International
Comparative
Legal Guides

Practical cross-border insights into securitisation

Securitisation
2023

16th Edition

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afme/ Finance for Europe

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U.S. Withholding on Asset-Backed and Structured Securities

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A. Introduction

This chapter discusses, in plain business English, special U.S. tax rules applicable to non-U.S. investors in asset-backed and structured securities. In this chapter, the term "asset-backed securities" refers to securities that are collateralized by, and whose payment terms reflect the payments received on, a pool of debt instruments, including receivables, real estate mortgages, and commercial loans. The term "structured securities" refers to securities whose payment terms reference a principal amount coupled with the performance (which may be negative) of one or more assets or indices of one or more reference debt instruments, currencies, commodities, equities, or sovereign or commercial default risk. Structured securities are typically not collateralized by the reference assets and derivatives but may (though often do not) provide for periodic coupons and may be (but often are not) fully or partially principal protected.

The primary issue discussed in this chapter is the 30% U.S. withholding tax on certain investment income earned by non-U.S. investors. For a more detailed discussion of that and related topics, complete with citations to the relevant primary authorities, readers should see chapter 12 of James M. Peaslee & David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions and Related Topics* (5th Edition, Tax Analysts Inc. 2018) from which this chapter is derived in large part. More information about the book is available at www.securitizationtax.com.

Asset-backed securities are typically characterized, for U.S. federal income tax purposes, as debt instruments (or indirect ownership interests in a pool of debt instruments); accordingly, this chapter begins with a discussion of the rules applicable to debt instruments. Many asset-backed securities are characterized as an interest in a debt instrument coupled with a derivative, such as an option, forward contract, or notional principal contract ("NPC," the tax term for what is commonly referred to as a swap). A discussion of the rules for these derivatives follows the discussion of debt.

Structured securities may be characterized for U.S. tax purposes as debt or as debt coupled with one or more derivatives. In such a case, the rules discussed in the context of asset-backed securities would apply. However, where a structured security is not by its terms divisible into its separate components, it may not be characterized solely as one or more financial instruments for which specific exemptions to withholding tax apply and, thus, may be subject to withholding. This risk, sometimes referred to by tax professionals as "amorphous FDAP" risk, is discussed in Part C. below.

The chapter continues with discussions of section 871(m) of the Internal Revenue Code of 1986 (the "Code"), which imposes a 30% withholding tax on certain "dividend equivalents" and the effect on mortgage-backed securities of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA").

The chapter finishes with a discussion of the Foreign Account Tax Compliance Act ("FATCA") rules. This network of legislation and bilateral treaties requires foreign entities to monitor and report on accounts or ownership interests held directly or indirectly by specified U.S. persons. Its purpose is to prevent U.S. persons from avoiding tax by hiding income earned through foreign accounts and entities. Non-compliance is penalized through a special additional withholding tax.

Except where otherwise noted, it is assumed in this chapter that a non-U.S. investor has no connection with the United States other than holding the asset-backed or structured security under discussion, and specifically that the investor does not hold the security in connection with a U.S. trade or business conducted by the investor. In very general terms, income of a non-U.S. investor that is effectively connected with a U.S. trade or business is not subject to the 30% withholding tax discussed below but is instead subject to a net income tax at the rates applicable to domestic taxpayers and in some cases a branch profits tax. Asset-backed securities and structured securities sold to non-U.S. investors are typically structured so that a non-U.S. investor will expect not to be deemed to be engaged in a U.S. trade or business on account of activities of the issuer.

It is also assumed in this chapter that the issuer of the security is a U.S. entity or, may be so treated under form-*versus*-substance or similar principles.

B. Asset-Backed and Structured Securities Characterized as Debt

1. Introduction

The United States generally imposes a 30% withholding tax on fixed or determinable, annual or periodic ("FDAP") income arising from U.S. sources that is payable to non-U.S. investors. FDAP includes interest and dividends and most other passive investment income, other than gains from sales of property. A principal tax objective of non-U.S. buyers of asset-backed and structured securities is to avoid the tax, by taking advantage of a statutory or treaty exemption. The most important statutory exemption for these investors is for portfolio interest.

Foreign investors may also seek to hold securities in bearer (as distinguished from registered) form, and in other ways limit reporting of personal information. This goal is for the most part no longer achievable. Accordingly, this chapter does not address the rules for holding securities in bearer form and assumes all securities are issued in registered form; that is, very generally: (1) registered as to both principal and interest with the issuer or its agent and can be transferred only by the surrender of the old obligation to the registrar for its reissuance, or the issuance of a new obligation, to the transferee; or (2) principal and interest may be transferred only through a book entry system maintained by the issuer or its agent or a clearing organization.

The balance of this Part B. is divided into two parts. Part B.2. discusses the withholding tax on income from asset-backed securities. Although it focuses on interest (and the portfolio interest exemption), since interest is the most important type of income from asset-backed securities, it also addresses withholding tax on income from rents, options, forward contracts and NPCs, and debt-related fees (such as consent fees). Part B.3. then discusses the tax certifications required to avoid or reduce any such withholding.

2. Withholding tax

a. Overview. In general, a non-U.S. investor that receives FDAP income from U.S. sources is subject to a 30% tax on the gross amount of such income, unless either a statutory exemption applies or the tax is reduced or eliminated under an income tax treaty between the United States and the investor's country of residence. The tax is required to be collected and paid over to the Internal Revenue Service (the "Service") by any withholding agent in the chain of payment, and is due irrespective of whether it is collected by withholding.

