

# FATCA, fungibility and foresight – beware 18 March 2012

**FATCA potentially imposes US withholding tax on, among other things, interest and principal paid by all US issuers and by non-US issuers that are "financial institutions". While the withholding is currently scheduled to be phased in over 2014 and 2015, FATCA contains a grandfather rule which excludes payments with respect to debt securities treated as outstanding on 18 March 2012. This may make it difficult for any issuer whose debt securities are potentially subject to FATCA withholding to tap (or re-open) after 18 March 2012 a series of debt securities issued and outstanding before this date.**

The US Hiring Incentives to Restore Employment Act of 2010 (the "HIRE Act") introduced some significant changes to the US withholding tax rules. These changes are commonly referred to as "FATCA", after an earlier piece of proposed legislation, the Foreign Account Tax Compliance Act, the principal elements of which were eventually incorporated into the HIRE Act.

FATCA potentially imposes withholding tax on, among other things, interest and principal paid by all US issuers and by non-US issuers that are "financial institutions" (as used in FATCA this would include banks, insurance companies and most funds). Tax would also be imposed on disposition proceeds of a security that produces interest or dividends subject to FATCA withholding. The withholding is currently scheduled to be phased in over 2014 and 2015. However, FATCA contains a grandfather rule which excludes payments with respect to debt securities (but not equity securities) treated as outstanding on 18 March 2012. This note highlights two situations in which notes that are covered by this grandfather rule could potentially lose their grandfathered status.

## **Taps, Re-openings or Fungible Issues**

Where an issuer has a series of debt securities outstanding and then seeks to issue more securities having essentially identical terms such that the outstanding securities and the new securities are treated by market participants as being the same for all practical purposes, this is variously known as a tap, a re-opening or a fungible issue. If after 18 March 2012 an issuer seeks to tap a series of debt securities issued and outstanding before this date, this may effectively cause the outstanding securities to lose their grandfathered status. Even where a particular investor is able to show that it holds securities outstanding before the tap, this may not be sufficient to allow payments to flow through the chain of financial intermediaries between the issuer and the investor without withholding tax being imposed under FATCA. For this reason, market participants may be reluctant to treat new issues after 18 March 2012 as fungible with securities issued and outstanding before this date and issuers and underwriters may be unwilling even to try to re-open such issues for fear of upsetting existing investors by jeopardizing the grandfathered status of the previously-issued securities.

## **Key Issues**

**New US withholding tax scheduled to be phased in over 2014 and 2015**

**Grandfathering for debt securities outstanding on 18 March 2012**

**Grandfathered status may be prejudiced by:**

- Subsequent taps or fungible issues; or
- Significant modifications to terms

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If a tap causes notes to lose their grandfathered status, it would apply even in deals with no US investors and regardless of the pricing of the new notes. This issue has been raised with the US taxing authorities. However, given the policy behind FATCA it would not be surprising if no relief is provided.

### **Amending the terms of outstanding securities**

A similar issue may arise if it becomes necessary or desirable after 18 March 2012 to alter terms of debt securities that were issued and outstanding before this date. If the terms of a debt security are modified in a manner that is considered significant under the relevant US tax rules, the modified securities are generally viewed as newly issued for US tax purposes. Absent special provisions being added to the FATCA regulations, modifying terms of debt securities in this manner would cause the securities to lose their grandfathered status. Even when it is not clear that a modification is significant for these purposes, institutions making payments in respect of these securities are likely to be conservative and withhold unless they are given clear comfort that FATCA will not apply to the modified instruments because they could be jointly and severally liable under the US tax rules for any withholding they fail to collect.

### **Conclusion**

Initial regulations under FATCA are scheduled to be released before the end of 2011. However, these issues may not be addressed in the proposed regulations. Even if they are, final regulations will not be promulgated before 18 March 2012. Consequently, many issuers may find that if they are considering re-opening an existing issue of debt securities, or modifying their terms, there is a good reason to make sure the process is completed before 18 March 2012. Also many issuers may find they are effectively prevented after 18 March 2012 from tapping, or modifying the terms of, debt securities that were issued and outstanding before this date.

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