

# FATCA: A PRIMER AND CURRENT PRACTICAL DEVELOPMENTS

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The Hiring Incentives to Restore Employment Act of 2010 ("HIRE") added a new Chapter 4 to Subtitle A - Income Taxes of the Internal Revenue Code (the "Code"), entitled "Taxes to Enforce Reporting of Certain Foreign Accounts", otherwise known as the Foreign Account Tax Compliance Act ("FATCA"). FATCA is generally thought of as an "invitation" to foreign banks, entities, and trusts which have any type of investment in the United States ("U.S.") to report its U.S. persons/customers to the Internal Revenue Service ("IRS") or suffer the consequences of a 30% withholding rate on such U.S. investment payments. Due to such a significant withholding rate on U.S. investment income, it is well known in the international tax and finance community that such "invitation" is not likely to be turned down. After certain extensions of the effective date of the FATCA provisions, the tax year 2014 saw the beginning of a large piece of FATCA compliance that will only increase (and become better understood by everyone) over the coming years.

In a nutshell, FATCA requires withholding by "withholding agents" where a "withholdable payment"<sup>1</sup> is paid to a certain foreign entity that has not provided the withholding agent with proper FATCA documentation. For FATCA reporting purposes, a withholding agent is defined as any person, U.S. or foreign, in whatever capacity having the control, receipt, custody, disposal, or payment of any withholdable payment or foreign pass-through payment. An individual who makes a withholdable payment that is not in the course of such individual trade or business is not a withholding agent as to such payment. FATCA withholding is imposed at the rate of 30% on gross income. To a great extent, the term "withholdable payment" includes U.S.-source interest even if such interest would otherwise qualify for the "portfolio interest exemption" of Section 811(c) of the Code (with certain exemptions).

The FATCA rules run parallel to the withholding rules under Section 1442 of the Code, which are the withholding rules applicable to any fixed, determinable, annual or periodical ("FDAP") income of a nonresident alien or foreign corporation received from U.S. sources. Such rules are contained in Chapter 3 to Subtitle A - Income Taxes of the Code, entitled "Withholding of Tax on Nonresident Aliens and Foreign Corporations" (Code Sections 1441-1465).

With certain exceptions, FATCA applies to Foreign Financial Institutions ("FFIs") and Non-Financial Foreign Entities ("NFFEs"). A FFI is a foreign (non-U.S.) entity<sup>2</sup> that is a financial institution. A NFFE is any foreign entity that is not a financial institution. In other words, with limited exceptions, no foreign bank, company, or trust can truly escape FATCA's broad reach.

On January 17, 2013, the Internal Revenue Service ("IRS") released final FATCA Regulations. According to IRS officials, the Regulations provide a complete picture of the substantive requirements for FFIs. On May 1, 2014, the IRS issued Notice 2014-33 which provided further guidance regarding the implementation of FATCA and the related withholding provisions (the "Notice"). In the Notice, the IRS announced that it will treat the tax years 2014 and 2015 as a transition period for the enforcement of FATCA rules, during which the IRS will take into account the extent to which a taxpayer has made "good faith" efforts for FATCA compliance.<sup>3</sup> On July 1, 2014, the first phase of the FATCA rules (i.e., the 30% withholding) took effect.

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<sup>1</sup> A "withholdable payment" includes any payment of U.S. source FDAP income, plus beginning after December 31, 2016, payments made for any sales or other dispositions, including any gross proceeds that can produce interest or dividends that are U.S. source FDAP income.

<sup>2</sup> Any person other than an individual.

<sup>3</sup> For example, the IRS will take into account whether a withholding agent, participating or deemed-compliant FFI, direct reporting NFFE, sponsoring entity, sponsored FFI, or sponsored direct reporting NFFE has made reasonable efforts during the transition period to modify its account opening practices and procedures to document the Chapter 4 status of payees, apply the standards of knowledge provided in Chapter 4, and, in the absence of reliable documentation, apply the presumption rules of Reg. § 1.1471-3(f).

Before January 1, 2015, FFIs under an IGA (as defined below) a jurisdiction had to register with the IRS and obtain their Global Intermediary Identification Number (“GIIN”). On September 30, 2015, FATCA reporting begins,<sup>4</sup> and will phase-in additional reporting requirements in the following years.<sup>5</sup> Footnote #16 to this article provides a link to an IRS webpage that contains the entire FATCA reporting timeline.

On July 2012, in order to facilitate the compliance of FATCA, but primarily in an effort to remove any potential conflict between FATCA and a foreign country’s privacy rules, the U.S. Treasury Department issued the first model for an Intergovernmental Agreement (or “IGA”) which facilitates FATCA compliance for partner countries (both under Model 1 and Model 2).<sup>6</sup> The vast majority of the world’s countries have entered into an IGA with the U.S. Treasury Department.<sup>7</sup> In these cases, FATCA compliance is governed exclusively by the IGA. Under the IGAs, both the U.S. and the foreign jurisdiction shall obtain information specified in the IGA with respect to certain reportable accounts, and annually exchange this information with the other party on an automatic basis.