The two types of income that are likely to be earned by an investor in asset-backed securities and structured securities taxable as debt are interest and gain from the sale or exchange of the securities. Although interest, which for this purpose, with limited exceptions, includes accrued original issue discount ("OID"), is FDAP income, gain from the sale or exchange of securities, including gain attributable to market discount and option premium, is generally not. Thus, the withholding tax discussion herein concentrates on interest income. Certain other types of income that may be earned from asset-backed and structure securities are discussed in Part B.2.c. below.

b. Portfolio Interest Exception to Withholding. In general, interest income is subject to the withholding tax if it is derived from U.S. sources, unless either the exemption for *portfolio interest* (described below) applies, or the tax is reduced or eliminated under a treaty. In some cases, tax may be required to be withheld from payments of interest even if those payments are not includible in full in the income of the payee. The investor, however, would be entitled to a refund of any excess tax withheld.

Notwithstanding the general rules discussed above, interest is exempt from withholding tax if such interest qualifies as portfolio interest. With limited exceptions – most significantly, for payments of interest to 10% corporate shareholders or partners, to related controlled foreign corporations, or to banks under bank loans, and for certain payments of contingent interest – interest on an obligation (including accrued OID) is portfolio interest if the obligation is in registered form, and the withholding agent receives a statement from the beneficial owner or certain intermediaries giving the owner's name and address and certifying that the owner is not a U.S. person. These certifications are discussed in Part B.3. below. For debt issued before January 1, 2016, more relaxed information reporting was allowed for registered obligations that were targeted to foreign investors. Portfolio interest also includes interest on an obligation in bearer form issued on or before March 18, 2012.

There are two basic approaches to applying the portfolio interest exemption to asset-backed securities, which are to treat them as stand-alone securities, or to look through to the underlying receivables. This distinction may be particularly important for securities backed by home mortgages or other consumer receivables because they are typically not in registered form. Accordingly, interest on such receivables received directly by foreign investors would not be eligible for the portfolio interest exemption. The same may be true for certain short-term debt obligations, although other exemptions from withholding may apply.

Pay-through bonds (debt instruments whose principal is repaid based on the timing of principal payments on the bonds' collateral) and real estate mortgage investment conduit ("REMIC") regular interests (certain mortgage-backed securities for which a REMIC election is made) are considered debt instruments in their own right, and thus can qualify for the portfolio interest exemption based on their own characteristics regardless of the bearer or registered status, or date of origination, of the underlying receivables.

In the case of a debt obligation that is held by a foreign investor through an entity that is tax-transparent (a partnership, grantor or fixed investment trust, or disregarded entity), it will be helpful to divide the requirements of the portfolio interest exemption into two parts: (1) those unrelated to the requirement that debt be in registered form; and (2) those relating to registration. For purposes of the first set of requirements, a look-through approach should generally be applied, as if the owner of the entity directly owned its share of the entity's assets. One deviation is that the exception to portfolio interest for interest on a loan made by a bank in the ordinary course of its banking business should not apply to debt held in the form of traded pass-through certificates.

For purposes of the second requirement that debt be in registered form, interest received on certificates issued by grantor trusts (and potentially a wider range of similar issuers) is considered to be received on the certificates rather than on the underlying receivables for purposes of meeting the requirement that interest be paid on obligations in registered form.

Portfolio interest does not include any interest that, with certain exceptions, is contingent on the profits or cash flow of the debtor (or a related person), the value of the debtor's (or a related person's) property, or distributions on the debtor's (or a related person's) equity. Thus, such interest will generally be subject to the 30% withholding tax unless the tax is eliminated or reduced under a treaty. Of particular relevance to securitizations, the contingent interest exclusion does not apply to interest that is considered contingent solely on account of (1) a contingency as to the timing of any interest or principal payment, (2) the debt being non-recourse or limited recourse, or (3) the interest being determined by reference to interest that itself is not contingent (or by reference to the principal amount of debt that does not bear contingent interest). While asset-backed securities may provide for payments that depend on cash flows of the issuer, these exceptions cover the features of typical asset-backed securities that would otherwise be problematic. Other exceptions are available that are more likely to be relevant for structured securities than asset-backed securities. They include contingencies arising from: (1) the debtor (or a related person) entering into a hedging transaction to reduce interest rate or currency risk; or (2) the interest being determined with reference to (a) changes in the value of publicly traded property, including stock, but not including U.S. real property interests, (b) changes in the yield of property described in (a) (other than contingent interest debt, or stock or other property, that represents a beneficial interest in the debtor or a related person), or (c) changes in an index of the values of property described in (a) or yields of property described in (b).

c. Swaps, Rents, Options, Forward Contracts and Debt-Related Fees. Two other categories of FDAP income that may be realized by holders of asset-backed and structured securities are income from interest rate, currency or other swap agreements and from the rental of real property. An investor may also have income from options (typically, from writing call options on debt instruments that are combined with the options) and from forward contracts or from fees relating to debt investments. These types of income are discussed in the next four sections.

Some asset-backed securities represent ownership interests in a trust holding both (1) a debt instrument (including a REMIC regular interest) or pass-through certificate, and (2) an NPC, such as an interest rate swap, cap or floor agreement. The trust may be classified for tax purposes as either a grantor trust or a partnership. The withholding tax treatment of income from the debt instruments held by the trust is discussed above and would not change because the securities are held in combination with an NPC.

