

# **FOREIGN WITHHOLDING RULES & FATCA**

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# AGENDA

- Introduction and Scope
- Chapter 3 (“FDAP”) Withholding
- Chapter 4 (“FATCA”) Withholding
- Withholding Audits
- Problem Areas and Recent Developments

# **INTRODUCTION AND SCOPE**

# RELEVANCE OF FOREIGN WITHHOLDING RULES

- U.S. multinationals manage corporate income taxes and rates.
  - Withholding may be overlooked and may not be part of a centralized process (as are other U.S. tax functions).
- Increasing emphasis on global commerce combined with governments' need for tax revenue results in increased scrutiny on withholding issues.
  - Global increase in reliance on indirect taxes (structurally similar to withholding taxes).
  - Section 1441 withholding was a Tier I mandatory audit issue (prior to revisions to tier system).
- Anecdotal evidence suggests that many U.S. companies may find their withholding procedures are inadequate and expose them to risk.

# RELEVANCE OF FOREIGN WITHHOLDING RULES

- Complexity of global withholding tax rules is increasing.
  - FATCA added an additional layer of withholding complexity and significantly increased Withholding Agent obligations.
  - Recent proposals to modify U.S. model tax treaty may require Withholding Agents to adopt a more nimble withholding process.
- Domestic withholding rules are designed to ensure that a foreign payee's U.S. tax liability is satisfied.
- In large U.S. multinationals, the withholding function may be decentralized.
  - Business people responsible for executing cross-border transactions may not be aware of recent changes to the tax withholding rules.
- Purchaser / Withholding Agent can be liable for any amount of tax due that it fails to collect and remit (plus penalties and interest).

# **CHAPTER 3 – FDAP WITHHOLDING**

# FDAP INCOME

- U.S. sourced “Fixed or determinable annual or periodical gains, profits, and income”
- FDAP income includes all income included in gross income per IRC § 61 except :
  - Capital gains (except certain gains on timber or a coal or iron ore deposits),
  - ECI, and
  - Any other income the IRS may determine is not FDAP income.
- Income specifically excluded:
  - ECI
  - Non-U.S. source income
  - Most gains from the sale of personal property and all from sale of real property
  - Portfolio interest
  - Bank interest
  - Interest and dividends from an existing 80/20 company
  - Dividends from a foreign corporation if 75% or more of gross income is foreign sourced
  - Payments to a QI or Withholding Partnership or Withholding Trust (no withholding)
  - Where no money or property is paid over

# WITHHOLDING AGENT RESPONSIBILITIES

- Liable for the correct withholding amount
- Documentation and due diligence (especially if withholding at other than the maximum 30% rate)
- Reporting
  - Form 1042 – “tax return” filed annually
  - Form 1042-S – information return filed with IRS and each foreign payee of FDAP income / FATCA withholdable payments.



# PAYEE DOCUMENTATION REQUIREMENTS

- Withholding Agent can “reliably associate” a payment with documentation indicating the payee’s status if, prior to payment:
  - It holds valid documentation (directly or through an agent),
  - It can reliably associate how much of the payment relates to the documentation, and
  - It has no actual knowledge or reason to know that documentation is incorrect / invalid.
- Documentation usually consists of a valid Form W-8 series
- If documentation is lacking, Withholding Agent may rely on presumption rules (rebuttable).
  - If the payee is deemed, under the presumption rules, to be a foreign person, then 30% withholding generally applies to FDAP withholdable payments.
  - If the payee is deemed to be a U.S. person, other (e.g., backup) withholding may apply.
- Additional documentation aspects discussed below (FATCA).

# PAYEE DOCUMENTATION FOR TREATY BENEFITS

- If payment is subject to withholding, Withholding Agent must w/h at 30% rate unless it can reliably associate the payment with documentation showing payee is entitled to a reduced rate under an applicable treaty.
- Entitlement is usually documented on a valid withholding certificate.
  - Key document upon audit.
- Payee must satisfy residence and Limitations on Benefits (LOB) provisions of the applicable treaty.
  - Purpose of LOB provision is to allow treaty benefits to be claimed only by foreign persons having a legitimate business purpose for its entity structure or a sufficiently strong nexus to the treaty country to warrant treaty benefits.
  - Objective set of tests.
- Eligibility for treaty benefits will not reduce FATCA withholding.

