U.S. Withholding and Reporting Regimes – One Old, One New

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INTRODUCTION – TWO U.S. WITHHOLDING REGIMES


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Generally, a withholding regime is designed to collect tax on a source country's payments made to non-residents. Usually, a withholding regime applies primarily to investment income for which a paying agent may be made liable for the payment of source country tax by withholding the tax from the payment. Such a system exists in the United States for U.S. source investment income paid to non-residents of the United States. As each payment is made, U.S. withholding tax of 30% is required to be withheld unless an exception applies. The withholding agent must withhold this tax, send an information return to the payee, and file an income tax return with the Internal Revenue Service ("IRS") that reflects the payments made and the tax withheld.

In addition to this non-resident withholding regime, the United States in March 2010 enacted a second withholding regime that is designed to ensure that investment income paid to an account of a U.S. person at a foreign financial institution, a foreign investment fund, or a foreign entity in which they have a significant ownership interest is reported to the IRS. Prior to the enactment of the Foreign Account Tax Compliance Act ("FATCA"), U.S. persons were (and still are) required to report income earned outside the United States on their tax returns and to report any foreign financial accounts on a separate information return referred to as an "FBAR"[1] The FATCA regime has a delayed effective date of January 1, 2013. In the intervening period, the IRS and Treasury Department must provide regulations that answer even the most elemental questions such as the scope of application; affected U.S. and foreign financial institutions must invest in computer systems based upon those regulations and institute compliance

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procedures. Preliminary guidance, Notice 2010-60, was issued on August 27, 2010.

Withholding is an important topic in the United States currently as the IRS has designated withholding as a "Tier 1" issue for auditors. "Tier 1" means that the issue is of high strategic importance to the IRS and has significant impact on one or more industries. "Tier I" designation also means that IRS audits will examine a taxpayer's compliance with the withholding rules.

This article will provide a basic description of each withholding regime and the persons affected by it. Both regimes will operate simultaneously so that coordination rules will be needed. Only one tax is to be collected under both regimes.

FATCA REPORTING AND WITHHOLDING REGIME

Background

The precursors to FATCA were many. First, the Senate Permanent Sub-committee on Investigations ("PSI") had been investigating and issuing reports on the use of tax haven institutions to avoid U.S. tax. However, it was the focused actions of the G-20 during its 2009 meetings that fuelled direct attacks on bank secrecy jurisdictions that were seen as fostering tax avoidance and abuse.

In the United States, the Justice Department brought suit against Union Bank of Switzerland ("UBS") for conspiring to defraud the United States by impeding IRS investigations.[2] That suit was ended by a voluntary agreement that required UBS to report income and other information about U.S. clients as well as other disclosure provisions.[3]

Purpose

FATCA is aimed at increasing the disclosure of U.S. beneficial owners of payments of U.S. source income that is paid to foreign entities and is far-reaching in its potential impact on both U.S. payors and foreign entity recipients.

The sole method for a foreign entity to avoid the reach of FATCA's provisions is to avoid investment in the United States. Just refusing to accept U.S. residents as account holders may not relieve a foreign entity from being subject to the FATCA provisions because it is the payment of U.S. source income that triggers its application. Even financial institutions that currently participate in the Qualified Intermediary program will be required to comply with the FATCA provisions in a separate reporting agreement with the IRS. It should be noted that a payment made directly to a non-resident alien individual is not affected by FATCA, although the non-resident withholding regime, discussed below, will continue to apply to such payments.

Although the provision is not effective until January 1, 2013, the work needed to be accomplished by the government and by U.S. and foreign financial institutions before that effective date is enormous. The primary problem is obtaining new information on existing account holders who may well be resistant to providing such information or who may be protected by local privacy laws.

General rules

FATCA imposes a 30 percent withholding tax on "withholdable payments," *i.e.*, U.S. source payments, made to a foreign entity unless the foreign entity is

- a "foreign financial institution" ("FFI") that enters into an agreement with the IRS that it will identify U.S. accounts and U.S. owners of foreign entities with U.S. accounts and provide annual reports of such account holders (a "Participating FFI") or
- a "non-financial foreign entity" ("NFFE") that provides a certification that the NFFE does not have a substantial U.S. owner or the name, address, and U.S. identification number of each substantial U.S. owner.