The income from payments received on the NPC generally would be FDAP income. Thus, the income would be subject to U.S. withholding tax unless the tax is eliminated or reduced under a tax treaty, or the source of the income is outside of the United States. (The portfolio interest exemption would not apply because swap income is not interest.) In fact, the withholding tax never applies to income from an NPC as such, because such income is sourced based on the residence of the payee and not the residence of the payor. However, to the extent there is a significant non-periodic payment under an NPC (other than an NPC cleared by a derivatives clearing organization or otherwise subject to similar margin rules), the instrument is generally split for tax purposes into an on-market NPC and a deemed loan. If a non-U.S. investor is the lender, the withholding tax treatment of the deemed interest income (specifically whether the portfolio interest exemption or some other relief applies) must be considered separately from the rules for NPCs. There are special rules for dividend equivalent swap payments that are not generally relevant to asset-backed securities but are often important for structured securities, and they are discussed below in Part D.

A non-U.S. investor that owns an interest in an NPC through a grantor trust would clearly benefit from the NPC source rule based on the investor's residence, since the trust would be ignored. The result would generally be the same for a non-U.S. investor holding an NPC through a partnership, provided the activities of the partnership are limited (as they typically are with asset-backed securities in which foreigners invest) to investing and trading in securities.

A credit default swap generally would be considered either an NPC (the more likely choice) or a put option, and payments thereon would not be subject to withholding tax under either characterization (options are discussed in Part B.2.e. below).

d. Rents. Rental income from real property located in the United States is considered U.S.-source FDAP income. There is no withholding tax exemption for such income comparable to the one for portfolio interest. Thus, if a non-U.S. investor holds pass-through certificates or other equity interests in an entity that is classified for federal income tax purposes as either a trust or a partnership, and the issuer acquires U.S. real property in connection with a default or anticipated default on a mortgage, the withholding tax generally would apply to the investor's share of any rents received on the property. Interesting allocation issues beyond the scope of this chapter arise where pass-through certificates are divided into junior and senior classes. On the other hand, income earned on an instrument that is taxed as debt of the issuer, such as a pay-through bond or REMIC regular interest, continues to be interest even if it is derived from rental income.

e. Income from Options and Forward Contracts. Income from the sale or cash settlement of options (including gain of an option writer from the lapse of an option and income from the cash settlement of an option) and forward contracts is generally considered gain from the sale or exchange of property. Accordingly, such income is not FDAP income and is not subject to the 30% withholding tax.

f. Debt-Related Fees. A creditor may receive various income amounts denominated as "fees" in connection with extending credit. How withholding tax rules apply to fees received by a non-U.S. person depends on how they are characterized for tax purposes, which should depend on their economic substance. For example, fees may represent interest if paid as additional consideration for lending funds or may instead be compensation for some ancillary service provided to a borrower and represent income from personal services. Certain fees may be treated as gain from the sale or exchange of property.

Fees that are not gain from the sale or exchange of property would be FDAP income and thus potentially would be subject to withholding tax if received from U.S. sources. The applicable source rule will depend on the type of income involved. Income from personal services is sourced where the services are performed.

The Service has issued guidance on a number of miscellaneous types of "fees" charged in connection with credit card accounts, which is helpful in providing a framework for analyzing fees. The guidance generally divides the fees between interest and services income, depending on whether they are tied to funded amounts. For example, fees charged as penalties for making late payments are interest and annual fees charged for issuing a credit card (whether or not the card is used) are services income.

Commitment fees are paid by a prospective borrower for an agreement of a prospective lender to lend on agreed terms. There are authorities treating such fees in the hands of domestic taxpayers as payments for a property right akin to an option. If this characterization controls for withholding tax purposes, income from commitment fees would not be FDAP income, although the point is not clear. Even if commitment fees were considered FDAP income, they might be sourced outside of the United States on the ground that they are more analogous to gain from the disposition of a property right than to other types of income, or on the ground that the commitment represents a use of the taxpayer's capital, which is located outside of the United States. In practice, withholding agents generally do not withhold on commitment fees.

Fees received for consenting to the amendment or waiver of the terms of a debt instrument would not be FDAP income if the amendment or waiver results in a deemed exchange of the debt instrument, so that the fee is properly considered part of the consideration received in an exchange of the unmodified instrument. Where that is not the case, the outcome depends on whether the fees are properly regarded as additional interest or some other kind of payment on the debt instrument, or as a fee for services (or possibly as the proceeds of the sale from the lender to the borrower of a portion of the lender's interest in debt instrument (e.g., the right not to consent to the amendment). There is an established practice of not withholding on loan amendment fees, which may be supported by any of the aforementioned characterizations.

3. Tax certifications

The tax on U.S.-source FDAP income is required to be collected and paid over to the government by any person that makes a payment to a foreign person or its agent. There may be more than one such withholding agent, but the tax need be collected only once. No withholding is required with respect to payments to certain classes of non-U.S. persons (most often foreign financial institutions or partnerships) that have assumed responsibility for the withholding of U.S. tax in the manner prescribed in regulations.

