

“Passthrough Payments” Under FATCA: U.S. Withholding Tax on Non-U.S. Source Income

By Caroline Rule

Caroline Rule discusses how withholding by participating FFIs on “passthrough payments” to nonparticipating FFIs is required even on non-U.S. source payments.

Introduction

After 2015, it may be virtually impossible for foreign financial institutions (FFIs) to avoid the reach of the Foreign Account Tax Compliance Act (FATCA),¹ even if they have no United States presence nor any direct U.S. investments. This is because, beginning sometime after January 2015, FFIs that have entered into agreements with the IRS under FATCA to disclose their U.S. accountholders (*i.e.*, “participating FFIs”) will be required to withhold a 30-percent tax on so-called “passthrough payments” made to FFIs that have not entered into such agreements (*i.e.*, nonparticipating FFIs). In this global economy, it is almost inevitable that nonparticipating FFIs will have investment relationships with participating FFIs. Withholding by participating FFIs on “passthrough payments” to nonparticipating FFIs is required *even on non-U.S. source payments*.

“Passthrough Payments”

FATCA generally requires FFIs, such as non-U.S. banks and offshore investment funds,² to search for and identify to the IRS their account holders and investors who are U.S. persons,³ or else be subject to a 30-percent withholding tax on all payments made to the FFIs in connection with all U.S.-source “withholdable payments,”⁴ as well as on “passthrough payments” made by other FFIs.⁵ An FFI that enters into

a formal written agreement (an “FFI agreement”) with the Treasury and the IRS to search for and provide information to the IRS about its U.S. accountholders is known as a “participating FFI” and will be exempt from FATCA’s 30-percent withholding tax.⁶ What is important to understand, however, is that a participating FFI will be required to withhold 30 percent on “passthrough payments” made to nonparticipating FFIs (*i.e.*, FFIs that have not entered into agreements with the IRS to search for and disclose their United States accountholders).⁷

A “withholdable payment” includes, *inter alia*, “interest ... , dividends, rents, salaries, wages, premiums, annuities, compensations ... , and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States.”⁸ A “passthrough payment” is “any withholdable payment *or other payment to the extent attributable to a withholdable payment.*”⁹ (Emphasis added.)

Significantly, the IRS has determined not to adopt a tracing method to determine whether a “passthrough payment” is “attributable to” a withholdable payment, but instead, in Notice 2011-34,¹⁰ has instituted a regime under which a participating FFI must calculate and publish its “passthrough payment percentage.”¹¹ This is a formula under which a percentage of non-U.S. source payments will be deemed attributable to U.S. sources in accordance with the ratio of the participating FFI’s U.S. assets to its non-U.S. assets.¹² Thus, the “passthrough payment percentage” is the sum of the participating FFI’s U.S. assets divided

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201033015, 201050022, 201050023, 201117011, 201108027, 201125002, 201126016, 201126026, and 201128009.

³² See, e.g., LTR 200916009, 200409016, 200534003, 200606016, 200606017, 200942006, 200722006, 200834020, 200816005, 200548020, 200826010, 200724028, and 200534003.

³³ See Rev. Proc. 2010-1, IRB 2010-1, 1.

³⁴ *Jahina*, T. C. Summ. Op. 2002-150, fn. 4. See also, *Ajah*, TC Summ. Op. 2010-90 and *A. Shiekh*, TC Memo 2010-126, Dec. 58,239(M), 99 TCM 1526..

³⁵ *May*, TC Summ. Op. 2005-146.

³⁶ See, e.g., *M. Kosonen*, TC Memo. 2000-107, Dec. 53,821(M), 79 TCM 1765.

³⁷ *Jahina*, T. C. Summ. Op. 2002-150; *D.W. Trask*, TC Memo 2010-78, Dec. 58,186(M), 99 TCM 1335.

³⁸ *Supra* note 1, Section 3.01.

³⁹ *Id.*, Section 4.01.

⁴⁰ *Supra* note 1, Section 4.02.

⁴¹ *Id.*, Section 4.03.

⁴² *Id.*

⁴³ T.D. 8645, 1996-1 CB 73, 60 Fed. Reg. 66499 (December 21, 1995) (emphasis added).

⁴⁴ *Supra* note 1, Section 7 (emphasis added).

⁴⁵ *Id.*, Section 5.