# POTENTIAL PENALTIES FOR FAILURE TO FILE FORM 1042 / 1042-S

- Failure to file (IRC Section 6651)
    - 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25%
  - Failure to pay (IRC Section 6651)
    - 1/2% of the unpaid tax for each month or part of a month the tax is unpaid, up to a maximum of 25%
  - Failure to deposit (IRC Section 6656)
    - Up to 10% of underpayment amount
  - Failure to file information returns (IRC Sections 6721-6723)
  - Negligence (IRC Section 6662)
- + Interest

# **CHAPTER 4 – FATCA WITHHOLDING**

# FATCA OVERVIEW

- Effective July 1, 2014, FATCA imposed a 30% withholding tax on “withholdable payments” to “foreign financial institutions” (FFI) and non-financial foreign entities (NFFE) which fail to adopt certain information reporting requirements with respect to U.S. owned accounts (FFI) and Substantial U.S. Owners (NFFE).

# FATCA DEFINITIONS

- Foreign Financial Institution (FFI)
  - Banks
  - Custodians
  - Investment Entity
  - Specified Insurance Company
  - Certain Holding Companies, Treasury Centers
- Non-Financial Foreign Entity (NFFE)
  - Excepted NFFE
  - Passive NFFE – any NFFE that is not an Excepted NFFE – Disclosure and FATCA withholding potentially apply.

# FATCA DEFINITIONS

- Withholdable Payments
  - U.S. source FDAP income – definitions follow rules in sections 1441/1442
    - *Note* that the statutory exceptions to withholding on U.S. source FDAP income do not apply to FATCA withholding (including, for example, portfolio and bank interest exceptions).
    - Treaty provisions that reduce chapter 3 withholding amounts have no effect on FATCA withholding.
  - Gross proceeds from sale of property that could produce U.S. source interest or dividends (beginning after December 31, 2018).

# IS A PAYMENT A “WITHHOLDABLE PAYMENT”

- Is the income FDAP? Sweeps in many payment streams and generally includes all income except that from the gains on sale of property.
- Is the income U.S. source? Sourcing rules found in IRC §§ 861-865 apply.
- Does an exception apply?



# EXCEPTIONS TO WITHHOLDABLE PAYMENTS

- Interest or OID on short term obligations (payable in  $\leq 183$  days)
- Effectively connected income (ECI)
- Excluded non-financial payments for:
  - Use of property
  - Services
  - Office / equipment leases
  - Software licenses
  - Interest on outstanding accounts payable arising from the acquisition of goods or services
- Gross proceeds from the sale of property producing excluded payments
- Grandfathered Obligations

# ITEMS NOT EXCLUDED FROM FATCA WITHHOLDING

- Payments related to lending transactions (including loans of securities), forward, futures, option, or notional principal contract, or a similar financial instrument.
- Premiums for insurance contracts or annuity contracts; amounts paid under cash value insurance or annuity contracts.
- Investment advisory fees; custodial fees; and bank or brokerage fees.
- Interest (including substitute interest described in Reg. §1.861-2(a)(7) related to substitute interest payment in a securities lending or sale-repurchase transaction).

# AVOIDING FATCA WITHHOLDING

- Payments made to a U.S. person (wage or backup withholding may apply).
- Payments made to a foreign individual – individuals are not subject to FATCA withholding (may be subject to wage and/or FDAP withholding).
- Payee is an “exempt beneficial owner.”
- Payee is an Excepted NFFE (any NFFE that is not a Passive NFFE).
- Payment is not a “withholdable payment” (e.g., payment with respect to a grandfathered obligation or for non-financial services).

# AVOIDING FATCA WITHHOLDING

- Payments to an FFI that complies with FATCA reporting and withholding:
  - Withholding Agent must be able to reliably associate the payment with documentation certifying the FFI's compliance with information reporting requirements.
  - Must obtain updated Form W-8 and verify GIIN is correct on IRS website.
  - Non-IGA regime (FFI that is not resident in a country with which the U.S. has entered into an intergovernmental agreement):
    - FFI must enter into an agreement with IRS to perform due diligence, reporting and potentially withhold with respect to its payees – “Participating FFI.”
    - Provisions in regulations apply – PFFI must identify U.S. accounts and report account holder information to IRS directly.

