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April 15, 2014

Tax Alert

FATCA Compliance for Entities Issuing Collateralized Loan/Debt Obligations

The Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 to prevent US federal income tax evasion by policing offshore investments, accounts and trust interests held by certain US persons. Recently, the US Internal Revenue Service (IRS) has issued FATCA guidance providing limited relief for certain entities that issue notes secured by loans or debt securities (hereinafter referred to as CLOs). CLOs that do not qualify for this relief remain subject to FATCA's general rules.

I. Background

FATCA operates by requiring certain foreign entities (including foreign financial institutions (FFIs) and other nonfinancial foreign entities (NFFEs)) to fulfill certain requirements regarding their US account holders or other owners. Failure to comply with these requirements can result in imposition on FFIs and NFFEs of an up to 30 percent US withholding tax on certain US-source income received by them. There are several approaches for complying with FATCA: adherence to final and temporary Treasury Regulations (Regulations) promulgated under FATCA or to one or more intergovernmental agreements (IGAs) that have been entered into between the United States and various non-US countries, which fall into either a "Model 1" or "Model 2" category, as described below.

A. Regulations

Under the Regulations, FFIs (including non-US banks and non-US "investment entities") generally are required to register with the IRS, obtain a Global Intermediary Identification Number (GIIN), and enter into an "FFI Agreement" (defined below). CLOs generally will be treated as investment entities. As a result, unless an exception applies, non-US CLOs generally will be treated as FFIs.

An FFI Agreement requires FFIs to: (i) identify their US accounts (which include certain accounts held by non-US entities that have US owners); (ii) report information about their US accounts to the IRS; (iii) adopt a compliance program for satisfying these FATCA requirements; and (iv) withhold tax on certain payments made to: (a) FFIs that do not enter into an FFI Agreement and (b) certain account holders that fail to submit information to the FFI or that fail to provide a waiver of any non-US law that would prevent FATCA reporting by the FFI with respect to such accounts. FFIs that enter into an FFI Agreement are called “participating FFIs.”

FFIs that fail to satisfy the above requirements generally are subject to a 30 percent US withholding tax on: (i) payments of US-source interest, dividends, rents, salaries and other similar (fixed and determinable annual or periodical) payments made on or after July 1, 2014, and (ii) gross proceeds from the sale or other disposition of property, occurring on or after January 1, 2017, that can produce US-source interest or dividends (collectively, “withholdable payments”).

The term “withholdable payments,” however, does not include payments made under a “grandfathered obligation” or payments of gross proceeds from the disposition of a “grandfathered obligation.” The term “grandfathered obligation” generally means an obligation, including a debt instrument, that is outstanding on July 1, 2014. A debt instrument is considered outstanding on July 1, 2014 if it is issued before that date. If a debt instrument is modified in a fashion deemed “significant” under applicable Treasury Regulations, however, the debt instrument will be deemed to be reissued for US tax purposes, and will no longer be treated as a grandfathered obligation. In addition, legal agreements that are treated as equity for US tax purposes or that lack a stated expiration or term are not eligible for treatment as grandfathered obligations.

B. IGAs

As noted above, the US Department of the Treasury has entered into IGAs with numerous jurisdictions to provide entities that are covered by such IGAs with alternative approaches for complying with FATCA. An IGA covers: (i) any FFI resident in (or, under some IGAs, organized under the laws of) the subject jurisdiction, but excludes any branches of such FFI that are located outside the subject jurisdiction and (ii) any FFI branches that are located in the subject jurisdiction even if the FFI is not a resident in (or, where applicable, organized under the laws of) the subject jurisdiction. Thus, FFIs may be subject to more than one IGA, and to both the IGAs and the Regulations, depending on where they reside (or under whose laws they are organized, where applicable), and the locations of their branches.

There are two basic types of IGAs: a Model 1 IGA and Model 2 IGA. FFIs in a jurisdiction that enters into a Model 1 IGA must register with the IRS and obtain a GIIN, but are not required to enter into an FFI Agreement. Thus, such FFIs are not required to report information directly to the IRS. Instead, they must, among other things, report information about their US accounts to their local governments under procedures prescribed under local law. The local governments, in turn, will relay the information to the IRS. In contrast, FFIs in a jurisdiction that enters into a Model 2 IGA are required to comply with the terms of an FFI Agreement, as modified by the Model 2 IGA. Thus, such FFIs must, as under the Regulations, report information directly to the IRS, although such information may be supplemented by a government-to-government exchange of information upon request. Numerous jurisdictions have entered into intergovernmental agreements. The Cayman Islands, for example, has entered into a Model 1 IGA.

