FATCA

Jack Miles

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Effective July 1, 2014, if a foreign entity fails to comply with its obligations under the “Foreign Account Tax Compliance Act” (“FATCA”), enacted in 2010 as part of the “Hiring Incentives to Restore Employment Act of 2010” (PL 111-147), US-source interest and dividend income and other US-source “fixed and determinable annual or periodical income” (“FDAP Income”) realized by the foreign entity will be subject to a new 30% US withholding tax (subject to certain exemptions).

If a US taxpayer makes specified US-source payments to a foreign entity that does not comply with FATCA and the US taxpayer fails to withhold the FATCA withholding tax, the US taxpayer, as a withholding agent, could be liable for the underwithheld FATCA tax.

To avoid a potentially significant tax obligation under FATCA, (i) foreign entities and (ii) US taxpayers making payments to foreign entities should understand the underlying requirements of the new FATCA tax regime. This Client Advisory provides an overview of FATCA.

Background

FATCA is a complex reporting and withholding tax regime, designed to promote US tax compliance with respect to offshore financial accounts, investments and income of US persons. Although FATCA is structured as a withholding provision, it is not designed to impose a withholding tax. Instead, the FATCA withholding tax is imposed as a penalty to force or incentivize foreign entities to disclose their US account holders and US owners.

FATCA withholding functions like back-up withholding. Upon receipt of appropriate documentation evidencing the foreign payee’s compliance with FATCA, the obligation to withhold is eliminated.

Analysis

FATCA distinguishes between “foreign financial institutions,” or “FFIs,” on the one hand, and “non-financial foreign entities,” or “NFFEs,” on the other hand. “FFIs” and "NFFEs” are mutually exclusive entity categories created by FATCA; a foreign entity is either an “FFI” or an “NFFE.” Different rules apply, depending upon whether the foreign payee is an “FFI” or an “NFFE.”

“FFI”

A foreign entity is classified as an “FFI” if:

- It accepts deposits in the ordinary course of a banking or similar business (a “depository institution”);
- A substantial portion of its business is holding assets for others (a “custodial institution”);
- It is an insurance company; or

- It is an “investment entity.”

An entity is classified as an “investment entity” if:

- The entity primarily conducts as a business one or more of the following activities on behalf of a customer: (i) individual or collective portfolio management; (ii) trading in money market instruments, foreign currency or commodity futures; or (iii) otherwise investing, administering or managing funds, money or financial assets on behalf of other persons;
- The entity’s gross income is primarily attributable to investing or trading in financial assets; or
- The entity functions or holds itself out as a collective investment vehicle, mutual fund, private equity fund, hedge fund or similar investment vehicle.

There are four types of entities described below:

- “Participating FFIs”;
- “Deemed-Compliant FFIs”;
- “Exempt Beneficial Owners”; and
- “Nonparticipating FFIs.”

“Participating FFI”

An “FFI” can comply with FATCA by qualifying as a “participating FFI.” “Participating FFIs” are generally required to enter into a so-called “FFI agreement” with the IRS. Pursuant to the “FFI agreement,” “participating FFIs” are obligated, among other things, to (i) report to the IRS their US account holders; (ii) withhold on “withholdable payments,” defined below, made to so-called “recalcitrant account holders” (i.e., account holders who fail to comply with requests for documentation or information), and “nonparticipating FFIs,” defined below; and (iii) conduct due diligence to identify US account holders.

“Deemed-Compliant FFIs”

In certain cases, entities are deemed to be FATCA-compliant without having to execute an “FFI agreement” with the IRS. These entities are classified as “deemed-compliant FFIs.”

“Exempt Beneficial Owners”

Government entities and government-controlled entities are usually exempt from FATCA altogether. These entities are designated “exempt beneficial owners.”

“Nonparticipating FFIs”

An “FFI” that does not qualify as a “participating FFI,” a “deemed-compliant FFI,” or an “exempt beneficial owner” is classified as a “nonparticipating FFI.” A “nonparticipating FFI” is an “FFI” that does not comply with FATCA. Effective July 1, 2014, “withholdable payments,” defined below, made to a “nonparticipating FFI” generally give rise to a 30% FATCA withholding tax obligation (subject to a transition rule for income attributable to certain grandfathered debt obligations).

“Withholdable Payments”

“Withholdable payments” include payments of US-source FDAP Income, such as interest, dividends, royalties and compensation. Effective January 1, 2017, “withholdable payments” also include gross proceeds from the sale or disposition of US stocks and securities.

Intergovernmental Agreements

The US has entered into “intergovernmental agreements” (“IGAs”) with foreign governments to implement FATCA. There are two types of IGAs – a “Model 1 IGA” and a “Model 2 IGA.” A “Model 1 IGA” refers to an agreement between the US and a foreign government to implement FATCA through reporting by “FFIs” to the foreign government, followed by automatic exchange of the reported information with the IRS. An “FFI” in a “Model 1 IGA” jurisdiction would perform the account reporting directly to its foreign jurisdiction.

A “Model 2 IGA” refers to an agreement between the US and a foreign government to implement FATCA through reporting by “FFIs” directly to the IRS in accordance with the requirements of an “FFI agreement,” supplemented by the exchange of information between the IRS and the foreign government.

Many “FFIs” comply with FATCA through “Model 1 IGAs” and “Model 2 IGAs.”

“NFFEs”

As noted above, a foreign entity that does not constitute an “FFI” is classified as an “NFFE.” Although “NFFEs” are not obligated to register with, or report to, the IRS, “withholdable payments” made to a non-publicly traded “NFFE” are generally subject to the 30% FATCA withholding tax if:

- The “NFFE” is classified as a “passive NFFE” (i.e., more than 50% of its income is “passive income” or more than 50% of its assets are passive assets); and
- The “NFFE” fails to provide information regarding its owners.

To avoid FATCA withholding, a non-publicly traded “passive NFFE” must disclose its “substantial US owners,” if any. A “substantial US owner” means, with respect to any entity, any specified US person which owns, directly or indirectly, more than 10% of the equity of such entity. An “NFFE” is not obligated to disclose its “substantial US owners,” however, if (i) the “NFFE” is a so-called “active NFFE” (i.e., less than 50% of its gross income is “passive income” and less than 50% of its assets are passive assets); or (ii) the “NFFE” is affiliated with a publicly-traded corporation.

Summary

Any US payor that makes a “withholdable payment” to an “FFI” or an “NFFE” should determine whether its foreign payee has complied with FATCA, because if the US payor makes “withholdable payments” free of the FATCA withholding tax and the foreign payee fails to comply with FATCA, the US payor could be liable for the underwithheld FATCA tax. IRS Form W-8BEN-E would typically be used by foreign entities to document their status as a payee under FATCA.

“FFIs” and “NFFEs” should generally attempt to comply with FATCA in order to avoid the FATCA withholding tax with respect to “withholdable payments.”

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For further information, or if you have any questions, please contact:

Jack Miles
(212) 808-7574
jmiles@kelleydrye.com