CLEARY GOTTLIEB

Alert Memo

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Summary of the Impact of the FATCA Proposed Regulations on Capital Markets Transactions

I. BACKGROUND

On February 8, 2012, the United States Department of the Treasury and Internal Revenue Service released proposed regulations implementing sections 1471 through 1474 of the Internal Revenue Code (commonly called "FATCA").[1] The proposed regulations would impose reporting and withholding obligations on "foreign financial institutions" (or "FFIs") that enter into an "FFI agreement." Under the proposed regulations, *starting in 2014*, FFIs that do not enter into an FFI agreement would be subject to a 30% withholding tax on U.S.-source interest, dividends, and other types of passive income ("FDAP income"). The proposed regulations defer imposition of a withholding tax on gross proceeds from the sale of property producing U.S.-source dividends and interest until 2015.[2]

A more detailed discussion of the proposed regulations is included in our February 15, 2012, Alert Memo "Treasury and the IRS Release Proposed Regulations under FATCA and a Joint Statement with Other Countries Regarding an Intergovernmental Approach to FATCA Implementation." This summary highlights certain provisions of the proposed regulations that are relevant to capital markets transactions.

II. IMPLEMENTATION TIMELINE

- *Grandfathered Obligations*. The proposed regulations extend the statutory "grandfather" rule from March 18, 2012 to cover all "obligations" outstanding on January 1, 2013.[3] **Thus, payments on obligations issued before that date, and any gross proceeds from the disposition of such obligations, generally will not be subject to FATCA.** For this purpose, the term "obligations" means legal agreements that produce or could produce withholdable payments or foreign passthru

[1] All references to sections herein are to the Internal Revenue Code of 1986, as amended.

[2] U.S.-source FDAP and such gross proceeds are together referred to as "withholdable payments" under the proposed regulations.

[3] An obligation issued prior to 2013 will cease to be covered by the grandfather rule if, after 2012, it has been materially modified for purposes of section 1001.

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payments,[4] other than instruments that are treated as equity for U.S. tax purposes or that lack a stated expiration or term (such as a savings deposit or demand deposit). Because U.S. equity interests are not treated as grandfathered "obligations," the FATCA requirements will apply with respect to such equity interests as of the relevant FATCA effective dates, regardless of when such U.S. equity interests are issued.

The proposed regulations generally provide that a debt instrument will be treated as outstanding on January 1, 2013 if its "issue date" is before January 1, 2013. Thus, the grandfather rule should cover a post-2012 "qualified reopening" of a debt instrument issued prior to 2013. The final regulations should make this explicit.

- *Proposed Effective Dates*. No FATCA withholding on U.S.-source FDAP will be required prior to January 1, 2014, and no FATCA withholding applicable to gross proceeds from the disposition of property that produces U.S.-source FDAP will be required prior to January 1, 2015. FATCA reporting requirements for participating FFIs will be gradually phased in beginning in calendar year 2013 (with the first reporting due in September 2014) and fully implemented by calendar year 2016. A draft model FFI agreement is expected to be released in early 2012, and online registration for FFI agreements is scheduled to begin no later than January 1, 2013. The due diligence requirements imposed on FFIs with respect to a financial account under an FFI agreement will be phased in over time and will generally be based on the account's size and characteristics and whether it is an account maintained as of January 1, 2013.

III. CAPITAL MARKETS DOCUMENTATION ISSUES

- *Tax Disclosure*. The tax disclosure in offering documents generally will need to reflect the potential application of FATCA where relevant, but the nature and the extent of the particular disclosure required will depend on the terms of the issuance, including the nature of the securities being offered, the date of the offering and whether the issuer is a U.S. issuer. Thus, disclosure for (i) U.S. issuer stock offerings, and (ii) debt offerings effected after December 31, 2012, where non-U.S. investors are covered generally should reflect the potential applicability of FATCA.

