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A nuisance called FATCA – Does the UK/US IGA make it bearable?

Peita Menon and Prabhu Narasimhan review the UK's implementation of the inter-governmental agreement between the US and the UK in the context of loan financing involving UK financial institutions. This article does not focus on the reporting or compliance mechanics associated with the implementation of FATCA.

The introduction by the US of the Foreign Account Tax Compliance Act 2010 (FATCA) set the proverbial cat amongst the pigeons in the international loan financing markets by requiring foreign and domestic borrowers, lenders and agents suddenly to consider and deal with the application of this legislation to their transactions and allocate FATCA risks to one or other party even in cases where there is no obvious US nexus.

Under FATCA, certain specified categories of non-US financial institutions (FFIs) are 'invited' by the US Internal Revenue Service (IRS) to enter into an agreement under the terms of which they are required to provide certain information about their US account holders to the IRS (irrespective of whether or not their domestic laws allow the disclosure of such information). An FFI which accepts such an invitation is referred to as a participating FFI (PFFI) and one which does not is referred to, rather uninspiringly, as a non-participating FFI. Declining this invitation has its consequences – primarily FATCA imposes US withholding tax (currently 30%) on a wide variety of payments made to such a non-participating FFI. Furthermore, a PFFI (as reward for accepting such an invitation) is required to assume more obligations (namely to act as the taxing agent of the IRS) and to withhold US tax (currently 30%) on account of FATCA from both US and some non-US source payments to non-participating FFIs.

FATCA is unique in many ways – even for a country that imposes taxation by citizenship (rather than residence, which is a more conventional international norm), FATCA represents a significant extension of extra-territorial legislative reach and taxation. This does not really need much explanation from the US (given its economic and political muscle) but nevertheless the US has volunteered one explanation – this being that FATCA is a necessary tool to combat offshore tax evasion by US persons.

The haphazard introduction of FATCA – the rules are being finalised on an ongoing basis (the uncharitable would say that rules are being 'made up as we go along') – has led to much confusion and debate, in a loan financing context, between lenders and borrowers as to (a) what FATCA risks exist in a given loan transaction; and (b) which party should contractually bear the risk. In the absence of any settled market practice on this matter outside the US (which is unsurprising given the radical extra-territorial nature and reach of this legislation), lenders and borrowers have reacted differently and largely on a case-by-case basis with the relative bargaining power of the parties eventually settling the matter. The Loan Market Association (LMA), reflecting this trend, has merely suggested two optional riders – one set of wording imposing the risk of FATCA on the borrower and another imposing the risk of FATCA on the lender.[1]

A partial (and some might say an interim) solution has been devised in the form of inter-governmental agreements (IGAs) being entered into by the US with a number of jurisdictions around the world; the result of which is that the risk of FATCA withholding should generally be eliminated for FFI lenders resident in such IGA jurisdictions subject to satisfactory compliance, by such jurisdictions and the relevant FFI lenders resident there, of the terms of the relevant IGA. The issue of FATCA withholding seems to (at least for the moment) remain live for FFI borrowers in such IGA jurisdictions where their lender is located in a non-IGA jurisdiction (in which case the issue has to still be settled by use of economic muscle).

The UK has been the 'first off the block' in signing up to an IGA with the US – the broad effect of which is that, when implemented in the UK (expected to be later this year), FFIs in the UK will generally not be subject to FATCA withholding. As more jurisdictions sign up to IGAs with the US, it is anticipated that FATCA withholding will become less of an issue both in domestic as well as cross-border loan-financing transactions.

FATCA – an overview

FATCA was enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act.[2] The IRS describes FATCA as "an important development in U.S. efforts to combat tax evasion by U.S. persons holding investments in offshore accounts". To achieve this objective of preventing tax evasion by US persons, FATCA requires FFIs to provide information to the IRS about their US account holders/investors.[3]

An FFI includes any non-US entity that:

(i) is engaged in banking or similar business;
(ii) holds financial assets for the account of others as a substantial portion of its business;
(iii) is in the business of investing, reinvesting or trading in securities, partnership interests, or commodities; or
(iv) is engaged in certain insurance related activities.