A withholding agent may treat a payment as exempt from withholding tax, or may withhold at a reduced rate, only if the agent can "reliably associate the payment with documentation" showing that the payee is a U.S. person, or is eligible for the exemption or reduced rate. The documentation used to establish entitlement to either the portfolio interest exemption (where a debt obligation is in registered form) or a reduced rate of tax under a tax treaty is typically a Form W-8BEN (for individuals) or Form W-8BEN-E (for entities). An entity claiming treaty benefits is required to certify that it satisfies the "limitation on benefits" article of the relevant treaty and is deriving the income as a resident of the relevant jurisdiction. A taxpayer identification number is required to claim a treaty exemption, with an exception for interest income paid on debt obligations that are "actively traded." In the case of asset-backed securities backed by underlying receivables that are taxed on a look-through basis, it is not clear if the actively traded test would be applied only to the securities (which would make sense as a policy matter), or also to the underlying receivables (which often would not themselves be actively traded).

A Form W-8BEN orW-8BEN-E is generally effective for the year in which received and the following three years, or for an indefinite period (other than for the purpose of claiming treaty benefits or an exemption for effectively connected income) if the beneficial owner provides documentary evidence of its foreign status. A withholding agent may not rely on certifications that the agent knows or has reason to know are unreliable or incorrect.

A withholding agent may make payments to an intermediary who will pay or distribute the income to the ultimate beneficial owner (the person treated as the taxpayer for U.S. tax purposes). Where the intermediary has become a *qualified intermediary* – by entering into an agreement with the Service setting forth procedures for collecting information from those beneficial owners and agreeing to specified audit procedures – then the withholding agent may accept a certification from the intermediary to the effect that the relevant exemption or tax reduction is available. The certification does not identify the beneficiaries to the withholding agent, and the intermediary is responsible for maintaining records identifying the beneficiaries and establishing their entitlement to the exemption.

Entities that are classified as partnerships generally do not file a Form W-8BEN-E. Instead, they file Form W-8IMY. Intermediaries, including qualified intermediaries (discussed above in the text), that hold securities on behalf of others also file Form W-8IMY, but the withholding statements differ. Most notably, a qualified intermediary is not required to identify the beneficial owners for whom it receives payments. That form must include a withholding statement containing, among other things, the name, address, TIN, if any, and the type of documentation (e.g., Form W-9 or type of Form W-8) for every person from whom documentation has been received by the partnership and whether that person is a U.S. exempt recipient, a U.S. non-exempt recipient, or a foreign person. Documentation (e.g., Form W-8BEN) from the partners must generally be attached to, or otherwise associated with, the partnership's Form W-8IMY. Documentation from the partners is not, however, required to be attached to a form from a partnership if the partnership is a "withholding foreign partnership." In addition, the withholding statement must allocate each payment, by income type, among the partners and must specify the rate of withholding to which each partner is subject, the partner's country of residence and, if a reduced rate of withholding is claimed, the basis for that reduced rate (e.g., treaty benefit or portfolio interest exemption). In general, a Form W-8IMY remains valid indefinitely, until there is a change in circumstances that makes the information on the certificate no longer correct. The indefinite validity period does not extend, however, to anything else associated with the certificate, such as the partners' withholding certificates and the withholding statements.

In general, a disregarded entity does not provide a withholding agent with a Form W-8BEN-E or W-9. Instead, the sole owner of the disregarded entity provides the withholding agent with the form appropriate to that sole owner. However, a disregarded entity is sometimes required to use a Form W-8IMY to avoid withholding under FATCA.

Foreign trusts issuing pass-through certificates are rarely used in securitizations. Where one is used, whether it uses a Form W-8BEN-E or W-8IMY or forms provided by its tax owners (under the grantor trust rules) depends on how it is classified. If it is a corporation, then it would provide a Form W-8BEN-E on its own behalf. If it is a partnership, then the rules described above requiring use of a Form W-8IMY apply. If it is a grantor trust, then it appears that for purposes of chapter 3 withholding, the payees of payments made to the trust would be the persons who are considered trust owners under the grantor trust rules rather than the trust itself.

C. Additional Concerns for Structured Securities

The classification of most structured securities is uncertain and depends on their terms. If a structured security is characterized as debt for tax purposes, it will be subject to the rules described above (and section 871(m) described below).

The classic definition of "debt" for tax purposes is a (i) a promise to pay, (ii) a non-contingent sum certain (the principal amount), (iii) on or before a specified maturity (provided that maturity is not too distant in the future). Although there are no hard and fast rules, most tax practitioners take the position that a structured security that is denominated as a debt instrument is sufficiently likely to be treated as debt (and thus payments on it are not subject to withholding) if it has either (i) 100% principal protection, or (ii) less than a 10% chance that the payment at maturity will be less than 90% of than the security's principal amount.

Full (100%) principal protection is a very favorable feature in characterizing a structured note as debt for tax purposes because the definition of debt is a promise to pay a "sum certain." In contrast, lacking principal protection is a very negative feature since a repayment of a "sum certain" is apparently lacking. Nevertheless, a security that possesses no less than 90% principal protection should not necessarily be treated as lacking a promise to pay a sum certain (even though such sum certain is not the full nominal or par amount of the security). For example, one reasonable characterization of such instruments is that it pays a sum certain (90% of par) with respect to a security that was issued at not too high a premium—111.11% of that sum certain in the case of 90% principal protection.

If a structured security is not characterized as debt for tax purposes, payments on it may escape withholding tax if the security could be treated as two (or more) separate financial instruments, each of which is not subject to withholding (for example, a debt instrument and a written cash-settled put option). Investment units comprised of financial instruments that can be separated and transferred separately are typically treated as a combination of financial instruments that are taxed separately, while those that may not be transferred separately are typically treated as a single financial instrument. The classic example is a comparison of a bond/warrant investment unit where the bond and the warrant are treated as separate assets and a convertible bond, which is treated as a debt instrument. Thus, this "bifurcation" of a structured security is most likely to succeed if the holder of the security has the right to transfer the components separately or terminate one while leaving the other outstanding.

