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Allocation of FATCA Withholding Risk in Financial Transactions Outside the United States

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The U.S. Treasury Department has delayed implementation of FATCA once again. However, this delay may be the last, and a phased implementation of FATCA is scheduled to begin on July 1, 2014. FATCA introduces the potential for U.S. tax withholding on passive U.S.-source payments made by U.S. entities to foreign financial institutions ("FFIs") and, more importantly for this Alert, possibly on payments "attributable to" such amounts made by FFIs to other non-U.S. entities. The extraterritorial nature of the FATCA tax regime means that U.S. tax withholding risk will be introduced into financial transactions that have almost no nexus to the United States.

An urgent issue for international finance professionals is to determine how to allocate the risk of 30% U.S. tax withholding risk under FATCA. This alert will discuss the FATCA withholding and reporting regime and the potential obligations it imposes on non-U.S. entities. It will then address the impact on negotiating tax provisions of loan agreements, repurchase agreements, swaps and other common financial transactions.

Background of FATCA

In General

Enacted in March 2010, the U.S. Foreign Account Tax Compliance Act ("FATCA") provides the U.S. Internal Revenue Service (the "IRS") with powerful tools to identify U.S. holders of foreign financial accounts and entities. FATCA creates a sweeping new reporting and withholding regime that is designed to deter offshore tax evasion by U.S. persons. The burden of this new regime falls heavily on FFIs, a term that is broadly defined to include banks, custodians, broker-dealers, investment managers, investment funds, insurance companies issuing cash-value policies, and certain holding companies and treasury centers.

Generally speaking, an FFI opts into the FATCA reporting regime (and becomes a "participating FFI") by entering into an agreement with the IRS, pursuant to which it must perform diligence procedures to determine whether its account holders are (or, in certain cases, are owned by) specified U.S. persons, report certain information about such account holders to the IRS, and act as a withholding agent in certain cases. Although U.S. law could not explicitly require FFIs to undertake these obligations, an FFI refusing to do so will be subject to a 30% withholding tax on "Withholdable Payments" it receives, which include: (1) U.S.-source payments of interest, dividends, royalties and other passive income made after June 30, 2014, and (2) gross proceeds from the sale or disposition after December 31, 2016, of property that can produce U.S.-source dividends and interest. FATCA withholding applies to interest payments that would otherwise be exempt (or subject to a reduced rate of withholding) under a tax treaty or pursuant to the U.S. portfolio interest exemption.

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FATCA considerably expands the existing U.S. tax regime by imposing an obligation on FFIs (through their agreements with the IRS) to withhold on certain payments made outside the United States to any account holder that is a nonparticipating FFI or that has not properly identified itself (a “recalcitrant account holder”). FFIs must withhold on any Withholdable Payment made to such an account holder. For example, a non-U.S. custodian would need to withhold on a U.S.-source dividend that it receives on behalf of an account holder that is a nonparticipating FFI. In addition, FFIs may be required to withhold on “Foreign Passthru Payments” made to such an account holder. The U.S. Congress in enacting FATCA legislation specifically included amounts “attributable to” Withholdable Payments as also subject to withholding. Consistent with this approach, the IRS’ implementing regulations provide that withholding on Foreign Passthru Payments will be required no earlier than 2017. Although the regulations reserve the term “Foreign Passthru Payments” to be defined on a future date, prior IRS public announcements suggest that the definition may be based on the ratio of an FFI’s U.S. assets to its total assets or a similar formula. One of the key FATCA risks in financial transactions is the possibility that participating FFIs will be required to withhold on offshore payments made to nonparticipating FFIs and recalcitrant accountholders.

Grandfathered Obligations

Payments under obligations entered into before July 1, 2014 (“grandfathered obligations”), are not subject to withholding. In addition, solely for purposes of Foreign Passthru Payments, a grandfathered obligation also includes any agreement entered into up to six months after the date on which the definition of Foreign Passthru Payment is published by the IRS. An obligation will lose its status as a grandfathered obligation, however, if it is “materially modified.” With a debt instrument, this could occur, for example, if the yield is changed by more than 25 basis points (or, if greater, 5% of the annual yield of the unmodified instrument), or if the obligation is changed from recourse to nonrecourse.

Timeline for FATCA Implementation

FATCA withholding will be implemented in phases. In broad outline, the important milestone dates for implementation are as follows:

- July 1, 2014 - Withholding on U.S.-source payments of interest, dividends, royalties and other passive income begins (though payments by FFIs with respect to an offshore obligation – a payment wholly outside the United States that is nonetheless treated as U.S.-source – will not commence until January 1, 2017, provided that the FFI is not acting as an intermediary).
- January 1, 2017 - Withholding on gross proceeds from the sale or disposition of any type of U.S. property that can produce income, such as U.S. stocks and bonds, begins.
- No earlier than January 1, 2017 - Withholding on Foreign Passthru Payments begins.