# AVOIDING FATCA WITHHOLDING

- Payments to a Passive NFFE that complies with FATCA reporting:
  - NFFE provides information regarding its Substantial U.S. Owners (or certifies there are none)
    - Substantial U.S. Owner is generally a U.S. person that owns (directly or indirectly) > 10% of stock in a corporation (vote or value) or > 10% of profit or capital interests in a partnership.
    - Reporting is done to the Withholding Agent that in turn reports to IRS.
    - For a Model 2 IGA, Substantial U.S. Owner means a Controlling Person as defined in the applicable Model 2 IGA.
  - NFFE may elect to register with IRS and report ownership information directly (“Direct Reporting NFFE”)
  - Information being provided re Substantial U.S. Owners:
    - Name
    - Address
    - TIN

# FATCA WITHHOLDING AGENT DUE DILIGENCE

- General requirements – Withholding Agent must:
  - Determine who is the payee and if the payee is a U.S. or foreign person, and determine the payee’s FATCA (Chapter 4) status
    - FFI (if so whether FATCA-compliant, resident in an IGA partner country, etc.)
    - NFFE (passive or excepted)
    - Exempt beneficial owner
  - Determine whether payments are “withholdable payments”
    - U.S. source
    - FDAP
    - Non-ECI
    - Non-grandfathered
    - Does an exception apply (e.g., excluded non-financial payment)?
  - Comply with documentation requirements or presumption rules to verify payee compliance with FATCA
- Failure to withhold when required results in secondary liability for the Withholding Agent

# FATCA WITHHOLDING AGENT DUE DILIGENCE

- Foreign payee-provided documentation – Form W-8
  - Withholding Agents need a process in place to obtain updated W-8s from foreign payees.
  - Complexity of forms (especially Form W-8BEN-E) will generate payee questions and/or resistance.
  - Must determine how much assistance you will provide payees being careful not to provide tax advice.
- Other withholding certificates that may apply:
  - Form W-8IMY (intermediary) – entity that is a QI, foreign partnership, foreign grantor trust or foreign simple trust – intermediary may assume withholding responsibility.
  - Form W-8ECI (effectively connected income)
  - Form W-8EXP (foreign governments, tax exempts)
- Changes to QI, WP and WT agreements to reflect FATCA
- Withholding Agent generally may rely on a valid withholding certificate provided by the payee unless it knows or has reason to know the certificate is not valid (no duty to investigate).

# FATCA WITHHOLDING AGENT DUE DILIGENCE

- Payee-provided documentation – Timing
  - Generally, withholding agents must obtain payee documentation and verify FFI's GIIN prior to making withholdable payments after July 1, 2014 to avoid withholding.
  - Compliance date is January 1, 2019 for withholdable payments that are gross proceeds or “pass-thru” payments.
  - Reporting Model 1 FFI had until January 1, 2015 to obtain GIIN.
- Validity of payee-provided documentation – W-8BEN-E
  - Generally valid for 3 years, exceptions apply.
  - Indefinite validity for W-8 provided by PFFI with a verified GIIN and a W-8BEN from foreign individual.
  - Signed under penalties of perjury, and
  - Form must contain sufficient information regarding the payee (entity status for U.S. tax purposes, FATCA status, etc.).
- Validity of W-8IMY – detailed rules in regulations for QI, WP & WT



# FATCA WITHHOLDING AGENT DUE DILIGENCE

- Payee-provided documentation – ongoing validity
  - Payee is obligated to notify Withholding Agent of any change in circumstances. (Include in contract language?)
  - Withholding Agent may rely on a valid withholding certificate provided by payee. No duty to inquire into possible changes (but can't ignore obvious discrepancies).
  - Payee-provided documentation becomes invalid on the date that the Withholding Agent knows or has reason to know that circumstances affecting the correctness of the certificate or documentation have changed.
  - Withholding Agent may choose to apply 90-day grace period during which Withholding Agent may treat payee as having the same FATCA status prior to the date the documentation became invalid.
  - Withholding Agent may require a new certificate or additional documentation at any time prior to a payment, regardless of whether the Withholding Agent knows or has reason to know that any information has changed.
- Publication of revised withholding certificate form – may continue to accept prior version of form for six months after the date the form was revised unless IRS guidance indicates otherwise.

# FATCA WITHHOLDING AGENT DUE DILIGENCE

- Record retention requirements
  - Withholding Agent must generally retain each withholding certificate, written statement, or copy of documentary evidence for as long as it may be relevant to the determination of the withholding agent's tax liability under §1474(a) and Treas. Reg. §1.1474-1 (secondary liability for failure to withhold).
    - May retain an original, certified copy, or photocopy (including a microfiche, electronic scan, or similar means of electronic storage).
    - With respect to documentary evidence, the Withholding Agent must also note in its records the date on which the document was received and reviewed.
    - Can accept withholding certificates electronically per Treas. Reg. §1.1441-1(e)(iv).
    - Can also use substitute forms in lieu of IRS W-8s.

