The Global Financial System Must Now Implement a New U.S. Reporting and Withholding System for Foreign Account Tax Compliance, Which Will Create Significant New Exposures–Managing This Risk (Part IV–Withholdable Payments)

By Dean Marsan[*]

In Part IV, Dean Marsan examines FATCA withholding liability for withholdable payments under Code Secs. 1471 and 1472, and provides a nine-point analysis–each of which must be answered affirmatively for the new 30-percent withholding tax to apply.

No financial instrument is evil per se; it just that some variations have far more potential for mischief than others.

—Warren E. Buffett[1]

This article continues what has now become a six-part series. The first thee parts appeared in the July, August and September 2010 editions of TAXES—THE TAX MAGAZINE. The next three parts of the article are scheduled to appear in the May, July and September 2011 editions of TAXES—THE TAX MAGAZINE.

On March, 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act[2] ("HIRE Act") into law that added an entirely new and significant U.S. withholding and information reporting tax regime. The new rules are based on legislative proposals that were originally introduced by Senators Baucus of Montana and Kerry of Massachusetts under a bill called the Foreign Account Tax Compliance Act (FATCA).[3] Selected provisions were passed in modified form as part of the HIRE Act and enacted new chapter 4 of the Code (sections 1471–1474), which are commonly known as FATCA.

Operative Rules

A withholding agent making a withholdable payment to a "Nonparticipating Foreign Financial Institution (FFI),"[4]must withhold a 30-percent withholding tax if such entity does not enter not a Code Sec. 1471(b) agreement with the IRS and comply with its terms as a participating FFI unless an exemption applies.[5] In addition, a withholding agent making a withholdable payment to an "other Non–Financial Foreign Entity (NFFE),"[6] must withhold a 30-percent withholding tax

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unless certain certification or documentation and reporting requirements are met as a compliant NFFE unless an exemption applies.[7] For purposes of new chapter 4, a withholding agent means "all persons in whatever capacity acting, having the control, receipt, custody, disposal or payment of any withholdable payment."[8] For U.S. GAAP financial statement reporting purposes, a company that would be the FATCA withholding agent will have to evaluate whether that liability should be accrued (*i.e.*, the law and facts are clear regarding the requirement that the amounts be withheld), or will conclude that the law and facts are not clear and therefore any liability is only contingent and as such should be evaluated pursuant to ASC 450.

Withholdable Payments to a Foreign Financial Institution (FFI) or Non–Financial Foreign Entity (NFFE)

In order for the 30-percent withholding tax to apply the operative rules require that a "withholdable payment" be made to either a Nonparticipating FFI or other NFFE.

The term "withholdable payment"[9] is defined in the new law to include two categories of payments:

- Any payment of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed or determinable income, if such payment is from sources within the United States (Fixed, Determinable, Annual, Periodical (FDAP) income)
- Any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from sources within the United States (gross proceeds from property which can produce U.S. source interest or dividends)

Triggers to Impose FATCA Withholding Tax

One would think that it would be fairly easy to determine the obligations of a withholding agent under new chapter 4 to withhold 30 percent for its "withholdable payments" since the operative withholding provisions in Code Secs. 1471(a) and 1472(a) are only one short sentence each.

Unfortunately, similar to the bon-bons on the candy conveyor belt in the famous "I Love Lucy" skit where Lucy and Ethel try to hide the candy bon-bons that they can't wrap from their boss, the U.S. tax rules for U.S. reporting and withholding taxes continue to escalate both in number and complexity as if on that same conveyor belt. Recall, in the "I Love Lucy" skit, Lucy and Ethel were so successful in convincing their boss that they were able to wrap all the candy, that their boss increased the speed of the conveyor belt. One can only hope that that the Treasury will say, "It ain't so," in the case of the new FATCA guidance and limit the complexity of the rules.

Professor Harvey Dale, in his seminal article entitled *Withholding Tax on Payments to Foreign Persons,*[10] framed the analysis for withholding imposed under chapter 3 of the Code (Withholding of Tax on Nonresident Aliens and Foreign Corporations)[11] with six different inquiries which must be made—a hexagon, each point of which must be touched upon. This paradigm was taught to generations of students in the New York University School of Law LL.M in Taxation program over the last three decades.

In fact, some 30 years later, the analysis still explains the classic conceptual treatment of U.S. withholding tax and provides an analytical tool as updated by the current U.S. tax law to determine if the FATCA withholding tax applies. Unfortunately, with the passage of FATCA into law, the hexagon has now become at the very least a nonagon with nine touch points to determine if the FATCA withholding tax applies. In order for the 30-percent FATCA withholding tax to apply to withholdable payments each of these inquiries must be answered affirmatively:

- Is the payment not excluded under the FATCA grandfather rule?
- Is the recipient a foreign entity?
- Is the foreign entity a nonparticipating FFI or other NFFE?
- Is the amount paid from sources within the United States?
- Does the amount paid include income of the type generally described as "fixed or determinable annual or periodical" or "gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends"?
- Does the payment include any item of income that is not effectively connected with the conduct of a trade or business within the United States by the recipient?
- Does the payment not include an arm's-length payment made for goods or services in the ordinary course of the withholding agent's trade or business?
- Is the payor or some other person in the transaction a "withholding agent?"

- Is there no exception applicable to the particular circumstances in question which might cut off FATCA withholding tax?

Again, to quote Professor Dale, "Each of these inquiries contains the seeds of possible confusion."[12]

Payment Not Excluded Under Grandfather Rule

Chapter 4 is generally effective for payments made after December 31, 2012, but it does not require any amount to be deducted or withheld from any payment under any obligation outstanding on March 18, 2012, or from the gross proceeds from any disposition of an obligation.[13]

On August 27, 2010, the Treasury issued Notice 2010-60 ("the Notice"),[14] which states that the Treasury intends to issue future guidance stating that the term "obligation" for this purpose means any legal agreement that produces or could produce withholdable payments, except that it does not include:

- any instrument treated as equity for U.S. tax purposes, or
- any legal agreement that lacks a definitive term or expiration date.

Fixed term instruments. Thus, most fixed-term instruments with a U.S. issuer that are classified as debt for U.S. tax purposes will be treated as obligations while savings and demand deposits accounts will not (presumably liquid deposit, escrow accounts and dormant or sleeping accounts are in this category). Also, a legal agreement that may produce withholdable payments includes brokerage, custodial and similar agreements to hold financial assets for the account of others and to make and receive payments of income and other amounts in connection with those assets.

Material modifications. A material modification of an obligation will result in the treatment of the obligation as being newly issued. For obligations that are indebtedness for U.S. tax purposes, a material modification means any "significant modification" as defined in Reg. §1.1001-3.[15] Presumably, there can be a significant modification even if the modification does not involve any extension of credit and in the case of other obligations the determination of whether material modification occurred will be determined based on the facts and circumstances.

Thus, under the grandfather rule, FATCA withholding will apply, unless the instrument is treated as an "obligation," outstanding on March 18, 2012, or from the gross proceeds from the disposition of such instrument. As noted above, for this purpose, an obligation will include a fixed term instrument with a U.S. issuer which is classified as debt for U.S. tax purposes. Any instrument which lacks a definitive term or expiration date (*e.g.*, demand deposit, brokerage or custodial agreement), or is classified as equity for U.S. tax purposes will not be treated as an obligation and, therefore, the grandfather rule will not apply to preclude FATCA withholding if the other inquiries are also satisfied.

While the Notice eliminated some of the uncertainty around the definition of "obligation," questions still remain as to whether a revolving credit agreement which permits an advance after March 18, 2012, even though it was entered into before this date will be treated as an obligation outstanding on March 18, 2012.

