FATCA Myths and Mysteries (Part 2)

By Kimberly Tan Majure and Christopher A. Riccardi

At long last, the IRS has released final regulations under the Foreign Account Tax Compliance Act (the "final FATCA regulations").[1] Measuring a robust 545 pages, the new regulations certainly provide more detail on the application of sections 1471 through 1474[2] to payments to foreign financial and non-financial payees. If only the regulations provided an equal measure of clarity. Months after their publication tax advisors and industry professionals are still struggling to decipher the new rules and to balance FATCA's underlying objectives with their own resource constraints.

This article is a follow-up to "FATCA: Myths, Mysteries, and Practical Perspectives," ("Myths Part 1"), which was published in July-August, 2012, edition of *The Tax Executive*. Myths Part 1 addressed substantive and practical issues raised in the proposed FATCA regulations.[3] For the most part, the general theme we explored in Myths Part 1 carries over into this article: Beware the gap between the conceptual and the practical application of the FATCA regulations.

The final FATCA regulations impose heavy compliance burdens. The heaviest burdens fall on financial institutions, but the implementation costs that non-financial companies face are nonetheless substantial. The final FATCA regulations contain several new twists on the rules for nonfinancial companies that were intended to reduce their costs of compliance and to increase the time they had to get their compliance processes in order. But do these changes really help? To find out, you should invest time now to realistically assess the final FATCA regulations, to determine how your company will implement them, and to project implementation time and costs. This investment should pay dividends – thankfully, the non-reportable kind.

FATCA Is Not a Tax

We've said it before and we'll say it again – FATCA is not a tax; it's not even about income (at least not directly). FATCA is about information.

Provisions of the Code which gather information are as common as those which gather revenue. As an example, consider section 6038B, which requires certain U.S. persons to file a Form 926 every time a transfer of property is made to a foreign corporation. Typically, neither the transferor nor the transferee recognizes any income. But, regardless, the transfer of the property triggers a reporting obligation. The fact that the transfer is not a recognition event is irrelevant. The transfer needs to be reported, along with certain facts about the transferor, the transferee, and the property transferred. Failure to report these facts results in a penalty.

Conceptually, FATCA works the same way. Someone makes a qualifying payment, and the payment triggers a reporting requirement. Sometimes the payment is a taxable amount (*e.g.*, interest); sometimes not (*e.g.*, the basis component of gross proceeds). Sometimes the payment is U.S. source and sometimes it isn't (again, consider a foreign seller's gross proceeds). Like the section 6038B reporting obligation, whether the payment is taxable in the United States is irrelevant. Once a qualifying payment is made, the payment needs to be reported, along with facts about the transferee. These facts specifically include information about the transferee's substantial U.S. owners.[4] Failure to report these facts results in 30 percent withholding assessed on the gross amount of the payment. The Code styles the 30 percent charge as a "tax." But let's face it: This 30 percent charge is essentially a penalty, not a tax.

And the more FATCA guidance we get, the more evident this is.

To this point, consider the two primary exceptions from FATCA withholding: the exceptions for payments on grandfathered obligations and excluded nonfinancial payments.[5] The final FATCA regulations expanded the types of obligations which may be grandfathered to include an obligation[6] that gives rise to a withholdable payment that is a dividend equivalent payment under section 871(m) and any agreement that requires that collateral be pledged to secure a grandfathered obligation. The final FATCA regulations also replaced the ordinary course of business ("OCB") exception of the proposed regulations[7] with an exception for nonfinancial payments.[8] Ordinary course of business is now an irrelevant concept. Qualification for the exception depends solely on whether a payment appears on the "good" list of payments (excepted from FATCA withholding), the "bad" list (subject to FATCA withholding), or no list at all (also subject to FATCA withholding).