As can be deduced from the above, the meaning of an FFI is intentionally wide ranging and encompasses not just banks and insurance companies but also entities such as hedge funds, private equity funds and other such collective investment vehicles (which one may not readily see as a 'financial institution'). That said, the FATCA rules specifically exclude a range of entities from the definition of an FFI.

As mentioned earlier, an FFI may either (a) enter into an agreement with the IRS and provide certain information required by FATCA and so become a PFFI; or alternatively (b) refuse to enter into such an agreement with the IRS and thereby constitute a non-participating FFI.

In general, becoming a PFFI ensures that no FATCA withholding arises on payments that such a PFFI receives (and as a *quid pro quo,* PFFIs are required to withhold US tax (currently 30%) on certain 'withholdable payments' they make to non-participating FFIs and recalcitrant account holders refusing to co-operate). Conversely, being a non-participating FFI means that such an entity is subject to US withholding tax (currently 30%) on certain 'withholdable payments' it receives but is not itself generally required to withhold US tax on any payments which it makes.

Withholdable payments are defined for the purposes of FATCA as, in broad terms, any payment of interest (including any portfolio interest and original issue discount), dividends, rents, royalties, salaries, wages, annuities, licensing fees and other income, gains, and profits, if such payments are from sources within the US (US source direct payments)[4] and any gross proceeds from the sale or disposition of US property of a type that can produce interest or dividends (US source gross proceeds payments).[5]

Certain foreign 'passthru' payments will also be within the scope of FATCA – foreign passthru payments (foreign passthru payments)[6] refer to foreign source payments originating from an FFI, to the extent 'attributable to' one of the two kinds of withholdable payments referred to above. Unfortunately, the IRS has not conclusively published regulations defining the precise scope of foreign passthru payments and therefore payments of this nature (whatever that might be) remain a continuing source of uncertainty. It is pertinent to note that, as currently drafted, a foreign passthru payment may include payments which have no direct or apparent US source.

FATCA withholding will apply to US source direct payments from 1 January 2014. Grandfathering provisions are in place to ensure that obligations outstanding as of this date are not subject to FATCA withholding (provided that the obligations are not materially modified after that date).[7]

As originally envisaged, FATCA withholding on US source gross proceeds payments was expected to apply from 1 January 2015. This date has now been pushed back to 1 January 2017.

FATCA withholding is expected to apply to foreign passthru payments, at the earliest, from 1 January 2017. Grandfathering provisions are in place which provide that foreign passthru payments will not be subject to FATCA withholding if the underlying obligation is outstanding on the date that is six months after the final regulations implementing foreign passthru payments are published. The IRS has not yet committed to a date for the publication of such regulations.

IGAs

One of the main problems faced by FFIs in their home jurisdiction as a result of the introduction of FATCA, is that obligations imposed by FATCA fail to take account of domestic rules (for example, data protection rules and confidentiality issues) prohibiting the sharing of the information sought by the IRS. Therefore, an FFI (otherwise willing to share information with the IRS) may (some might say somewhat unfairly) be subject to withholding tax on account of FATCA on payments it receives merely because it complies with the laws of the jurisdiction where it is located (or operates).

To address this issue and to simplify the practical implementation of FATCA in their respective jurisdictions, France, Germany, Italy, Spain, the UK and the US have created a model agreement (referred to as Model 1) which establishes a framework for IGAs to be entered into by these (and other) countries. An alternative to this is another model agreement (referred to as Model 2).

The basic purpose of the IGAs is that any FFI which is resident (or carrying on business) in an IGA jurisdiction will be required to comply with certain prescribed reporting obligations. As reward for compliance, such FFIs (resident or operating in the relevant IGA jurisdiction) will not be subject to FATCA withholding on the payments they receive.

Whilst the purpose of this article is not to analyse the two model agreements themselves, it is worth noting that one of the key distinctions between the two models is that Model 1 requires FFIs in the relevant jurisdiction to submit the required information to their own tax authorities which in turn will, if asked by the US, share such information with the US. Under Model 2, FFIs in the relevant jurisdiction are required by local law to submit the required information directly to the US.