Similarly, it is presently unclear whether an obligation must be executed on or before March 18, 2012 in order to be grandfathered or whether a transaction will be subject to this safe harbor if it otherwise qualifies because all of the substantial terms of a legal agreement governing a nonequity transaction are fixed on or before March 18, 2012, and the transaction has a definitive expiration or term, but is executed after such date. The recent Securities Industry and Financial Markets Association (SIFMA) Comments provided the following examples in their recent comments:[16]

- Simple term loans (where the loan agreement may be signed or a commitment letter entered into days or months before the loan proceeds are advance)
- Syndicated loan facilities (which are designed to provide for periodic issuances of term loans)
- Revolving loans
- Letters of credit
- Repos under Master Repurchase Agreements (which are designed to provide for periodic repos of securities under a standard framework agreement)
- Notional principal contracts under ISDA Master Agreements (which are designed to provide for periodic notional principal contracts under a standard framework agreement)

SIFMA in its comments also suggested that "payments in respect of" an obligation be defined to include any payments paid by reference to an obligation. In particular, where the obligation in question is a loan, "payments in respect of" the obligation should include both payments of interest and principal, as well as commitment fees, facility fees, amendment fees and other common types of compensation typically paid to lenders in respect of loans.[17]

Recipient of Payment Is a Foreign Entity (FE)

Chapter 3 withholding may impose a withholding obligation on payments made to a "foreign person."[18] For this purpose, the term "foreign person" means a nonresident alien individual, a foreign corporation, a foreign partnership, a foreign trust, a foreign estate and any other person that is not a U.S. person.[19]

The term "U.S. person" means (i) a citizen or resident of the United States; (ii) a partnership created or organized in the United States or under the law of the United States or of any state; (iii) a corporation created or organized in the United States or under the law of the United States or of any state; (iv) any estate other than a foreign estate; or (v) a trust if a court within the United States is able to exercise primary supervision over the administration of the trust ("the court test") and one or more U.S. persons have the authority to control all substantial decisions of the trust ("the control test").[20]

Under Code Sec. 1471(a) or 1472(a) withholding may be imposed on a narrower subset of foreign person, to wit, a "foreign entity." Code Sec. 1473(5) simply defines "foreign entity" to means any entity that is not a U.S. person.[21] Thus, the first inquiry is whether there is an "entity" rather than a natural person. Since an individual is not included in the definition of foreign financial institution or nonfinancial foreign entity, payments that are beneficially owned and paid directly to an individual and not to his or her FE will not be treated as withholdable payments for purposes of chapter 4, but may continue to be subject to U.S. withholding tax as "passthrough payments" under Code Sec. 1471(b)(1)(D) or 1471(b)(3) or under chapter 3.[22]

The regulations provide classification standards for a "business entity"[23] and provide that a business entity is "any entity recognized for tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner[24]) that is not properly classified as a trust (or otherwise subject to special treatment under the Internal Revenue Code)." As an initial matter, the regulations focus upon whether the organization can be separated from its owners by providing:

> Whether an organization is an entity separate from its owners for federal income tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.[25] The regulations differentiate between this relationship and co-ownership of property or joint undertakings to share expenses which does not create a separate entity.[26] An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes and is an integral part of the State.[27]

Trusts. The Treasury will likely have to consider before it issues proposed regulations whether various trust entities should be implicated by FATCA. For example, there well may be certain small trusts or trusts below a certain value which should be treated as outside the purview of chapter 4 entirely. In addition, the Treasury will likely look at the following types of trusts in assessing whether there is a risk of tax evasion by Americans:

- Testamentary trusts created following the death of the testator in accordance with the terms of the will
- Trusts established for specific purposes such as providing for the needs of disabled beneficiaries, former spouses and/or children following a divorce, or education
- Trusts that provide for the distribution of the capital to charity or other nonprofit entity upon the death of the income beneficiary
- Informal trust arrangements under which a parent or other adult holds relatively small amounts of funds (often received as gifts by the children for birthdays, christenings, religious holidays, *etc.*) "in trust for" children until they reach the age of majority
- Trusts established by a corporation under a regulated program for the purposes of providing benefits to employees or former employees
- Trusts established for a public purpose (such a land use trusts or trusts established for the benefit First Nations arising from a land claim settlement)[28]

Foreign simple trusts and foreign grantor trusts. For purposes of chapter 3 (and chapter 61) and Code Sec. 3406 (backup withholding), a foreign simple trust will not be treated as beneficial owner or a payee of a payment.[29] Also, a foreign grantor trust (or a portion of a trust that is treated as a foreign grantor trust) is not considered a beneficial owner or a payee of a payment except to the extent the payment is ECI.[30]

Foreign complex trusts and estates. For purposes of Code Sec. 1441, a foreign complex trust or foreign estate is generally considered to be the beneficial owner of income paid to the foreign complex trust or foreign estate.[31] As such beneficial owner, the Treasury may decide to treat such foreign trust or foreign estate as a FE for purpose of testing whether such entities are compliant under new chapter 4.

Foreign private foundations. A number of foreign countries use private foundations or stichtings, siftings and other vehicles, rather than a trust established under foreign law. It has been noted by commentators that some jurisdictions do not recognize the existence of a trust or do not have a separate trust law. It is possible the Treasury may treat such entities as FEs under chapter 4.

Foreign partnerships. Under chapter 3 (Code Secs. 1441–1446) payments made to a nonwithholding foreign partnership are generally treated as if they were made to the foreign partners and are subject to withholding by the withholding agent and must look through any partners that are treated as passthrough entities for federal income tax purposes to find the first non–passthrough entity who will be treated as the payee.[32] However, the foreign partnership is the payee to the extent the withholding agent treats the income as ECI.[33] A withholding foreign partnership is a foreign partnership which has entered into an agreement with the IRS.[34] Such partnerships assume primary withholding responsibility for withholding to their partners under chapter 3.[35]

Protected cell companies or asset pools. In 1986, Congress added Code Sec. 851(g) which contains a special rule for series funds and provides that in the case of a regulated investment company[36]with more than one fund, each fund is generally treated as a segregated portfolio of assets the beneficial interests in which are owned by holders of interests in the regulated investment company that are preferred over other classes or series with respect to these assets.

The issue whether a protected cell company, segregated portfolio company or asset pool is separate legal entity appears to be still evolving for federal tax purposes. Generally these companies are used for commercial parties to achieve administrative and other cost efficiencies for enterprises that typically need little active management but where there are significant advantages to isolating assets and liabilities into separate, discrete pools and provide the potential for the pools to have separate beneficial owners.[37]

According to at least one commentator, some jurisdictions' statutes treat each cell as a separate legal entity (and separate from the protected cell company itself), but many statutes are either ambiguous or clearly indicate that cells are not treated as separate legal entities for local law purposes.[38]

In referring to the Delaware statute,[39] the NYSBA Cell Companies Report stated:[40]

> The statutes provide for an unambiguous separateness of assets and liabilities of a protected cell company and permits beneficial ownership to be held on a cell by cell basis. That is, these statute[s] provide for the power (i) to establish designated "cells" (whether called that, or called "series," "pools," "portfolios" or "accounts" or any similar phrasing) of members, trustees, managers, or ownership interests having separate rights, powers, or duties with respect to specified property or obligations) and (ii) to provide that the debts, liabilities, and obligations existing with respect to a particular cell may be enforced against the assets of that cell only, and not against the assets of the protected cell company generally or of any other cell. This factor is of course fundamental to the commercial purpose of using a protected cell company and the legal and theoretical underpinning of its characterization for Federal income tax purposes. The statutes of the following [foreign] jurisdictions provide for this type of separation:[41]
>
> - Anguilla
> - Barbados
> - Bermuda
> - British Virgin Islands
> - Cayman Island
> - Gibraltar
> - Guernsey
> - Jersey
> - Isle of Man
> - Luxembourg
> - Mauritius

The protected cell company itself is not a *per se* corporation under Reg. §301.7701-2 (*e.g.*, is not a U.S. corporation, a French S.A. or German AG). This is distinct from a determination that any cell itself may become a *per se* corporation as a result of its activities or other features, for example, by reason of predominantly conducting an insurance business or being a "taxable mortgage pool."[42]

On September 13, 2010, the IRS issued proposed regulations[43] covering the tax treatment of protected cell companies or segregated portfolio companies. If a protected cell company is formed under non-U.S. law, only cells that qualify as insurance companies for federal tax purposes (*e.g.*, more than 50 percent of its business is issuing insurance or annuity contracts)[44] would be recognized as separate entities. Until the IRS provides future guidance, the preamble to the proposed regulations states that the entity status of non-U.S. protected cell companies that are not engaged in the insurance business "will be determined under applicable law."