We'll talk in more detail about these exceptions, below. For now, let's focus on the fact that the two exceptions are of limited practical benefit despite their very broad reach (especially for payors that are nonfinancial companies). If FATCA were simply a tax, you would think that grandfathered or otherwise excepted payments would be excepted from FATCA altogether. You would think that you could pretty much ignore these payments. And that was, in fact, the approach that the proposed regulations took, at least with respect to payments covered by the OCB exception.[9]

The final regulations don't work this way. While FATCA withholding is not required on payments that qualify as grandfathered or nonfinancial payments, both of these payments remain subject to information reporting.[10] If you don't believe it, take a look at the draft Form 1042-S covering 2014 payments (released April 2, 2013).[11] Among other things, the form requires the withholding agent to indicate a chapter 4 withholding exemption applied, *e.g.*, for grandfathered payments (code 13), where the payee is not subject to chapter 4 withholding (code 15), and for excluded nonfinancial payments (code 16). The draft Form 1042-S also requires the filer to note the chapter 4 status of the payee (*e.g.*, as active NFFE, passive NFFE with no substantial U.S. owners, or passive NFFE with substantial U.S. owners). The draft Form 1042[12] (released a few days later) requires a reconciliation of all of a withholding agent's U.S. source FDAP payments, including a specific breakout (by reason for exemption) of income not subject to FATCA withholding. Any variance between total payments reported on the withholding agent's Forms 1042-S and payments reported on the Form 1042 must be explained in detail.

What does this prove? The real operating provisions of the FATCA rules aren't the ones that talk about tax, but the ones that require reporting. So don't focus on the "tax" part of the rhetoric. Or, more importantly, don't believe that if you are making "excepted" payments you can rest easy. FATCA is an information reporting regime. Payments that are "chapter 4 reportable amounts" must be reported even if the payments are exempted from withholding. And reporting will take some work.

An "Exception" Is an Exception Is an Exception

The regulations are sprinkled with exceptions. Typically, an exception is a good thing. And, an exception can be good in the FATCA world too. But, as we discussed above, the exceptions generally have no bearing on whether the payments must be reportable. The question is, then, what benefit do these exceptions really provide?

a. ...for Payments

As we've seen, an excepted payment doesn't mean "free pass on FATCA." That is, there are "withholdable payments" and there are "chapter 4 reportable amounts."[13] While the exceptions remove the threat of 30 percent withholding, they don't excuse a failure to report those payments. As a result, information reporting drives the real FATCA implementation cost to a withholding agent because a company could have a very high volume of reportable amounts, very few of which are withholdable payments.

This cost can be high. A withholding agent must have the exact same system in place – vendor intake, payment tracking, and reporting – whether it makes $1, $1 billion, or even $0 of withholdable payments, so long as it has at least $1 of chapter 4 reportable amounts. The amount of time and resources a company will need to create and implement the system will, therefore, be driven by the magnitude of reportable, not withholdable, payments. (And, aside from nonparticipating FFI cases, if the required information is collected and reported, no 30 percent withholding is owed.) Consequently, the withholding "exceptions" do nothing to reduce a withholding agent's compliance burden. In fact, the exceptions probably create more work for withholding agents considering, for example, that companies will need to monitor grandfathered obligations for material modifications.[14]

The idea that reporting is required even when withholding is zero is nothing new; this is also true in the chapter 3 world. There, a withholding agent is required to report an amount subject to withholding even if the amount of withholding is zero, *e.g.*, because a tax treaty applies and a valid treaty claim is made on a Form W-8BEN. As it is, a withholding agent often has a tough time getting the payee to provide the relatively diminutive, one-page Form W-8BEN, especially if a TIN is necessary. In that case, at least, a withholding agent can fall back to 30 percent withholding to compel the payee to provide the proper documentation. Otherwise, the payee is required to file a refund claim and take the issue up with the IRS, which is a course of action that very few foreign payees are willing to undertake. All in all, the prospect of 30 percent withholding gives withholding agents a pretty good "stick" for compelling production of a Form W-8BEN.

But, in the FATCA context, zero withholding is really a bane, not a benefit. The final FATCA regulations require foreign payees to provide withholding agents with a new Form W-8BEN-E, the draft version of which was lengthy and complicated. No one imagines it will be any easier to get valid Forms W-8BEN-E from foreign payees than it was to get the Form W-8BEN. And in this case, the IRS took a withholding agent's best tool for getting the form. "No withholding" means "no stick." If a withholding exception applies to a payment, the withholding agent will have to rely on a contractual obligation to provide a valid Form W-8BEN-E as a condition to payment, if any. Otherwise, the withholding agent may be forced to pay the gross amount to avoid a breach claim.