Certain indivisible combinations of financial instruments are treated as a combination of separable financial instruments, even though the component parts are not separately tradable. Two examples are (i) a cash-settled written option and a deposit to cover the writer's exposure, and (ii) certain swaps that are treated as combinations of an NPC and a debt instrument. Some tax practitioners are comfortable bifurcating some structured securities into their components to determine that the security should not be subject to any withholding, as none of the components would be subject to withholding separately.

Even if a structured security cannot safely be assumed to be bifurcatable, payments thereon may not be subject to withholding. If the security can be characterized as a single NPC or cash-settled option or forward contract, there will be no withholding, as discussed in Part B.2.c. and e. above.

If a structured security cannot safely be assumed to be a financial instrument, the payments of which are not subject to withholding or a combination of such financial instruments, payments made on it may be subject to what is sometimes referred to as amorphous FDAP withholding.

As discussed above in Part B, above, a non-U.S. investor that receives FDAP Income from U.S. sources is subject to a 30% tax on the gross amount of such income. Thus, a payment on a structured security will be subject to withholding if it (i) is treated as income, (ii) that is characterized as FDAP income, and (iii) arises from sources in the United States. Very generally, FDAP income is passive income, other than gain from the sale or redemption of a security (and other than gain attributable to market discount and option premium). If a security is not easily categorized as a specific type of security for which there are known rules (e.g., as an NPC, option, forward contract, or a debt instrument), it is possible that the Service will treat the periodic payments thereon as FDAP income (sometimes referred to as "amorphous FDAP") because it literally is "periodical." This recharacterization could conceivably occur, even if no withholding would apply, if the security was bifurcated into indivisible securities on which all periodic payments would not be subject to withholding either: (i) under the portfolio interest rules; (ii) because they are not income; (iii) because if they are income, they are not FDAP income; or (iv) if they are FDAP income, because they arise from sources outside the United States.

Importantly, FDAP income is subject to U.S. withholding tax only if it arises from U.S. sources. So, even if the income on a security is amorphous FDAP income, that income will not be subject to U.S withholding tax if it is treated as arising at the location of the payee (foreign) rather than the U.S. payor. There are no specific rules regarding the sourcing of amorphous FDAP income. Under case law, it is likely to be sourced in the same manner as the income it most resembles for which there is a sourcing rule. Interest is considered to arise at the location of the payor, which would be unfavorable. In contrast, income on an NPC and gain from the cash settlement, sale, or other termination of an option or forward contract is considered to arise at the location of the recipient, thus outside the United States (which is favorable). There is, however, in many cases, a risk that the Service would argue that a structured security has too many derivative features to be characterized as a debt instrument but too few derivative features to follow the sourcing rules for derivatives. That argument is not altogether compelling but, on the other hand, is not patently indefensible. Thus, in at least some cases, there is a non-trivial risk that payments made on a structured security will be subject to withholding on account of being treated as amorphous FDAP arising from sources in the United States.

D. Section 871(m) Dividend Equivalent Payments

U.S. withholding tax is imposed on a myriad of types of income, including dividends. A dividend is a distribution by a corporation of a portion of its earnings to its stockholders, with the amount to be distributed based upon the number of shares held by each stockholder. Dividends paid by a U.S. corporation to non-U.S. persons that are not connected with a U.S. business are subject to a tax rate of 30%, although that rate could be reduced by a United States tax treaty.

As indicated above at Part B.2.c., payments on NPCs are not subject to withholding because such payments are treated as foreign- (as opposed to U.S.-) source income. Prior to the advent of section 871(m) in 2010, financial institutions often utilized total return swaps on equities to help non-U.S. persons avoid the tax otherwise due on the payment of dividends. A total return swap is an agreement in which one party (the "short party") transfers the total economic performance of a reference obligation to the other party (the "long party"). Essentially, the short party agrees to pay an amount equal to any appreciation in the stock price plus the amount of any stock dividends paid during the term of the swap, while the long party agrees to pay any depreciation in the stock price plus certain fees, which usually include an interest component. Thus, the swap provides the long party with virtually all of the economic benefits and burdens of holding stock without taking physical possession of the shares. And, absent a rule to the contrary, the payment of the amount of the actual dividends to the long party would not be subject to the tax on dividends (since the long party is not actually receiving dividends on a stock).

Section 871(m) of the Code and Treasury Regulations promulgated thereunder ("Section 871(m)") was enacted to combat the above-described (as well as other actual and perceived) abuses. With limited exceptions, Section 871(m) imposes a withholding tax of 30% (or lower treaty rate applicable to dividends) on certain "dividend equivalent payments" paid or deemed paid to non-U.S. investors on certain financial instruments linked to U.S. equities (which may include equity in certain partnerships) or indices that include U.S. equities (other than certain qualified indices). In very general terms, a dividend equivalent is any payment that references a dividend from an underlying security. Under these rules, withholding may apply even where the relevant U.S. equity linked instrument does not provide for any payment that is explicitly linked to a dividend. Generally, the issuer's determination of whether a security is subject to section 871(m) is binding on non-U.S. holders of the securities, but it is not binding on the Service.