Insurance companies. While insurance companies are treated for tax purposes as per se corporations and cannot elect to be treated as partnerships or disregarded entities, it may be possible for an insurance company to make a Code Sec. 953(d) election to be treated as domestic corporation to avoid being treated as a FE for purposes of FATCA. For purposes of Code Sec. 1446 (withholding on tax on foreign partner's share of effectively connected income), a foreign insurance company which makes a qualifying Code Sec. 953(d) election will be treated as a U.S. person if the required documentation is completed (*e.g.*, Form W-9).[45]

Subsidiary formed to comply with foreign law. Under Code Sec. 1504(d) a domestic corporation owning or controlling (directly or indirectly) 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country (*e.g.*, Mexico or Canada) and maintained solely for the purpose of complying with the laws of such country as to the title and operation of the property shall treat such foreign corporation at the option of the domestic corporation as a domestic corporation.[46] It may be possible to also use this provision to treat such FE as a domestic corporation for purposes of FATCA.[47]

Stapled entities. Similarly, it may be possible for a foreign corporation to be treated as a domestic corporation for purposes of FATCA under the "stapled entity" provision of the Code. If a foreign corporation is a "stapled foreign corporation" such foreign corporation will be treated as a domestic corporation for U.S. federal income tax purposes.[48] However, if the foreign corporation and domestic corporation are foreign owned (*e.g.*, less than 50 percent of the total combined voting power and value of the stock of the corporation is held directly or indirectly by U.S. persons) this rule will not apply.[49] A foreign corporation is a stapled foreign corporation if such foreign corporation and a domestic corporation are stapled entities. The term "stapled entities" means any group of two or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests. Interests are stapled if a transferor of one or more interests in one entity is required by form of ownership, restrictions on transfer or other terms or conditions to transfer interests in the other entity.[50] For this purpose, the term "entity" means corporation, partnership, trust, association, estate or other form of carrying on a business or activity.[51]

Entities that issue "tracking stock." FEs may issue "tracking stock" or other securities whose value is derived from the value of the portfolio of investments in unrelated entities. While it is unclear whether such entities will be treated as FFIs, "partial FFIs," NFFEs, or excepted NFFEs among other FE classifications, it seems clear that such entities will be treated as FEs.

Payments to U.S. agents of a FE. Under Code Sec. 1441 a withholding agent making a payment to a U.S. person (other than a U.S. branch treated as a U.S. person for chapter 3 withholding purposes) and who has actual knowledge that the U.S. person receives the payment as an agent of a foreign person must treat the payment as made to the foreign person. However, the withholding agent may treat the payment as made to the U.S. person if the U.S. person is a financial institution and the withholding agent has no reason to believe that the financial institution will not comply with the obligation to withhold under Code Sec. 1441.[52] Presumably, the Treasury will require a withholding agent who has knowledge that it is making a payment to an agent of a FE to verify whether it is making a payment to a Nonparticipating FFI or other NFFE for purposes of Code Sec. 1471(a) or 1472(a).

Payments to wholly owned domestic entities. Under Code Sec. 1441, a payment to a wholly owned domestic entity that is disregarded for federal tax purposes as an entity separate from its owner and whose single owner is a foreign person will be treated as a payment to the owner of the entity.[53] For this purpose, a domestic entity means a person that would be treated as a U.S. person if it had an election in effect under Reg. §301.7701-2(c)(2) to be treated as corporation. Thus, a foreign person owning a U.S. limited liability company cannot avoid withholding under Code Sec. 1441. It is likely a similar rule will be followed for purposes of new chapter 4 to impose withholding on any Nonparticipating FFI or other NFFE who receives a withholdable payment through its wholly owned disregarded domestic entity.

Application to chapter 4 withholdable payments. Based on the foregoing and absent further guidance from the Treasury, FATCA withholding may apply to the following foreign entities unless an exemption applies:

- Any partnership created or organized in a foreign jurisdiction[54]
- Any corporation created or organized in a foreign jurisdiction[55]
- Any "foreign estate" meaning an estate the income of which is from sources without the United States that are not effectively connected with the conduct of a trade or business which is not includable in gross income under subtitle A (income taxes)[56]
- Any *inter vivos* or testamentary foreign trust meaning any trust other than a trust in which a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust which would be treated as a grantor trust, simple trust or complex trust under federal tax rules including those trusts with vested as well as remote or discretionary beneficiaries
- Any foreign protected cell company, segregated portfolio company, taxable mortgage pool or asset pool that is treated as an entity for federal tax purposes
- Any other foreign entity that is not a U.S. person including for this purpose entities that may be fiscally transparent or disregarded for U.S. tax purposes, other than for FATCA

Recipient Is a "Nonparticipating FFI" or "Other NFFE"

Prior to the recent guidance provided by the Treasury, the FATCA provisions found in new chapter 4 simply divided the world into two classes of FEs: FFIs and NFFEs. The Notice now divides this world into many more FE classifications:

- Exempt FFIs
- Entities described in Code Sec. 1471(f)
- Deemed compliant FFIs
- Territory-organized FIs
- Participating FFIs or PFFIs
- NFFEs
- Excepted NFFEs—entities described in Code Sec. 1472(c)
- Excepted NFFEs—active trade or business entities
- Nonparticipating FFIs
- Other NFFEs

While a discussion of the proper classification of a foreign entity into one of these categories is not addressed as part of this article, it will be discussed in the Part V of the series because of its complexity and scope. Suffice it to say, in order for FATCA withholding to apply to withholdable payments, the recipient must be either a "nonparticipating FFI" or an "other NFFE."

Payments Are U.S. Source Income or Gross Proceeds

Code Secs. 1471(a) and 1472(a) as a condition to impose a 30-percent withholding tax require that the payments received by a Nonparticipating FFI or other NFFE be "withholdable payments." For this purpose, Code Sec. 1473(1) requires that the FDAP income or gross proceeds be "from sources within the United States."

According to Professor Dale:[57]

> Most doubts affecting source of income determinations involve uncertainties about how to properly characterize the transaction giving rise to the income. For example, it may be difficult to decide whether a particular transaction is a sale or a lease for tax purposes.[58] Different conclusions about the source of the resulting income may flow from different choices for characterizing the transaction. As an example, suppose an artist paints a picture in France which he then sells in the United States. If the resulting income is treated as compensation for services, as strongly suggest by recent precedent, the income will be entirely foreign source.[59] If, however, the income is treated as deriving from the production and sale transaction, then at least one half of the resulting income may be from sources within the United States.[60] … Examples of source problems could be multiplied almost without limit. They derive not only from doubts about how to characterize the facts, but also from problems ascertaining all of the relevant facts.

Presumably, the U.S. source rules in chapter 3 will continue to apply to withholdable payments under the new law with certain exceptions (*see* "Special rule for sourcing interest paid by foreign branches of domestic financial institutions"), unless the Treasury provides future guidance otherwise. If the source of an amount cannot be determined at the time of payment, it must be treated as an amount from U.S. sources.[61]

Interest and original issue discount. Under the FDAP withholding tax rules interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof (other than a possession of the U.S. or an agency or instrumentality thereof), a State or any political subdivision thereof, or the District of Columbia.[62] Thus, for example, income from sources within the United States includes interest received on any refund of income tax imposed by the United States, a State or any political subdivision thereof or the District of Columbia.[63]

Interest is also from U.S. sources if it is paid on a bond, note or other interest-bearing obligation from a (i) domestic corporation; (ii) an individual who at the time of payment of the interest is a resident of the United States; (iii) a domestic partnership that is at any time during its tax year engaged in trade or business in the United States; or (iv) a foreign corporation or a foreign partnership which at any time during the tax year is engaged in trade or business in the United States.[64]

For this purpose, the term "resident" of the United States includes (i) an individual who at the time of payment of the interest is a resident of the United States; (ii) a domestic corporation; (iii) a domestic partnership that at any time during its tax year is engaged in a trade or business within the United States; or (iv) a foreign corporation or foreign partnership which at any time during its tax year is engaged in a trade or business in within the United States.[65]

The method by which or the place where payment of the interest is made is immaterial in determining whether interest is derived from sources within the United States.[66] In the case of interest received by a foreign corporation, the above source rules will apply whether or not the interest is effectively connected for the tax year with the conduct of a trade or business in the United States by such corporation.[67]

The term "interest" includes all amounts treated as interest, including for this purpose under Code Sec. 483 (interest on certain deferred payments). It also includes original issue discount,[68] whether or not the underlying bond, debenture, note, certificate or other evidence of indebtedness is a capital asset in the hands of the taxpayer under Code Sec. 1221.[69]

If interest is paid on an obligation of a resident of the United States by a nonresident of the United States acting in the nonresident's capacity as a guarantor of the obligation of the resident, the interest will be treated as U.S. source.[70] Conversely, if interest is paid on an obligation of a nonresident of the United States by a resident of the United States acting in the capacity as a guarantor of the obligation of the nonresident, the interest will generally be treated as foreign source.[71]

If a foreign partnership is predominantly engaged in the active conduct of a trade or business outside the United States, any interest that is not paid by a trade or business engaged in by the partnership in the United States and not allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States will be foreign source.[72] Interest other than specified above will be treated as foreign source.

