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Jack Grocott

## How FATCA affects cross-border reinsurance deals

8 December 2014 | By Jason Kaplan, Christine Lane



Hogan Lovells lawyers dissect tricky issue

The Foreign Account Tax Compliance Act (FATCA) is here, and it has complicated consequences for global reinsurance deals. Here, Hogan Lovells partner Jason Kaplan and senior associate Christine Lane explain the issue.

### ***In Brief***

Enacted in 2010 (but with phased implementation), FATCA is an information reporting regime enforced through a 30% gross basis withholding tax on "withholdable payments" made to non-U.S., non-compliant entities. FATCA is part of an overall U.S. enforcement effort intended to help 'close the tax gap' by identifying U.S. citizens and U.S. residents who beneficially own financial accounts at foreign financial institutions ("FFIs") or interests in non-financial foreign entities ("NFFEs") but do not disclose such holdings (or report the associated income) on their U.S. tax returns. FATCA's implementation raises potentially significant issues in cross-border reinsurance transactions. Unless an exemption is established, FATCA withholding applies to U.S. source premiums (considered 'withholdable payments') paid to a non-U.S. reinsurer regardless of whether the underlying policies have a cash value or investment component of the type subject to FATCA information reporting. FATCA withholding tax applies in addition to U.S. federal excise tax on premium payments.

FATCA withholding was implemented beginning July 1, 2014. This article examines key contractual provisions becoming commonplace in negotiating cross-border reinsurance agreements. This article assumes the reader is familiar with the FATCA rules as applicable to insurance and reinsurance companies and omits citations to the relevant provisions of the Internal Revenue Code

and U.S. Treasury Regulations. The relevant FATCA Code sections (and corresponding Treasury regulations), unless otherwise noted, are at sections 1471 through 1474 of the code.

### ***U.S. Market Approach***

In the authors' experience, the evolving U.S. market position on allocating FATCA withholding risk in reinsurance transactions is to shift risk to non-U.S. reinsurers. This is consistent with the approach in financial transactions including loan, swap and derivatives transactions—e.g., the Loan Syndication and Trading Association (LSTA) model credit agreement provisions exclude from the tax gross-up, U.S. federal withholding taxes imposed on payments by reason of FATCA. Accordingly, non-U.S. lenders bear risk of FATCA withholding on payments of interest and principal as a borrower will not be required to gross-up or pay additional amounts if the borrower is required to withhold under FATCA. The International Swaps and Derivatives Association (ISDA) has followed a similar approach.

### ***Non-U.S. Market Approach***

The non-U.S. market's response to allocating FATCA withholding risk in financial transactions is not as settled—e.g., the Loan Market Association (LMA) issued three riders to standard loan documentation allocating FATCA withholding risk entirely to the: (i) borrower, or (ii) lender either in a limited manner (allocation of the FATCA risk assuming the obligation is 'grandfathered' with a right of termination if grandfathering status is lost, e.g., by reason of a material modification) or unlimited manner (whereby the lender bears the risk of FATCA withholding, although in such cases the borrower may represent that no payments are U.S. source). (2014 Summary Note on FATCA, released June 9, 2014). The LMA issued a further statement adopting the 'lender unlimited' approach in its default LMA model agreements (accordingly, payments pursuant to default LMA loan agreements can be made net of any deduction for FATCA withholding).

### ***Allocation of FATCA Withholding Risk to Non-U.S. Reinsurer***

The following are contractual provisions becoming commonplace in negotiating reinsurance agreements:

- **Provision for U.S. Tax Forms.** At the very least, it is typical for the reinsurance agreement to require the non-U.S. reinsurer to certify to its FATCA exempt status by providing the appropriate IRS Form W-8 or certification prior to payment of premiums. While the U.S. cedent may desire an ongoing contractual requirement for the reinsurer to update such information, applicable U.S. federal tax rules already require updating of such forms if a change in status occurs or if the form expires.
- **Requiring FATCA Compliance.** Many U.S. cedents will request a representation that the reinsurer is presently FATCA compliant and a covenant that the reinsurer will continue to be FATCA compliant during the term of the agreement.
- **Right to Withhold.** U.S. cedents generally will require the right to withhold FATCA tax should premium payments become subject to FATCA withholding.
- **No Right of Set-Off.** The U.S. cedent typically will resist a reinsurer's right of set-off – a set-off would effectively shift the burden of FATCA withholding to the U.S. cedent.
- **No Cancellation or Defense.** Consistent with the U.S. market approach, U.S. cedents will resist (i) granting non-U.S. reinsurers a termination right on account of FATCA withholding, and (ii) permitting FATCA withholding to give rise to a defense to payment of losses or be treated as a breach of the agreement.

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