If a structured security issued by a non-U.S. Issuer is subject to withholding under Section 871(m), the issuer of the security will typically also be subject to an additional 30% withholding tax on the income it earns on the assets that the issuer uses to hedge its exposure under such security. To offset the potential cost of this withholding, the issuer may assess an additional 30% charge against gross amounts of dividend equivalent payments made on such securities. This additional 30% charge is often referred to as "double withholding" and will be in addition to the 30% withholding tax imposed under Section 871(m) itself. Thus, the total amount that may be effectively withheld on a security subject to Section 871(m) could be 60% of any dividend equivalents payments. The double withholding will likely (and a portion of the withholding under Section 871(m) may) be treated as an adjustment to the amount payable on the security and not as a withholding tax for U.S. and non-U.S. tax purposes, such as determining the amount of any foreign tax credit.

Subject to the discussion below concerning securities issued before January 1, 2025, a security linked to U.S. equities or indices that include U.S. equities will generally be subject to the Section 871(m) withholding regime if, at issuance, it has a "delta" of 0.80 or higher with respect to the underlying U.S. equity. In general, delta is the ratio of the change in the fair market value of the security to a small change in the fair market value of the number of shares of the underlying security that is referenced by the security. The calculations of "delta" are generally made at the "calculation date," which is the earlier of (i) the time of pricing of the securities, i.e., when all material terms have been agreed on, and (ii) the issuance of the securities.

The Treasury Department and the Service have determined that it is appropriate for taxpayers and withholding agents to delay certain provisions in the section 871(m) regulations for non-delta-one transactions. Accordingly, under a notice issued by the Service, Section 871(m) will not apply to securities issued before January 1, 2025 that do not have a "delta" of one with respect to any U.S. equity. This threshold date addressing the coverage of non-delta one transactions has been repeatedly extended, and it is conceivable that, prior to January 1, 2025, it will be postponed once again.

A qualified derivatives dealer (a "QDD") is subject to tax on dividend equivalent payments based on the QDD's net delta exposure for each underlying security. It also remains liable for tax under dividends it receives. However, to allow taxpayers time to implement the net delta exposure method, dividends and dividend equivalents received by a QDD in its equity derivatives dealer capacity will not be subject to tax under section 881(a)(1) or subject to withholding under chapters 3 and 4 until 2025. Accordingly, if a securitization vehicle hedges its issuance with a QDD, the vehicle could avoid double withholding. However, a QDD is responsible for withholding on dividend equivalents it pays to a foreign person on a section 871(m) transaction, whether acting in its capacity as an equity derivatives dealer or otherwise.

Section 871(m) is complex, and its application may depend on the non-U.S. holder's particular circumstances. For example, the application of Section 871(m) may be affected if a non-U.S. securityholder enters into another transaction in connection with the acquisition of a U.S. equity linked security. Accordingly, non-U.S. securityholders should always consult their tax advisers regarding the potential application of Section 871(m) to the securities in their particular circumstances.

E. FIRPTA

FIRPTA enacted section 897, which subjects non-U.S. investors to U.S. tax on gain from sales of certain United States real property interests (including equity interests in "United States real property holding corporations") in the same manner as if such gain were effectively connected with a U.S. trade or business. Section 1445 implements the FIRPTA provisions by requiring payers to withhold tax from the proceeds of such sales. The FIRPTA rules do not apply to interests in real property that are solely creditor interests. Any interest in real estate (even one that is treated solely as a debt instrument under general tax principles) that permits its holder (directly or indirectly) to participate in the income, revenues, or appreciation of the property would not qualify as solely a creditor interest. Consequently, a foreign investor holding a mortgage-backed security will not be subject to the FIRPTA rules if the mortgages underlying the security lack such participation features and the issuer does not acquire the underlying real property.

If, however, a non-U.S. investor holds a mortgage-backed security taxable as an equity interest in a grantor trust or partnership, and the issuer acquires a real property interest in connection with a mortgage default, the investor will generally be treated for purposes of FIRPTA as owning a non-creditor interest in such property. Any gain attributable to such property that is allocable to the investor will be taxed under FIRPTA, either when the owning entity disposes of the real property, or when the investor disposes of its interest in the entity. A creditor acquiring real property collateral generally would have a basis in the acquired real property equal to its fair market value at the time of acquisition, so that any gain would be limited to increases in the property's value during the period it is held by the entity.

If any class of interests in a domestic entity is regularly traded on an established securities market (including certain over-the-counter markets), then gain from the disposition of interests in the entity (whether or not such interests are part of the traded class) by a person whose interests have not exceeded 5% during the five years preceding the disposition would generally not be subject to the FIRPTA tax. In the case of a publicly traded real estate investment trusts, section 897(k) increases the maximum portion of the stock that may be owned to 10%. This rule does not, however, affect the taxation of gain realized upon a disposition of real property by the entity. The definition of "regularly traded on an established securities market" is highly technical. For example, under current regulations, a class of interests is not "regularly traded" if 100 or fewer persons own 50% or more of the class, or if the market is outside the United States and the interests are not in registered form.

The section 1445 withholding tax currently does not apply to dispositions of interests in partnerships or trusts, unless, among other requirements, at least 50% of the gross assets of the entity consist of U.S. real property interests. A domestic trust or partnership that disposes of interests in real property is, however, required to withhold tax on a non-U.S. investor's share of any gain.

A REMIC regular interest should be treated as a creditor interest that is not subject to the FIRPTA tax without regard to any holdings of real property by the issuer.