UK/US IGA

The UK entered into a Model 1 IGA with the US on 12 September 2012 (the UK IGA). HM Revenue & Customs (HMRC) published draft UK regulations (the Regulations) which implement the UK IGA and the Regulations are intended to come into effect later this year (after the Finance Act 2013 is enacted). HMRC also published detailed draft guidance (the Guidance) setting out its interpretation of the Regulations. The Guidance is the subject of extensive public consultation and the final form of both the Regulations and the Guidance may therefore change.

The crux of the UK IGA as far as UK financial institutions are concerned is contained in Article 4 of the UK IGA, which provides that "each Reporting United Kingdom Financial Institution shall be treated as complying with, and not subject to withholding under, section 1471 of the U.S. Internal Revenue Code" provided that the UK complies with its treaty obligations under the UK IGA dealing with exchange of information, and the relevant reporting UK financial institution (RUKFI) itself complies with certain specified reporting obligations outlined in the UK IGA and the Regulations.

A RUKFI is defined as any UK financial institution that is not a Non-Reporting UK financial institution. A Non-Reporting UK financial institution in turn means any UK financial institution or other entity resident in the UK that is listed in Annex II to the UK IGA. Such Non-Reporting UK financial institutions are treated as a deemed-compliant FFI or as an exempt beneficial owner (as appropriate) for the purposes of FATCA.

A UK financial institution comprises one of four categories of entities (equating broadly to the definition of FFIs in the FATCA legislation):

1. **Custodial institutions**. This includes entities that hold as a substantial portion of their business, financial assets for the account of others. A substantial proportion in this context means 20 per cent or greater by reference to the entity's gross income (broadly, over a three-year period or since the entity has been in existence).
2. **Depository institution**. The definition of depository institution caused some concern initially as the IGA defined this to mean "any entity that accepts deposits in the ordinary course of a banking or a similar business". Naturally, the concern was focused on whether this goes above and beyond the UK regulatory meaning of a banking business and thereby catches entities which would not conventionally be seen as such. To address these concerns HMRC has clarified in the Guidance that such an entity means a person carrying on a regulated activity for the purposes of the Financial Services and Markets Act 2000 read in conjunction with Article 5 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(1).
3. **Investment entity**. This means any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer –
    a. Trading in money market instruments, foreign exchange, interest rate and index instruments, transferable securities or commodity futures trading;
    b. Individual and collective portfolio management; or
    c. Otherwise investing, administering or managing funds or money on behalf of others.
4. **Specified insurance company**. This means any entity that is an insurance company, or a holding company of an insurance company, that issues or is obliged to make payments with respect to certain specified insurance and annuity contracts.

Although it is not within the scope of this article to consider the treatment of collective investment vehicles, it is worth mentioning that the definition of an 'investment entity' is different in each of the Model 1 and Model 2 IGAs as well as the US FATCA rules and for that reason the reporting obligations under the IGAs may extend to persons associated with the collective investment vehicle (for example, the manager or operator of the collective investment vehicle).

The benefit of being a RUKFI is that pursuant to Article 4 of the UK IGA, a compliant RUKFI is "not subject to withholding under section 1471 of the U.S Internal Revenue Code". It is clear from this that a RUKFI will not suffer withholding tax on account of FATCA on payments received by it. Because Article 6.2 of UK IGA states that "the parties are committed to work together, along with other partners, to develop a practical and effective alternative approach to achieve the policy objectives of foreign passthru payment and gross proceeds withholding that minimises burden", it is possible to take the view that a RUKFI may nevertheless be required to administer or withhold on account of FATCA until the UK and the US have developed an alternative approach (whatever that might be). However, in our view, the tone and tenor of Article 4 of the UK IGA is that RUKFIs should not be required to administer FATCA withholding on payments they make to other FFIs whether FATCA compliant or not.[8] But this is an annoying and unnecessary uncertainty that could easily have been avoided.