Specifically, the IGA provides that a jurisdiction’s Reporting Financial Institution (which will be referred to for purposes of this article as a “**Reporting FFIs**”) shall apply the due diligence procedures contained in the IGA to identify U.S. reportable accounts,<sup>8</sup> and report this to the corresponding country’s tax authority.

Under FATCA, all non-U.S. entities (including trusts) are either FFIs or NFFEs. Because both categories are mutually exclusive, no entity can be both at the same time. A foreign bank, entity, or trust that wishes to comply with FATCA must determine its status either as an FFI or an NFFE, and provide the applicable form to either the U.S. withholding agent or the tax authority of the country where such FFI or NFFE has a foreign bank account.

In general terms, regarding an FFI and in accordance to the internal procedures adopted internally by each jurisdiction for the application of the IGA, a Reporting FFI must certify to the corresponding foreign government entity, through the applicable Forms W-8 or W-9, that an account holder is or is not a citizen or resident of the U.S. (i.e., a U.S. person). If the account holder is a foreign corporation, it is likely that the applicable form to identify the corporate entity would be Form W-8BEN-E or a similar form published under the applicable IGA. If the account holder is a foreign individual, a Form W-8BEN or its IGA equivalent should be the applicable form. In the case of a foreign trust, however, it not only needs to be classified as either a “grantor” or a “nongrantor” trust, but also whether such trust it is an FFI or an NFFE.

For example, in the case where an Investment Entity “manages” a foreign trust, such trust may be considered a Reporting FFI for FATCA purposes. An “Investment Entity” “is defined as any entity that conducts as a business (or is “managed by” an entity that conducts as a business) certain activities for on behalf of a customer. The IGAs do not define the term “managed by” (unlike the FATCA regulations). Presumably, however, the trustee is the person or entity that manages a trust itself. Thus, if a foreign trust has an Investment Entity which is the trustee of such trust, then the trust is considered a Reporting FFI. The foreign trust would either need to be sponsored by its trustee, or it would need to obtain its GIIN number (through the trustee).

If the foreign trust does not have an Investment Entity acting as its trustee (but rather, an individual trustee), then the foreign trust would likely fall under the category of NFFE. A further analysis would be required to determine if the trust should be considered an “active” or “passive” NFFE.

An NFFE is a foreign entity that is excluded from the definition of a Reporting FFI. However, under FATCA and the applicable IGA, such an entity must complete a Form W-8 (or its equivalent), and needs to further classify itself as either “active” or “passive.” In general terms, an entity is an “active” NFFE if less than 50% of its gross income for a calendar year is income deriving from investments, and less than 50% of its assets produce or are held for the production of passive income. Active NFFEs will not be required to report or disclose their ownership on Forms W-8, but are required to disclose on such Forms their “active” status to any foreign financial institution in which they have an account.

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<sup>4</sup> March 31<sup>st</sup> for FFIs in non-IGA jurisdictions and FFIs in Model 2 IGA jurisdictions.

<sup>5</sup> For a complete timeline of FATCA and a general summary of the reporting requirements for FFIs and NFFEs, see <http://www.irs.gov/Businesses/Corporations/Summary-of-FATCA-Timelines>

<sup>6</sup> For purposes of this article, we will only refer to a Model 1 IGA jurisdiction, where the FATCA compliant bank, entity or trust will report directly to the non-U.S. foreign jurisdiction’s tax authority.

<sup>7</sup> For a complete list of these countries, see <http://www.treasury.gov/resource-center/tax-policy/treaties/pages/fatca-archive.aspx>

<sup>8</sup> Certain accounts exceeding certain thresholds.

The most likely forms which will need to be filed by foreign banks, entities, trusts and individuals are Form W-8BEN-E (Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)), Form W-8IMY (Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting), Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)), Form W-9 (Request For Taxpayer Identification Number and Certification), Form 8938 (Statement of Specified Foreign Financial Assets), and Form 8966 (FATCA Report).

The purpose behind FATCA, in short, is to cause foreign banks to report to the U.S. tax authorities its U.S. clients who have failed to report income from (and the existence of) their foreign bank accounts to the U.S. government. Consequently, FATCA not only impacts foreign financial institutions and U.S. individuals (or U.S. residents for tax purposes), but also has a direct effect on foreign entities and foreign trusts (and their beneficiaries), particularly foreign trusts, which have an "investment entity" trustee (whether or not this "investment entity" trustee is a U.S. or Foreign Service provider).

Although a substantial amount of guidance has been issued by the IRS regarding FATCA, including the applicable timelines and a list of all the FATCA related forms, more guidance regarding FATCA is expected as the primary parts of FATCA became effective in 2014.

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