The exceptions seemingly and simultaneously increase the costs and burdens (both in time and money) of withholding agents. So what's the point of the exceptions?

Secondary liability. The exceptions may be best understood as reducing a withholding agent's exposure for compliance failures. That is, assuming the withholding agent has FATCA procedures in place, and assuming the procedures are otherwise consistently followed, the withholding agent won't face the 30 percent secondary liability for mistakes involving excepted payments. Not a bad result on the back end, but not something withholding agents should bank on when planning for FATCA.

b. ...for Payees

The foreign payee "exceptions" are also a bit misleading.

The value of a payee exception is significant for quasi-financial foreign entities, *i.e.*, entities that conduct substantial financial activities and earn financial income. For those entities, eligibility for a payee exception may mean the difference between FFI status, which comes with heavy duty due diligence, tracking, and reporting requirements,[15] and NFFE status and compliance, which comes with a substantial but much lower level of compliance involving disclosure of substantial U.S. owners, if any, or certification of excepted payee status.

If your company is a U.S. multinational with foreign affiliates that receive U.S. source FDAP payments, this is where you should first focus your attention. Review the activities of any foreign affiliates with financial activities – captive insurance companies, finance companies, trading desks, etc. – and determine whether they qualify as excepted NFFEs. Excepted NFFEs include start-up companies, entities that are liquidating or emerging from bankruptcy, non-profit organizations, or holding companies, treasury centers, or captive finance companies that are members of a nonfinancial group.[16] If tested entities do not qualify, you may need to register them as FFIs and get them into compliance by January 1, 2014 to avoid 30 percent withholding on their U.S. source FDAP payments.

For other, non-financial types of foreign entities, the stakes in qualifying for one of the payee exceptions are much smaller. The primary nonfinancial payee exceptions apply to publicly traded NFFEs and their foreign corporate affiliates[17] and active NFFEs.[18] The publicly traded company and affiliates exceptions apply, respectively, to foreign regularly publicly traded companies and their foreign subsidiaries that are members of their expanded affiliated group (*i.e.*, that are more than 50 percent related, by vote and value).[19] These exceptions were introduced in the proposed regulations[20] and carried over into the final regulations with no material changes.[21]

In contrast, the active NFFE exception, also introduced in the proposed regulations,[22] has changed significantly. First, the final regulations require a tested entity to have less than 50 percent passive gross income *and* less than 50 percent passive assets (by book or fair market value, tested quarterly), not one or the other as required in the proposed regulations.[23] On the other hand, the regulations contain three modifications that make it easier for entities to qualify as active NFFEs:

(i) a look-through rule for interest, dividends, rents, or royalties paid from the active income of a related person;[24]
(ii) relaxation of the proposed regulations' requirement that active rents and royalties be derived in a trade or business conducted (apparently entirely) by the NFFE's employees;[25] and
(iii) special provisions treating active dealer income as "active."[26]

While these three exceptions (publicly traded, publicly traded affiliate, and active NFFE exceptions) do make life easier for foreign payees, it may not always be worthwhile spending significant time and resources confirming qualification. After all, what do these exceptions get you? Unlike the exceptions discussed above, these exceptions do not demarcate the line between FFI and NFFE status. These exceptions only apply to entities that have already been identified as NFFEs and therefore have already avoided the burdensome FFI compliance regime.

Instead, at stake is whether the tested entity must provide a substantial U.S. owner statement or, if excepted, merely certify its excepted status to a withholding agent to avoid 30 percent withholding. If the tested NFFE is owned through a complicated foreign trust structure or other relatively impenetrable arrangement, identifying substantial U.S. owners (or certifying that there are none) may be a big enough hassle to merit close attention to this payee exception. On the other hand, if the tested NFFE's ownership structure is more transparent, *e.g.*, the entity has no U.S. owners whatsoever or the NFFE is owned by a U.S. publicly traded company or a domestic holding company, the payee may wish to consider simply making the ownership disclosure.[27]

The basic point here is that an "exception" may sometimes, but not always, mitigate FATCA compliance obligations or reduce the attendant costs. Companies should look before they leap, and consider whether it's worthwhile spending significant resources chasing exceptions that may be of little practical value.

