Facing up to FATCA

by Leland Goss

The US Foreign Account Tax Compliance Act (FATCA) is a far reaching piece of legislation. While intended primarily to stop tax avoidance by wealthy US citizens investing offshore, FATCA will significantly impact non-US firms perhaps much more than many currently realise and will impose a costly and complex compliance burden upon financial services firms globally.

A complete explanation or guide to FATCA is not possible here, however, ICMA is working closely with its members and industry experts to assist with understanding its practical application and ramifications for the business of our members and assisting with its implementation over the coming months. A new section of ICMA's website (www.icmagroup.org/fatca) is dedicated to providing and linking third party materials and resources regarding FATCA.

Some facts about FATCA

In order to be compliant with FATCA, foreign financial institutions (including any non-US entity that holds financial assets for the account of others or is in the business of investing or trading securities (FFIs)) must agree to perform certain due diligence procedures and report information regarding identified US accounts (Participating FFIs). FFIs who do not comply (Non-Participating FFIs) will be subject to a penalty deduction of 30% on US source income and the gross proceeds from the sale of US debt and equity instruments, *irrespective of whether payments are made to the FFI itself or on behalf of the FFI's clients*.

Importantly, from 1 January 2017, Participating FFIs must deduct withholding on payments to non-participating or uncooperative FFIs ("passthru payments") and non-US investors or counterparties therefore may only receive the full payment if *all* the intermediaries in the chain are Participating FFIs or are otherwise compliant. Note that passthru payment withholding potentially applies to transactions in any security or asset whether or not issued by a US issuer. Because major financial institutions and intermediaries in the payment, custody and settlement chain will likely have US assets and therefore have to become Participating FFIs, these key market participants and other Participating FFIs are going to be unwilling or reluctant to transact with Non-Participating FFIs.

FATCA is aimed not just at US investors investing in US assets through foreign intermediaries. Any investor or fund which derives some income from the US is subject to the law. Thus, a Dutch wealth manager investing its Dutch clients' funds solely in the Netherlands might appear to be outside FATCA. However, the law will

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apply to investments which the manager may have in other Dutch institutions such as a Dutch bank, which itself derives some of its income from the US, and result in the Dutch wealth manager becoming subject to withholding.

Furthermore, the fact that a non compliant FFI avoids doing business with US customers or holding assets that produce withholdable payments does not necessarily exclude the FFI from the effects of FATCA as the rules regarding "passthru" payments mentioned above generally make a non-participating FFI subject to withholding on payments from Participating FFIs. The end-result, through the operation of both the new rules and commercial interests, quite possibly is a world where US withholding may be largely avoided by non-US market participants by virtue of their compliance with FATCA's due diligence and disclosure obligations.

The operation of FATCA as described above may be altered by inter-governmental agreements (IGAs) between the US and partner jurisdictions. The first IGA has been signed by the US and the UK, and has the effect of eliminating FATCA withholding on payments made to and by compliant FFIs in the UK. Given the number of jurisdictions which are usually involved in a typical payment chain, however, this development should not change the need to monitor and deal with FATCA risk in the near to medium-term.

Repurchase agreements

The burden of the withholding obligation will fall on the Participating FFI under a repo documented on the standard form of Global Master Repurchase Agreement published jointly by the ICMA and SIFMA unless the agreement is specifically amended otherwise.

A repo may be characterised, for US federal income tax purposes, as one of the following three types of transactions: (a) as a secured loan; (b) as a disposal of the collateral; or (c) as a combination of (a) and (b).

- Where the buyer/lender is not permitted to rehypothecate or otherwise dispose of the collateral the repo will be characterised as a secured loan and the seller remains the owner of the collateral for US tax purposes.
- Where the buyer is permitted to rehypothecate or dispose of the collateral, and does so, the repo will be treated for US tax purposes as a transfer of the collateral from the seller to the buyer. Upon maturity the buyer will be treated as transferring a replacement asset to the seller.
- Where the buyer is permitted to rehypothecate or dispose of the collateral *but does not do so*, it is not clear whether the transaction will be treated as a secured loan or a disposal and taxed as described above. Complicating matters further, where additional collateral is transferred by either party, similar rules will apply to the additional collateral.

Finally, FATCA withholding may apply to a repo if either of the parties is a Non-Participating FFI and the other is either a Participating FFI or a US person. The withholding may also apply even where neither the seller nor the buyer is a US person and may apply where the collateral is not a US debt or equity obligation.

It is clear that compliance will be a complex and costly process for many firms who should act now to ensure that they are ready in time to meet the approaching deadlines for the implementation of FATCA.

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