Special rule for sourcing interest paid by foreign branches of domestic financial institutions. Under the Code Sec. 861(a)(1)(B) interest is not treated as U.S. source income and is thus exempt from chapter 3 withholding tax (regardless of whether the recipient is a U.S. or foreign person):

- if the interest is from deposits with foreign branch of a domestic corporation, or a domestic partnership if such branch is engaged in the commercial banking business;
- amounts on deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loans or similar associations under federal or state law, but only to the extent such deposits or accounts are deductible under Code Sec. 591 (determined without regard to Code Secs. 265 and 291) in computing the taxable income of such institutions; and
- amounts held by an insurance company under an agreement to pay interest thereon.[73]

In contrast, under FATCA in determining the source of a payment, the above rule (Code Sec. 861(a)(1)(B)), for sourcing interest paid by foreign branches of domestic financial institutions will not apply.[74] Presumably, this provision was put into the new law to ensure that interest on deposits and other obligations in foreign branch of a domestic financial institution will be treated as a withholdable payment if paid to a FFI or NFFE to ensure such entities are FATCA compliant.

Substitute interest payments. A substitute interest payment will be sourced in the same manner as the interest accruing on the transferred security.[75] A substitute interest payment is a payment made to the transferor of a security in a securities-lending transaction or a sale-repurchase transaction of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. A securities-lending transaction is a transfer of one or more securities that is described in Code Sec. 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash.[76]

Dividends. Dividend income is sourced by reference to the payor's place of incorporation.[77] Thus, a dividend from a domestic corporation other than a corporation that has an election in effect under Code Sec. 936 (Puerto Rico and possession tax credit) will be U.S. source.[78]

A dividend from a foreign corporation will generally be foreign source. However, if 25 percent or more of the gross income from all sources of such foreign corporation for the three-year period ending with the close of its tax year preceding the declaration of such dividend was effectively connected (or treated as effectively connected under Code Sec. 884(d)(2)) with the conduct of a trade or business within the United States (ECI), a portion of the dividend may be treated as U.S. source.[79] For this purpose, this amount will generally bear the same ratio to such dividends as the gross income of the corporation which was ECI bears to the gross income from all sources.

Under Code Sec. 861(a)(2)(C) a dividend from a foreign corporation will also generally be treated as U.S. source to the extent such amount is treated by the recipient corporation under Reg. §1.243-3 as a dividend from a domestic corporation subject to U.S. income taxation.[80] Also, a dividend from a DISC or former DISC (as defined under Code Sec. 992(a)) will generally be treated as U.S. source.[81] A dividend shall have the same meaning as set forth in Code Sec. 316 (dividend defined) and the regulations thereunder.

Notional principal contract. For purposes of chapter 3, the source of notional principal contract income is generally determined by reference to residence of the recipient of the income.[82] A "notional principal contract" is defined as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[83]

Substitute dividend payment. In contrast, a substitute dividend payment made to the transferor of stock in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as actual dividends paid on the transferred stock for purposes of chapter 3.[84] Accordingly, because dividends paid with respect to the stock of a U.S. company are generally U.S. source, if a foreign person lends stock of a U.S. company to another person (or sells the stock to the other person and later repurchases the stock in a transaction treated as a loan for U.S. federal income tax purposes) and receives substitute dividend payments from that other person, the substitute dividend payments are U.S. source and are generally subject to U.S. withholding tax.[85]

A substitute dividend payment is a payment made to the transferor of a security in a securities-lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution that the owner of the transferred security is entitled to receive during the term of the transaction. A securities-lending transaction is a transfer of one or more securities that is described in Code Sec. 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash.[86]

Dividend equivalent payments. Section 541(a) of the HIRE Act adds new Code Sec. 871(m) and will treat a "*dividend equivalent*" as a dividend from U.S. sources for purposes of Code Sec. 881 (and presumably Code Sec. 871), and as a consequence subject to U.S. withholding tax under Code Secs. 1441 and 1442 effective for payments made on any notional principal contract made after March 18, 2012, unless the Treasury determines that contract is of a type that does not have the potential for tax avoidance.[87] The new law specifically references the application of chapter 3 and chapter 4 (dealing with withholding under Code Secs. 1471–1474, as well as makes reference to Code Sec. 4948(a) (dealing with withholding of tax on gross investment income of foreign private foundations subject to the Code Sec. 4948(a) (excise tax).

Under new Code Sec. 871(m)(2), the term "dividend equivalent" will mean:

- any "substitute dividend" made pursuant to a securities-lending or sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S. source dividend;
- any payment made pursuant to a "specified notional principal contract" that (directly or

indirectly) is contingent upon, or determined by reference to, the payment of a U.S. source dividend; and

- any other payment determined by the Secretary to be substantially similar to a "substitute dividend" or a "specified notional principal contract" that is contingent on, or determined by reference to a U.S. source dividend.

For this purpose, a dividend equivalent includes any substitute dividend as defined in Reg. §1.861-3(a)(6).[88] While the HIRE Act has a catch-all for the Treasury to identify transactions substantially similar to payments arising under a notional principle contract, the HIRE Act specifically adds "substitute dividends" to the definition, and then defines a new term, "specified notional principal contract" as a dividend equivalent.[89] In addition, the Treasury may conclude that payments under certain forward contracts or financial contracts are dividend equivalents.[90]

Specified notional principal payment. Under new Code Sec. 871(m)(3)(A), a "specified notional principal contract" means any notional principal contract if:

- in connection with entering into such contract, any long party transfers the underlying security to any short party to the contract (*i.e*., "crossing-in"),[91]
- in connection with the termination of such contract, any short party transfers the underlying security to any long party to the contract (*i.e.*, "crossing out"),[92]
- the underlying security is not readily tradable on an established securities market,[93]
- in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract,[94] or
- such contract is identified by the Secretary as a specified notional principal contract.[95]

In a transition rule, dividend withholding will apply to any equity swap or other arrangements that satisfies each of the identified first four conditions above, or is otherwise identified by the Treasury as such a contract for any payments made after September 14, 2010.

Rental income. Rental income is sourced by reference to the location or place of use of the leased property.[96] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, tangible or intangible.[97]

Royalties or license fees. Royalties are sourced in the place of use (or the privilege of use) of the property for which the royalties are paid.[98] The source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names and franchises.[99]

Classification of transactions involving computer programs. Software generally is protected by copyright laws around the world. Under the United States Model Income Tax Convention, consideration received for the use, or the right to use computer is treated as business profits is the nature of the rights transferred.[100] The primary factor in determining whether consideration received for the use or the right to use computer software is treated as royalties or as business profits is the nature of the rights transferred.[101] The fact that the transaction is characterized as a license for copyright law purposes is not dispositive of the issue. For example, a retail sale of "shrink wrap" software will not be considered to give rise to royalty income even though for copyright law purposes it may be characterized as income.

Compensation for services. Generally, compensation for labor or personal services including fees, commissions, fringe benefits and similar items performed wholly within the United States is gross income from sources within the United States.[102] This rule is applicable regardless of the residence of the payor, the place in which the contract for service was made or the place or time of payment.[103] Compensation for personal services performed in the United States will not be deemed to be income from sources within the United States if:

- the labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the tax year;
- such compensation does not exceed $3,000 in the aggregate; and
  - (i) the compensation is for labor or services performed as an employee of or under contract with a nonresident alien, foreign partnership, or foreign corporation not engaged in a trade or business in the United States, or
  - (ii) an individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership or corporation.[104]

In addition, compensation for labor or services performed in the United States will not be deemed to be income from sources within the United States if the labor or services are performed by a nonresident alien individual in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States.[105]

In the case of compensation for labor or personal services partly within and partly without the United States by a person other than an individual, the part of that compensation that is attributable to the labor or personal services performed within the United States and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on a time basis will be acceptable.[106] In general, the amount of compensation for labor or personal services performed within the United States determined on a time basis is the amount that bears the same relation to the individual's total compensation as the number of days of performance of the labor or personal services by the individual within the United States bears to his or her total number of days of the performance of labor or personal services.[107]

Pension or retirement benefits. Similar to compensation for services, pension, retirement and other fringe benefits are generally sourced where the personal services are performed.

Annuities. Annuities are sourced where the payor resides.

Legal awards or settlements. Legal awards and settlements are sourced where the cause of action arose.

Income from insurance. Under Code Sec. 861(a)(7) insurance premiums or amounts received as underwriting income derived from issuing or reinsuring of any insurance or annuity contract in connection with property or liability arising out of an activity in or in connection with the lives or health of residents of the United States is U.S. source. Thus, insurance underwriting income from insurance or reinsurance of U.S. risks could be subject to withholding tax under Code Sec. 871(a)(1) or 881(a)(1) as U.S. source FDAP income. However, in Rev. Rul. 89-91,[108] the IRS ruled that a foreign insurance company that is not engaged in a trade or business within the United States (ETB) who receives premiums which are subject to the excise tax imposed by Code Sec. 4371 is not subject to tax on such premiums under Code Sec. 881(a) or to withholding under Code Sec. 1442.