Although there are numerous complications to this regime such as the treatment of "recalcitrant" account holders who refuse to provide necessary information or a waiver from foreign law privacy disclosure statutes, the basic concept is straightforward—U.S. withholding tax is required unless compliance with the above requirements is satisfied. The impact of these rules is, of course, enormous and banks and other affected institutions have provided comments about the difficulties they face, particularly in complying

with local privacy laws, but also in obtaining information about existing account holders that was not previously collected.

Withholdable payment

The definition of "withholdable payment," which triggers application of FATCA, has two parts. The first part covers the same income as the non-resident withholding regime, discussed below, and includes any "fixed, determinable annual or periodic income" ("FDAP"), which is essentially any income except capital gains that are not specifically subject to withholding. In addition, however, FATCA also applies to gross proceeds from FDAP producing property, as well as potentially to short-term OID instruments, although the legislative history provides that the regulations may provide an exception. Notice 2010-60 is silent as to the treatment of short-term OID instruments, which are not otherwise subject to U.S. tax and withholding under U.S. statutory law.

Note that FATCA withholding is potentially imposed on items of income such as gross proceeds from the sale of U.S. stocks and debt obligations and short-term OID that are not subject to U.S. tax if not effectively connected with a U.S. trade or business. Effectively connected income ("ECI") is statutorily excepted from the definition of "withholdable payment." However, Notice 2010-60 does not provide procedures for claiming the statutory exception, but requests comments on methods under which a withholding agent may determine the application of the ECI exception. Notice 2010-60 makes clear that the ECI presumption for regulated banks and insurance companies under the non-resident withholding regime will not apply for FATCA purposes. That presumption does not require any documentation.

Note further that the withholding requirement would not permit an offset for basis on the sale of stock and, therefore, would not limit the withholding to the net gain amount. As a result, a payment that represents return of capital could be subject to FATCA withholding. If a refund claim is not made or cannot be made, the FATCA withholding tax would become a final tax not only on items of income that otherwise would not be subject to U.S. tax but on non-income items as well.

United States Account

The term "United States account" means any financial account that is held by

- one or more "specified U.S. persons" or
- a "U.S. owned foreign entity."

The term "financial account" means any depository or custodial account, or any equity or debt interest in a financial institution except for publicly traded securities.

A *de minimis* exception is provided for a depository account maintained by a natural person if the aggregate value of all depository accounts held in whole or in part by the holder and maintained by the same financial institution does not exceed $50,000 unless the financial institution elects not to apply this exception. The aggregate accounts include all accounts held in financial institutions that are members of the same affiliated group, which includes majority owned subsidiaries and controlled partnerships and other related entities.

The challenge will be to identify all the accounts held by a single account holder for purposes of the $50,000 *de minimis* exception. Because of the burden involved in identifying all such accounts, many FFIs may elect not to apply the *de minimis* exception.

Foreign Financial Institution

Definition

The key to the scope of application is the term "foreign financial institution." It is a broadly defined term with expansive regulatory authority to include entities beyond banks in its scope. It is clearly meant to apply to a variety of types of businesses such as securities firms, money services businesses, money exchange houses, hedge funds, private equity funds, commodity traders, derivative dealers, and any other type of financial firm that holds, invests, or trades assets on behalf of itself or another person.

One key industry that is not clearly addressed is the insurance industry. The legislative history suggests that special rules may be provided to

address when insurance companies will be affected. Notice 2010-60 provides that property and casualty and reinsurance companies will be excluded from the definition of FFI and also exempt from FATCA withholding. Comments are requested on the treatment of entities that issue cash value insurance policies and annuities.

Although the definition of FFI is expansive, certain types of entities may not be included such as certain holding companies, research and development subsidiaries, and financing subsidiaries within a group of non-financial operating companies. Notice 2010-60 confirms that several classes of foreign corporations will not be classified as FFIs including those listed above plus non-financial companies that are in the process of liquidating, reorganizing, or are in bankruptcy and non-finance start-up companies for the first 24 months after organization.

