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The Foreign Account Tax Compliance provisions of the Hiring Incentives to Restore Employment Act ("FATCA") were enacted in March 2010 with an effective date of January 1, 2013.[1] FATCA requires foreign financial institutions ("FFIs") that opt in to this regime ("participating FFIs") to report information to the US Internal Revenue Service ("IRS") regarding their US account holders in order to assist the IRS in enforcing U.S. taxpayer compliance. The definition of FFI includes most types of financial services entities as well as any other entity that holds investments as its primary business objective.[2] FATCA imposes a 30% withholding tax on an expansive list of payments, including payments of gross proceeds (as discussed further below) to non-participating FFIs and other payees that are not FATCA compliant. U.S. financial institutions also have considerable new obligations.

Market participants <u>shortly will be</u> entering into derivative transactions that could extend beyond the effective date of the various FATCA provisions (and have payments that would be subject to FATCA withholding). In particular, trades entered into after March 18, 2012 will not qualify for the existing grandfathering relief, and the final scope of the grandfathering relief is uncertain.[3] To address the effects of FATCA on derivatives transactions, the North American Tax Committee has drafted proposed language for counterparties to consider using in their ISDA transactions, which is included in

[1] The IRS issued guidance in Notice 2011-53 extending the effective date for various aspects of FATCA, including aspects with direct effect on derivatives.
[2] For example, FFIs include: family owned investment trusts, securitization vehicles, charities that make investments, pension funds, hedge funds, private equity funds, mutual funds, banks, broker dealers, custodians, and clearing organizations (such as Euroclear).
[3] IRS Notice 2011-53 indicates that an agreement has to have a definitive term to be grandfathered, which raises questions about Credit Support Annexes, for example.

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Appendix A hereto. The impact of the proposed language is to place the FATCA withholding tax burden on the recipient of the payment by eliminating this tax from the definition of "Indemnifiable Tax" in the ISDA Master Agreement. The rationale is that the recipient is the sole party that has the ability to avoid the withholding tax by complying with the FATCA rules; therefore, the recipient should be the party burdened with the FATCA withholding tax if it chooses to not comply.

Although not included in the proposed language, parties may wish to consider including other FATCA-related provisions. For example, under the forthcoming regulations, it may be necessary for a US payor or participating FFI to obtain additional documentation from a counterparty to establish the counterparty's status for FATCA purposes. Parties may wish to consider including document delivery provisions to detail the manner in which any such document request/delivery will operate. In addition, FATCA may require in certain instances that a non-financial foreign entity ("NFFE") that receives withholdable payments certify that there are no US persons that own more than 10% of the stock or interest in the NFFE. Parties entering into transactions with an NFFE may wish to include language to confirm that US persons do not own more than 10% of the stock or interest in the NFFE, unless one or more exceptions apply as prescribed under FATCA and applicable regulations. Parties may also wish to consider including a termination right (or whether their current documents already give them a termination right) for FATCA withholding tax to avoid either having to be withheld upon on a transaction or having to perform the withholding and remitting function. This is not an exhaustive list of FATCA related considerations or documentation changes and parties are strongly encouraged to consult with their legal, tax and other advisers.[4]

<u>Further FATCA Information</u>

The FATCA withholding stakes are considerable. This is driven primarily by the following two features: first, gross proceeds on sales of securities are subject to the withholding tax, and, second, the "passthru payment" rules, under IRS guidance issued to date, would require US withholding on a broad range of payments not typically considered US source income if such payments are made by a participating FFI that holds US assets anywhere in its group to a recipient that is a nonparticipating FFI or recalcitrant account holder.[5] For example, the passthru payment rules could potentially impose US withholding tax on an interest payment made by a British Bank's London office to a

[4] For example, parties may also wish to consider including language that a participating FFI will not transfer its withholding obligations to the other party, because the FATCA legislation authorizes participating FFIs to assign its withholding obligations to the payor of withholdable payments.

