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ISDA Publishes 2012 FATCA Protocol

August 28, 2012

On August 15, 2012, the International Swaps and Derivatives Association (the "ISDA") opened the ISDA 2012 FATCA Protocol (the "FATCA Protocol") for adherence. The FATCA Protocol is intended to allow adherents to amend certain tax-related definitions in ISDA Master Agreements in advance of the effective date of the new U.S. income tax reporting and withholding requirements commonly referred to as "FATCA."[1] In brief, the FATCA rules impose a 30% withholding tax on certain types of U.S. source income, as well as certain payments of "gross proceeds" from the disposition of assets that can produce such U.S. source income, unless the recipient of such payment either complies with various due diligence, reporting, and withholding obligations or is exempt from FATCA withholding. Depending on the terms of the individual trade, it is possible that a derivative contract entered into under the ISDA Master Agreement could generate the types of U.S. source income that are potentially subject to FATCA withholding. FATCA withholding tax could only apply, however, to payments made to a foreign entity that neither provides certification to the payor that the foreign entity has complied with its obligations under FATCA nor provides certification that such foreign entity is exempt from FATCA withholding. As a result, FATCA withholding tax on payments under a derivative contract generally can be avoided entirely, regardless of the terms of that derivative contract, if the recipient of the payment complies with its certification obligations under FATCA.[2]

The FATCA Protocol, as proposed, accounts for the fact that FATCA withholding tax can be avoided entirely by actions of the recipient of a payment, and that, therefore, the risk of the imposition of FATCA withholding tax in the first instance should be allocated to such recipient. The FATCA Protocol achieves this result by expressly removing FATCA withholding tax from the ISDA Master Agreement's definition of "Indemnifiable Tax." In the release accompanying the FATCA Protocol, the ISDA described the decision to place the default FATCA withholding tax risk allocation on payment recipients as a response to market counterparties' concerns with trading under ISDA Master Agreements that require a payor to gross up for the FATCA non-compliance of the recipient, where the decision of whether or not to comply with FATCA obligations is entirely within the control of the recipient of the payment.

Notably, the FATCA Protocol only changes the definitions of "Indemnifiable Tax" and "Tax" to implement this change, and does not relieve the parties to the ISDA Master Agreement of the obligation to ensure that the schedule includes proper certifications of compliance, to the extent required in the parties' individual circumstances.

The FATCA Protocol incorporates within the scope of FATCA any intergovernmental agreements that the U.S. government enters into with other nations ("IGAs"). While this inclusion appears intended to bring the entire universe of FATCA-related compliance obligations within the scope of the FATCA Protocol, it is not clear that ISDA market participants in countries that have expressed an intent to enter into IGAs will be able to commit to complying with the FATCA Protocol until such IGAs enter into force, and the interaction of the IGAs and the market participant's obligations under foreign law are more fully developed.

Adherents to the FATCA Protocol will be deemed to have agreed to replace any provisions relating to FATCA withholding taxes in previously enacted schedules or confirmations. This appears intended to bring uniformity to these provisions, as well as to allow adherents to bring the FATCA provisions in their existing arrangements up-to-date without requiring the specific amendment of those existing arrangements.

Since certain of the FATCA rules will become effective as of January 1, 2013, the ISDA recommends parties begin adhering to the Protocol as soon as possible to prevent any disruption in the derivatives market. Currently, the Protocol is open to both ISDA members and nonmembers and has no cut-off date; however, the ISDA reserves the right to impose a cut-off date in the future.

If you would like to discuss the application of the FATCA Protocol to your particular situation, or have questions about the taxation of derivatives generally, please contact one of the Proskauer lawyers listed on this alert, or the Proskauer lawyer with whom you normally consult on these matters.

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[1] "FATCA" refers to the Foreign Account Tax Compliance Act, the provisions of which were enacted as part of the Hiring Incentives to Restore Employment Act in 2010, and which are codified as Sections 1471 through 1474 of the U.S. Internal Revenue Code of 1986, as amended. Treasury regulations implementing FATCA have been proposed by the U.S. tax authorities, although those proposed regulations have been the subject of extensive commentary and could be amended prior to being issued in final form. Also, the governments of the United States and certain other key trading partner nations also have issued draft model intergovernmental agreements to simplify FATCA compliance for residents of those partner nations.

[2] A complete discussion of whether and under what conditions a derivative arrangement could give rise to FATCA withholding is beyond the scope of this discussion. However, if FATCA withholding were to apply to a payment on a derivative contract, the method for avoiding FATCA withholding on such payments generally would be the same regardless of the specific terms of such derivative contract.

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