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The Foreign Account Tax Compliance Act 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. Alternatively, under intergovernmental agreements, FFIs located in certain partner countries may be required under local law to comply with FATCA and provide the requested account information to either their home government or the IRS.[2] 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.[3] 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 under FATCA.

On January 1, 2013, market participants will be entering into derivative transactions that are no longer grandfathered and could extend beyond the effective date of the various FATCA provisions (and have payments that would be subject to FATCA withholding). Grandfathering of transactions from FATCA withholding is based on the date of the confirmed transaction, and not the date the applicable ISDA Master Agreement was

[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] http://www.treasury.gov/press-center/press-releases/Pages/tg1653.aspx
[3] 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).

executed. Given the relatively recent enactment of FATCA, the tax provisions of even the 2002 ISDA Master Agreement do not address FATCA. To address the effects of FATCA on derivatives transactions, the North American Tax Committee has drafted a Protocol to amend the ISDA Master Agreement tax provisions consistent with the existing paragraph's goal of a proper division of tax risk between the Payor and Payee. The impact of the Protocol 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.

Further FATCA Information

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, which are still unknown but may 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.[4] 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 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 Treasury Department issued Proposed Regulations under FATCA in February, 2012. Treasury also has released its first Model Intergovernmental Agreement in July, 2012. Treasury currently expects to release a second Model IGA in August/September, 2012 and to publish the Final Regulations and Model FFI Agreement by end of summer/early fall. Currently, it is unclear to what extent the FATCA rules will impact derivative transactions. Starting January 1, 2014, under the Proposed Regulations the withholding tax will 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)

[4] 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.

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. In 2015, this withholding will be expanded to include gross proceeds on the transactions.

With respect to withholding on passthru payments, the Proposed Regulations indicate that withholding will occur no earlier than January 1, 2017, but reserve of the definition of passthru payments. 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, 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 withholding if the payor is a participating FFI and the payee is a nonparticipating FFI.[5] In addition, payments on gross proceeds from loans and other US securities will also be subject to FATCA withholding.

[5] 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.