SARS that they expect the necessary compliance work to be done and returns submitted, all on pain of significant criminal sanctions in the event of non-compliance.

- In any event, any new legislation will be with effect from 1 July 2014 and so there will be a lot of catching up to do for FIs that have done nothing.

- The financial community, in particular banks and investment funds, is generally behaving as though FATCA applies. Therefore, technical arguments, whether or not correct, will fall on deaf ears of those FIs that are obdurately applying the FATCA regime and that will not do business, and indeed cease to do business, with another person that they consider is not to be FATCA compliant.

So the bottom line is that, if any FIs still have delusions that FATCA may not yet apply or may be a problem for governments only, these should be very quickly abandoned. FIs should behave as if the IGA applied directly to them and should take account of the draft Guidance Notes that SARS published for comment on 17 December 2014.

The future position – multilateral FATCA

Before we know it, 1 January 2016 will be upon us and that means that the Common Reporting Standard (CRS), being the OECD version of FATCA, will be in play for those governments that have committed to so-called early adoption. There are over fifty early adopters (including South Africa) and this number is likely to increase. At the moment, South African FIs only need to worry about reporting to SARS on US taxpayers for whom they hold accounts either directly or indirectly. As from 1 January 2016, the full range of CRS due diligence and reporting will apply in relation to accounts maintained for tax residents in all of the early adopter countries. And SARS will need to package all of those reports and exchange the relevant information on an automatic basis with the relevant countries, hopefully all in a secure way.

Immediate priorities

At the risk of re-stating the obvious, a South African resident entity that has not yet determined its FATCA status should do so without further delay. Without understanding its status, and in particular

whether it is a so-called Reporting FI, the entity will not be in a position to understand the extent of its FATCA obligations.

Which takes us on to the next immediate priority, namely due diligence and reporting. In summary, a Reporting FI now needs to take care of the following:

- It needs to identify accounts that it maintains for clients or investors that existed as at 30 June 2014 or that it opened between that date and 31 December 2014 – these are referred to as "pre-existing accounts" and in the context of a private equity fund would be the debt or equity interests held in the fund.

- The fund then needs to carry out due diligence on those accounts to determine whether there are US taxpayers behind them. The nature and level of due diligence depends on the size of the account and whether it is held by an individual or entity.

- For any accounts opened from 1 January 2015, the due diligence needs to be carried out at the point of the account being opened and should be completed before the account can be treated as operational. For example, an investment subscription should not be accepted and implemented before the due diligence has been completed.

- The deadline for the first reports, which will cover the period from 1 July 2014 to 28 February 2015, is 30 June 2015. SARS will be required to report any relevant information to the US Inland Revenue Service by 30 September 2015.

- Reports will need to be made in the format proposed by SARS and as published on the SARS website accessible through the following path www.sars.gov.za - Business and Employers - Modernised 3rd party data Platform - Automatic Exchange of Information, scroll down to 'Useful Links' and select 'SARS External BRS 2014'.

- Even where the due diligence process reveals that nothing needs to be reported, it would appear to be necess*ary that the FI in question file a nil return with SARS.*

CONCLUSION

Not only is FATCA here to stay, its impact will soon criss-cross the globe. While parts of the South African financial community have been pro-active in dealing with FATCA, there would appear to be a number of FIs that are not fully engaged and are therefore at risk of being non-compliant with the serious consequences that can result. Although SARS has itself been pro-active, the continued lack of clarity in the legal position, including in the form of definitive guidance, is making an already difficult situation more difficult to manage. It may also be the cause of some entities remaining detached from the reality of the new FATCA environment in which the entire world is now living.

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