⁴⁶ *Supra* note 39.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

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of a banking or similar business, (B) as a substantial portion of its business, holds financial assets for the account of others, or (C) is engaged ... primarily in the business of investing, reinvesting, or trading in securities ... , partnership interests, commodities ... , or any interest ... in such securities, partnership interests, or commodities." Code Secs. 1471(d)(4) and (5). Thus, FFIs could include commercial and savings banks, broker-dealers, mutual funds, hedge funds and private equity funds.

³ The FFI must identify "United States accounts." Code Sec. 1471(b)(1). "'United States account' means any financial account which is held by one or more specified United States persons or United States-owned foreign entities." Code Sec. 1471(d)(1). A specified United States person means any United States person other than "(A) any corporation the stock of which is traded on an established securities market, (B) any corporation which is a member of the same expanded affiliated group ... as a corporation which is regularly traded on an established securities market, (C) any organization exempt from taxation under 501(a) or an individual retirement plan; (D) the United States or any wholly owned agency or instrumentality thereof, (E) any State, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing, (F) any [U.S.] bank ... , (G) any [domestic] real estate investment trust ... , (H) any [domestic] regulated investment company ... , (I) any [domestic] common trust fund ... and (J) any [charitable remainder trust] or [charitable trust]. Code Sec. 1473(3).

⁴ Code Sec. 1471(a) and (b).

⁵ Code Sec. 1471(b).

⁶ *Id.*

⁷ Code Sec. 1471(b)(1)(D)(i). Withholding on "passthrough payments" will also be required with respect to "recalcitrant accountholders," i.e., any accountholder that "(A) fails to comply with reasonable requests for [information necessary to determine if the account is a United States account] or (B) fails to provide a waiver [of foreign laws that would prevent the disclosure of information about account ownership and other information required by FATCA] upon request." Code Secs. 1471(b)(1)(D)(i) and 1471(d)(6).

⁸ Code Sec. 1473(1)(A).

⁹ Code Sec. 1471(d)(7).

¹⁰ Notice 2011-34, IRB 2011-19, 765.

¹¹ *Id.*, Section II. The IRS noted that it had received several comments proposing that payments attributable to withholdable payments should include only payments that are either withholdable payments or directly traceable to withholdable payments, but the

IRS determined that this approach would not "be consistent with the purposes underlying the "passthrough payment" concept." *Supra* note 9.

¹² The IRS intends to publish regulations defining what constitutes a U.S. asset.

¹³ Notice 2011-32, IRB 2011-18, 737, Section II. B.

¹⁴ If a participating FFI does not determine and publish its "passthrough payment percentage," that percentage will be deemed to be 100 percent. *Id.*

¹⁵ It should be noted, however, that, where a participating FFI makes a payment to an account in its capacity as a custodian (e.g., an account in connection with which the participating FFI acts as custodian, broker or other agent for the benefit of the accountholder), the "passthrough payment percentage" for this kind of payment is the "passthrough payment percentage" of the issuer of the security with respect to which the withholdable payment is made. Notice 2011-34, Section II.C.

¹⁶ Notice 2011-53, II.C.2.

¹⁷ There is an exception for strictly local banks that do not have branches in more than one country, that do not open accounts for individuals or entities from any other country, including nonparticipating FFIs; and that implement policies and procedures to ensure that they do not open or maintain accounts for nonresidents or nonparticipating FFIs. These banks may be "deemed compliant" under FATCA, Code Sec. 1471(b)(2); Notice 2011-34, Section III, and thus be exempt from withholding, if they apply for certification as same. The exception, however, is quite narrow.

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is not really to collect withholding taxes, but instead to force as many FFIs as possible to become participating FFIs.

ENDNOTES

¹ On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act ("HIRE Act"), which added an entirely new and significant U.S. withholding and information reporting tax regime. The HIRE Act enacted new chapter 4 of the Code (Code Secs. 1471-1474), which are commonly known as FATCA.

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the traditional role as a settlement official rather than the mediator in FTS, who retains settlement authority to facilitate resolution.

The rules pertaining to *ex parte* would benefit from consistency for both processes pertaining to the functioning of the mediator, with no *ex parte* contact between the mediator and the mediation participants until the day of the mediation session. As currently designed, the taxpayer waives the *ex parte* provision when the FTS application is signed. This could be changed to the day of the

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