Clients&FriendsMemo

Announcement 2012-42 Provides Transitional FATCA Relief for Foreign Financial Institutions

November 2, 2012

On October 24, the Internal Revenue Service issued Announcement 2012-42, which (i) delays gross proceeds withholding under the "Foreign Account Tax Compliance Act" provisions contained in sections 1471-1474 of the Internal Revenue Code ("**FATCA**"), (ii) grandfathers (i.e., exempts from FATCA withholding) obligations that give rise only to foreign-source income or will give rise to U.S.-source dividend-equivalent payments under future section 871(m) regulations, and collateral arrangements that relate only to grandfathered swaps and other grandfathered "notional principal contracts," and (iii) extends the deadlines under FATCA for completing due diligence with respect to counterparties and financial account holders.[1]

Introduction

The purpose of FATCA is to reduce U.S. tax evasion by requiring certain "foreign financial institutions" to enter into an agreement with the U.S. Treasury Department (an "FFI agreement") to report information to the IRS about U.S. holders of their non-publicly traded debt and equity interests and other "financial accounts," and to withhold 30% on certain payments that are attributable to U.S. assets (referred to as "passthru payments") that they make to holders that do not provide the required information or to foreign financial institutions that have not themselves entered into an FFI agreement.[2] Under proposed regulations that were issued in July, a foreign financial institution that does not enter into an FFI agreement with the U.S. Treasury Department will be subject to a 30% withholding tax on (i) U.S.-source income beginning in 2014, (ii) gross proceeds from its sale of assets that produce U.S.-source income and from its receipt of principal on those assets beginning in 2015, and (iii) passthru payments from other foreign financial institutions beginning no earlier than 2017.[3] The proposed regulations do not define "passthru

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1 All references to section numbers are to the Internal Revenue Code of 1986, as amended, or to the temporary or proposed Treasury regulations promulgated thereunder

2 FATCA also imposes information reporting requirements on non-financial foreign entities. This memorandum does not address those rules.

3 We discussed the proposed regulations in a previous Clients & Friends memo, available at http://www.cadwalader.com/assets/client_friend/021712ApplicationProposedFATCARegulations.pdf.

payment," and so it is unclear whether the calculation of passthru payments will reflect a "tracing" approach that attempts to determine which payments by a foreign financial institution are attributable to U.S. assets, a "percentage" approach that treats a portion of each payment by a foreign financial institution as being attributable to U.S. assets, or a hybrid or other approach.

This memorandum summarizes the aspects of the Announcement that are most relevant to foreign hedge funds and their foreign "blockers," foreign private equity funds, foreign "collateralized loan obligation" issuers, and "catastrophe bond" issuers (collectively, "**foreign funds**").[4]

Announcement 2012-42

Announcement 2012-42 makes the following changes to the proposed regulations:

- **Two-year delay of gross proceeds withholding.** The Announcement extends the effective date for withholding on the gross proceeds of sales of assets that produce U.S.-source income (and on the payment of principal on those assets) from 2015 to 2017. The Announcement does not extend the effective date for withholding on U.S.-source income that does not constitute gross proceeds. Therefore, a foreign fund that does not enter into an FFI agreement will be subject to FATCA withholding on U.S.-source income beginning in 2014, but will not be subject to FATCA withholding on gross proceeds from its sale of assets that produce U.S.-source income or from its receipt of principal on those assets until 2017.

- **Expansion of grandfathering rule.** Under the existing proposed FATCA regulations, FATCA withholding will not be required on any debt or derivative[5] that has a stated maturity and is issued or entered into before 2013 (and is not significantly modified after 2012). The Announcement adds a new grandfathering rule for three types of instruments:

  - Obligations that give rise only to foreign-source income. As mentioned above, a foreign financial institution that enters into an FFI agreement will be required to withhold 30% on foreign-source "passthru payments" that it makes to holders of its non-publicly traded debt and equity interests and other financial accounts that do not provide sufficient information for the foreign financial institution to determine whether they are U.S. persons, and to foreign financial institutions that have not themselves entered into an FFI agreement with the U.S. Treasury

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4 Some practitioners take the position that a catastrophe bond issuer that enters into a reinsurance agreement is a reinsurance company that is not treated as a foreign financial institution under FATCA. This position is not taken if the catastrophe bond issuer enters into a "catastrophe swap" or other noninsurance derivative.

5 Financial instruments that constitute equity for tax purposes are not grandfathered.

Department. Thus, a foreign fund that does not enter into an FFI agreement will be subject to 30% withholding on any foreign-source passthru payments that it receives from a foreign financial institution that has entered into an FFI agreement. As mentioned above, the proposed regulations do not define the scope of passthru payment withholding, and provide that passthru payment withholding will not be required before 2017.

The Announcement grandfathers obligations that give rise only to foreign-source passthru payments and are outstanding six months after the publication of final regulations that define the scope of passthru payment withholding, even if the obligations mature after 2016. Therefore, a foreign fund that does not enter into an FFI agreement will not be subject to FATCA withholding on debt obligations, swaps, and other derivative contracts that were entered into with foreign counterparties, give rise only to foreign-source income, and are outstanding now or are entered into until six months after the passthru payment regulations are finalized.[6]

- <u>Obligations that produce U.S.-source dividend equivalent payments</u>. Under section 871(m), payments on certain equity swaps, securities loans, and securities repurchase transactions are treated as U.S.-source dividends and subject to 30% withholding tax if the payments are "dividend equivalent payments"—that is, if the payments are contingent upon, or determined by reference to, U.S.-source dividends. In addition, beginning in 2014, dividend equivalent payments on all equity swaps and other financial instruments will be treated as U.S.-source dividends and subject to the 30% withholding tax unless regulations are issued that exempt the payments from this treatment.[7]

  The Announcement provides that the extended grandfathering date described above for obligations that produce only foreign-source passthru payments also will apply to obligations that produce U.S.-source income solely by reason of section 871(m), so long as the obligations are outstanding now or are issued until six months after the effective date of any regulations that cause the payments to be treated as U.S.-source dividends.

