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FATCA
Market Education Call

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What is FATCA?

- U.S. tax rules contained in the H.I.R.E Act, created with the goal of giving the IRS better tools to audit U.S. citizens and residents utilizing foreign accounts to evade U.S. tax on their worldwide income
- Enacted in March 2010; effective January 1, 2013 with staggered implementation
- Legislation provides the skeletal framework, details to be provided in Treasury regulations (not yet released).
- Provides for withholding on certain payments to foreign financial institutions ("FFIs") that do not enter into an agreement with Treasury to document account holders and provide information on U.S. citizens and residents in their account base to the IRS
- U.S. payers must withhold on U.S. source payments, including dividends, interest, substitute dividends, substitute interest and gross proceeds from the sale of securities that they pay to non-participating FFIs and any account holders that fail to provide adequate documentation
- Per guidance issued by the IRS/Treasury to-date, participating FFIs must withhold on all payments they make to account holders that are non-participating FFIs or inadequately documented individuals or non-financial foreign entities
- Based on a broad reading of the legislation and IRS/Treasury guidance issued to-date, counterparties to derivatives transactions are considered account holders
- Withholding on non-U.S. source payments made by participating FFIs is computed based on a formula that computes the proportion of the payment treated as attributable to U.S. sources

Foreign Financial Institutions ("FFIs")

- An entity is an FFI if:
  - It is a deposit taking entity
  - As a substantial portion of its business it holds financial assets for the account of others; or
  - It engages primarily in the business of investing or trading in securities, commodities or partnership interest or any interest in such asset classes

- Includes:
  - Banks, Credit Unions
  - Brokers, Dealers, Custodians, Clearing Organizations
  - Funds of all types (e.g., mutual funds, pension funds, hedge funds, private equity funds, etc.)
  - Life insurance companies
  - Securitization vehicles
  - Investment trusts, corporations, partnerships

- FFIs that do not either (1) enter into an agreement with Treasury or (2) qualify for one of the very limited exclusions from FATCA, will suffer FATCA withholding tax on most payments they receive

Counterparties Other than Financial Institutions

- FATCA classifies foreign entities as either foreign financial institutions ("FFIs") or non-financial foreign entities ("NFFEs")
- NFFEs generally must provide documentation to establish they are non-US entities and documentation related to any substantial U.S. owners (generally requires a greater than 10% direct or indirect interest in the entity)
- NFFEs may be excepted from FATCA requirements; more details on which NFFEs will qualify as 'excepted' to be provided in forthcoming regulations
- Non-U.S. individuals must provide documentation to establish that they are not U.S. persons; no FATCA reporting is required with regard to these individuals
- US entities and individuals will generally be required to provide documentation to establish their U.S. status; once documented as U.S., these counterparties are to be reported to the IRS in accordance with forthcoming FATCA requirements

Relevant Differences from Current U.S. Withholding Rules

- FATCA requires a participating FFI to obtain documentation from and report on substantial U.S. owners of non-financial foreign entities
- FATCA withholding tax can apply to both U.S. source payments and to foreign source payments
- The nature of the reporting obligations under FATCA does not, from a practical perspective, generally enable one participating FFI to delegate its reporting obligation to another participating FFI or U.S. withholding agent
- FATCA does not currently adopt the existing tax withholding and reporting exemptions for certain types of U.S. payments (e.g. interest on T-bills, deposit interest)
- Existing Forms W-8 likely will not be sufficient to document foreign counterparties
- Existing Forms W-9 may not be sufficient to document U.S. counterparties
- U.S. exempt recipients may need to provide FATCA documentation to a participating FFI
- No clear exemptions from documentation requirements is provided for governments, international organizations, entities wholly owned by governments, etc.
- FATCA is a liability of the paying FI; while the paying FI may generally recover the tax from the recipient, the IRS will seek to recover from the paying FI, regardless of whether the recipient ultimately files an accurate and complete U.S. tax return
- The legislation provides extremely narrow opportunities to obtain a refund of FATCA withholding

Pre-Existing Transactions (aka the "Grandfathering Rule")