Further regulatory authority is provided to exempt classes of entities that present a "low risk" of non-compliance. Notice 2010-60 provides that certain foreign retirement plans will be classified as "low risk" and will not be subject to the FATCA provisions.

U.S. controlled foreign corporations that are financial institutions and U.S. branches of FFIs will be classified as FFIs according to Notice 2010-60, although payments of effectively connected income to a U.S. branch of an FFI will not be subject to withholding. It is likely that some documentation will be required to certify that the payment qualifies for the exception.

Collection of Information and Identification of Persons by FFIs

The most significant portion of Notice 2010-60 contains the detailed description of the procedures to be applied by an FFI in collecting information on account holders and identifying U.S. persons. Helpfully, Notice 2010-60 provides separate procedures for pre-existing accounts, *i.e.*, accounts in existence prior to the effective date of the FFI's agreement with the IRS, and new accounts. Pre-existing and new accounts are further sub-divided into individual accounts and entity accounts. The procedures applicable to entity accounts are somewhat less burdensome than for individual accounts. The procedures obtaining documentation concerning pre-existing accounts permit a gradual phase-in of the new account procedures and are initially limited to information contained in electronically searchable files. Below is a summary of the procedures set forth in Notice 2010-60.

For pre-existing individual accounts, an FFI may rely on existing documentation such as Forms W-9 or W-8BEN. For accounts for which the FFI does not have existing documentation, the FFI must search its electronic records for indicia of U.S. status such as a U.S. address and other items. For those accounts with U.S. indicia, the FFI will have to obtain within one year documentation to establish the account holder's U.S. or non-U.S. status. Within two years of the effective date of the FFI's agreement with the IRS, for accounts that exceed one million dollars during the year prior to the year in which the FFI agreement becomes effective, the FFI must apply the procedures applicable to new accounts. For all other accounts, an FFI has five years in which to apply the new account procedures.

For pre-existing entity accounts, similar procedures must be followed. First, the electronic files must be searched for U.S. status indicia such as a U.S. place of incorporation. If an entity is not classified as a U.S. person, the entity will be presumed to be an FFI if the entity's name and other available information clearly indicates as such. An entity that is tentatively classified as an FFI must provide its FFI EIN and certification of its compliant status. An FFI that does not provide a valid FFI EIN within one year of the requesting FFI's IRS agreement effective date will be treated as non-compliant. If an invalid FFI EIN is provided, the IRS is contemplating that information about that FFI be reported to the IRS. With respect to the remainder of its entity accounts, an FFI may look for evidence that the entity is engaged in a U.S. trade or business. Such an entity will be excepted from the FATCA requirements.

After identifying entities engaged in an active trade or business, the FFI must then classify any remaining foreign entities based on new documentation obtained or in existing files. If the foreign entity does not qualify as an excepted entity (*e.g.*, a foreign government), the FFI must identify each individual that has an interest in

the entity, either directly or indirectly. Documentation must be obtained with respect to any U.S. individuals as if the individual were a new account holder and information with respect to such U.S. individuals must be reported to the IRS.

Under procedures for new individual accounts, *i.e.*, accounts opened after the effective date of an FFI's agreement with the IRS, an FFI must obtain and examine documentary evidence that establishes U.S. or non-U.S. status of the account holder.

- If the account holder is a U.S. person, the FFI must obtain a Form W-9.
- For an account that is not documented as a U.S. account, the FFI must examine all other information it has collected with respect to the new financial account to identify indicia of potential U.S. status, documentation that suggests that the account holder is a U.S. resident or U.S. citizen, a U.S. address, a U.S. place of birth, a power of attorney with a U.S. address, or instructions to transfer funds to a U.S. account. Such accounts are treated as potential U.S. accounts and documentation must be obtained for those accounts. Depending on the U.S. status indicia associated with the account, the following procedures apply.
  - If the account holder is identified as a U.S. resident or citizen, the FFI must obtain a Form W-9 from the account holder.
  - If there is a U.S. address associated with the account holder or a U.S. place of birth, the FFI must obtain either a Form W-9 or a Form W-8BEN with documentary evidence that establishes non-U.S. status, which requires the presentation of a non-U.S. passport or other evidence of non-U.S. citizenship.
  - If there is an "in care of" address, a "hold mail" address or only a P.O. box address, a power of attorney or signatory authority granted to a person with a U.S. address, or standing instructions to transfer funds to a U.S. account or directions received from a U.S. address, the FFI must obtain either a Form W-9 or a Form W-8BEN with documentary evidence. However, a Form W-8BEN is not required, but if obtained, may be relied upon by the FFI.