FATCA Implementation Is Delayed

This one's a huge myth.

There's been a lot of talk about how the final regulations allow withholding agents more time for implementation. But let's think this through.

FATCA withholding (and therefore, reporting) starts on January 1, 2014, for payments on all new – *i.e.*, non-grandfathered, not pre-existing – obligations. That covers payments to all new vendors and payments on all new contracts with pre-existing vendors. Thus, by January 1, 2014, withholding agents will need to have some semblance of a system in place for new vendor / new contract intake, payment and payee classification, and reporting.

The timing is superficially different for payments on "pre-existing" obligations.[28] Withholding for these payments is staged, depending on the FATCA status of the payee, and begins as follows:

- January 1, 2014, for payments of U.S. source FDAP to nonparticipating FFIs and to passive NFFEs reporting at least one substantial U.S. owner.[29]
- July 1, 2014, for U.S. source FDAP payments to prima facie FFIs (which are treated as nonparticipating FFIs as of this date, until the date a different FATCA status is established).[30]
- January 1, 2015, for U.S. source FDAP payments to remaining NFFEs.[31]
- January 1, 2016, for U.S. source FDAP payments to any remaining payees.[32]
- January 1, 2017 (or later), for payments of gross proceeds and foreign pass-thru payments.[33]

Note, the IRS has indicated that the final regulations were intended to push the date of withholding for all payments on pre-existing obligations not made to prima facie FFIs or passive NFFEs reporting at least one substantial U.S. owner to January 1, 2016.[34] That is, it does not appear to have been the intent to have withholding on remaining pre-existing obligation payments to NFFEs start on January 1, 2015, while withholding on remaining pre-existing obligation payments start on January 1, 2016. However, until the IRS issues clear guidance on this point, withholding agents are looking at multiple different start dates. To further confuse matters, some of the timing provisions explicitly delay withholding and information reporting (*see* Treas. Reg. § 1.1472-1(b)(2)) while others only refer to delayed withholding (*see* Treas. Reg. § 1.1471-2(a)(4)(ii)(A)). Presumably, reporting is still required unless explicitly relieved.

While the regulations provide a lot of nuances on the timing of withholding, these nuances may be irrelevant from an implementation standpoint. After all, as noted above, assuming a withholding agent makes a payment of a single chapter 4 reportable amount, even if it is only $1, the withholding agent will be required to have a system to identify and deal with it, and that system needs to be in place prior to the payment. In addition, delayed withholding on pre-existing obligations technically only applies after a withholding agent has determined (in accordance with the documentation requirements and other rules) that a payee is a foreign entity and is something other than the presumed, nonparticipating FFI.[35] Thus, a withholding agent may utilize the various transition rules and staggered withholding dates only if the withholding agent has done the foreign payee legwork prior to January 1, 2014.

In the end, the varying effective dates may be best understood as tools for heat-mapping a withholding agent's exposure and prioritizing pieces of its FATCA implementation. Although specific priorities may differ from company to company, here are general recommendations to use as a starting point:

- **Address systems issues first.** All withholding agents should be conforming their systems to accommodate FATCA reporting requirements, starting immediately. (While you're at it, this is a good time to confirm that there are no gaps in your chapter 3 withholding processes.) Use the new (currently draft) Forms 1042 and 1042-S as guides to determined the information you should request on vendor intake questionnaires and vendor account coding, and to train tax and tax-savvy A/P groups to assess new vendor packages (intake questionnaires, contracts, invoices, and Forms W-8BEN-E).

- **Collect Forms W-8BEN-E.** Prioritize Form W-8BEN-E collection from payees posing the greatest downside risk to your company, *i.e.*, payees receiving the earliest withholdable payments – new vendors, vendors with new and amended contracts, and financial-looking entities receiving financial payments. Take the opportunity to obtain a Form W-8BEN-E from any pre-existing vendors that are replacing obsolete or stale Forms W-8BEN. Withholding agents can then turn attention to the remaining payees (*e.g.*, vendors receiving nonfinancial payments).
- **Document your FATCA systems.** Update written withholding procedures and policies to reflect FATCA-related analyses and processes.

