FATCA Practice Point Series: Derivatives

Speed read

On January 17, 2013, the U.S. Internal Revenue Service (the IRS) issued final regulations under the Foreign Account Tax Compliance Act (FATCA and such regulations the Final Regulations). The A&O U.S. Tax Group will issue a series of short bulletins highlighting practical FATCA issues relevant to specific areas of the financial markets. These bulletins will reflect our view of the law and how market practice has evolved since the IRS issued the Final Regulations and subsequent administrative guidance.

This bulletin discusses FATCA in the context of derivatives and ISDA documentation.

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Background

FATCA generally imposes a 30% withholding tax on (i) withholdable payments (generally, U.S. source interest and dividends and gross proceeds from a disposition of equity and debt instruments issued by U.S. persons); (ii) foreign passthru payments (a term yet to be defined), if such payments are made to a foreign financial institution (an FFI) that fails to provide certain information about its account holders to the IRS; and (iii) certain payments made by an FFI to an account holder that fails to establish whether it is a U.S. person (or whether it is a non-U.S. entity owned by U.S. persons).

Collateral supporting derivatives transactions

Special source of income rules, "grandfathering" protection, and the expectation of a widespread network of FATCA intergovernmental agreements (each an IGA) promise significant relief from the threat of FATCA withholding in derivatives transactions. Nevertheless, there are gaps in such relief. Collateral that produces withholdable payments (e.g., U.S. Treasury securities or cash collateral deposited with U.S. banks) presents a particular FATCA withholding
risk, since withholding on collateral payments can arise even when the related derivative transaction would not otherwise be subject to withholding under FATCA.

GRANDFATHERING PROTECTION GENERALLY

Under the Final Regulations and subsequent guidance, a “grandfathered obligation” (generally, an obligation which is exempt from FATCA withholding) is one which, *inter alia*, has a stated term and is:

- An obligation outstanding on July 1, 2014;
- An agreement requiring a secured party to make payments with respect to collateral securing one or more grandfathered obligations; or
- *Solely for purposes of determining whether a foreign passthru payment is subject to withholding*, an obligation executed on or before the date that is six months after the date of final regulations defining the term “foreign passthru payment”.

Collateral arrangements, whether documented under a New York law or English law Collateral Support Annex (CSA), or under an English law Collateral Support Deed (CSD), cannot themselves qualify as grandfathered obligations because they lack a stated term.

LIMITATIONS ON GRANDFATHERING OF COLLATERAL PAYMENTS

At first glance, the second and third elements of the grandfathering rules above may appear to offer protection from FATCA withholding for payments on collateral posted in certain derivatives trades between non-U.S. parties. On closer examination, however, grandfathering relief generally will not apply to payments on U.S. collateral when the related trade is entered into after June 30, 2014. For example, a post-June 30, 2014 interest rate swap between two non-U.S. banks may be treated as a grandfathered obligation under the third test above. As a result of the phrase highlighted in italics in that test, however, payments on U.S. Treasury securities posted as collateral for that trade would not be treated as grandfathered. This is the case because, by its terms, the third test applies only to determine whether *foreign passthru payments* on the derivative trade itself are subject to FATCA withholding. Thus, collateral that produces U.S. source *withholdable payments* (e.g., U.S. Treasuries) and that supports a post-June 30, 2014 swap between two non-U.S. parties does not appear to be grandfathered, even if the swap itself is a grandfathered obligation.

The Final Regulations state that collateral securing both grandfathered and non-grandfathered obligations will be allocated *pro rata* by value among all outstanding obligations secured by such collateral in determining which payments are subject to FATCA withholding. It is unclear how this allocation mechanism is intended to work on a practical level (e.g., how parties will distinguish between grandfathered and non-grandfathered obligations, and when the valuation of the secured obligations should occur).