II. Exception for Limited Life Debt Investment Entities

CLOs that qualify as so-called "limited life debt investment entities" (LLDIEs) are exempt from FATCA, provided they satisfy the applicable procedural requirements described in Section III.A below. Pursuant to recently issued guidance, a CLO qualifies as an LLDIE if it is the beneficial owner of the payment (or of payments made with respect to the account) and meets the following six-pronged test:

- The CLO is an investment entity that issued one or more classes of debt or equity interests to investors pursuant to a trust indenture or similar agreement, and all of such interests were issued on or before January 17, 2013.

- The CLO was in existence as of January 17, 2013, and has entered into a trust indenture or similar agreement that requires the CLO to pay investors holding substantially all of the interests in the CLO all of the amounts that such investors are entitled to receive from the CLO, no later than a set date or period following the maturity of the last asset held by the CLO.

- The CLO was formed and operated for the purposes of purchasing or acquiring specific types of debt instruments or interests therein and holding these assets to maturity, subject to reinvestment only under prescribed circumstances.

- "Substantially all" of the CLO's assets consist of debt instruments or interests therein. The term "substantially all" is not defined for these purposes, nor is it clear how frequently this test must be applied. By analogy to rules in other US federal income tax contexts, there is arguably support for the position that CLOs should be treated as satisfying the "substantially all" requirement if 80 percent or more of their assets consist of debt instruments or interests therein. Furthermore, while also not entirely clear, a CLO's assets likely will need to be valued periodically, and not just at the outset.

- All payments made to the CLO's investors (other than holders of a *de minimis* interest) are: (i) cleared through a clearing organization or custodial institution that is a participating FFI, a US financial institution or a "reporting Model 1 FFI" (an FFI that is subject to, and in compliance with, a Model 1 IGA's FATCA requirements); or (ii) made through a transfer agent that is a participating FFI, US financial institution or reporting Model 1 FFI.

- The CLO's trustee or fiduciary is not authorized, through a fiduciary duty or otherwise, to fulfill the requirements of an FFI Agreement, and no other person has the authority to fulfill the requirements of an FFI Agreement on the CLO's behalf.

As a result of the last LLDIE requirement, a CLO will not be able to qualify as an LLDIE if its operative documents contemplate FATCA. In contrast, if a CLO has operative documents that do not contemplate FATCA (for example, where the CLO is formed prior to FATCA's enactment), and the operative documents also prohibit amending the documents in any fashion that would enable FATCA compliance, such CLO would satisfy the last LLDIE requirement. What is not clear is whether a CLO can qualify as an LLDIE if, although its operative documents do not contemplate FATCA, they do permit amendments to be made that could enable FATCA compliance. Arguably, therefore, a CLO in that situation would not qualify as an LLDIE and would be required to amend its operative documents and to comply with FATCA.

III. FATCA Compliance Procedures for CLOs

A. CLOs that Qualify as LLDIEs

CLOs that qualify as LLDIEs are not required to register with the IRS or obtain a GIIN. Instead, they are treated as so-called "certified deemed-compliant FFIs" and, as such, will not be subject to FATCA withholding so long as they certify as to their status by providing withholding agents with a properly completed withholding certificate, generally IRS Form W-8BEN-E. (The IRS has recently issued the final version of IRS Form W-8BEN-E, and the applicable instructions are expected to follow.) In addition, although FATCA withholding goes into effect beginning July 1, 2014, transitional rules may apply in certain circumstances so as to permit payments made prior to January 1, 2015 to be made to a CLO without withholding, even if the CLO does not provide the withholding agent with a withholding certificate with respect to such payments.

B. Non-LLDIE CLOs

CLOs that do not qualify as LLDIEs are subject to the general FATCA rules. Thus, unless another exemption applies, non-LLDIE CLOs will be required to comply with the FATCA requirements described in Section I above, as applicable; to register with the IRS and to obtain a GIIN. Such CLOs will not be subject to FATCA withholding so long as they certify their FATCA-compliant status by providing withholding agents with a properly completed withholding certificate (generally IRS Form W-8BEN-E). The withholding certificate must contain a GIIN for the CLO that is verified against a list (the "List") to be published by the IRS and updated monthly. The IRS believes that it can ensure CLOs that register by May 5th that their GIIN will appear on the List to be published before withholding goes into effect and, thus, that they will not be subject to FATCA withholding.

As noted above, although FATCA withholding goes into effect beginning July 1, 2014, transitional rules may apply in certain circumstances so as to permit payments made prior to January 1, 2015 to be made to a CLO without withholding, even if the CLO does not provide a withholding certificate. In addition, special transitional rules apply to CLOs covered by a Model 1 IGA jurisdiction, such as the Cayman Islands, under the laws of which many CLOs are formed and operate. For example, such CLOs generally will not be subject to withholding on payments made to them prior to January 1, 2015 even if they have not yet obtained a GIIN that can be verified against the List, provided they provide the withholding agent with a withholding certificate that indicates their FATCA-compliant status and contains the name of the applicable Model 1 IGA country.

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