As an aside, it is worth noting that the definition of UK financial institution means any financial institution (as described above) which is resident in the UK (excluding its overseas branches as well as any UK branch of a non-UK resident financial institution). As the test of corporate residence is that provided under UK domestic law (ie incorporation or central management and control in the UK), it is possible for a corporate financial institution to be resident both in the UK as well as another jurisdiction which may well have entered into its own IGA with the US. This potentially gives rise to a somewhat tedious result whereby the same financial institution may possibly be required to comply with the reporting requirements under two separate IGAs, which may well be different.[9]

HMRC rather conveniently confirms the obvious in the Guidance that "if an entity is a dual resident, so resident in the UK and also resident in another country it will need to apply the UK legislation."

The loan financing dimension

Leaving grandfathering provisions aside for the moment, in the context of loan financing involving non-US borrowers, agents and lenders, FATCA is unlikely to be relevant in a majority of cases. If the borrower in question is not an FFI, we need to consider FATCA no further in the context of payments under the loan financing as FATCA withholding will generally not arise in such circumstances irrespective of the status of the lender.

However, if the borrower were to be an FFI, FATCA might be an issue if the interest (and principal) payments (or repayments) constitute one of the categories of withholdable payments. In a vast majority of instances, it is likely to be the case that the payments under the loan financing will not, as a matter of fact, constitute US source direct payments or US source gross proceeds payments. Given the uncertainty surrounding what constitutes foreign passthru payments, it may be the case that in some circumstances such payments under the financing in question may well constitute foreign passthru payments (or more likely on balance there exists a risk that such payments may constitute foreign passthru payments) and for that reason FATCA withholding may be a real concern.

Even in those circumstances, if the recipient of the payment is a PFFI (or an entity located in an IGA jurisdiction – see above), the FATCA risk is effectively eliminated. If not, then FATCA withholding might well be a real issue to deal with.

Of course if the borrowers are non-US persons and are not FFIs, or if FFIs are not PFFIs, no FATCA withholding arises either. If the borrowers are RUKFIs (or are their equivalents in other Model 1 IGAs), FATCA withholding on foreign passthru payments should effectively be eliminated on payments made to other PFFIs (or FFIs resident or located in another IGA jurisdiction) or non-participating (non-IGA) FFIs.[10]

In the context of loan financing involving US lenders but overseas borrowers, FATCA is irrelevant.

In the context of loan financing involving US borrowers but overseas lenders, FATCA withholding would be a real risk for the overseas lenders (as payments under the loan financing will constitute US source payments) unless the recipient (ie the lender) is either not an FFI (unlikely in most cases) or is a PFFI (or otherwise located in an IGA jurisdiction). If the lender is a Non-Participating FFI not resident in an IGA jurisdiction, FATCA withholding can be expected to arise.[11]

The logical inference that can be drawn from the above permutations is that it is generally possible for lenders in such loan financing to influence the imposition of FATCA withholding on the payments they receive. In simple terms, if the lender becomes a PFFI or is a financial institution covered by a relevant IGA then such a lender can be comfortable (subject to it carrying the change of law risk) that no FATCA withholding will arise on payments made to it by the borrower under the loan agreement in question. The borrower can also be comfortable that no withholding on account of FATCA would arise in these circumstances provided that the lender continues to comply with the FATCA rules or the relevant IGA.

The above 'simple' permutations have led to natural friction between lenders and borrowers as to the allocation between themselves of the risk of FATCA withholding arising in connection with the loan financing in question. In many cases, one or both parties are simply not interested in analysing the risk of FATCA and see it as simpler to place the risk contractually on the other party.

The US market standard has developed quite cogently to place the risk of FATCA withholding fairly and squarely on the lenders (and not the borrowers) on the premise that the lender is best placed to influence whether or not FATCA withholding arises as a result of the lender's own status. It is fair to say that this has been largely due to the fact that the introduction of the FATCA rules does not fundamentally increase the reporting/compliance burden of US persons.