# FATCA REPORTING REQUIREMENTS

- Form 1042 / 1042-S is used to report all Withholdable Payments (regardless of whether any amounts actually withheld).
  - Due March 15 for previous calendar year.
  - Also used to report FDAP income and withholding.
  - Thus, must be able to categorize payments as FDAP, FATCA or subject to both chapters 3 & 4.
- Form 8966 (FATCA)
  - Used by FFI to report U.S. account holders
    - Name and TIN of “specified U.S. persons”
    - Account identifying and financial information
  - Also used to report Substantial U.S. Owners of passive NFFEs
    - Name, address and TIN of Substantial U.S. Owners
    - Either filed by Withholding Agent or a “Direct Reporting NFFE”

# FATCA COMPLIANCE PLAN

- Successful implementation of FATCA compliance program is directly related to the process for chapter 3 withholding and reporting.
  - Overlap in requirements and reporting between FDAP and FATCA; documentation, withholding and reporting.
  - Thus, it makes sense to address any chapter 3 gaps first / concurrently.
- FATCA implementation will require inputs from finance, accounting, legal, tax, IT and client managers (to name a few).
  - Involvement of senior leadership may be key.
  - Must ultimately identify all payment streams to foreign payees (AP, finance, payments to service providers) to determine whether they are Withholdable Payments.
    - Process to address payments that are partially subject to FATCA withholding (e.g., partly U.S. source and partly foreign source)
  - Must identify all payees and ensure documentation is in order to substantiate decision to withhold / not withhold.
    - Must recognize when payment / payee is subject to an IGA and apply applicable definitions and rules.
- Process should be auditable.

# FATCA COMPLIANCE PLAN

- One of the most difficult issues will be obtaining new Forms W-8 from clients.
  - Foreign payees may be ill-equipped to handle the complexity (especially the new Form W-8 BEN-E).
  - Training may be necessary for employees that interact with vendors.
- Identify and plan for non-customer payments and one-off payment streams.
- Recognize that most payments to foreign persons will be subject to some sort of reporting even if no withholding is required.
- Need to inventory non-U.S. joint ventures and related entities
  - Determine ownership (and whether exception to NFFE applies)
  - ID nonexempt NFFEs and take steps to make them FATCA compliant
- Consider using centralized control over withholding functions to ensure FATCA compliance.

# FATCA COMPLIANCE PLAN

- Consider how FATCA will require changes to legal agreements.
  - Loan, swap documents.
  - Requirement to notify parties if FATCA status changes.
  - Liability protection for withholding IAW regulations, IGA.
  - FATCA compliance representations.
  - Touches service providers, distribution agreements, etc.
  - Specific language may depend on whether the other party is in an IGA country.
- FATCA due diligence for acquisitions; indemnities for Withholding Agent liability.
- Review and revise procedures for on-boarding new vendors.
  - Consider on-line “frequently asked questions” to address common questions.
  - Have in place means to review vendor documentation and categorize clients based on relevant information.
- Have a plan for what to do if you do not receive a valid W-8.
- Create IRS reporting mechanism for U.S. ownership disclosures from passive NFFEs that report to you.

# COORDINATION WITH OTHER WITHHOLDING RULES

- U.S. payee – backup withholding under section 3406 may apply
- If foreign payee, withholding under FDAP may apply in addition to FATCA
  - If FATCA withholding applies, then no withholding under FDAP (FATCA withholding rate is always 30%).
  - If FATCA withholding doesn't apply, must still determine whether withholding under FDAP applies (rate may be reduced or withholding eliminated under applicable tax treaty).

# RECENT FATCA GUIDANCE

- Notice 2014-33
  - Calendar years 2014 and 2015 will be regarded as a transition period for purposes of IRS enforcement.
  - IRS will take into account the extent to which a PFFI, direct reporting NFFE, or withholding agent has made good faith efforts to comply with the requirements of the FATCA regulations.
  - An entity that has not made a good faith effort to comply with the new requirements will not be given any relief from IRS enforcement during the transition period.
- Revised FFI and QI agreements
- Revised forms and instructions (W-8, Form 8966, etc.)
- FATCA FAQs



# **WITHHOLDING AUDITS**

# WITHHOLDING AGENT DETERMINATIONS

- Withholding audit will likely include examinations into whether:
  - Payment is of a type that is subject to w/h;
    - Whether payment is eligible for a statutory exception from w/h;
    - Whether payment is U.S. source;
  - Payee is a foreign person (and whether an individual or entity, the payee's FATCA status and whether the payee is the beneficial owner of the income);
  - Whether documentation supports a position that a treaty reduces the applicable w/h rate.