It remains to be seen whether the Treasury will follow a similar rationale to avoid the imposition of a withholding tax under Code Sec. 1471(a) or 1472(a) for such insurance underwriting income or take the position that the later provisions are intended to penalize recalcitrant FEs which have not complied with FATCA who are not otherwise excluded FFIs or excepted NFFEs.

Guarantee fees. The U.S. Tax Court in *Container Corp.*[109] recently rejected IRS arguments that fees paid by a U.S. subsidiary to its Mexican parent with respect to guarantees issued by the parent for the debts of the domestic corporation were analogous to interest. The Tax Court held that the payments were more closely analogous to compensation for services, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources. In exchange for the guarantee the U.S. subsidiary paid the Mexican parent corporation a guarantee fee equal to 1.5 percent of the outstanding principal balance of the notes and did not withhold U.S. tax. The IRS argued that the guarantee fee was U.S. source income because it was analogous to interest paid by the U.S. subsidiary and should be sourced based on the residence of the obligor.[110] The U.S. subsidiary argued that the fee was akin to service income and should be treated as foreign source FDAP since the services provided by the Mexican parent company were performed in Mexico.[111] The Tax Court found that the payments were analogous to fees for the performance of services based on the Mexican parent's creditworthiness, goodwill and other assets.

The Small Business Jobs Act of 2010[112] contained in Senate Amendment 4594 to H.R. 5297 overrode the opinion in *Container Corp.* by amending the source rules of Code Secs. 861 and 862 to address income from guarantees issued after September 27, 2010. Under new Code Sec. 861(a)(9) income from sources within the United States includes amounts received, whether directly or indirectly from a noncorporate resident or a domestic corporation for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank owed by the foreign corporation's domestic subsidiary, where the cost of the guarantee is passed on to the domestic subsidiary through for example additional interest charged on the indebtedness. Such U.S. source income also includes amounts received from a foreign person whether directly or indirectly for the provision of a guarantee of indebtedness of that foreign person if the payments received are ECI. A conforming amendment to Code Sec. 862 provides that amounts received from a foreign person, whether directly or indirectly for the provision of a guarantee of that person's debt, are treated foreign source if they are not from U.S. sources under Code Sec. 861(a)(9).

For purposes of this provision, the phrase "noncorporate residents" has the same meaning as for purposes of Code Sec. 861(a)(1), except that foreign partnerships are not included. Payments received from a foreign partnership for the provision of a guarantee of indebtedness of that foreign partnership are U.S. source if the amounts received are connected with the income which is ECI. A conforming amendment to Code Sec. 864 provides that amounts received whether directly or indirectly for the provision of guarantee are deemed to be ECI if it is derived in the active conduct of a banking, financing or similar business. Although the new provision overturns the opinion in *Container Corp.* no inference is intended with respect to the source of the income received for the provision of a guarantee issued before September 27, 2010.

Fails charges on Treasury securities. On December 8, 2010, the IRS issued temporary regulations (T.D. 9508) that are effective on or after this date on the treatment of so-called fails charges or amount paid by one party to another party for failure to deliver U.S. securities. The preamble to these regulations provides in certain situations such as a low interest rate environment, a party to a delivery-versus-payment transaction may lack the economic incentive to deliver Treasury securities in a timely manner. In such instances, the parties may have agreed that if one party fails to deliver Treasury securities at the time specified in the contract, the failing party will pay an amount (a fails charge) to the party entitled to receive Treasury securities. The fails charge is calculated using a formula that takes into account current interest rates and trade proceeds and accrues each day that the failure to deliver continues. The trading practice is generally expected to impose a fails charge whenever the interest rate on a repo that can be settled with any of a variety of securities fails below a certain level. The preamble also points out that some transactions such as a repo where delivery is required both at inception and at settlement can produce more than one fails charge and that in back-to-back transactions it may be difficult to determine whether a party to a fails charge is acting as a intermediary or principal.

Reg. §1.863-10T provides a source rule for qualified fails charges that arise in the delivery-versus-payment market for Treasury securities by providing that the source of the income from a "qualified fails charge" is generally determined by the reference to the residence of the taxpayer that is the recipient of the qualified fails charge income, with two exceptions. First, qualified fails charge income earned by a qualified business unit (QBU)[113] of a taxpayer is sourced to the country in which the QBU is engaged in a trade or business. Second, qualified fails charge income that arises from a transaction that has ECI is sourced in the United States and treated as ECI.

The qualified fails charge must satisfy two requirements. First, it must be paid pursuant to a trading practice or similar guidance approved by a U.S. government agency or Treasury Market Practices Group (which is sponsored by the Federal Reserve Bank of New York) or published guidance by the IRS. Second, the transaction that generates the fails charge must be with respect to a bill, note, or other evidence of indebtedness issued by the Treasury. The preamble also suggests that although there is not currently a fails charge trading practice relating to securities other than Treasury securities, one may be considered in the future for agency securities (including mortgage backed securities), if such practice is widely adopted that the Treasury may consider whether such fails charged should be sourced under these regulations.

Subscription fees. Subscription fees are generally sourced where the data is accessed from server (*e.g.*, subscription fees paid for the use of a U.S.-based server would likely be U.S. source).

Cancellation of debt income. Debt discharge income would generally be sourced to where the payor resides.

Sale of personal property. Gains, profits and income derived from the purchase and sale of personal property will be treated as derived entirely from the country in which the property is sold.[114] Thus, gross income from sources within the United States includes gains, profits and income derived from the purchase of personal property without the United States and its sale within the United States.[115]

Sale of real property. Gross income from sources within the United States includes gain computed under the provisions of Code Sec. 1001 derived from the sale or other disposition of real property located in the United States.[116]

Payments Are "Fixed or Determinable Annual or Periodical Income" or "Gross Proceeds from the Sale or Other Disposition of Any Property of a Type Which Can Produce Interest or Dividends"

Amounts subject to withholding under chapter 3. Code Secs. 881(a)(1) and 871 impose a 30-percent tax on U.S. source income received by nonresident aliens and foreign corporations as "interest (other than OID[117]), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income," which is commonly known as "FDAP" income.

Definition of FDAP. The regulations define FDAP for purposes of chapter 3 as "all income included under Code Sec. 61" except for certain items excluded by the regulations,[118] such as gains on sales of property and insurance premiums paid to a foreign insurer or reinsurer.[119] Thus, at least for purposes of chapter 3 (withholding of tax on nonresident aliens and foreign corporations) any item of income is FDAP income unless it constitutes an item of income that is specifically excluded under the regulations.[120]

Under the regulations, items of income that are excluded from gross income under a provision of the law without regard to the U.S. or foreign status of the owner of the income, such as tax-exempt interest under Code Sec. 103 or qualified scholarship income under Code Sec. 117 will not be treated as FDAP income.[121] Conversely, income excluded from gross income under Code Sec. 892 (income of foreign governments) or Code Sec. 115 (income of a U.S. possession) would be FDAP income since the exclusion from gross income under these sections is dependent on the foreign status of the owner of the income.[122]

Income on notional principal contracts. Under chapter 3, a withholding agent that pays amounts attributable to a notional principal contract described in Reg. §1.863-7(a) or 1.988-2(e) (currency swaps and other notional principal contracts) will have no obligation to withhold on the amounts paid under the terms of the notional principal contract regardless of whether a withholding certificate is provided.[123]

Insurance proceeds. Under chapter 3, income derived by a nonresident alien or foreign corporation from U.S. sources upon the surrender of or at the maturity of a life insurance policy is FDAP and is subject to withholding under Code Sec. 1441 or 1442.[124] This includes income derived under a life insurance contract issued by a foreign branch of a U.S. life insurance company. The proceeds are income to the extent they exceed the cost of the policy. However, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before death (accelerated death benefits) may not be subject to tax under chapter 3. This also applies to certain payments received for the sale or assignment of any portion of the death benefit under contract.[125]

Original issue discount. Under chapter 3, OID is subject to the 30-percent tax only when a payment is made in respect of the OID obligation[126] or upon sale or exchange of the obligation.[127] In both cases, the amount subject to the tax is limited to the accrued and unpaid OID at the time of the payment or sale.[128] However, under Reg. §1.1441-2(a)(6) no withholding is required at the time of the sale of the obligation, on the OID paid as part of the purchase price of an obligation sold or exchanged, other than in redemption of such obligation, unless the purchase is part of a plan the principal purpose of which is to avoid tax and the withholding agent has actual knowledge or reason to know of such plan.[129]

If a withholding agent cannot determine the taxable amount of the OID on the redemption of an OID obligation or on the sale or exchange of such obligation, if the principal purpose is to avoid tax, then it must be withheld upon on the entire amount of the OID accrual from the date of the issue until the redemption date or the date the OID obligation is sold or exchanged determined on the basis of the most recently issued "List of Original Issued Instruments."[130]