Intergovernmental Agreements

Many foreign governments, particularly in Europe, expressed concern that compliance with the reporting obligations under FATCA would require their FFIs to violate privacy or data protection laws in their home countries, thus placing FFIs in an impossible position. In early 2012, five European governments announced that they would negotiate intergovernmental

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agreements (“IGAs”) with the United States to implement FATCA. Eventually two models developed: an indirect approach (the “Model 1 IGA”) and a direct approach (the “Model 2 IGA”).

Under the Model 1 IGA, an FFI’s host government would intermediate with the IRS to provide the information required by FATCA. Under this model, the FFIs in a particular jurisdiction would be required to report information about U.S. account holders to their home government, which would then share that information with the IRS pursuant to an IGA. Under the Model 2 IGA, FFIs would enter into individual agreements and share basic account holder information with the IRS, but the relevant home government would share information with the IRS about nonparticipating FFIs and recalcitrant account holders (so that FFIs would not need to withhold on Foreign Passthru Payments to these account holders). To date, Denmark, Germany, Ireland, Mexico, Norway, Spain and the U.K. have entered into the Model 1 IGA, and Japan and Switzerland have executed the Model 2 IGA. The IGA appears to be the preferred method for dealing with FATCA implementation, with as many as 75 countries reportedly in negotiations with the IRS.

In addition to alleviating the concerns about compliance by FFIs with host-country privacy laws, IGAs appear to eliminate the need for FFIs to withhold on Foreign Passthru Payments. This greatly reduces the shadow that FATCA casts over offshore financial transactions. However, some uncertainty remains surrounding this issue, because the IGAs commit the parties “to develop a practical and effective alternative approach to achieve the policy objectives of foreign passthru payment and gross proceeds withholding that minimizes burden.” Some have worried that this provision creates a risk that future rules could still require FFIs to withhold on Foreign Passthru Payments, and that transaction documents, particularly for long-term transactions, should address this risk. Even if concerns about this issue under the IGAs are unfounded, the potential for withholding on Foreign Passthru Payments still exists for FFIs in jurisdictions that have not entered into IGAs.

Loan Agreements and FATCA Withholding

In loan documents, lenders and borrowers typically allocate the risk that withholding taxes will apply to interest payments under the loan. For example, U.S. borrowers generally agree to “gross up” interest payments if a change in law causes withholding taxes to increase during the term of the loan. Parties must now consider how to draft agreements to deal with the risk of FATCA withholding.

The 30% withholding obligation under FATCA can arise in several ways. Common circumstances that can require imposition of a FATCA withholding tax include the following:

- The borrower is a U.S. entity, or (in certain circumstances) has its obligations guaranteed by a U.S. entity, so that interest payments are U.S.-source and subject to FATCA withholding if paid to a noncompliant lender.
- The borrower is an FFI that earns some U.S.-source income, and rules are issued during the term of the loan requiring withholding on Foreign Passthru Payments.
- Payments on a loan that otherwise would avoid withholding because the loan is a grandfathered obligation could become subject to withholding if the loan loses that status.

An existing agreement with a standard gross-up provision tied to taxes “imposed by law” may not apply to FATCA withholding on Foreign Passthru Payments if this withholding is imposed

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pursuant to an agreement with the IRS (and not under non-U.S. legislation implementing an IGA).

For transactions with borrowers that are U.S. persons, the consensus position in the U.S. loan market is to allocate the risk of FATCA withholding to the lender because compliance is within the lender's control. This position is reflected in Section 2(g)(i)(D) of the 2012 Model Credit Agreement Provisions published by the Loan Syndications and Trading Association (the "LSTA").¹

Outside the United States, the lending market has not yet coalesced around a single approach to FATCA withholding for loan agreements. The Loan Market Association (the "LMA") has suggested three alternative approaches:²

- Unlimited lender risk. This approach is similar to the consensus approach in the United States, with the lender bearing the risk of FATCA withholding on the theory that compliance is within the lender's control. A lender would be comfortable with this approach if it was confident of its own FATCA compliance or that it could syndicate the loan to participating FFIs.³
- Limited lender risk. The lender bears the risk of FATCA withholding, but the risk is limited because the borrower represents that no payments are U.S.-source and the lenders must consent to any change they reasonably believe could cause a material modification of the loan (and, thus, a loss of grandfathered status).
- Borrower risk. This approach makes sense if the lender group might include lenders that are not FATCA-compliant. A borrower might be comfortable with this approach if it is neither an FFI nor a U.S. payor, so that its payments are outside the scope of FATCA.