- No withholding is required under FATCA on any payment made under any obligation outstanding on March 18, 2012 or from the gross proceeds from any disposition of such an obligation.
- IRS/Treasury guidance provides that the obligation must be a fixed-term obligation that is not characterized as equity for US tax purposes
- ISDA Master Agreements do not typically have a fixed term, accordingly, the Master Agreement itself would not qualify for grandfathering relief
- Transactions entered into under an ISDA Master Agreement should generally qualify for grandfathering relief, provided they are entered into on or before March 18, 2012 and provide for a fixed term
- Substantial modifications to existing transactions may cause them to be treated as new transactions, which may cause them to lose the grandfathering protection if modified after March 18, 2012
- Credit Support Annexes are not typically fixed term contracts and typically treat the pledging of collateral as a separate transaction that also does not provide for a fixed term; therefore, payments on collateral may not qualify for grandfathering relief even where the collateral is held in connection with a transaction entered into on or before March 18, 2012
- Transferee's right of substitution is potentially useful in minimizing FATCA withholding applicable to certain forms of collateral

FATCA Creates Serious Financial Risk

Non-Compliance Risk

FFIs that do not enter into a FATCA Agreement with Treasury by December 31, 2013 are likely to bear FATCA withholding tax on a variety of payments, including payments on "wholly foreign" transactions

Absence of FATCA Language Risk

Participating FFIs and US FIs that do not modify their Master Agreements to address FATCA are at risk for grossing up a counterparty for FATCA withholding tax (30% * Passthru Payment Percentage * Payment to Counterparty or 30% * [U.S. source FDAP + U.S. source gross proceeds from securities]

March 18, 2012 Risk

Trades entered into or substantially modified post March 18, 2012 will not qualify for grandfathering relief

Because of the gross up language, participating FFIs that enter into (or substantially modify) trades post **March 18, 2012** are at risk of bearing the FATCA withholding tax due to the IRS, if the counterparty is a non-participating FFI or a recalcitrant account holder, absent amendments to the Master Agreement

Where is the Greatest Risk Under an ISDA Master Agreement?

- FATCA tax applies only to non-participating FFIs and recalcitrant account holders, so if all FFI counterparties opt into FATCA and if all counterparties provide proper documentation to the paying FFI, an FFI will not need to gross up for FATCA tax, even in the absence of FATCA language in an ISDA
- Trades entered into after March 18, 2012 with a term that extends beyond December 31, 2013 or December 31, 2014, as applicable, with a counterparty that chooses not to become a participating FFI or provide proper documentation where FATCA language is not contained in the ISDA
- Trades entered into before March 18, 2012 but the terms of which are substantially modified after March 18, 2012, with a term that extends beyond December 31, 2013 or December 31, 2014, as applicable, with a counterparty that chooses not to become a participating FFI or provide proper documentation where FATCA language is not contained in the Master Agreement
- Collateral held beyond December 31, 2013 or December 31, 2014, as applicable, on behalf of a counterparty that chooses not to become a participating FFI or provide proper documentation where FATCA language is not contained in the Master Agreement
- If a US FI or a participating FFI transacts with another participating FFI, that participating FFI could, under current rules, require the paying FI to perform its withholding in respect of its non-participating FFIs or recalcitrant account holders; putting a participating FFI that transacts only with compliant counterparties at risk of being required to perform withholding
    - A number of comment letters to the IRS have proposed that the paying FFI be entitled to decline a request to perform withholding for another participating FFI

FATCA Withholding Tax Example

Sample Master Agreement Trade

On March 19, 2012, a participating FFI (PFFI) and a non-participating FFI (NPFFI) enter into a 10 year IR cross currency swap

- The notional principal of the swap is 50,000,000 CAD, corresponding to 42,500,000 EUR, at the current market rate of 1 CAD=0.85 EUR[1]
- PFFI receives fixed rate of 1.2% on the CAD notional, and pays fixed rate of 1.5% on the EUR notional
- The payments are quarterly, on the 1st day of the month. The interest is calculated on an actual/365 basis
- PFFIs current Pass Thru Payment Percentage (PPP)[2] is 20%

Swap Payment Overview

Total funds received by PFFI	Total funds paid out by PFFI	Total FATCA taxes[3,4]
On Value Date = 42.5MM EUR	On Value Date = 50MM CAD	On Value Date = 0
Total Quarterly Interest = 5.8MM CAD	Total Quarterly Interest = 6.37MM EUR	On Quarterly Interest = 326M USD[5]
On Maturity Date = 50MM CAD	On Maturity Date = 42.5MM EUR	On Maturity Date = 3MM USD