F. FATCA Reporting and Withholding

1. Introduction

FATCA requires certain foreign financial institutions and other foreign entities ("FFIs") to provide information to the Service regarding U.S. persons who hold financial assets, directly or indirectly, through the entities. An FFI is defined broadly as any entity that is not a United States person and: (1) accepts deposits in the ordinary course of a banking or similar business; (2) as a substantial portion of its business, holds financial assets for the accounts of others; or (3) is engaged (or holds itself out as engaged) primarily in the business of investing, reinvesting, or trading in securities (which includes stocks, debt instruments, interest rate, currency, or equity NPCs), partnership interests, or commodities, or any interest in any of the foregoing. Under the last part of the definition, virtually any foreign entity issues asset-backed or structured securities will be an FFI.

The FATCA regime uses the threat of a withholding tax on U.S.-source income as the lever to compel reporting. FATCA is exceedingly complex and, for many financial institutions and Americans living abroad, extremely burdensome. The practical application of FATCA to issuers of, and investors in, asset-backed and structured securities, however, is, for the most part, benign. Accordingly, the balance of this section will provide only a high-level overview of FATCA, sufficient to set up the discussion in Part F.2. below, of the practical aspects of FATCA for issuers of, and investors in, asset-backed and structured securities. For a more detailed description of FATCA complete with citations, please see Chapter 12, Part E of James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions and Related Topics* (5th Edition, Tax Analysts Inc. 2018).

These rules are modified for FFIs located in a country that has entered into one of two types of intergovernmental agreement (an "IGA") relating to the implementation of FATCA with the United States. In general, an FFI that is located in a "Model 1 IGA" jurisdiction, which includes most of the United States's major trading partners, does not report to the Service, but rather complies with local law in its home country, requiring it to report similar information to that country's taxing authority, which is then obligated to forward the information to the Service. However, FFIs that are located in a "Model 2" IGA jurisdiction generally do still report directly to the Service.

FATCA imposes a 30% withholding tax on certain "withholdable payments" made to an FFI, whether or not the FFI is the beneficial owner of the payment, unless the FFI enters into an agreement ("FFI Agreement") with the Service that obligates it, among other things, to collect and report to the Service information about United States accounts, or an exemption applies. FATCA also imposes a 30% withholding tax on a withholdable payment made to any foreign entity that is not an FFI (referred to as a "non-financial foreign entity" ("NFFE")) that is the beneficial owner of the payment, unless the withholding agent receives a certification as to the ownership of the NFFE by U.S. persons or an exception applies.

Withholdable payments are generally payments of U.S.-source FDAP income (thus including interest or dividends). However, they also include the gross proceeds of sale of property that produces withholdable payments in the form of interest or dividends. Payments treated as dividend equivalents under section 871(m) will also be treated as withholdable payments for FATCA purposes, but not until six months after the publication of regulations implementing FATCA withholding on such payments.

In order to prevent an FFI from being used as a "blocker" for U.S.-source income, "foreign passthru payments" (very generally, income earned that is foreign-source but attributable to U.S.-source income of the payor) will be subject to FATCA withholding. The term "foreign passthru payment" has not yet been defined in regulations and withholding on foreign passthru payments will not apply to any payments on any obligation that is outstanding as of the date that is six months after promulgation of final regulations defining the term "foreign passthru payment."

And in order to prohibit FFIs from establishing non-compliant subsidiaries that can bear the burden of FATCA withholding by avoiding earning U.S-source income, an FFI will not be considered compliant with its obligations under FATCA unless each member of its expanded affiliated group that is an FFI is itself a participating FFI or otherwise FATCA-compliant.

Under either an FFI Agreement or the modified rules of an IGA, FFIs are generally required to: (1) register with the Service and obtain a "global intermediary identification number" ("GIIN"); (2) collect information from their clients and investors; (3) perform diligence on them to determine their U.S. or foreign status (and in some cases, the U.S. or foreign status of their clients' and investors' investors); (4) report to the Service (or, pursuant to a Model 1 IGA, their home country taxing authority) information about the accounts and investments of their U.S. clients (and in some cases the U.S. investors of their clients and investors); and (5) in some cases, withhold on withholdable payments made to non-compliant account holders. For financial institutions with a large retail client base, complying with these requirements can be extremely burdensome. It is less of a burden for securitization vehicles for the reasons given below.

The FATCA withholding tax is distinct from the regular 30% withholding tax on U.S.-source FDAP income paid to non-U.S. investors, which is discussed in Part A.2. above. To show their separateness, they are in different chapters of subtitle A, the income tax subtitle of the Code (chapter 3 for the regular withholding tax and chapter 4 for FATCA).

Unlike chapter 3 withholding, FATCA focuses on payments to foreign entities (not individuals) and has as its goal identifying ultimate U.S. (not foreign) owners of the payments (both individuals and closely held corporations) who may be hiding behind foreign entities. Consistent with this goal, the rules generally require the reporting to the Service of the identities of the U.S. owners and the existence and size of accounts and gross payments rather than income amounts. Further, the required reporting is not limited to U.S.-source payments. Thus, an FFI receiving U.S.-source payments may be compelled by the threat of withholding on those payments to report on accounts of U.S. persons earning solely foreign-source income. Congress clearly viewed the withholding taxes on U.S.-source income as a club to impose a broader range of reporting and withholding obligations.

Chapter 4 taxes that are withheld may be refunded or credited if the beneficial owner is entitled to a reduced rate of withholding pursuant to an income tax treaty with the United States, or, in the case of a beneficial owner that is an NFFE, it certifies that it does not have any substantial U.S. owners, identifies its substantial U.S. owners, or provides documentation establishing that withholding was not required.