[5] A "nonparticipating FFI" is a foreign financial institution that does not sign an FFI Agreement with the IRS in which the financial institution agrees to comply with the requirements of FATCA. A "recalcitrant account holder" is an account owner at a participating FFI that refuses to provide the necessary documentation to prove it is not a US taxpayer or fails to provide the participating FFI with the necessary legal waiver to allow the participating FFI to comply with its reporting obligations under FATCA. Participating FFIs and US financial institutions are required to withhold on certain payments made to a nonparticipating FFI or a recalcitrant account holder.

German Bank's Frankfurt office if the German Bank is a nonparticipating FFI and the British Bank is a participating FFI, provided the British Bank holds any US assets in any of its global offices. The FATCA withholding rate in such case is 30% times the passthru payment percentage of the British Bank. The passthru payment percentage is expected to be calculated at least annually by dividing an FFI's Total US Assets by the FFI's Total Assets (in each case determined on a global basis).

Regulations under FATCA are expected to be proposed in December of 2011, and finalized by the end of the summer of 2012. Currently, it is unclear to what extent the FATCA rules will impact derivative transactions. Starting January 1, 2014, we expect the withholding tax to apply to: (a) any payment of interest by a US payor (including a US branch of a foreign entity) under a Credit Support Annex or the pass through of US source interest on collateral held in custody; (b) transactions that create deemed loans, and therefore deemed US source interest payments, under US tax rules (e.g., a significant upfront payment under a swap) if payor is US (including a US branch of a foreign entity); (c) payments on US equity swaps that are subject to withholding tax under Section 871(m), or regulations thereunder expected to be issued in 2012, regardless of whether the dividend equivalent payor is foreign or US; and (d) certain payments relating to interest or dividends made by a payor under a derivative referencing a US debt or equity security if the recipient of the derivative is considered the "tax owner" of the underlying asset under US tax rules. Periodic payments under a swap or gross proceeds from the early termination of a swap may also be subject to FATCA withholding. [6]

Moreover, starting January 1, 2015, FATCA withholding on nonparticipating FFIs and recalcitrant account holders is required under the yet to be defined passthru payment rules. Depending on how the regulations are written, the passthru payment rules could impose FATCA withholding on a significantly more expansive universe of payments, including payments on derivatives that do not reference US assets. For example, based on current IRS guidance, a swap payment from a participating FFI to a non-participating FFI or recalcitrant account holder could be subject to FATCA withholding if the participating FFI holds US assets either directly or indirectly, even if the reference asset is a non-US asset (e.g. a Korean bond). In addition, the passthru payment rules could cover payments on derivatives referencing US debt or equity securities regardless of whether the recipient is deemed the tax owner of the referenced securities and whether the payor is US or foreign (i.e., foreign to foreign payments). For example, a total return swap between two Japanese counterparties on US equities could potentially be subject to FATCA

[6] According to IRS Notice 2011-53, FATCA withholding in 2014 is limited to payments relating to US Source Fixed, Determinable, Annual, Periodical ("FDAP") Income. Swap income is generally sourced based on residence of the recipient. Therefore, for payments not covered in items (a)-(d) above, this likely means that only US Recalcitrant Account Holders would be subject to FATCA withholding in 2014. For these payments, Nonparticipating FFIs would be covered starting in 2015 to the extent the passthru payment rules apply.

withholding if the payor is a participating FFI and the payee is a nonparticipating FFI.[7] In addition, payments on gross proceeds from loans and other US securities will also be subject to FATCA withholding.

[7] It is not clear whether or how the FATCA rules will apply to derivatives. In particular, assuming the rules apply to derivatives, it is unclear whether this situation would generate a 30% FATCA withholding tax on the entire payment because the assets referenced in the swap are US equities or whether the Japanese payor's passthru payment percentage would be multiplied by 30% to arrive at the withholding rate.

APPENDIX A

Foreign Account Tax Compliance Act. (a) For purposes of any Payer Tax Representation, the words “any tax from any payment” shall not include any tax imposed under Sections 1471 and 1472 of the Internal Revenue Code of 1986, as amended, (or the United States Treasury Regulations or other guidance issued thereunder) ("FATCA Withholding Tax"); and (b) the definition of “Indemnifiable Tax” shall not include any FATCA Withholding Tax.