What...The FATCA (Foreign Account Tax Compliance Act)?

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What is FATCA, and why should you care? FATCA refers to the "**Foreign Account Tax Compliance Act**"[1], which was enacted as part of the "Hiring Incentives to Restore Employment Act of 2010".[2] FATCA imposes a 30% withholding tax on U.S.-source payments to certain non-U.S. persons (foreigners). You should care because the FATCA rules are very broad and will need to be considered for all transactions involving payments with a U.S. connection that are made to foreigners.

FATCA was enacted, in part, as a response to scandals over the last few years involving U.S. taxpayers using offshore accounts and shell corporations to hide income and thereby avoid U.S. federal income tax on such income. While FATCA is similar to the traditional U.S. withholding tax regime[3] in that it imposes a requirement to withhold taxes from payments made to foreigners, the objectives of FATCA are very different in that FATCA is designed to increase compliance by U.S. taxpayers rather than to enforce collection from foreigners. In order to achieve its compliance objective, FATCA requires foreigners to report information related to the ownership by U.S. persons of assets held overseas and, thereby prevent U.S. persons from hiding income abroad.[4] While the Joint Tax Committee estimated that the implementation of FATCA would generate 8.7 billion dollars of additional revenue over 10 years,[5] the source of this revenue increase is expected to be tax collections from increased federal income tax compliance by U.S. taxpayers rather than actual collections of the 30% withholding tax on payments destined for foreigners.[6]

Overview of the Rules

If you are making a U.S.-source payment to a foreigner, you need to be concerned with the application of FATCA. Since it is difficult to envision a situation in which a 30% withholding would be acceptable, you should either make sure that FATCA does not apply or confirm that the payee qualifies for an exemption. Note that unlike certain withholding regimes whereby treaties reduce traditional U.S. withholding rates below the statutory 30%, there is no corresponding FATCA treaty regime – it is 30% withholding or 0% withholding.[7]

Foreign Entities Subject to FATCA

The principal targets of FATCA enforcement are "foreign financial institutions" (FFIs). An FFI is a foreign entity that is engaged in a banking, brokerage, investment or similar business. Targeting FFIs makes sense because U.S. persons are likely to hold offshore accounts with these types of

institutions. In addition, related parties (generally at or above the 50% common ownership and control threshold) are treated as FFIs. Thus, the parent holding company of a foreign bank, and its affiliates, are all FFIs. While the definition specifically includes typical financial institutions (i.e., banks, investment banks and brokerage firms), the definition is broad enough to include private equity funds, hedge funds and insurance companies.

FATCA also targets "non-financial foreign entities" (NFFEs) unless they provide information on their U.S. owners, if any. This prevents U.S. persons from simply setting up an offshore company to hold their overseas accounts.

Payments Subject to FATCA

FATCA withholding applies to "withholdable payments" made to FFIs or NFFEs. A withholdable payment broadly includes any payment of U.S.-source: (a) interest (including OID), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed and determinable annual or periodical gains, profits or income, or (b) gross proceeds from the sale or other disposition of any property of a type that can produce U.S.-source interest or dividends.[8]

Sometimes sourcing is easy – if a U.S. airline borrows money from a foreign lender, the interest payments to that foreign lender are of a U.S. source and subject to FATCA. However, in the complex financing structures often used in aircraft transactions, sourcing can be trickier. Additionally, rental income sourcing, particularly for transportation assets, may be particularly challenging, and possibly subject to special statutory rules to determine source, as rental income is sourced based on the location in which the property is used.

How Do FFIs and NFFEs Avoid Withholding?

An FFI can avoid FATCA withholding by agreeing in writing to provide the U.S. Treasury with information on its U.S. account holders.[9] The information required to be reported includes such matters as name, address, U.S. TIN and account information (such as balance, value, withdrawals and receipts) for each U.S. account holder. In addition, FFIs domiciled in a jurisdiction that has entered into a bilateral inter-governmental agreement (an IGA) with the United States do not need to execute individual agreements with the U.S. Treasury. Rather, these FFIs will report to their governments, which will pass the information along to the U.S. Treasury. The United States has already negotiated several IGAs,[10] and numerous other IGAs are in the process of being negotiated. There are also other methods by which an FFI can become compliant.