For new entity accounts, an FFI must examine all information with respect to such account not limited to information available in electronic files. This information includes account opening information, correspondence information, and anti-money laundering/know your customer information.

The major compliance issue continues to be pre-existing account holders who either do not respond to requests for documentation or who choose not to waive their privacy rights under their home country law. The FFI, of course, will then be faced with 30 per cent withholding on amounts attributable to those accounts. The IRS is contemplating how to address this issue and has asked for comments on sanctions with respect to recalcitrant account holders. One possibility raised by Notice 2010-60 is terminate the FFI Agreement of an FFI which has a number of recalcitrant account holders remaining after a reasonable period of time. Notice 2010-60 makes clear that withholding should not become a permanent substitute for collecting and reporting of information about U.S. accounts. Notice 2010-60 is silent as to whether accounts of recalcitrant account holders will be required to be closed. A requirement to close accounts of recalcitrant account holders may be quite difficult to implement under some countries' law.

Participating FFI Reporting Requirements On U.S. Accounts

The FATCA statutory provisions provide very specific reporting requirements that include the name, address, and taxpayer identification number of each U.S. person subject to reporting, the account number, the annual account balance or value, any deposits of gross receipts or withdrawals that occurred during the year.

In addition, Notice 2010-60 requires information reporting with respect to recalcitrant accounts.

An FFI must provide the number and aggregate value of all recalcitrant accounts and the number and aggregate value of related and unrelated non-participating FFIs. Moreover, reporting as to the number and aggregate value of financial accounts of recalcitrant account holders with U.S. indicia will also be required.

Non-Financial Foreign Entities

A non-financial foreign entity ("NFFE") is any foreign corporation that is not an FFI. An NFFE is not subject to the same onerous due diligence and reporting requirements as an FFI and, unlike an FFI, is not required to enter into an agreement with the IRS. As noted above, an NFFE is required only to submit a certification that it has no U.S. owners or, if it has a U.S. owner, the name, address, and taxpayer identification of that U.S. owner in order to avoid withholding. However, the preceding reporting requirement does not apply to publicly traded corporations or its affiliates, any U.S. possession corporation, any foreign government or its political sub-divisions, any international organization, any foreign central bank, and any other class of persons identified by regulations that present a low risk of tax evasion.

Credits and Refunds

The rules concerning credits and refunds are similar to those imposed under the non-resident withholding regime, as discussed below. A beneficial owner eligible for reduced withholding under an income tax treaty or an exemption from withholding for portfolio interest is eligible for a credit or refund of the amount of the tax that was an overpayment. Furthermore, a beneficial owner of a payment of gross proceeds from the sale of stock not subject to U.S. tax would generally be eligible for a refund of the total amount of tax withheld.

However, no refund or credit will be allowed unless the beneficial owner of a payment provides information as required under regulations. Regulatory authority is provided to require beneficial owners to provide appropriate documentation that establishes that they are the beneficial owner and, if claiming a treaty benefit, that they are eligible for such benefits.

The legislative history explains that the credit and refund method under the FATCA provisions is designed to be consistent with existing U.S. treaty obligations. Furthermore, the legislative history notes that, although a reduction at source on withholding tax is preferred under the OECD Commentaries, it is not required. The FATCA withholding mechanism was designed to address prior inappropriate treaty claims by U.S. persons. Under the "saving" clause contained in all U.S. income tax treaties, U.S. persons are subject to U.S. tax as if the treaty had never come into effect even if a U.S. citizen is a resident of a tax treaty partner country. Consequently, a U.S. person is not eligible for reduced withholding rates under an income tax treaty even if the U.S. person is a resident of the treaty country.