The bottom line here: The timing provisions in the final FATCA regulations may not give withholding agents a tremendous amount of additional time to implement the new rules, but they are valuable guidelines for staging FATCA implementation.

Nonfinancial Companies Make "Nonfinancial" Payments

Well, that's the intention. And it is true, at least to some extent.

As discussed above, the final regulations replace the OCB exception of the proposed regulations, with an exception for "excluded nonfinancial payments." The ordinary course concept is dead. Instead, a payment must simply be described in a specified list to qualify for the exception.

The final regulations modify the list of excepted payments. For NFFEs making nonfinancial payments, the relevant payments the proposed regulations applied to were (i) payments for goods, nonfinancial services, and the use of property and (ii) interest on payables related to the acquisition of goods, nonfinancial services, or use of tangible property.[36] In contrast, the final regulations cover payments for "services and the use of property" and interest on payables for the acquisition of goods and services, but not for the use of any property.

For the most part, the changes are favorable. The elimination of "goods" avoids potential confusion as to FATCA's application to purchase proceeds (other than gross proceeds), which are generally excepted from the definition of payments subject to withholding for purposes of chapter 3 (and FATCA) in any case. The IRS also replaced the fuzzy concept of "nonfinancial services" with a list of specific, non-excluded payments (including, *e.g.*, payments on financial instruments, insurance premiums, and brokerage and custodian fees).

On the other hand, the new exception leaves some gaps. Contingent gains on the purchase of intangibles, as well as gains from the sale of certain U.S. minerals with a retained economic interest – which can represent significant cross-border flows for specific industries – are subject to chapter 3 withholding, but are left out of the exception. This makes little sense in the FATCA context. Both non-contingent sales proceeds and royalties are designated as excluded nonfinancial payments and it is hard to see why a payment that looks like one but is calculated like the other (*e.g.*, purchases of IP where consideration is paid under a co-revenue arrangement) falls through the cracks. This appears to be an inadvertent carveout, but it's one that stings some industries more than others and there are no guarantees the IRS will change the drafting in the future.

The narrower interest exception is a more troubling. The preamble to the final regulations provides no insight as to why interest payments associated with the use of property (*e.g.*, late fees on delayed rental payments, license fees, or royalties) falls outside the scope of the exception while interest associated with the purchase of property is covered. (The proposed regulations, at least, excepted interest on payables arising from the use of tangible property.) Whatever the reasoning, this carveout appears to be a deliberate change by the IRS and, consequently, likely to last.

As noted above, the nonfinancial payment exception may have limited practical value, other than reducing a withholding agent's downside risk of compliance mistakes. Nonetheless, if your company makes significant, non-excepted payments, the prospect of greater exposure may affect your approach to FATCA implementation. Just be sure to check your list of FATCA payment types against the regulation language and don't assume that, as a nonfinancial company, you generally make "nonfinancial" payments which are exempt from FATCA.

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The final FATCA regulations leave non-financial companies with many unanswered questions. With January 1, 2014 looming on the horizon, companies may not have the luxury of timely answers. Take a hard look at the rules and decide how your company is going to live with them. Compliance, particularly any compliance necessitating systems changes, will take time and resources, and the various exceptions and delayed withholding provisions may not offer significant practical relief. It's time to get going.

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1. *See* T.D. 9610, 2013-15 I.R.B. 765.
2. Unless otherwise stated, all section references herein are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

