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FATCA – problems postponed?

FATCA – the rules originally introduced as the Foreign Account Tax Compliance Act – imposes US withholding taxes and significant compliance obligations on banks and financial institutions worldwide. Many lending, derivative and capital market transactions entered into prior to 1 January 2013 are "grandfathered", and potentially never subject to FATCA withholding or compliance. But with the end of the grandfathering looming, many financial institutions have been concerned that the rules remain unclear, and that this could create systemic risk in the financial markets as 2013 approaches.

On Wednesday the IRS announced measures extending and expanding the scope of the grandfathering rules. We look at the practical impact of the announcement and ask whether FATCA-related difficulties in the international financial markets have been eased, or merely postponed.

What is FATCA and why is it a problem for financial transactions?

FATCA was conceived to counter tax evasion by US taxpayers. Foreign financial institutions (FFIs) – such as banks, insurance companies and many funds and capital markets issuers are invited to sign agreements with the IRS to disclose details of their US accountholders. An FFI that doesn't sign faces a punitive 30% withholding tax on all "withholdable payments" paid to it out of the US. FATCA catches an impressively broad range of payments, including dividends, interest, returns of principal, derivative payments and sale proceeds.

In signing up to FATCA so as to avoid withholding on payments to it, an FFI agrees to itself withhold US tax from payments to other FFIs that are not FATCA compliant. This "passthru withholding" applies even on arrangements that have no US nexus. So, for example, a non-participating FFI that makes a loan to a participating FFI could suffer US withholding tax on payments of interest and principal from the participating FFI – even if the loan has no connection with the US.

These rules create three headaches for financial institutions who wish to sign up to FATCA. First, a considerable compliance and systems burden. Second, a concern that disclosing their US accountholders will violate local law in a number of jurisdictions. Third, the potential for outbound payments to be subject to "passthru withholding", and often with uncertainty as to which party would bear the cost.

Key changes

- Grandfathering from "passthru withholding" will continue until July 2013 at the earliest
- Gross proceeds withholding delayed until 2017
- Payments on posted collateral under grandfathered derivative contracts should themselves be grandfathered
- FATCA reporting dates for non-IGA FFIs aligned with the dates for IGA FFIs

A number of countries have announced the intention to sign intergovernmental agreements (IGAs) with the US which simplify disclosure, reduce or eliminate conflicts with local law, and eliminate outbound passthru withholding. The UK has already signed an IGA. Others, including France, Germany, Italy, Spain, the Netherlands, Japan and Switzerland, have announced their intention to follow suit. There are a variety of reports concerning other jurisdictions, but few that can be regarded as confirmed.

So, whilst the application of the IGAs is not straightforward, UK financial institutions can be reasonably relaxed that they will neither be subject to FATCA withholding on their receipts, nor required to impose it on outbound payments. FFIs in the other potential IGA jurisdictions may also be relaxed, depending on their assessment of the likelihood of their governments signing an IGA. But there are many branch and entity FFIs in other jurisdictions who do not know at this point whether they will benefit from an IGA - with the problem particularly acute in Africa, Asia, the Middle East and Eastern Europe. So many of these FFIs are proceeding on the prudent assumption that there will be no IGA, and they will have to deal with being subject to either FATCA passthru and US source withholding on their receipts (if they do not sign an IRS agreement) or passthru withholding on their payments and potential illegality (if they do).

How grandfathering helps

Prior to this week's announcement, many FFIs have been proceeding on the basis that their historic and current transactions would be grandfathered, and outside FATCA withholding and compliance rules for their term.

- The key date was 1 January 2013.
- Most loans, derivatives, debt securities and other obligations advanced or committed prior to that date would be grandfathered.
- Grandfathering can be lost if a pre-2013 obligation is substantially modified/amended on or after 1 January 2013. And some types of arrangement, such as equity instruments and deposits, are never grandfathered.

Many had been hoping that by the time the grandfathering date approached, the full scope of FATCA and the IGAs – and therefore their ability to comply - would be clear. However the US authorities have made slow progress finalising the FATCA regulations and signing IGAs. This created a real prospect that by the end of grandfathering, FFIs would find their transactions becoming subject to FATCA even though at that point the effect of FATCA was unclear. The difficulty of allocating essentially unknown risks between counterparties has created real concerns.