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[6] Likewise, a foreign fund that enters into an FFI agreement will not be required to withhold on passthru payments that it makes under debt obligations, swaps, and other derivative contracts issued or entered into earlier than six months after passthru payment regulations are finalized, even if the instruments mature after 2016 and the counterparties fail to provide required FATCA certifications or are foreign financial institutions that have not entered into their own FFI agreement.

[7] We discussed section 871(m) and the temporary and proposed regulations thereunder in a previous Clients & Friends Memo, available at http://www.cadwalader.com/assets/client_friend/012512ProposedRegsAddressUSTaxOnCBEquityDerivatives.pdf.

- Certain collateral arrangements. As mentioned above, FATCA withholding will not be required on payments of U.S.-source income on any debt or derivative that has a stated maturity and is issued or entered into before 2013 (and is not significantly modified after 2012), or on gross proceeds from the disposition of the obligation. Some practitioners have raised concerns that, because collateral arrangements typically do not have stated maturities, a counterparty may be required to withhold under FATCA when it repays collateral or passes an income payment through on any securities posted as collateral (even if the securities were issued before 2013).

  The Announcement provides that a collateral arrangement will be grandfathered, and the posting of collateral after 2012 will not itself give rise to withholding under FATCA, so long as the collateral secures only "grandfathered notional principal contracts"—that is, swaps or other notional principal contracts[8] that were entered into before (i) 2013, in the case of a notional principal contract that provides for U.S.-source payments (other than dividend-equivalent payments that are not currently treated as U.S.-source dividends),[9] (ii) six months after final regulations are issued defining the scope of passthru payment withholding, in the case of a notional principal contract that provides for only foreign-source payments, and (iii) six months after the effective date of any regulations that cause payments under the notional principal contract to be treated as U.S.-source dividends, in the case of a notional principal contract that provides for U.S.-source dividend-equivalent payments.

  This grandfather provision is extremely narrow and unlikely to be of much practical use unless it is expanded, because it applies only to collateral arrangements that secure only grandfathered notional principal contracts. Thus, if a collateral agreement serves as security for a single instrument that is not a notional principal contract, or for a single notional principal contract that is not a grandfathered notional principal contract, then the collateral agreement will not be grandfathered.

[8] Very generally, a notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by multiplying a notional principal amount by (i) a fixed rate (e.g., LIBOR) or (ii) an index that is based on current, objectively determinable financial or economic information that is not within the control of either of the parties to the contract and is not unique to one of the parties' circumstances (such as the party's dividends or profits, or the value of its stock), in exchange for specified consideration or an obligation to pay similar amounts. Notional principal contracts may include interest rate swaps, caps, and floors, and commodity swaps.

[9] Payments under a notional principal contract to a non-U.S. counterparty generally are treated as foreign-source payments, so long as the counterparty is not engaged in a trade or business in the United States for U.S. federal income tax purposes. However, a notional principal contract may be treated as giving rise to U.S.-source payments if it provides for upfront or back-end payments (other than for a cap or floor, or a termination payment), or produces foreign currency gain or loss, and certain other conditions are present.

- **Extension of due diligence deadlines.** The Announcement extends the time that a foreign financial institution has to determine the FATCA status of a holder that purchased a non-publicly traded debt or equity interest in the foreign financial institution or that otherwise was treated as opening a "financial account" at the foreign financial institution before the foreign financial institution entered into an FFI agreement.[10] A foreign fund that enters into an FFI agreement will not be required to report information about these "preexisting" account holders until after the due diligence deadlines, unless the foreign fund completes its due diligence before the deadlines and discovers a noncompliant holder. In this case, immediate reporting is required. These changes generally are intended to conform the timeline to that contained in the model FATCA intergovernmental agreement released in August.[11]

  Very generally, the revised deadlines are:

  Entities:

- For any holder that is a "prima facie FFI," six months after the effective date of the FFI agreement. In general, a "prima facie" FFI is an account holder that the foreign financial institution has documented as an intermediary in its electronically searchable information. For this purpose, the effective date of an FFI agreement that is entered into before 2014 is January 1, 2014. Thus, the earliest date by which a foreign fund must complete its due diligence with respect to prima facie FFIs will be July 1, 2014.

- For any holder that is not a "prima facie FFI," two years after the effective date of the FFI agreement.

  Individuals:

- For an individual with an aggregate account balance in excess of $1 million, one year after the effective date of the FFI agreement.

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10 Consistent with these extensions, the Announcement also provides that foreign financial institutions will not be required to file their first information report under FATCA until March 31, 2015. The proposed regulations required the first information report to be filed by September 30, 2014.

11 We discussed the model FATCA intergovernmental agreement in a previous Clients & Friends Memo, available at http://www.cadwalader.com/assets/client_friend/081012USTreasuryDeptReleasesFATCAAgreements.pdf. We also discussed the intergovernmental agreement signed by the United States and the United Kingdom in September in a previous Clients & Friends Memo, available at http://www.cadwalader.com/assets/client_friend/092012USandUKSignIntergovernmentalAgreementUnderFATCA.pdf.

- For an individual with an aggregate account balance not in excess of $1 million, two years after the effective date of the FFI agreement.

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If you have any questions about the foregoing, please contact Jean Bertrand, Shlomo Boehm, Mark Howe, David Miller, Daniel Mulcahy, Jason Schwartz, or any other member of our Tax Department.