3. Kimberly Tan Majure and Mathew R. Sontag, FATCA: Myths, Mysteries, and Practical Perspectives, 64 *The Tax Executive* 4, 315 (Jul./Aug. 2012).
4. If the transferee qualifies as a "low-risk" payee the transferee may instead certify its low-risk status.
5. Treas. Reg. § 1.1471-2(b); Treas. Reg. § 1.1473-1(a)(4)(iii).
6. For these purposes, an obligation generally includes any legally binding agreement or instrument, including a debt instrument, an agreement to extend credit for a fixed term, derivatives transactions memorialized under an ISDA Master Agreement, life insurance contract payable no later than upon death, and an immediate annuity contract payable for a certain period or for life. Treas. Reg. § 1.1471-2(b)(2)(ii)(A). An obligation does not, however, include equity, any legal agreement or instrument that lacks a stated expiration or term (e.g., savings deposit), a brokerage or custodial agreement, or a master agreement that sets out standard terms and conditions that are intended to apply to series of transaction but which does not set out all of the specific terms necessary to conclude a particular transaction. Treas. Reg. § 1.1471-2(b)(2)(ii)(B). Note, this definition of "obligation" is a little narrower than the one used in the "pre-existing obligation" rules discussed below. Cf. Treas. Reg. § 1.1471-1(b)(98).
7. *See* 77 Fed. Reg. 9022 (Feb. 15, 2012).
8. Treas. Reg. § 1.1473-1(a)(4)(iii).
9. Prop. Treas. Reg. § 1.1474-1(d)(2)(iii) (excluding payments which were not withholdable payments); Prop. Treas. Reg. § 1.1473-1(a)(4)(iii) (excluding OCB payments from the definition of withholdable payments). In contrast, payments on grandfathered obligations remained reportable. *Id.*
10. *See* Treas. Reg. § 1.1474-1(d)(2).
11. Available at: http://www.irs.gov/pub/irs-dft/f1042s--dft.pdf.
12. Available at: http://www.irs.gov/pub/irs-dft/f1042--dft.pdf.
13. Treas. Reg. § 1.1474-1(d)(2).
14. *See* Treas. Reg. § 1.1471-2(b)(2)(iii).
15. *See* Treas. Reg. § 1.1471-2(a).
16. *See* Treas. Reg. § 1.1471-5(e)(5).
17. Treas. Reg. §§ 1.1472-1(c)(1)(i), (ii).
18. Treas. Reg. § 1.1472-1(c)(1)(iv).
19. Treas. Reg. § 1.1472-1(c)(ii); Treas. Reg. § 1.1471-5(i).
20. *See* Prop. Treas. Reg. § 1.1472-1(c)(1)(i), (ii).
21. Note that, in response to comments, the final regulations clarify application of the publicly traded rules in the year of a public offering. Preamble to T.D. 9610.
22. *See* Prop. Treas. Reg. § 1.1472-1(c)(1)(v).
23. *Compare* Prop. Treas. Reg. § 1.1472-1(c)(1)(v) with Treas. Reg. § 1.1472-1(c)(1)(iv).
24. Treas. Reg. § 1.1472-1(c)(1)(iv)(B)(1).
25. *Compare* Prop. Treas. Reg. § 1.1472-1(c)(1)(v)(C) with Treas. Reg. § 1.1472-1(c)(1)(iv)(A)(4). Note, the final regulations require such rents and royalties to be derived in the active conduct of a trade or business conducted, "at least in part," by employees of the NFFE.
26. Treas. Reg. § 1.1472-1(c)(1)(iv)(B)(2).
27. The entity could, for example, take a reasonable position that the active NFFE exception applied but disclose substantial U.S. owners on a protective basis.
28. Treas. Reg. § 1.1471-1(b)(98)(i) defines a pre-existing obligation as any account, instrument, contract, debt, or equity interest maintained, executed or issued by the withholding agent that is outstanding on December 31, 2013.
29. Treas. Reg. § 1.1471-2(a); Treas. Reg. § 1.1472-1(b).
30. Treas. Reg. § 1.1471-2(a)(4)(ii)(B); Treas. Reg. § 1.1472-1(b)(2).
31. Treas. Reg. § 1.1472-1(b)(2).
32. Treas. Reg. § 1.1471-2(a)(4)(ii)(A).
33. Treas. Reg. § 1.1471-2(a)(2)(vi) (reserved); Treas. Reg. § 1.1471-4(b)(4) (no withholding on foreign passthrough payments required until the later of January 1, 2017 or six months after the date final regulations defining the term are published)
34. *See* Announcement 2012-42, 2012-2 C.B. 561.
35. Treas. Reg. § 1.1471-2(a)(4). Also note, the requirements to identify payees are currently in effect. Treas. Reg. § 1.1471-3(g).
36. Prop. Treas. Reg. § 1.1473-1(a)(4)(iii).