



JONES DAY
COMMENTARY

THE FATCA PROTOCOL: TO ADHERE OR NOT TO ADHERE?

On August 15, 2012, the International Swaps and Derivatives Association (“ISDA”) released a new Protocol relating to the effect on ISDA derivatives of taxes levied by the United States under the Foreign Account Tax Compliance Act (“FATCA”). FATCA was enacted in 2010 as part of the HIRE Act, and it has been the subject of other Jones Day updates.¹ The Protocol proposes a standardized set of amendments to the ISDA Master Agreement that can be automatically adopted by a participant in the swap market. If both parties to a given ISDA Master Agreement adhere to the Protocol, the amendments it provides are automatically made to the agreement between them.² Adherence to the Protocol, however, has not been universal. If market participants want to amend their ISDA Master Agreements to deal with the application of FATCA to their over-the-counter derivatives trades, they may decide either to adhere to the Protocol, or alternatively, to amend their ISDA Master Agreements on a bilateral basis.³

RELEVANT FATCA RULES

To recap FATCA itself, these rules require a U.S. withholding agent, which would include a U.S. counterparty to an ISDA derivatives transaction, to withhold 30 percent of any U.S. source payment made to a “foreign financial institution” unless the institution enters into an agreement with the IRS and satisfies significant reporting and disclosure requirements. All non-U.S. banks and swap dealers will be treated as foreign financial institutions for this purpose, as will many non-U.S. investment funds (including hedge funds, CDOs, private equity funds, and in some cases, real estate funds). As a result, beginning in 2014, any U.S. source payment on an ISDA derivative made to a foreign financial institution (as defined above) will be subject to a 30 percent U.S. withholding tax unless the financial institution (i) enters into an agreement with the Internal Revenue Service (“IRS”) requiring it to obtain and report information regarding its U.S. investors and to meet other requirements⁴ and (ii) provides the counterparty with a form

W-8BEN attesting to its agreement with the IRS and providing its FATCA ID number. Where such form is not provided, the swap counterparty must also withhold on proceeds of a disposition of an instrument providing for certain U.S. source payments, but this withholding of proceeds is required only beginning in 2017. All ISDA derivatives entered into in 2013 and previous years are exempt from FATCA withholding as “grandfathered” (unless they are subsequently modified in a manner that causes them to be treated as new obligations for tax purposes).

Even for derivatives entered into in 2014 and thereafter, only a limited number of derivatives payments will be U.S. source for purposes of the FATCA withholding tax. See, e.g., section 871(m)⁵ (treating certain equity derivatives payments as U.S. source dividends, although a special grandfather rule exempts such payments from FATCA if the derivative is executed six months or more before the controlling part of the section 871(m) regulations become final); Treas. Regs. § 1.446-3(g) (treating a swap with “significant nonperiodic payments” as, in part, a loan).⁶ The larger dollar impact on ISDA derivatives may be on payments on collateral posted by non-U.S. counterparties to U.S. counterparties. These payments are U.S. source and thus potentially subject to FATCA withholding, if the collateral posted is either cash or securities of U.S. obligors. And, as noted above, proceeds of dispositions of any of these instruments that give rise to U.S. source payments—e.g., a termination payment on a derivative or a payment of principal on collateral securities—may be subject to 30 percent FATCA withholding beginning in 2017.

Under the IRS agreement a foreign financial institution must enter into with the IRS in order to avoid the withholding tax, it must commit, beginning in 2014, to withhold on U.S. source “pass-through” payments to other foreign financial institutions that are not compliant with FATCA (i.e., that do not enter into and maintain the IRS agreement).⁷ Technically, it appears that certain derivatives payments (payments on equity derivatives that are recharacterized as U.S. source dividends under section 871(m), when the grandfather treatment above terminates) and payments on securities of U.S. obligors posted as collateral will be subject to this rule.⁸ It is fair to say that not all financial institutions are prepared to collect U.S. withholding tax on payments they make to other non-U.S. counterparties.

The U.S. Treasury has also entered into bilateral agreements with certain countries to implement and mitigate the above FATCA rules. These countries are the United Kingdom, Denmark, Germany, Ireland, Mexico, the Netherlands, Spain, and Switzerland. But the Treasury has indicated that it has been conducting negotiations aimed at bilateral agreements with several other countries. At this point, it is very uncertain how many such agreements will be concluded prior to the effectiveness of the FATCA statutory regime in 2014 (as described above).

ISDA PROTOCOL

Turning now to the ISDA Protocol, probably its most important feature is that the payee will bear the risk of any FATCA withholding tax. Under the Protocol, where a non-U.S. counterparty fails either to enter into the above-described IRS agreement or fails to provide the required documentation to its counterparty, the 30 percent FATCA tax required to be withheld is not an “Indemnifiable Tax” for purposes of the ISDA Master Agreement. This treatment also applies to any taxes levied under one of the bilateral agreements to implement FATCA that are described above. Thus, the status of FATCA withholding under ISDA will be unique; it will be a withholding tax imposed by a major jurisdiction that will be withheld by the payer and actually borne by the counterparty, rather than being grossed up by the payer as an Indemnifiable Tax. The logic of the Protocol appears to be that a FATCA withholding tax, unlike a general statutory withholding tax, can be avoided if the payee enters into the IRS agreement and provides the required documentation to the payer.