# FOCUS ON NON-FINANCIAL INSTITUTIONS

- IRS focus on non-financial entities that have w/h and reporting obligations in conjunction with payments for services or other entitlements.
- Industries identified in the IRM that are likely to have withholding and reporting obligations:
  - Professional services (law, accounting)
  - High tech (software, hardware, medical equipment)
  - Intellectual products producers (entertainment, publishing)
  - Pharmaceutical

# EXAMINATION ELEMENTS

- **IDRs**
  - Copies of Forms W-8, 1042, 1042-S, 5471, and 5472, and related work papers and other supporting documentation used in their preparation.
  - Identification of the systems in place to ensure that payments that are subject to withholding have been identified.
  - Identification of systems that ensure withholding certificates are requested from foreign persons receiving income subject to w/h.
- Identifying unrelated foreign vendors (those who don't appear on Forms 5471 / 5472).
- Reconcile U.S. source FDAP payments to Form 1042.

# **PROBLEM AREAS AND RECENT DEVELOPMENTS**

# SECTION 871(M) DIVIDEND – EQUIVALENTS PAYMENTS

- Issue: under Treas. Reg. § 1.863-7(b)(1), the source of income from notional principal contracts (“NPC”) is generally determined by reference to the taxpayer’s residence.
  - Thus, payments to foreign person would not be U.S. source.
- Under section 871(m)(1), a “dividend equivalent” constitutes U.S. source income for purposes of sections 871(a) and 881 and Chapters 3 and 4 withholding.
- Under Treas. Reg. § 1.1441-2(d)(1), withholding applies to “distributions with respect to stock” despite the general rule that withholding only applies if the Withholding Agent has control or custody of property or money.

# NOTICE 2015-10

- Provides that IRS will disallow refunds or credits on amounts withheld to the extent the Withholding Agent failed to remit amounts required to be withheld.
- Applies to any over-withholding under Chapters 3 or 4.
- Effect is to place the risk that a Withholding Agent will fail to remit withheld amounts on the beneficial owner of the payment.
- May result in contractual safeguards against over-withholding / indemnities.
- Question whether future regulations will be consistent with applicable statutes and existing treaty obligations.
  - Possibly susceptible to challenge to validity of regulation.

# PROPOSED CHANGES TO U.S. MODEL TAX TREATY

- Special Tax Regimes
  - Any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to an item of income.
  - Provides that treaty benefits will be denied with respect to one of these items of income if the recipient, resident of the other Contracting State, is related to the payor of such income and “is subject to” an STR in its residence State with respect to such income.
  - New rules contained in Art. 11 (interest), Art. 12 (royalties) and 21 (other income).



# PROPOSED CHANGES TO U.S. MODEL TAX TREATY

- Subsequent changes in law (new Art. 28)
  - Provides that certain other provisions of the Model may cease to have effect, specifically Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income) if either of two triggers are met:
    - The general rate of tax applicable in either Contracting State falls below 15% with respect to substantially all of the income of resident companies; or
    - Either Contracting State provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties).

# IMPACT OF *VALIDUS* CASE ON FOREIGN-TO-FOREIGN WITHHOLDING

- Per Treasury Regulations, FDAP w/h (and to some extent FATCA w/h) applies to both domestic and foreign Withholding Agents.
  - Thus F-T-F withholding is clearly contemplated / required by the regs.
  - For example, section 871(m) equity swap between foreign persons – U.S. source income even though parties are both foreign.
- *Validus Reinsurance, Ltd. v. United States*
  - Court held that the presumption against extraterritoriality applied to reinsurance excise taxes imposed between foreign parties since the IRS did not identify any Congressional intent that the tax should apply to wholly foreign retrocession transactions.
  - May support the argument that F-T-F withholding (at least in the FDAP context) violates the presumption against extraterritoriality.

# PARTING THOUGHTS FOR ADDRESSING WITHHOLDING TAX ISSUES

- Shifting focus to global withholding tax management.
- Process and risk assessments (including exposure from prior-year failures to withhold).
- Centralization of withholding tax functions and standardization of processes.
- Review of automated systems needed to streamline compliance.
- Periodic review of changes to tax laws.
- Payments to non-U.S. directors.



**THANK YOU...**

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