FATCA Consequences

Scenario 1: ISDA Master Agreement not updated for FATCA and CP is recalcitrant/non-FATCA participating	Scenario 2: ISDA Master Agreement updated for FATCA and CP non-FATCA participating or recalcitrant	Scenario 3: CP FATCA participating
Due to IRS = 3.3MM USD Party economically responsible: PFFI, (due to gross up)	Due to IRS = 3.3MM USD Party economically responsible: NPFFI, (due to gross up)	Due to IRS = 0

Note 1: Assumes exchange rate is set at 1 CAD:0.85 EUR for duration of swap contract

Note 2: PPP calculation is still uncertain. However current guidance suggests that PPP = PFFI's U.S. assets / Total assets

Note 3: Taxes remitted to the IRS are due in USD (example assumes 1 CAD: 1 USD)

Note 4: FATCA tax commences Jan. 1, 2015 on pass-thru payments. Therefore, in this swap contract, the first 2 years 9 months are not taxable under FATCA

Note 5: FATCA tax is not applicable to interest paid before 1/1/2015.; no compounding of interest for purposes of the calculation

Relevant Dates

March 18, 2012

- Transactions entered into or substantially modified after this date may be subject to FATCA tax

January 1, 2013

- Likely date FFIs can apply to become participating FFIs (no ability to collect required documents from a participating FFI until it applies for participating FFI status, perhaps no ability for participating FFI to deliver documents until its participating FFI-EIN is issued by the IRS)

January 1, 2014

- FATCA tax begins to apply to US source fixed, determinable, annual or periodical income – e.g., dividends, interest, substitute dividends
- FATCA tax applies to payments related to U.S. collateral (including USD cash) and trades with U.S. assets or certain U.S. referenced assets when made to non-PFFIs and undocumented counterparties
- See ISDA FATCA market education note, available at www.isda.org, for more details regarding potential covered payments

January 1, 2015

- FATCA tax begins to apply to US proceeds of sale and may begin to apply to foreign source payments
- FATCA tax applies to all payments to non-PFFIs and undocumented counterparties
- See ISDA FATCA market education note, available at www.isda.org, for more details regarding potential covered payments

Relevant Existing ISDA Master Agreement Language

2(d) (i) Gross Up. All payments under this Agreement will be made without any deduction or withholding for or on account of any Tax unless such deduction or withholding is required by any applicable law, as modified by the practice of any relevant governmental revenue authority, then in effect. If a Party is so required to deduct or withhold, then that party (“X”) will: …

(4) If such Tax is an Indemnifiable Tax, pay to Y, in addition to the payment to which Y is otherwise entitled under this Agreement, such additional amount as is necessary to ensure that the net amount actually received by Y (free and clear of Indemnifiable Taxes, whether assessed against X or Y) will equal the full amount Y would have received had such deduction or withholding been required. However, X will not be required to pay any additional amount to Y to the extent that it would not be required to be paid but for :--

(A) The failure by Y to comply with or perform any agreement contained in Section 4(a)(i), 4(a)(iii) or 4(d); or

(B)The failure of a representation made by Y pursuant to Section 3(f) to be accurate and true unless such failure would not have occurred but for (I) any action taken by a taxing authority, or brought in a court of competent jurisdiction, after a Transaction is entered into (regardless of whether such action is taken or brought with respect to a party to this Agreement) or (II) a Change in Tax Law.

ISDA Industry Standard Language

Part 5

<u>Foreign Account Tax Compliance Act</u>. (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.

Additional FATCA Related Considerations for ISDA Master Agreement Modifications

- Document delivery language for any documents required for FATCA purposes
- Termination rights for either or both parties if FATCA withholding will apply
- Broadening transferee's right of exchange to facilitate minimal or no withholding on collateral
- Representations that there are no US persons that have more than a 10% beneficial interest in a party to the Master Agreement
- Representations as to FATCA compliance where one party is required by rating agency considerations to gross up the other party for all taxes
- Mutual agreement that neither party will delegate withholding responsibility under 1471(b)(3) of the Code to the other
- Limitation on use of Master Agreement post March 18, 2012 absent insertion of FATCA language

Questions?