The Protocol also defines “Tax” as used in Part 2(a) of the Schedule to the ISDA Master Agreement (Payer Tax Representations) to exclude any FATCA withholding tax. In most Schedules, the payer represents that it is not required to withhold any taxes. Thus, the Protocol provision allows this representation to be made without considering potential FATCA withholding. What is notably absent in the Protocol is any clarification of whether the imposition of a FATCA withholding tax is a “Tax Event” for purposes of section 5 of the ISDA Master Agreement, which would allow the payee a termination right (after reasonable efforts to transfer the contract under section 6 have not succeeded).

DECIDING ON ADHERENCE

What are the considerations for foreign financial institutions in deciding whether or not to adhere to the Protocol or to agree to bilateral amendments to their ISDA Master Agreements? At this point, although the IRS still has to release the required FATCA agreement (and few bilateral agreements with foreign governments have been entered into), there is no reason to expect the procedure to be a bar to FATCA compliance in most cases. Addressing FATCA is important whether a foreign financial institution is concerned about being withheld on by a counterparty or is concerned that it will be obligated to withhold on a noncompliant foreign financial institution (under the above rules).

A foreign financial institution may be asked by its counterparty to adhere to the Protocol or to agree to a bilateral amendment to that ISDA Master Agreement so that the counterparty knows whether or not it has to withhold (i.e., to have clarity that a FATCA tax is not an Indemnifiable Tax and that a FATCA tax is not part of the Payer Tax Representations). Whether a foreign financial institution should agree to such a request depends, first, on whether the foreign financial institution intends to become FATCA compliant (i.e., to enter into the IRS agreement and be willing to provide its FATCA ID number to its counterparties). Agreement should depend, second, on whether the foreign financial institution is a party to ISDA Master Agreements with other foreign financial institutions, where it may want the protections with respect to the Indemnifiable Tax definition and Payer Tax Representations in its role as withholding agent (as described above). Another dilemma may be deciding whether or not a foreign financial institution will ever pay or receive a payment that may be subject to FATCA withholding. Since the types of trades and collateral posted may change under an ISDA Master Agreement, a counterparty's status as payer and recipient of FATCA-withholdable payments may change, and this should be considered carefully.

Once a foreign financial institution decides that it will address FATCA in its ISDA Master Agreements, it will need to determine whether it prefers to do so by adhering to the Protocol or by bilateral amendments. There are FATCA provisions that can be added to a bilateral amendment that are not in the Protocol.

Whether a foreign financial institution chooses adherence to the Protocol, bilateral amendments to its ISDA Master Agreements, or no action at all, a foreign financial institution has to consider the impact of FATCA—both from its perspective of payee on ISDA derivatives with other counterparties, which may request the foreign institution's adherence to the Protocol, as well as from the perspective of its relationships with other foreign financial institutions, when it will be the payer and withholding agent for potential FATCA tax.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Ilene K. Froom

New York
+1.212.326.3821
ifroom@jonesday.com

Kent L. Killelea

Washington
+1.202.879.3448
kkillelea@jonesday.com

Edward J. Nalbantian

London / Paris
+44.20.7039.5145 / +33.1.56.59.39.23
enalbantian@jonesday.com

Todd Wallace

Dallas
+1.214.969.3713
twallace@jonesday.com

ENDNOTES

- 1 See “Treasury Issues Proposed Regulations on the Information Reporting and Withholding Tax Provisions of FATCA,” *Jones Day White Paper*, April 2012; “New FATCA Proposed Regulations; the System Moves Forward for Funds,” *Jones Day Commentary*, March 2012.
- 2 The ISDA had previously released two sets of proposed amendments to the ISDA Master Agreement—one in November 2011 and one in May 2012—to deal with the issues raised for derivatives by FATCA. The May amendments were very similar in substance to the Protocol. But, as amendments to the ISDA Master Agreement, the earlier proposals would have had to be adopted bilaterally between the counterparties.
- 3 This *Commentary* focuses on non-U.S. counterparties who, potentially at least, face withholding under FATCA and need to take this into account for their ISDA agreements. A separate *Commentary* will focus on the concerns of U.S. counterparties as potential withholding agents under FATCA.
- 4 The required IRS agreement will obligate the foreign financial institution to (i) obtain information necessary to determine which of its account holders are U.S. persons; (ii) report annually to the IRS the name, Social Security or taxpayer identification number, and investment amount of each of these U.S. holders; and (iii) deduct and withhold 30 percent from any payment it makes either to a U.S. investor or a foreign financial institution that does not itself comply with these provisions. The IRS is expected to release its model agreement very soon.
- 5 Unless otherwise specified, all references to “sections” are to sections of the Internal Revenue Code of 1986, as amended.
- 6 Most derivatives payments made to non-U.S. counterparties are foreign source because derivative payments are generally sourced according to the residence of the recipient. See Treas. Regs. § 1.863-7(b) (dealing with notional principal contracts); section 865 (dealing with disposition payments).
- 7 See endnote 4.
- 8 Starting in 2017, the amount of payments on ISDA derivative contracts made between non-U.S. financial institutions that could be subject to FATCA withholding could rise dramatically. In the proposed Treasury regulations implementing FATCA, the Treasury has reserved on the definition of “foreign pass-through payments” that are subject to withholding beginning in that year. If the approach of earlier IRS guidance is followed, a portion of each derivatives payment made by a FATCA-compliant foreign financial institution to a noncompliant one would be subject to withholding; the portion would be the same as the portion of the payer’s assets that generates U.S. source income. See Notice 2011-34.