To say that the UK market has developed in any sense in respect of FATCA risks and their allocation would be an exaggeration as the LMA has taken a rather ambivalent approach by providing alternative sets of model wording:

- Rider 1 is referred to as 'borrower risk' and it contains wording which effectively makes the application of FATCA withholding to the particular loan financing the borrower's risk. This is achieved by either the borrower(s) representing that they are outside the scope of FATCA and/or by extending the scope of the actual gross-up and indemnity to cover FATCA tax risks.
- Rider 2 is referred to as 'lender risk' but it effectively seeks to facilitate the application of the grandfathering rules to the loan financing in question by giving lenders the right to veto any amendment or change of borrower(s) that would result in the financing losing grandfathering. Lenders, however, carry the risk of FATCA withholding arising if, for whatever reasons, grandfathering provisions were not to apply in circumstances where there has been no material modification or change of borrower(s).

As is clear from the above, the LMA proposals do not really provide an answer in that they do not establish a 'market standard' whereby the risk of FATCA withholding is placed on one or the other party as the standard/usual position. Therefore ultimately, who assumes the contractual risk of FATCA is largely down to relative commercial bargaining power of the parties.

In summary

The introduction of the UK IGA simplifies the situation somewhat in the sense that a UK lender (which is expected to be a RUKFI in most circumstances) will not expect any withholding arising on account of FATCA to the extent that it complies with its own legal obligations in the UK pursuant to the UK IGA and the Regulations. So, like in the US, we would expect a UK market standard to develop such that a UK lender carries the risk of FATCA withholding in a loan financing context.

Lenders lending to RUKFIs should also be able to rest easy on the basis that irrespective of their FFI status FATCA withholding may not arise by virtue of Article 4 of the UK IGA (and likely the application of equivalent provisions in other IGAs) unless there is a change in approach following discussions between the various IGA jurisdictions.

Given that most of the European jurisdictions are in the process of signing up to their own IGAs, it is our expectation that come 2017 (the earliest date when FATCA on foreign passthru payments is expected to come into effect), it is likely that the European loan market will largely settle at the lender assuming FATCA risks. In that case, it would also be safe to assume that intra-EU borrowing (between parties in European jurisdictions which have entered into Model 1 or Model 2 IGA) would simply not have to consider the risk of FATCA withholding arising.

However, a certain level of volatility can be safely expected in loan-financing transactions involving non-IGA jurisdictions as in those cases FATCA risks will still have to be resolved the old fashioned way – by wielding bargaining strength and muscle.

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References

1. In contrast, the Loan Syndications and Trading Association has taken a more 'clear cut' approach and placed the FATCA risk fairly and squarely on the lenders on the premise that it is within the lenders control to comply with FATCA and thereby eliminate the US withholding risk in question. This is therefore now settled US practice.
2. FATCA legislation is included in the US Internal Revenue Code in four new sections (ss1471-1474 Pub. L No. 111-147, 124 Stat.71).
3. Certain NFFEs are also subject to some information reporting requirements. To ensure that non-exempt NFFEs are not subject to FATCA withholding, such entities are required to report US owners (broadly, any US investor holding more than 10% interest in the relevant entity).
4. Internal Revenue Code ss1473(1)(A)(i).
5. Treasury Regulations s 1.1473-1(a)(ii).
6. Internal Revenue Code s1471(d)(7), Treasury Regulations s 1.1471-5(h).
7. It is worth noting that the grandfathering provisions do not apply to certain financial instruments and obligations that do not have a definite expiration or term. It also does not apply to umbrella agreements that set out the terms for present and future transactions.
8. In the context of other IGAs, the expectation is that FFIs in countries which have signed a Model 1 IGA should not be required to apply passthru withholding on payments they make to other FFIs, whether FATCA compliant or not.
9. Although it is worth noting that many international financial institutions already have to do that under the local rules of jurisdictions where they operate.
10. In the context of other Model 2 IGAs, our expectation is that FFIs in countries which have signed a Model 2 IGA should not be required to apply passthru withholding on payments they make to other FFIs, whether FATCA compliant or not. The rationale for this expectation is the same as the rationale explained above in the context of Model 1 IGAs.
11. FATCA withholding may also be an issue for a UK agent who is a 'qualified intermediary' in circumstances where it has assumed primary withholding responsibility.