FATCA Withholding under Other Common Types of Financial Agreements

Other agreements present similar issues in allocating the risk of FATCA withholding. Examples include notional principal contracts and securities lending arrangements. In the United States, standard documents prepared by industry associations have generally allocated the risk of FATCA withholding to the party receiving the payment. We discuss below some of the specific initiatives taken by certain market-leading bodies with respect to particular types of transaction.

Claims Trading Documents

FATCA creates a complex legal regime (much of which remains in draft) and its precise effects on secondary debt trading currently remain unclear. Furthermore, the implications of FATCA in any particular case will depend upon a number of factors, including the terms of

¹ This model agreement provides that in the event the borrower is a U.S. person, if a payment made to a lender under any loan document would be subject to U.S. federal withholding tax imposed by FATCA if such lender were to fail to comply with the applicable reporting requirements of FATCA, the borrower is entitled to request documentation as may be necessary for the borrower and the administrative agent to comply with their obligations under FATCA and to determine that such lender has complied with such lender's obligations under FATCA or to determine the amount to deduct and withhold from such payment.

² See 2013 FATCA riders for LMA investment grade facility – July 2013 Update (available to LMA members at http://www.lma.eu.com/documents_download.aspx?T=2&CID=1612).

³ This is the approach taken by the model credit agreement form published by the LSTA. See 2012 LSTA Model Credit Agreement Provisions' Section 2(g)(ii)(D).

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the underlying loan, the nature and status of the underlying obligors, and the identity and status of the parties to the trade.

In addition to loan documentation, the LSTA and LMA coordinate documentation for secondary trading of loan participations and claims.⁴ The tax provisions in that documentation focus on the allocation of tax withholding risk not between a borrower and a lender but between a participant and a lead bank where the lead bank may be responsible for passing on proceeds or other payments it has received. Secondary transactions in which the participant is a nonparticipating FFI face the risk that payments of the settlement amount for purchased assets, as well as interest, fees, breakage amounts and delayed settlement compensation or payments by the seller/grantor to the participant, could be subject to FATCA withholding tax. It is challenging to assess the precise effects of FATCA on secondary debt trading, not only because of the complexity of the topic and the absence of clear determination of certain issues, but also because the implications of FATCA in any particular case will depend on a complex set of factors, including not only the identity and status of the parties to the trade but also the terms of the underlying loan and the nature and status of the underlying obligors.

LSTA

As with the LSTA model credit agreement, LSTA has considered how FATCA withholding risk should be allocated in secondary transactions. As in the case of the LSTA model credit agreement, LSTA generally views FATCA withholding risk as being a payee risk. An important consideration for the LSTA drafting committee that considered this position was that in situations where payments are passed on, such as with proceeds or payments under a participation agreement, it is necessary to ensure that full payments are made to receiving parties that comply with FATCA. Therefore, under the LSTA draft language, a seller who receives a payment that was subject to FATCA withholding would have to pay a grossed-up amount to the buyer unless (i) the buyer did not comply with the FATCA provision or (ii) the buyer would still have been subject to FATCA withholding if it had received the payment directly from the underlying borrower. The draft FATCA provision for secondary documentation, therefore, requires the remitting party to request forms from the receiving party to ascertain its status under FATCA and to make clear that forms are required if necessary to reduce withholding on payments on the underlying debt (not just payments between the buyer and seller). A remitting party can refrain from making a payment until it receives the necessary FATCA documentation from the receiving party.

LMA

As with the LMA riders for loan transactions, LMA has also proposed riders for the allocation of FATCA withholding risk in secondary transactions.⁵ These riders are based on worst-case scenarios and allocate FATCA withholding risk to the payee. They provide that each party is

⁴ LSTA secondary trading documents include the Standard Terms and Conditions for several basic documents. These include Par/Near Par Trade Confirmations, Participation Agreements for Par/near Par Trades, Chapter 11 Plan proceeds letter agreements for Post-Effective Date Settlement of Distressed trades, Letter Agreements for Post-Repayment Date Settlement of Distressed Trades, Purchase and Sale Agreement for Distressed Trades, Participation Agreements for Distressed Trades and Confirmations for Distressed Trades. LMA secondary trading documents include Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims), LMA Funded Participation (Par/Distressed), LMA Risk Participation (Par), LMA Trade Transactions (Par/Distressed)

⁵ See 2013 FATCA riders for LMA secondary debt trading documentation – July 2013 Update (available to LMA members at http://www.lma.eu.com/documents_download.aspx?T=4&CID=1611).

