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"FATCA" WITHHOLDING
ON PAYMENTS TO FOREIGN PERSONS

I. BACKGROUND

The primary purpose of **FATCA** ("Foreign Account Tax Compliance Act") is to prevent and detect tax evasion by U.S. persons with offshore bank accounts and investments. To accomplish this goal, effective July 1, 2014, FATCA requires foreign financial institutions to provide the Internal Revenue Service ("**IRS**") with information regarding their U.S. depositors.

However, even U.S. taxpayers that have nothing to do with financial services will be required to collect, analyze, document, and report information regarding payments to both foreign financial institutions and nonfinancial foreign entities.

As a result, any U.S. person (whether an individual, a corporation, a trust, a retirement plan, a tax-exempt organization, etc.) making a payment of U.S. source income is considered a withholding agent and must consider whether that payment is subject to FATCA.

II. INTERPLAY WITH REGULAR WITHHOLDING

FATCA withholding (Chapter 4 withholding) applies independently of regular withholding for income tax purposes (Chapter 3 withholding). FATCA withholding applies first. Assuming the withholding agent validates a payee's documentation and determines that FATCA does not apply, the U.S. withholding agent must still determine whether and the extent to which regular withholding tax is necessary.

If FATCA withholding applies, the 30% withholding is credited against any regular withholding (*i.e.*, there is no duplicative withholding).

III. INTERPLAY WITH TAX TREATIES

The 30% FATCA withholding overrides any reduced withholding rates or exemption afforded by U.S. income tax treaties. This means that if payments of dividends or interest to a foreign company are otherwise subject to a reduced withholding under a U.S. tax treaty, the application of FATCA withholding would deny the ability to use this lower treaty rate.

IV. ENTITIES SUBJECT TO FATCA

FATCA separates entities between "financial" and "non-financial."

A. Foreign Financial Institutions

The main focus of FATCA is on payments to "foreign financial institutions" ("**FFIs**"). The definition of FFIs is very broad and includes, among others, entities such as banks, broker-dealers, custodian banks, hedge funds, private equity funds, family investment vehicles, and other investment vehicles.

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IV. ENTITIES SUBJECT TO FATCA CONT.

FFIs must enter into, and comply with, a reporting and withholding agreement ("**FFI Agreement**") with the IRS with respect to U.S. account holders. An FFI that enters into an FFI Agreement is referred to as a "Participating FFI ("**PFFI**")." An FFI that does not enter into an FFI Agreement (referred to as a "**Non-Participating FFI**") is subject to a 30% gross withholding tax on withholdable payments, unless it is otherwise exempted from the FATCA regime.

Pursuant to an FFI Agreement, a PFFI generally must agree to collect and report to the IRS information with respect to (1) U.S. persons that hold "financial accounts" and (2) substantial U.S. owners of certain non-financial foreign entities ("**NFFEs**"), unless certain exceptions apply with respect to the account or payee.

B. Non-Financial Foreign Entities

A NFFE is any foreign entity that is not an FFI. A NFFE is also subject to FATCA's 30% withholding unless:

- The payment involves a non-withholdable payment;
- The entity is an "excepted" NFFE; or
- The entity provides the withholding agent with the required documentation.

V. PAYMENTS SUBJECT TO FATCA WITHHOLDING

Under the FATCA regulations, payments subject to withholding made to either FFIs or NFFEs include the following:

- Interest;
- Dividends;
- Gross proceeds from the sale (occurring after December 31, 2016) of U.S. source interest or dividend producing property;
- Lending transaction payments, including loans of securities;
- Forward, futures, options, or notional principal contracts;
- Investment advisory fees;
- Custodial fees;
- Bank or brokerage fees;
- Premiums for insurance or annuity contracts; and
- Cash-value insurance or annuity payments.

From the above lists, it is clear that FATCA targets payments that are more financial in nature, as opposed to those routinely made by nonfinancial entities.

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VI. PAYMENTS NOT SUBJECT TO FATCA WITHHOLDING

Nonfinancial payments excluded from the definition of withholdable payment include, among others, the following:

- services (including wages and other forms of employee compensation such as stock options),
- the use of property,
- office and equipment leases,
- software licenses,
- transportation and freight, and
- interest on outstanding accounts payable.

The definition of withholdable payment also excludes:

- payments in respect of any obligations outstanding on July 1, 2014,
- interest on certain short-term debt obligations, and
- income effectively connected with a US trade or business included in the beneficial owner's gross income.

VII. EXCEPTED ENTITIES

FATCA withholding does not apply to certain "excepted NFFEs." Some of the most common types of excepted NFFEs are:

Publicly traded NFFE - corporations that are publicly traded on an established securities market and members of their expanded affiliated group;

Active NFFE – this is an entity in which:

less than 50% of gross income for the preceding calendar year is passive income; and

less than 50% of whose assets during the preceding calendar year are passive assets.

Nonfinancial group entity - certain nonfinancial entities including holding companies, treasury centers, captive financial companies of a non-financial group, start-up companies, liquidating or bankrupt companies, and non-profit organizations.

Although an excepted entity is not subject to FATCA withholding, it still must complete a Form W-8BEN-E and provide it to the withholding agent.

An NFFE other than an excepted NFFE is a "passive NFFE." Even a passive NFFE may still be able to avoid FATCA withholding if it satisfies certain documentation requirements.

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VIII. DOCUMENTATION REQUIREMENTS

A payment to a foreign payee is subject to 30% FATCA withholding unless the payee provides the withholding agent with a Form W-8BEN-E *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)* and certifies that either:

- The foreign payee is excepted,
- The payment is a non-withholdable payment,
- The foreign payee has no U.S. substantial owners (a substantial U.S. owner is any specified U.S. person with a greater than 10 % direct or indirect ownership interest in the foreign entity); or
- The foreign payee has substantial U.S. owners and these owners are disclosed.

The withholding agent will report the U.S. substantial owner information to the IRS by completing Form 8966, *FATCA Report*. Form 8966 will be submitted to the IRS annually. Form 8966 will provide the IRS the name, address, and tax identification number of each substantial U.S. owner of the NFFE, and the total payments made to the NFFE.

IX. PREPARING FOR FATCA

U.S. payers will need to properly identify potentially withholdable payments and foreign payees from whom Form W-8BEN-E must be obtained. Implementing these new procedures will take time.

In addition, the new and much lengthier Form W-8BEN-E will represent a complex challenge for many foreign payees to complete, and you should expect many more requests for assistance from foreign payees.

Although the necessary documentation is not required until July 1, 2014, the complexity of the rules makes it important to start planning now. Funaro & Co.'s tax professionals are available to assist with this process.

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