Special rule when an FFI is the beneficial owner

A special rule is applicable to an FFI that is the beneficial owner of a withholdable payment. In that case, a credit or refund is available only to an FFI that is eligible for benefits under an income tax treaty. An FFI that is not eligible for the benefits of an income tax treaty therefore is subject to a final 30 per cent tax if the FFI does not enter into an IRS reporting agreement under section 1471(b).[4] Even where a credit or refund is available to a FFI that is eligible for treaty benefits, the IRS is not required to pay any interest.[5]

It would appear that the reason for those rules is to provide a detriment for those FFIs that do not enter into an agreement with the IRS in order to promote compliance. However, to refuse to provide a refund to an FFI resident in a treaty country could be construed as a violation of the treaty so the treaty exception addresses that issue.

Summary

The new FATCA statutory provisions leave much to regulations. Notice 2010-60 states that it provides "preliminary" guidance regarding priority issues. It is tentative in many respects and requests comments on most issues, some of which are not developed by Notice 2010-60. Notice 2010-60 explains that the IRS and Treasury intend to

issue proposed regulations that will incorporate the guidance in Notice 2010-60, as well as address other matters necessary to implement the FATCA legislation. In addition, Notice 2010-60 announces that a draft FFI Agreement and draft information reporting and certification forms will be published.

Notwithstanding the issuance of Notice 2010-60 within six months of the enactment of the FATCA provisions, there are only 27 months left before the effective date. With many questions unanswered at this date, it may be a difficult deadline to meet not only for the government, but for the affected financial institutions that must develop software and operating procedures to implement the FATCA requirements. The scope and ambition of the legislation is truly remarkable—it affects every account holder of every financial institution in the world that invests in U.S. financial markets.

NON-RESIDENT WITHHOLDING REGIME

General rules

The rules applicable to non-residents, including individuals, estates, and trusts, and corporations, require withholding of U.S. tax at a 30 per cent rate on any income that is "fixed, determinable annual or periodic," or "FDAP" and on any gain specifically enumerated by the statutory provision. Gains subject to withholding tax include (*i*) gains from the disposal of timber, coal, or domestic iron ore with a retained economic interest) and (*ii*) gains relating to contingent payments received from sales or exchanges of patents, copyrights, and similar intangible property. Any other gain is not subject to withholding because such other gain is not subject to U.S. tax unless the gain is effectively connected with a U.S. trade or business. The payor of the FDAP or gain subject to withholding must withhold the appropriate amount of U.S. tax and report that payment and tax withheld to the IRS annually.

Documentation requirements

Prior to making a payment of U.S. source income, a withholding agent must obtain documentation as to the identity and character of the payee. This documentation usually consists of either a Form W-9 (U.S. status) or a Form W-8BEN (foreign status).[6] These forms permit the withholding agent to determine how the withholding agent should withhold, if at all. For certain payments made outside the United States, a withholding agent may rely upon other types of local documentation such as a passport or driver's license. If no documentation is provided, presumption rules are provided that the withholding agent must apply. The presumption rules determine whether the payee is U.S. or foreign and whether the payee is an individual, partnership, estate, trust, or corporation. Different withholding rates apply depending on the presumption that must be made under the presumption rules. The presumption rules do not permit a withholding agent to apply an exception to withholding, however.

Exemptions and reduced withholding rates

1. **Portfolio interest on registered obligations**. The United States provides a statutory exception from U.S. tax and withholding for interest payments on registered obligations made to foreign persons as long as the interest is not contingent interest and the foreign payee is not a bank or related to the payor. Generally, this means that most U.S. source interest will not be subject to U.S. withholding tax. Interest that does not qualify as portfolio interest may be exempt or subject to a reduced rate of withholding tax under an income tax treaty as discussed below.