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entitled to withhold on account of FATCA if required to do so and need not pay a grossed-up amount. The riders also contain contractual language entitling each party to request information from the other party concerning its status under FATCA.

Repurchase and Securities Lending Transactions

The standard documentation for repurchase agreements has been developed and published by the Securities Industry and Financial Markets Association ("SIFMA"). For transactions governed by New York law, the basic form of agreement is the Master Repurchase Agreement (the "MRA"), which was published in 1996. For transactions governed by English law, the basic form of agreement is the Global Master Repurchase Agreement (the "GMRA"), which was originally published in 1996 and has been revised in versions issued in 2000 and 2011.

The MRA is used for a repurchase transaction in which one party agrees to transfer to the other securities or other assets against the transfer of funds by the buyer, with a simultaneous agreement by the buyer to transfer to the seller such securities at a date certain or on demand, against the transfer of funds by the seller. In a GMRA, one party agrees to sell securities and financial instruments to the other against the payment of the purchase price by the buyer to the seller, with a simultaneous agreement by the buyer to sell to the seller securities that are equivalent to such securities at a date certain or on demand against the payment of the repurchase price by the seller to the buyer.

As a general matter, both the MRA and the GMRA generally allocate withholding tax risk to the payor. If withholding tax is imposed on a payment, the payor must generally gross up for the withheld amount and pay an additional amount to the payee so that the payee receives the same amount of cash it would have received had the withholding tax not been imposed.⁶

For international transactions under the MRA, SIFMA has proposed an amendment to the MRA that is designed to address the allocation of withholding risk arising under FATCA. Subparagraph 5(b)(iv)(A)(y) of Annex III (the annex for international transactions) provides that additional gross-up amounts are not required to be paid in respect of any U.S. federal withholding tax imposed or collected pursuant to FATCA, regulations thereunder, any FFI agreement or an IGA, regardless of whether they are collected or required to be collected by a U.S. or non-U.S. withholding agent. Subparagraph 5(b)(iv)(A)(y) is not intended, however, to apply to any non-U.S. withholding taxes, regardless of whether the adoption of such laws is related in some way to FATCA. The approach adopted by SIFMA for the MRA is generally similar to the corresponding language in the 2012 LSTA model credit agreement and for the same reasons.

SIFMA, however, has not yet developed a consensus for the treatment of FATCA withholding on payments made pursuant to a transaction governed by the GMRA. Important issues would include the general allocation of risk and whether to define FATCA withholding payments narrowly (to only include amounts required to be withheld by U.S. law) or broadly (to include amounts that an FFI agrees to withhold or amounts that an FFI is required to withhold pursuant to the law of a state that has entered into an IGA).

⁶ Withholding taxes allocated to the payor do not include taxes that result from certain connections between the taxing jurisdiction and the payee or to the extent that the tax results from the payee's failure to comply with certain tax documentation and related obligations.

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Swap Documents

The gross-up of withholding for indemnifiable taxes imposed in respect of swap transactions is addressed in Section 2(d) of the ISDA master agreement.⁷ As in the case of loan agreements, the basic rule is that payments must be made without deduction for indemnifiable taxes, thus placing the withholding risk on the payor.⁸ Although swap payments to non-U.S. parties are generally considered non-U.S. source, and thus would not be subject to FATCA withholding, 30% FATCA withholding could apply to payments under certain equity swaps that are treated as U.S.-source dividends and to payments under swaps that are otherwise recharacterized as U.S.-source.

In 2012, ISDA's North American Tax Committee proposed a protocol that parties could use to amend their existing or future swap agreements to allocate the risk of FATCA withholding. The proposed language places 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, because the recipient is the sole party that can control whether it will comply with the FATCA rules and thereby avoid the withholding tax, it is fair to allocate the risk of any FATCA withholding tax to the recipient if it chooses not to comply with FATCA.

The basic approach towards FATCA withholding taken by ISDA with respect to swaps is similar to that taken by the LSTA for loan agreements. An interesting question is whether that approach is also valid for transactions entered into outside the United States. Two considerations may be relevant in considering that question. The first is that swap transactions outside the United States may be subject to U.S. regulation under the cross-border guidance adopted by the U.S. Commodity Futures Trading Commission,⁹ meaning that the extraterritorial application of U.S. regulation to swap transactions may affect whether LSTA conventions would be more appropriate than LMA conventions in a particular case.