An FFI that demonstrates FATCA compliance to the IRS will be issued a "global intermediary identification number" (GIIN). As a practical matter, a U.S. payor will require the payee's GIIN prior to remitting any payments to such payee that would otherwise be subject to FATCA withholding. The IRS will maintain and publish a list of entities and their GIINs so that payors can check the validity of the number provided. The IRS is modifying its W-8 form series to account for the FATCA regime.[11]

Note also that when an FFI agrees (or is deemed to agree under an IGA) to report, it also agrees (or is deemed to agree) to become a withholding agent with respect to any U.S.-source payments it makes to other FFIs or to certain account holders who do not provide the required information.

NFFEs generally can avoid withholding by certifying that they are the beneficial owner of the payment being made to them and that they have no substantial U.S. owners (i.e., 10% or greater) or by disclosing the name, address and TIN of each substantial U.S. owner. In addition, certain classes of

NFFEs are exempt (such as publicly traded companies or companies predominantly engaged in an active business).

When Do the FATCA Rules Go Into Effect?

After several delays and extensions, the FATCA rules are currently scheduled to apply to payments of interest, dividends, rentals and similar payments made after December 31, 2013. Obligations outstanding on January 1, 2014 are "grandfathered," and the FATCA rules do not apply to payments made under these pre-existing obligations unless such obligations are substantially modified after that date. A substantial modification may be triggered by, among other things, a change in interest rate, maturity or obligor. Withholding on payments of "gross proceeds" is not set to begin until after December 31, 2016. Although FATCA withholding will not apply until 2014, transactions being documented currently should take into account the possible application of FATCA withholding in the future.

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The above is intended as a practical summary. With the "final" regulations exceeding 420 pages, a complete explanation of the FATCA rules is far beyond the scope of this article. The key takeaway is that beginning on January 1, 2014, before you make a U.S.-source payment to a foreigner, require the foreigner to supply its W-8, in order to be able to verify its GIIN or other exempt status.

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[1] I.R.C. §§ 1471-1474.

[2] Pub. L. No. 111-147.

[3]*See* I.R.C. § 1441 et seq. The U.S. taxes its citizens on their worldwide income and taxes foreigners on U.S.-sourced income. The traditional U.S. withholding tax is designed to collect taxes on U.S.-sourced income paid to foreigners by collecting the relevant tax from the U.S. payor before funds leave the country and escape the jurisdictional grasp of the United States. These taxes are often reduced or eliminated by bilateral treaty exemptions or statutory relief. For example, many treaties provide for zero withholding on interest and aircraft rent.

[4] While the U.S. tax system is labeled a "voluntary" tax regime, history has amply demonstrated that taxpayer compliance is significantly increased when the voluntary system is backed up by the "trust but verify" mechanism of information reporting. The classic example is the 1099 (interest, dividends, etc.) information reporting system. Laws, and significant related penalties for failure to comply, already established a strong incentive for U.S. taxpayers to report their income from assets held abroad. However, in light of recent scandals, Congress felt that these mechanisms were inadequate and sought to institute an information-reporting regime. Unlike U.S. financial institutions, foreign entities not otherwise engaged in business in the United States are not subject to the jurisdiction of the United States. Therefore, the 30% withholding tax imposed by FATCA is the "stick" to force these foreign persons to report their U.S. account holders, and in some cases U.S. owners, to the U.S. Treasury.

[5]*See* Joint Committee on Taxation, "Estimated Revenue of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act, under Consideration by the Senate," JCX-5-10 (Feb. 23, 2010).

[6] As a practical matter, the 30% withholding tax will make it economically impractical to do business with foreign persons who are not FATCA compliant, or exempt, if the transaction has any U.S.-source payment component.

[7] Under limited circumstances, refunds, or credits against taxes otherwise owed, may be available.

[8] A further variance from traditional withholding rules is that the FATCA regime will eventually apply to proceeds from the sale or other disposition of instruments producing U.S.-source interest or dividends. The rules are broad enough to include principal payments on debt instruments. A 30% withholding tax on payments of principal is harsh medicine indeed.

[9] The Treasury has released model forms of such agreements, which are available at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.

[10] So far, IGAs have been signed with the United Kingdom, Denmark, Ireland, Mexico and Switzerland.

[11] A new W-8BEN-E form will be used for foreign entities and will include the appropriate information to demonstrate FATCA compliance or exemption from FATCA withholding.

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National Law Review, Volume III, Number 73

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