Capital gains. In general, capital gains are subject to the chapter 3 withholding tax[131] only if they are (i) gains described in Code Sec. 631(b) (disposal of timber held for more than one year before such disposal under any form or type of contract whereby the taxpayer retains an economic interest in such timber);[132] (ii) gains under Code Sec. 631(c) (disposal of coal, including lignite or domestic iron ore with a retained economic interest mined in the United States and held for more than one year before such disposal);[133] or (iii) gains from the sale or exchange of patents (including but not limited to by reason of Code Sec. 1235-sale or exchange of patents), copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises (excluding Code Sec. 1253 transfers of franchises, trademarks and trade names), or other like property or of any interest in any such property to the extent the gains are from payments (whether in lump sum or in installments) that are contingent on the productivity, use or disposition of the property or interest sold or exchanged or from payments.[134]

Miscellaneous income. Under chapter 3, withholding is not required in the case of any amount received as an annuity if the amount is exempt from tax under Code Sec. 871(f).[135] Periodic guarantee premium payments constitute FDAP within the meaning of Code Sec. 871(a)(1).[136] However, option premiums are not subject to withholding tax under Code Sec. 1441.[137] Payments received for a promise not to compete are FDAP income.[138] Its source is the place where the promisor forfeited the right to act.[139] In addition, U.S, source patronage dividends paid by a cooperative will be treated as FDAP for purposes of chapter 3[140] as well as monthly payments made by a pipeline company to a Canadian syndicate agent for oil sold.[141]

Determination of amount to withhold. An item of income is fixed when it is to be paid in amounts definitely pre-determined. An item of income is determinable if the amount to be paid is not known but there is a basis of calculation by which the amount may be ascertained at a later time. For example, interest is determinable even if the amount is contingent in that its amount cannot be determined at the time of payment of an amount with respect to a loan because the calculation of the interest portion is contingent upon factors that are not fixed at the time of the payment. An amount of income does not have to be determined at the time that the payment is made in order to be determinable. An amount of income which the withholding agent knows is part of the payment it makes but which it cannot calculate exactly at the time of payment is nevertheless determinable if the determination of the exact amount depends upon events expected to occur in the future. In contrast, a payment that may be income in the future based upon events that are not anticipated at the time the payment is made is not determinable. For example, loan proceeds may become income to the borrower when to the extent the loan is cancelled without repayment. While the cancellation of the debt is income to the borrower when it occurs, it is not determinable at the time the loan proceeds are disbursed to the borrower if the lack of repayment leading to the cancellation of part or all of the debt was not anticipated at the time of the disbursement.[142]

Where the withholding agent makes a payment and does not know at the time of the payment the amount that is subject to the determination of the source of the income or the calculation of the amount of income subject to tax depends upon facts that are not known at the time of payment then the withholding agent must withhold an amount based on the entire amount paid that is necessary to assure that the tax withheld is not less than 30 percent or the applicable percentage.[143] For example, the gross amount of stated interest on an interest bearing obligation payable on the interest payment date, regardless of whether the payment constitutes a return of capital or the payment of income may be subject to withholding under chapter 3.

Series or lump-sum payment. It is immaterial whether the payment of an item of income otherwise includable as FDAP is made in a series of payments or in a single lump sum. Similarly, the income need not be paid annually if it is paid periodically, that is to say from time to time. Also, the fact that the length of time during which the payments are to be made may be increased or decreased by someone's will or by the happening of an event does not disqualify the item of income as determinable or periodical.[144]

U.S. or foreign currency. Under chapter 3 a payment includes amounts paid in a medium other than U.S. dollars.[145] Presumably, the Treasury will adopt this rule for purposes of new chapter 4.

Withholdable payment—FDAP. For FATCA purposes, new Code Sec. 1473(1)(A)(i) provides, "[T]he term withholdable payment means any payment of "interest (*including any original issue discount*), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits or income." The language in this clause is identical to the definition of FDAP income under Code Secs. 871(a)(1)(A) and 882(a)(1) with the exception for inserting the highlighted phrase in lieu of using "*other than original issue discount as described in section 1273*."[146] While the scope of withholding under FATCA will no doubt be broader than under chapter 3 (*see* "Gross proceeds from the sale or other disposition of any property of a type which can produce U.S. source interest or dividends," absent future guidance to the contrary it is reasonable to assume that the 10 specific income classes identified under the chapter 3 together with the catch-all language "*fixed or determinable annual or periodical gains, profits or income*" may rely on the body of tax law that has grown up under chapter 3 for these income classes.

Gross Proceeds from the Sale or Other Disposition of Any Property of a Type That Can Produce U.S. Source Interest or Dividends

While in most cases capital gain from the sale of shares will be sourced to the domicile of the non-resident seller,[147] FATCA changes this rule because it includes "gross proceeds from the sale or disposition of any property of a type that can produce interest or dividends from sources within the United States."[148] Thus, the sale of stock or securities by an FFI or NFFE will be sourced based upon the sourcing rules for dividends or interest, respectively.

Background—FIRPTA. In general, gains recognized by a non-U.S. person on the sale of stock of a U.S. corporation that constitutes a U.S. real property interest (USRPI) will be treated as ECI and subject to a net basis tax under Code Sec. 897(a). The term "USRPI" means any interest other than an interest solely as a creditor in either real property or a corporation unless it is established that the corporation was not a real property holding corporation.[149] An interest in real property other than solely as a creditor includes includes fee ownership, co-ownership or leasehold interest in real property. The term also includes any direct or indirect right to share in the appreciation in the value or gross or net proceeds or profits generated by the real property. A loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of or gross or net proceeds or profits generated by an interest in real property of the debtor or of a related person is in its entirety an interest in real property other than as a creditor.[150]

Reportable barter exchanges and gross proceeds of sales of securities or commodities by brokers. Code Sec. 6045(g)(2)(A) requires brokers to report on the gross proceeds of the sale for any covered security on an information return. Reg. §1.6045-1(a)(9) defines the term "sale" to mean "any disposition of securities, commodities, regulated futures contracts, or forward contracts, and includes redemptions of stock, retirements of indebtedness, and entering into short sales … In the case of a regulated futures contract or forward contract a sale is any closing transaction … . Grants or purchases of options, exercises of call options, and entering into contracts that require delivery of personal property or an interest therein are not sales. For purposes of this section only, a constructive sale under Code Sec. 1259 and a mark to market value under Code Secs. 475 and 1296 are not sales."

The instructions to Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions,* indicate a broker must file a Form 1099-B for each person for whom the broker has sold (including short sales) stocks, bonds, commodities, regulated futures contracts, foreign currency contracts (pursuant to a forward contract or regulated futures contract), forward contracts, debt instruments, *etc.* for cash, who received cash, stock or other property from a corporation that the broker knows or has reason to know has undergone a reportable change in control or substantial change in capital structure, or who exchanged property or services through a barter exchange.

Reg. §1.6045-1(a)(14), (15) includes in the term "covered security" any share of stock or any interest treated as stock, including, for example an American Depositary Receipt) in an entity organized as or treated for federal tax purposes as a corporation (foreign or domestic).

Reg. §1.6045-1(a)(5) defines the term "gross proceeds" to be the total amount paid or credited to the beneficial owner's account as a result of the sale of disposition and increased by any amount not paid or credited by reason of repayment of a margin loans. In the case of a closing transaction that results in a loss, gross proceeds are the amount debited to the beneficial owner's account. Under these regulations a broker may, but is not required to, reduce gross proceeds by the amount of commissions and transfer taxes provided the treatment chosen is consistent with the books of the broker.[151]

Gross proceeds from the sale or other disposition. For FATCA purposes, Code Sec. 1473(1)(A)(ii) provides the term "withholdable payment" includes "any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends." The legislative history provides that "the term includes any gross proceeds from the sale or other disposition of any property that could produce interest or dividends from sources within the United States, including dividend equivalent payments treated as dividends from sources in the United States."[152] Until the Treasury issues further guidance it is currently not possible to define the parameters of this new provision. Suffice it to say, one commentator has suggested that inclusion of the phrase "or other disposition" goes far beyond Code Sec. 6045 requirements for withholding domestically on gross proceeds.[153]

Sale or Disposition of U.S. Stock or Securities

Taxable sales or dispositions of U.S. stock or securities. If U.S. stock or securities are sold or disposed of in a taxable transaction by a Nonparticipating FFI or other NFFE it is likely that the gross proceeds attributable to such sale or disposition will be treated as withholdable payments under Code Sec. 1471(a) or 1472(a) whether the U.S. stock or securities are sold at a gain or loss for federal income tax purposes.