2. **Interest on bearer bonds**. Interest paid on certain bearer bonds is exempt from U.S. tax if arrangements exist that are designed to ensure that the obligation would be sold only to a non-U.S. person and the interest was payable only outside the United States and its possessions. The HIRE Act,[7] however, repealed the so-called bearer bond exception effective for obligations issued two years after March 18, 2010, the enactment date of the HIRE Act. However, a debt obligation held through a dematerialized book entry system or other book entry system permitted under regulatory guidance is treated as held in registered form.[8] Consequently, a debt obligation that is formally in bearer form but which may

be transferred only through a dematerialized book entry system or other IRS approved book entry system will be treated as in registered form and will qualify for the portfolio exemption.

3. **Treaty benefits**. Foreign persons that are qualified residents of a country with which the United States has in force an income tax treaty may be eligible for a reduced rate or an exemption under that treaty. To qualify for a treaty benefit, a foreign person must submit a Form W-8BEN with Part II completed. Additionally, the foreign person must obtain a U.S. International Taxpayer Identification Number unless the claim for benefits is with respect to publicly traded securities.

4. **Bank deposit interest.** Interest paid on a U.S. bank account to a foreign person is not subject to U.S. tax under U.S. statutory rules. A Form W-8BEN generaly must be provided to the bank. A tax payer identification number is not required.

5. **Short-term obligations**. Interest paid on debt obligations with a term of 183 days or less is not subject to U.S. tax when paid to a foreign person. A Form W-8BEN generally should be provided.

6. **Effectively connected income.** Income that is effectively connected to a U.S. trade or business (or attributable to a U.S. permanent establishment under an income tax treaty) is not subject to U.S. withholding if the payee provides a Form W-8ECI.

7. **Compensation for services.** Payments for compensation for dependent personal services, *i.e.*, an employee, is subject to U.S. wage withholding and not non-resident withholding. Payments for independent personal services are subject to 30 per cent withholding unless a treaty provision provides otherwise. A service provider subject to 30 per cent withholding must file a U.S. tax return and may claim a refund if an overpayment of tax was made. Generally Form 8233 should be provided.

Intermediaries

One of the significant aspects of the U.S. withholding regime is the "deputation" of foreign financial institutions as "Qualified Intermediaries" ("QI"). Under the QI program, foreign financial institutions enter into a standard agreement with the IRS in which they agree to collect the information necessary to confirm non-resident payees' identity and to either perform withholding functions or to provide aggregate information to withholding agents so that the appropriate amount of U.S. tax may be withheld. In exchange for this information, a QI is not required to provide the Forms W-9 and W-8BENs of its customers to other financial institutions in the chain or to the U.S. withholding agent, thus protecting its competitive advantage and the identity of its customers. Moreover, instead of an audit by the IRS, such QIs are audited by outside accounting firms under procedures prescribed by the IRS.

Withholding agents

A withholding agent is any person (whether U.S. or foreign) that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to U.S. withholding. A withholding agent is liable (along with the payee) for any U.S. tax that should have been withheld. However, a withholding agent may rely on documentation provided by the payee that the withholding agent may reasonably associate with the payment unless the withholding agent knows or has reason to know that the information is incorrect. A withholding agent must file annual returns and information returns concerning the payments it has made to non-residents.

Summary

The preceding discussion is a high-level overview that is intended to familiarize the reader with some of the key aspects of the U.S. non-resident withholding regime. For more detailed information and discussion, please refer to BNA Tax Management Portfolio 915-3d *Payments Directed Outside the United States-Withholding and Reporting Provisions Under Chapters 3 and 4*.

1. FBAR is the acronym for Foreign Bank Account Report, Form TD F-90-22.1.
2. *U.S.* v. *UBS AG*, No. 09-20423-CIV (S.D. Fla., Miami Div.).
3. Settlement Agreement (Aug. 19, 2009). Also see IR-2009-75, Aug. 19, 2009.
4. Section 1474(b)(2)(*ii*).
5. Section 1474(b)(2)(*i*)(*II*).
6. Other forms in the W-8 series are for different situations, such as the W-8IMY for intermediaries that are not beneficial owners, W-8EXP for exempt organizations and foreign governments, and W-8ECI for income subject to U.S. net taxation.
7. P.L. 111-147 (Mar. 18, 2010).
8. Section 163(*f*)(3).