The FATCA regime is a blend of domestic and international law. The Code rules are modified by IGAs. The IGAs now in effect are based on one of two models, Model 1 and Model 2. For a country that enters into a Model 1 IGA (a "Model 1 Partner Country"), a country resident FFI (a "Model 1 FFI") must register with the Service and obtain a taxpayer identification number, but is not required to enter into an FFI Agreement. Instead, the Model 1 FFI is required to comply with the reporting, withholding, and other obligations delineated in the applicable IGA. Two versions of the Model 1 IGA were released. One provides for an automatic reciprocal exchange of information by the United States and the Model 1 Partner Country. The other, non-reciprocal, version provides for a flow of information only from the Model 1 Partner Country to the United States. For a country that enters into a Model 2 Agreement, a country resident FFI must still register with the Service and enter into and comply with an FFI Agreement, but it is permitted and required by its home country law to do so.

2. Practical consequences for issuers of, and investors in, asset-backed and structured securities

Broadly speaking, FATCA can affect an issuer of securities in two ways. First, if the issuer makes withholdable payments, then any person acting as a withholding agent with respect to those payments must now receive documentation to establish that the payee either is domestic or, if foreign, is not subject to withholding under chapter 4 as well as under chapter 3. This requirement applies broadly to any type of domestic resident issuer and is not in any way unique to securitizations.

In practice, such an issuer avoids both chapter 3 and chapter 4 taxes by obtaining standard form documentation from payees, most often an IRS Form W-9 from a U.S. person and a Form W-8BENE from a foreign entity (FATCA withholding does not apply to payments to foreign individuals). Form W8BENE is an expanded version of the Form W-8BEN, with many boxes added to indicate the basis for an exemption under, or compliance with, FATCA. Any foreign entity buying U.S. securities must determine its FATCA status, but the Form W-8BEN-E can be completed quite easily and doing so is routine. Also, for securities held through a clearing organization, the burden of collecting the forms from investors falls on the clearing organization (or brokerage firms) and not on the issuer.

FATCA falls most heavily on a securities issuer if it is an FFI that must comply with the terms of an FFI Agreement or with comparable requirements under an IGA. The task of collecting, verifying, and reporting account information is extremely burdensome for both domestic and foreign banks, insurance companies, securities dealers, and money managers. It is, however, only modestly onerous for typical securitization vehicles.

Although a foreign issuer of asset-backed or structured securities (which would meet the definition of an FFI) must collect, verify and report account information, for most issuers, the collection and verification exercise can be accomplished by asking all investors for an IRS Form W-9, W-8BEN or W-8BEN-E, or some other variation thereof, just as if the issuer were domestic. Typically, investors in these vehicles are comfortable providing these forms, and the vehicle can expect to achieve very high compliance with the requests. Also, the number of investors for which separate reporting is required is likely to be modest. This is true because of large denominations and limited trading, and because securities are mostly held through clearing organizations.

A foreign issuer that is an FFI (and typically a Model 1 FFI) would generally comply with FATCA by hiring the manager or one of the professional service providers working on the transaction (or one of their affiliates) to register the vehicle with the Service, collect the forms described above, and report collected information as required to the local tax authority. Further, it is typical for securities documentation: (1) to require the issuer to be FATCA-compliant; (2) to require investors to provide standard form IRS beneficial ownership documentation (or more broadly, any forms necessary to avoid withholding on payments to them or for the issuer to comply with FATCA); and (3) to provide that withholding is permitted (without the payment of any sort of gross-up) if required under FATCA.

As discussed above in Part F.1., an FFI is not treated as FATCA-compliant unless each FFI that is a member of its expanded affiliated group is FATCA-compliant. Thus, an FFI could go out of compliance if more than half of its equity, by vote and value, were acquired by a corporate parent that is also an FFI but that is not compliant with FATCA. That could be a significant practical issue for an issuer having transferable equity with a relatively small value. In light of this, many securitization vehicles and investment funds permit the forced sale or redemption of any equity held by any person whose holding of such equity would cause the securitization vehicle or investment fund to fail to be FATCA-compliant.

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David has extensive experience representing clients in tax matters involving structured securities, CLOs, asset-and mortgage-backed securities, repackagings, REMICs, and credit and equity derivatives. He also advises clients on a variety of cross-border taxation issues, including passive foreign investment companies ("PFICs") and FATCA. David has played a significant role in the structuring of a wide variety of innovative financial products in both domestic and cross-border markets.

David regularly acts as local U.S. tax counsel on asset-backed and structured securities transactions.

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Since our founding in 1913, Chapman has focused exclusively on finance. We have encountered nearly every finance issue imaginable and have helped financial services clients create many original financing products and structures used today. Chapman is one of the leading and most active law firms in the U.S. securitization industry, ranking among the top-10 underwriter's counsel for U.S. asset-backed securities, mortgage-backed securities and collateralized loan obligation (CLO) transactions in statistics reported by *Asset-Backed Alert*. We have a deep understanding of the nuances and complexities of executing highly sophisticated financing transactions in the United States and abroad. Our asset securitization group includes partners who are leading authorities on taxation involving CLOs, asset- and mortgage-backed securities, municipal and taxable bond repackagings, REMICs, and credit and equity derivatives. Chapman attorneys regularly act as local U.S. tax and securities law counsel on asset-backed and structured securities transactions.

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