  Debt and equity offerings by non-U.S. issuers, including FFIs, generally will not require disclosure regarding FATCA, other than in cases of issuances by FFIs that are investment funds or similar entities.[5]

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[4] The proposed regulations reserve on the definition of "foreign passthru payment."

[5] As discussed in Part IV, below, debt and equity issued by FFIs that are banks, brokers or insurance companies generally are excluded from the definition of "financial account" and thus generally are not subject to FATCA.

- *Gross-Up Exclusion*. Under current market practice, taxes imposed under FATCA generally are excluded from taxes subject to an "additional amounts" or "gross-up" provision. The proposed regulations should not change this practice.

IV. DEBT AND EQUITY ISSUANCES

- *Short-Term Debt Generally Is Exempt From FATCA Withholding*. Payments of interest on, and gross proceeds from the disposition of, short-term obligations (*i.e.*, those having an original term to maturity of 183 days or less) are excluded from the definition of "withholdable payments." Thus, payments on obligations such as U.S. Treasury bills or U.S. issuer commercial paper generally will not be subject to FATCA's reporting and withholding requirements.

- *Debt and Equity Issued by Certain FFIs Are Not "Financial Accounts."* The proposed regulations provide that debt and equity issued by an FFI that is a bank, broker or custodian, or insurance company generally will not be treated as a "financial account." This rule is subject to certain exceptions, including an exception for issuances by an FFI of an instrument the value of which is determined by reference to U.S. assets (*e.g.*, certain structured notes). Thus, in general, foreign banks will not need to treat holders of their privately placed conventional debt as holding "financial accounts" for FATCA purposes. Consequently, the FATCA due diligence requirements would not apply to such debt and equity that is not treated as a financial account.

- *The Scope of the FATCA Exemption for "Regularly Traded" Debt and Equity Issuances by FFIs Is Clarified*. FATCA excludes from the definition of "financial account" interests issued by an FFI that are "regularly traded on an established securities market." The proposed regulations clarify the scope of this exception by providing a mechanical test to determine whether a debt or equity interest is "regularly traded on an established securities market." Generally, the test is based on the volume and frequency of the trades effected in the previous calendar year.[6] While this test is restrictive (especially with respect to debt issuances, which are less likely than equity to have a high volume of trading), FFIs (other than certain FFIs such as investment funds) may be able to rely on the separate exception from the definition of "financial accounts" for certain debt and equity described in the immediately preceding paragraph.

- *Deferral of Effective Date of "Passthru Payment" Rules*. The proposed regulations defer until at least 2017 the application of the rules requiring withholding with respect to certain foreign-source "passthru payments" and reserve on the treatment of

[6] The proposed regulations provide no guidance regarding the application of the "regularly traded" rule for the first year in which such a debt or equity interest is traded.

such amounts. Thus, payments made with respect to debt or equity issued by an FFI generally will not be subject to withholding until 2017 or later, although the proposed regulations provide no guidance regarding how broadly those rules will apply once they are in effect.

V. SECURITIZATION TRANSACTIONS

- Debt and equity interests issued by offshore securitization vehicles (*e.g.*, collateralized loan obligations) will generally be treated as "financial accounts" of the securitization vehicle for FATCA purposes because the offshore securitization vehicle is treated as an FFI. However, a securitization vehicle should be able to minimize its FATCA compliance burdens to the extent that its debt and equity interests are held by certain FFIs or U.S. financial institutions (*e.g.*, certain clearing organizations). In that case, the FATCA compliance responsibilities would be shifted to the financial intermediaries in the ownership chain. If a securitization vehicle's interests are not held through such a financial institution (*e.g.*, in certificated form), it will have to enter into an FFI agreement and perform FATCA due diligence, reporting, and withholding with respect to the holders of such interests in order to avoid FATCA withholding in respect of withholdable payments paid to it.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our U.S. partners and counsel listed under Tax under the "Practices" section of our website at http://www.clearygottlieb.com.

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