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FATCA protocol on derivatives can yield streamlined modifications

Beginning on January 1, 2014, provisions of the Foreign Account Tax Compliance Act (FATCA)[1] could subject derivatives transactions to a 30% withholding tax on certain U.S. source payments (FATCA Withholding). For a contract trading under an International Swaps and Derivatives Association, Inc. (ISDA) Master Agreement, a payor could be required to gross-up a recipient for FATCA Withholding due to the recipient's non-compliance with FATCA. ISDA released a new protocol which may provide payors with an opportunity to allocate the cost of FATCA Withholding to their counterparties, rather than treat FATCA Withholding as an 'Indemnifiable Tax' for which a payor has responsibility.

This new protocol allows for an ***automatic modification*** of master agreements if both parties to the agreement act, potentially avoiding the need for negotiating individual amendments to address FATCA Withholding. This modification clarifies which party bears the cost for any FATCA Withholding that may otherwise be required.

Click here to view the protocol which was opened on August 15, 2012 and related materials.

Why was the protocol promulgated?

ISDA issued the protocol to address the effects of FATCA Withholding on derivative transactions governed by ISDA Master Agreements, which are widely-used market standard agreements between parties of a derivative contract.

As a general matter, the ISDA Master Agreement contractually allocates the economic burden of withholding tax to the payor as a starting point. From that starting point, tax forms and counterparty representations assist in determining the scope of the payor's tax withholding and reporting obligations and can shift the economic burden of tax withholding if imposed, to the payee. This is the impact of

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[1] FATCA was enacted as part of the Hiring Incentives to Restore Employment Act of 2010.

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the change in the ISDA protocol, the shift in economic burden of FATCA Withholding from the payor to the payee.

In the event that a recipient (the payee) does not provide a payor with evidence of its compliance with FATCA, a 30% withholding tax under FATCA is required to be levied on certain U.S. source payments. Under the standard ISDA tax language, withholding is generally treated as an 'Indemnifiable Tax' for which the payor has responsibility. The payor would be required to gross up its payments to compensate the counterparty for the 'Indemnifiable Tax' that was withheld.

> ***PwC Observation:*** *The Frequently Asked Questions (FAQ) section of the ISDA site notes that many counterparties in the market have expressed concerns with trading under ISDA Master Agreements that require the payor to gross up for the FATCA non-compliance of the payee. As such, ISDA has provided these protocols in order to prevent potential market disruption.*

Under the protocol, which party would be responsible?

As compliance with FATCA is solely in the control of the recipient, ISDA concluded that it was more equitable to amend its standard tax language to allocate responsibility for the cost of FATCA Withholding to the recipient. The new protocol would carve out the 30% FATCA Withholding from the definition of 'Indemnifiable Tax' in the ISDA Master Agreement (i.e., under the protocol, 30% FATCA Withholding tax would **not** be an Indemnifiable Tax). This change will enable a payor to withhold the appropriate tax under FATCA at 30%, pay the tax over to the Internal Revenue Service and pay the net amount to the recipient without any obligation to pay a gross up. Recipients of these net payments would include non-participating FFIs and other payees that are not FATCA compliant.

How can the protocol be adopted by the parties?

The ISDA website (click here) provides an on-line process for executing an Adherence Letter to the protocol. Generally, a letter signed by an authorized signatory must be uploaded onto the ISDA website. Once approved by ISDA, an e-mail will confirm the participant's adherence to the protocol. The effect of the Adherence Letter is that all Master Agreements to which the signatory is a party would be automatically amended to include the carve-out of FATCA Withholding from the definition of an Indemnifiable Tax with other parties that have already adhered to the Protocol or that adhere before a designation of the Annual Revocation Date.

The amendment would cover all aspects of the Master Agreement including credit support provisions governing collateral arrangements.

> ***PwC Observation:*** *Both parties must execute the protocol in order for it to be effective. The ISDA website conveniently allows parties to review what other companies or entities have submitted Adherence Letters.*

When could FATCA Withholding apply to derivatives?

While FATCA contains a grandfathering rule with respect to transactions entered into before the end of 2012, that rule applies to individual transactions entered into under an ISDA Master Agreement and not the Agreement itself. As a result, derivative transactions entered into after the end of 2012 (or pre-existing contracts that are modified after 2012) could be subject to withholding tax under FATCA as early as January 1, 2014.

PwC Observation: *Parties to a derivatives contract should consider signing up to the protocol by the end of the year so that counterparties can obtain certainty as to the legal provisions governing their transactions once grandfathering ends. ISDA is not setting a deadline for filing Adherence Letters, but it specifically recommends that parties get a head start and adhere to the protocol as quickly as possible.*

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