The second is that the same ISDA form is intended for use in transactions that are governed by New York law or English law. This makes swaps different from loan agreements, which conform to LSTA or LMA standards based largely on the choice of law. Thus, the approach adopted by ISDA for North American transactions may not be appropriate for transactions in other regions or jurisdictions. In particular regions where non-ISDA documentation is used to document derivatives transactions, it may be necessary to consider whether FATCA withholding is addressed appropriately. One area of particular interest is Shari'ah-compliant derivatives transactions. The other is derivative transactions between counterparties or accounts in the People's Republic of China (the "PRC").

Shari'ah-Compliant Derivatives

Shari'ah-compliant derivatives are documented under the ISDA/IIFM Ta'Hawwut Master Agreement, which may be used with product-specific confirmations such as the ISDA/IIFM

⁷ Swaps transactions are generally documented under one of two forms of master agreement published by the International Swaps and Derivatives Association ("ISDA") in 1992 and in 2002. Both forms are used in transactions governed by New York law and in transactions governed by English law. Both employ the same basic approach to gross-up of indemnifiable taxes.

⁸ Indemnifiable taxes generally exclude those that result from a connection between the taxing jurisdiction and the payee or that result from noncompliance with tax compliance representations made by the payee.

⁹ Click [here](#) for a link to our recent client alert on the CFTC Guidance on Cross-Border Application of United States Swap Regulations (September 17, 2013).

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Mubadalatul Arbaah Profit Rate Swap.¹⁰ The Ta'Hawwut Master Agreement is generally modeled on the 2002 ISDA form, permitting the parties to select English or New York law and including a tax withholding provision that is identical to that contained in the 2002 ISDA form. However, it contemplates that parties to a transaction under the Ta'Hawwut form of master agreement would enter into underlying Shari'ah-compliant transactions and contains an undertaking (known as a "wa'ad") by each party in certain circumstances to enter into such transactions in the future at the election of the other party. In considering FATCA withholding risk in connection with a transaction under the Ta'Hawwut form, one would have to consider the issues outlined above in general but would also have to consider whether a wa'ad under a grandfathered agreement would result in the transaction being modified such that the agreement is no longer grandfathered.

Swaps Between PRC Entities

Swap transactions between counterparties in the PRC and subject to the law of the PRC are documented using the NAFMII form of master agreement.¹¹ The NAFMII form does not address tax withholding. If a non-PRC entity is involved, it is common market practice for the parties to document the transaction using an ISDA master agreement. In that case, the FATCA withholding issues would be similar to those described above. If both parties to a transaction are PRC domestic entities, withholding would not normally apply because the payee would be a PRC taxpayer, and the payor would not be required to pay PRC withholding tax, in which case there is no need for withholding provisions in the NAFMII form. However, if two PRC entities are party to a swap agreement under the NAFMII form but one could be considered to be an FFI, it would be necessary to consider FATCA withholding, either by using an ISDA form rather than the NAFMII form or amending the NAFMII form to include FATCA withholding provisions. In either case, the FATCA withholding issues would be similar to those described above.

Modifications to Grandfathered Agreements

Parties to an agreement that was entered into before the FATCA implementation date should consider carefully the implications of transactions or modifications (or a wa'ad) that may cause the agreement to lose its grandfathered status. An agreement that is restructured, has its payments rescheduled or is otherwise materially modified will be considered newly executed as of the date of such modification. The implications of this effect are significant and mean that parties to international finance transactions should consider the allocation of FATCA tax withholding risk in all agreements entered into through the grandfathering date, and any modifications considered thereafter, unless they are certain that all payment obligations will be concluded by the implementation date indicated in the timeline above for the relevant type of payment.

Conclusion

To the extent that parties are subject to LSTA documents, the MRA or New York-law ISDA agreements, the allocation of FATCA withholding risk is relatively simple because the LSTA,

¹⁰ The Ta'Hawwut Master Agreement is jointly published by ISDA and International Islamic Financial Market ("IIFM"). Click [here](#) for an article co-written by K&L Gates lawyers that assesses the Ta'Hawwut form of master agreement.

¹¹ That form is jointly published by the National Association of Financial Market Institutional Investors ("NAFMII") and the Asia Securities Industry & Financial Markets Association ("ASIFMA")

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SIFMA and ISDA have driven a broad market consensus in the United States allocating FATCA withholding risk to the recipient of the payment. For transactions under LMA forms, the GMRA, ISDA master agreements governed by English law or, more generally, offshore financial transactions governed by local law (non-U.S./U.K.), it will be necessary to consider the appropriate allocation with care because of the lack of a clearly defined consensus. Although FATCA withholding may not become fully effective until January 1, 2017, parties should consider the allocation of FATCA withholding risk in agreements currently being negotiated and, where appropriate, the incorporation of the necessary terms into these agreements to allocate that risk.

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