The effect of Wednesday's announcement

We see the key changes as:

1. Gross proceeds withholding pushed back

Withholding on US source gross proceeds (e.g. the sale proceeds of US assets or the repayment of principal by a US obligor) was due to take effect from 1 January 2015. This has now been deferred two years to 1 January 2017.

2. Grandfathering protection from passthru withholding extended

It was highly unsatisfactory that grandfathering would be lost on 1 January 2013, and non-US arrangements potentially subject to passthru withholding, when the IRS had yet to publish even draft regulations setting out how passthru withholding would work (and there is even some doubt if passthru withholding will proceed at all).

The IRS has acknowledged this problem, and the grandfathering of obligations that are potentially subject to non-US source passthru withholding will continue until 6 months after the date on which the FATCA regulations dealing with passthru withholding are finalised. Realistically that means July 2013 at the earliest (and perhaps much later).

There has been a similar solution to the grandfathering of certain instruments tracking US dividends. Payments on such instruments can be classified as US source income, causing them to be subject to FATCA withholding. The IRS has the authority to expand these rules to more instruments than are currently covered. The grandfathering of these instruments will therefore continue until six months after they first become subject to these rules.

3. The posting of collateral under a grandfathered derivative will now itself be grandfathered

Most pre-2013 derivatives should be grandfathered. However there has been a concern that collateral posted under a grandfathered derivative may not itself be grandfathered – in practice this could in many circumstances make it difficult for derivative counterparties to rely on the grandfathering at all.

The IRS has now stated that the grandfathering will extend to obligations to make payments under collateral posted to secure derivatives and other "notional principal contracts" which are themselves grandfathered. This would seem to cover (for example) manufactured interest and dividends on posted collateral under a grandfathered derivative. However it doesn't on its face cover the actual posting and/or return of collateral – and there may therefore remain a concern that this could be subject to FATCA withholding in some circumstances, even when made under a derivative that is itself grandfathered.

4. FATCA reporting dates for IGA and non-IGA FFIs now aligned

Some of the timelines for non-IGA withholding agents and FFIs to complete due diligence and other compliance obligations have been relaxed, and made consistent with the timelines for FFIs in IGA jurisdictions. So, for example, new account opening procedures now need to be put in place from 1 January 2014 rather than 1 January 2013.

So, in short:

FFIs in IGA jurisdictions:

- Should generally neither be subject to FATCA withholding on payments they receive, nor required to apply passthru withholding on payments they make - provided the IGAs are implemented and FFIs comply with their requirements.
- When intermediating US source payments, will be required to provide to the underlying US source payer sufficient information to enable it to apply the correct US withholding and reporting rules (in certain limited circumstances, most notably where the FFI is a qualified intermediary for US tax purposes, the FFI may be required to apply the US source withholding itself).
- Outside of such US source intermediation cases, grandfathering should be irrelevant.

FFIs in non-IGA jurisdictions:

- Many loans, derivatives and debt securities where there is a US payer (or payments have a US source) entered into prior to 1 January 2013 will be grandfathered, and never subject to FATCA withholding.
- Many other non-US source loans, derivatives, debt securities and other arrangements will continue to be grandfathered, and never subject to FATCA withholding, if entered into prior to July 2013 (at the earliest).
- Payments under collateral posted in respect of grandfathered derivatives should themselves be grandfathered (but query if the actual posting/return of collateral is grandfathered).
- Payments under arrangements that by their nature are never grandfathered (e.g. equities or deposits), that lose grandfathering, or are entered into after the above dates will be subject to:
  - 30% withholding on interest, dividends and other US source payments from 2014
  - 30% withholding on US source gross proceeds (e.g. the sale proceeds of US assets or the repayment of principal by a US obligor), from 2017
  - foreign passthru withholding (to be defined in future guidance) on non-US source payments by an FFI that doesn't have the benefit of an IGA and has signed an IRS agreement, from 2017.

Of course, there are still a number of outstanding questions relating to FATCA and its implementation. It is to be hoped that the outstanding questions are clarified once the FATCA regulations are finalised and a form of FFI agreement is released.

We'll be releasing further notes and briefings as the position becomes clearer, and looking in more detail at the terms of the IGAs and the implications under US tax law, EU law and domestic law in the G5. In the meantime, if you have any questions please call your usual Clifford Chance contact, or the partners listed overleaf.

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