EFFECT OF INTERGOVERNMENTAL AGREEMENTS

While an FFI that benefits from a “Model 1” IGA between the United States and its country of residence (a Reporting FI) generally should not be required to withhold for FATCA, this will not eliminate risk to the party receiving the U.S. collateral (the Collateral Recipient). Under Article 4.1(e) of the Model 1 IGA, if the Collateral Recipient is a Reporting FI which acts as an intermediary with respect to a U.S. source withholdable payment, the Collateral Recipient must notify the payer of that payment of the FATCA status of the beneficial owner of the payment.
Generally, the beneficial owner of the payment will be the collateral provider (the **Collateral Provider**) if the Collateral Recipient does not have the right to sell the collateral. In such a case, if the Collateral Provider is subject to FATCA withholding the payer of the U.S. source income will withhold at source, leaving the Collateral Recipient only a net amount to pay to the Collateral Provider. Under standard ISDA documentation, the Collateral Recipient would be obliged to gross up for the shortfall.

Finally, under a Model 1 IGA, certain Reporting FIs that have entered into an agreement with the IRS to act as a "qualified intermediary" or "withholding foreign partnership" will still be required to withhold on U.S. source withholdable payments, as will all Reporting FIs in a "Model 2" IGA jurisdiction. Accordingly, a party to a derivative transaction resident in an IGA jurisdiction could still be required itself to withhold on payments in respect of collateral that gives rise to U.S. source income.

## Risk Allocation

### ISDA ACTIONS

In August of 2012, the International Swaps and Derivatives Association (**ISDA**) published a protocol (the **FATCA Protocol**) to modify the traditional allocation of tax risk in transactions governed by ISDA Master Agreements. The FATCA Protocol allocates FATCA withholding risk to the payee by carving FATCA out of the definition of "Indemnifiable Tax", so that a payer does not have to pay additional amounts in respect of FATCA withholding. For more information on the FATCA Protocol, see our client bulletin [here](#).

In recent months, a working group established by the ISDA North American Tax Committee (**NATC**) drafted language to amend the payee representations in ISDA Master Agreements (the **FATCA Representations**) as an alternative for parties who have not adhered to the FATCA Protocol. Whereas the operative provisions of the FATCA Protocol carve FATCA withholding out of the definition of Indemnifiable Tax, the FATCA Representations require a counterparty to represent that it is exempt from withholding under FATCA. Making the FATCA Representations has the same effect as entering into the FATCA Protocol – if a party breaches the FATCA Representations, there will be no gross-up for FATCA withholding and if the payer has a liability for its failure to withhold, such payer is indemnified by the payee. The FATCA Representations also serve an informational purpose in addition to allocating the FATCA withholding risk in that payees must represent as to their status under FATCA. Whereas the FATCA Protocol does not create termination rights in respect of withholding pursuant to FATCA, the NATC is also considering language for parties to incorporate payer termination rights should such rights be commercially negotiated.

Subject to the discussion below, the adherence of both parties to the FATCA Protocol, or the incorporation of the language of either the FATCA Protocol or the FATCA Representations into the Schedule or Confirmation governing a trade, will shift the risk of withholding on U.S. source collateral to the payee (**i.e.,** the Collateral Recipient).

### CSDS

Both New York law governed and English law governed CSAs are part of the ISDA Master Agreement, and therefore subject to the taxation provisions in the ISDA Master Agreement and accompanying Schedule. The English law governed CSD, however, is not part of the ISDA Master Agreement. Consequently, where counterparties adhere to the FATCA Protocol or
include FATCA Representations in a Schedule to the ISDA Master Agreement, and are using a CSD for their collateral, FATCA withholding risk will need to be addressed in the Schedule to the CSD as well.

Circular 230

To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that the U.S. federal tax discussion contained herein (i) was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax-related penalties under the Internal Revenue Code and (ii) was not written to support the promotion or marketing of any transaction. Taxpayers should seek the advice of their own independent tax advisers based on their own particular circumstances.

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