Presumably, the Treasury will follow its recent guidance under Code Sec. 6045 and include direct and indirect interests in U.S. stock or securities as economic equivalent of owning the U.S. securities unless the Treasury provides an exception in future guidance.

Direct and indirect nontaxable sales or dispositions of U.S. stock or securities. Since Code Secs. 1471(a) and 1472(a) are intended to penalize Nonparticipating FFIs or other NFFEs, which in the Treasury's view are assisting in U.S. tax evasion, it may not be unreasonable for the Treasury to issue future guidance that attempts to tax nontaxable transactions engaged in by these FEs. Thus, it is an open question whether payments that otherwise may qualify for nonrecognition (subject to the rules under Code Sec. 367 where applicable) will be treated as such for FATCA purposes:

- Code Sec. 354 exchanges of stock in certain reorganizations or recapitalizations
- Code Sec. 351 transfers to corporations controlled by transferors
- Code Sec. 332 complete liquidations of subsidiaries
- Code Sec. 721 nonrecognition of gain on contribution to a partnership
- Code Sec. 731(b) distribution to a partner of U.S. stock or securities
- Code Sec. 1032 exchange of stock for property
- Code Sec. 1035 certain exchanges of insurance policies
- Code Sec. 1037 certain exchanges of United States obligations
- Code Sec. 1036 stock for stock in same corporation
- Code Sec. 1058 transfer of securities under certain agreements

Distributions and other items attributable to U.S. stock that may be treated as an "other disposition" to Nonparticipating FFIs or other NFFEs. It is also possible certain of the following distributions under Subchapter C of the Code may be treated as "withholdable payments":

- Dividends under Code Sec. 301(c)(1)
- Return of capital under Code Sec. 301(c)(2) (Under chapter 3 rules, a distributing corporation or intermediary may elect to not withhold on a distribution (actual or deemed) to the extent it is not paid out of accumulated earnings and profits or currently earnings and profits based on a reasonable estimate.)[154]
- Capital gains under Code Sec. 301(c)(3)
- Redemptions of stock that may be treated as exchanges of stock under Code Sec. 302(a) unless it is essentially equivalent to a dividend (Under chapter 3 rules, a distributing corporation or intermediary may elect not to withhold on a distribution to the extent it represents a distribution in part or full payment in exchange for stock.)[155]
- Distributions subject to the redemption rules under Code Sec. 304 between related corporations (Deemed dividend distributions under Code Sec. 304 resulting from a related party sale or other transaction are subject to chapter 3 withholding tax.)[156]
- Distributions of stock and stock rights or disposition of stock under Code Sec. 305 or 306, respectively (*e.g.*, stock dividends, stock splits, issuance of stock rights, warrants, *etc.*) (Under chapter 3 rules, a distributing corporation or intermediary may elect to not withhold on a distribution to the extent it represents a nontaxable distribution payable in stock or stock rights.)[157]
- RIC or REIT ordinary income and capital gain distributions under Code Sec. 852 or 857 respectively (Under chapter 3 rules, a RIC or intermediary may elect to not withhold on a distribution representing a capital gain dividend or an exempt interest dividend.)[158]
- Disposition of RIC
- Constructive sales of appreciated financial positions under Code Sec. 1259
- Dispositions of USRPIs or REIT shares (Under chapter 3 rules, a U.S. real property holding corporation or a real estate investment trust or intermediary may elect not withhold on a distribution to the extent it is subject to withholding under Code Sec. 1445—withholding of tax on dispositions of USRPIs.)[159]
- Dispositions of Exchange Traded Funds (ETFs) or distributions or ordinary and capital gain distributions from such interests

It is also possible the Treasury may include as "other dispositions" or withholdable payments both taxable distributions (ordinary income and capital gain). as well as distributions which are a nontaxable return of capital even though under some of the above provisions the distribution would not be treated as a "sale or exchange" for purposes of Subchapter C.

Repayment, refinancing or cancellation of U.S. debt. While the repayment and satisfaction of outstanding indebtedness is normally not taxable event for federal income tax purposes, it is possible that the repayment of such indebtedness at face value or at a premium or discount may give rise to a withholdable payment under FATCA. Presumably, a refinancing will be treated as an "other disposition" if it is regarded as a "significant modification," under Reg. §1.1001-3, although other refinancings may also be treated as withholdable payments.

Lastly, debt or equity instruments that are issued as part of a reorganization or recapitalization of U.S. stock or securities may be tainted as withholdable payments. Similarly, if an issuer forgives all or a portion of the debt COD income may arise unless an exception applies.[160] Notwithstanding these exclusions it is possible this forgiveness whether or not taxable to the obligor will be treated as a withholdable payment.

Disposition of U.S. stock or securities held by a foreign partnership, trust or estate directly or indirectly through a U.S. partnership or U.S. trust. If a foreign partnership, trust or estate disposes of U.S. stock or securities directly, or if such FE invests in a U.S. partnership or U.S. trust which itself invests in U.S. stock or securities and has (i) U.S. source FDAP income or gross proceeds from the sale or other disposition of such U.S. stock or securities; (ii) disposes of its partnership or trust interest; or (iii) enters into a disguised sale transaction under Code Sec. 707(a)(2)(B)[161] and directly or indirectly distributes the proceeds, or alternatively distributions the U.S. stock or securities in kind to a Nonparticipating FFI or other NFFE, the Treasury appears to have the statutory authority to treat such payments as withholdable payments under Code Sec. 1471(a) or 1472(a).

Disposition of financial products or hybrid instruments. It is possible the Treasury may also include in the concept of "withholdable payments" payments from various financial products that may produce interest or dividends from sources within the United States, including dividend equivalent payments treated as dividends from sources in the United States. One approach may be for the Treasury to use the same definition, (as expanded by regulatory guidance in the near future) that they decide to use for Code Sec. 6038D for purposes of individual reporting of "specified foreign financial assets" or "SFFAs" on an individual's income tax return if the aggregate value of all such assets exceeds $50,000 beginning for tax years in 2011. Code Sec. 6038D(b)(2)(A) includes "any financial instrument or contract held for investment that has an issuer or counterparty which is other than a U.S. person."

Presumably, forward contracts, repurchase agreements or repos, securities lending—substitute dividends and interest, certain options, various types of derivatives, certain contracts, annuities and many other structured financial products which may be packaged as investment units or wrappers may be swept in under this definition. In addition, it can be expected that withholdable payments under Code Sec. 1471 will include certain payments arising in connection with securities lending and notional principal contracts including (i) rebate fees (interest paid by U.S. lenders), (ii) U.S. source borrow fees paid by U.S. borrowers, (iii) substitute U.S. interest/dividend payments, and (iv) outbound repo spreads (interest).[162]

Payments Are Not Effectively Connected Income

Code Sec. 1473(1)(B) provides any item of income effectively connected with the conduct of a trade or business within the United States that is taken into account under Code Sec. 871(b)(1)[163] or 882(a)(2)[164] will not be treated as a withholdable payment for purposes of the new law (the ECI exclusion).[165] The language in the statute brings with it confusion as to how broad this exemption will be for purposes of FATCA.

Income that is effectively connected with the conduct of a trade or business within the United States or ECI is taxed by the United States on a net basis at regular graduated income tax rates that apply to U.S. persons, and when includable in income by a foreign corporation may also be subject to branch profits tax.[166] In order to have ECI, the first inquiry is whether the foreign person or foreign entity is considered to be engaged in the conduct of a traded or business within the United States (ETB), and second inquiry is whether the income is ECI or FDAP.

ETB. As a preliminary matter, in order to qualify for the ECI exclusion, the foreign entity must be engaged in a "trade or business within the United States," (ETB) even though neither the Code nor the regulations provide a comprehensive definition of the term. The only statutory and regulatory guidance regarding when a foreign entity is ETB relates to the performance of personal services within the United States and special rules relating to banking, financing or similar business activity.[167] Case law and the IRS have adopted a facts-and-circumstances test for determining whether an activity constitutes a U.S. trade or business.[168] The analysis involves both a qualitative and quantitative aspect; that is, both the type and the frequency of the activity conducted by the foreign entity in the United States are taken into account. A foreign person or entity must be significantly involved in a profit-oriented activity in order to be deemed to be ETB[169] and the activities must be considerable, continuous and regular to be treated as ETB.[170]

Under Code Sec. 875 a nonresident alien individual or foreign corporation will be considered as being engaged in a trade or business within the United States if the partnership which such individual or corporation is a member is so engaged.[171] Similarly, a nonresident alien individual or foreign corporation which is a beneficiary of an estate or trust which is engaged in a trade or business within the United States will be treated as being engaged in such trade or business within the United States.[172]

The Committee on Taxation of Business Entities of the New York City Bar in its Report[173] dated May 3, 2007, added some relevant analysis to the ETB issue by stating: "Engaging in two isolated transactions without 'sustained activity' has been held not to constitute a U.S. trade or business.[174] Ministerial and clerical activities that occur in the United States for a business that is otherwise foreign will not cause the Foreign Person to be ETB.[175] Finally, the 'mere management of investments and the collection of rents, interest and dividends' has been held to be insufficient to cause a Foreign Person to be ETB."[176]

Securities and commodities trading safe harbors. Code Sec. 864(b)(2)(A) provides a safe harbor and excludes from the definition of ETB (i) trading in stocks or securities through a resident broker, commission agent, custodian or other independent agent (the "Independent Agent Safe Harbor"); and (ii) trading in stock for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions (the "Nondealer Safe harbor").[177] Reg. §1.864-2(c)(i) defines securities to mean any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase of the foregoing.

According to the NYC Bar Report,[178] the IRS has:

> [S]tated that the definition of security includes financial futures (if they provide a holder a right to purchase the underlying financial instruments), Treasury bond futures, Treasury note futures, Treasury bill futures, and GNMA futures;179 an "evidence of indebtedness" created in purchase funding agreements or sales funding agreements;[180] bankruptcy/trade creditor claims;[181] and futures contracts for 90-day domestic bank certificates of deposit.[182] Certain real estate mortgage investment conduits ("REMICs"), collateralized mortgage obligations ("CMOs"), and financial asset securitization investment trusts (FASITs) also may be considered securities.[183] The term "security" should include regular interests in REMICs, as such interests are debt instruments under Code Sec. 860B(a). Residual interests in REMICs do not appear to be securities, since they are not debt instruments under Code Sec. 860F(e) (which provides, in part, that for purposes of subtitle F, a REMIC is a partnership and holders of residual interests in the REMIC are partners). Mortgage-backed securities, typically called CMOs, should be considered securities provided they are structured as debt instruments or otherwise are debt instruments under Code Sec. 860B. Lastly, under prior law, FASITs which qualified as "qualified debt instruments" and "permitted debt instruments" were considered securities, as they were debt instruments under Code Sec. 860G(b) (now repealed), but a "sole class of ownership interest" that is treated as a partnership interest under repealed Code Sec. 860H(d) most likely was not a security (by analogy to a residual interest in a REMIC as discussed above.

Reg. §1.864-2(c)(2)(c) defines "trading" broadly to include the "effecting of transactions in stocks or securities" including "buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stock or securities, or margin or otherwise, for the account and risk of the taxpayer, and any other closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling or trading). The volume of stock or security transactions effected during the tax year shall not be taken into account in determining" under this provision "whether the taxpayer is engaged in a traded or business within the United States." The IRS includes securities lending transactions[184] and transactions in futures contracts for debt instruments (such as Treasury bonds and Treasury notes).[185]

The NYC Bar Report addressed the treatment of derivatives for purposes of the securities trading safe harbor with the following analysis: "Under the proposed regulations, a Foreign Person which is an eligible non-dealer is not considered to be ETB by reason of effecting transactions in derivatives for its own account, including hedging transactions within the meaning of Reg. §1.1221-2. For these purposes, a derivative includes: ((1) any interest rate, currency, equity, or commodity notional principal contract: and (2) any evidence of an interest, or derivative financial instrument (including any option, forward contract, short position, and any similar financial instrument), in any commodity, currency, share of stock, partnership or beneficial ownership interest in a widely held or public traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, or notional principal contract."[186]

Thus, if the securities (or commodities) trading safe harbors are met by a foreign entity, the income therefrom will not be treated as effectively connected with the conduct of a trade or business within the United States or directly taxed by the United States on a net basis at regular graduated income tax rates that apply to U.S. persons, or exposed to the branch profits tax if the foreign entity is a corporation. However, the ECI exclusion will likely not apply to shelter such income from FATCA withholding if the other inquiries are also satisfied.

ECI. While most income from U.S. sources is automatically ECI for a foreign person or foreign entity that is engaged in ETB,[187] Code Sec. 864(c)(2) includes FDAP and gains from the sale or exchange of capital assets as ECI if two tests are met; namely the asset-use test[188] and the business-activities test.[189] These tests look to the relevant facts and circumstances.[190] Under the asset-use test, a determination must be made whether the income, gain or loss is derived from assets used in, or held for use in the conduct of a trade or business in the United States.[191] Under the business-activities test a determination must be made whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain or loss.[192] Uncertainties still arise as to whether these tests are applied properly to cause the income in question to be ECI from a direct tax viewpoint. However, here again the foreign entity may not be able to secure relief from FATCA withholding.

Code Sec. 953 election to treat RPII Income as ECI. It is possible that a foreign corporation that is an insurance company may be able to secure some relief under the ECI exclusion even if it is not engaged in a U.S. trade or business. Code Sec. 953(c)(3)(C) provides an election to treat Subpart F income that is related person insurance income or RPII, as ECI provided the requirements are otherwise met. RPII is defined under Code Sec. 953(c)(2) as "any insurance income ... attributable to a policy of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a United States shareholder in the foreign corporation or a related corporation to such shareholder." Therefore, only RPII income is eligible for treatment as ECI under this rule and unrelated insurance income may not be ECI absent such characterization of such income as ECI with a trade or business within the United States under Code Secs. 871(b)(1), 882(a)(1) and 864(c). Presumably, RPII income that is eligible for treatment as ECI may qualify for the ECI exclusion under Code Sec. 1473(1)(B), although there is no guidance on this issue yet.

Election to treat real property income as ECI. It is also possible that an FE can avail itself of the ECI exclusion by virtue of certain elections. For example, a nonresident alien or foreign corporation that derives any income from real property located in the United States may elect under Code Sec. 871(d) or 882(d) to treat all such income as ECI. The election may be made whether or not the taxpayer has ETB and it is immaterial that no tax would be imposed on the income by Code Sec. 871(a) or 881(a).[193] The election applies to all income from real property located in the United States including (i) gains from the sale or exchange of such property or interest; (ii) rents or royalties from mines, oil or gas wells, or other natural resources; and (iii) gains described in Code Sec. 631(b) or (c) relating to the treatment of gain on the disposal of timber, coal or iron ore with a retained economic interest. The regulations specify that income from real property or an interest therein does not include, among other items, (i) interest on a debt obligation secured by a mortgage of real property, or (ii) any portion of a dividend that is paid by a corporation or trust, such as a real estate investment trust which derives income from real property.[194]

Application of treaties to exempt ECI from U.S. taxation. In general, various U.S. tax treaties exempt income effectively connected from a U.S. trade or business unless such income is attributable to a permanent establishment.[195] As a general rule, a statute or law which is enacted after a tax treaty will not change the provisions of a tax treaty unless Congress clearly expresses its intent to modify the tax treaty. Neither the statute nor the legislative history[196] address whether income effectively connected with a U.S. trade or business must be subject to U.S. tax in order to be exempt from the definition of withholdable payment under new Code Sec. 1473(1)(B).

More specifically, under Code Sec. 1473(1)(B) how will the Treasury interpret the meaning of the phrase "taken into account"? For example, if the Treasury interprets this phrase narrowly will a FFI or NFFE have in fact to be subject to U.S. taxation and to file a U.S. tax return (*e.g.* Form 1120F) and report the income which is effectively connected to the conduct of a trade or business within the United States, or will the Treasury permit an exception from withholding even if the such U.S. income tax returns are not timely filed or exemption otherwise applies to such income[197] under a tax treaty or U.S. tax law?

The Notice also discusses the ECI exclusion. Thus, payments received by a U.S. branch of a FE that is an FFI may be able to obtain some relieve from being subjected to withholding under Code Sec. 1471(a) with respect to income it takes into account under Code Sec. 871(a) or Code Sec. 882(a). The ECI exclusion does not, however, cover all payments that are made to an FFI's U.S. branch. For example, the ECI exclusion is generally inapplicable to withholdable payments that a U.S. branch of an FFI received on behalf of its account holders, rather than for its own account. The ECI exclusion is also inapplicable to withholdable payments that a U.S. branch of an FFI is paid for its own account and that are not taken into account under Code Sec. 871(b)(1) or Code Sec. 882(a).[198]

Thus, under the ECI exclusion, FATCA withholding may apply, unless the only income the FFI has is income which is effectively connected with the conduct of a trade or business within the United States that is *taken into account* under Code Sec. 871(b)(1)[199] or 882(a).[200] As the Notice points out, the exclusion will not cover the withholdable payments the U.S. branch of an FFI receives on account of its account holders or customers, is also inapplicable to the withholdable payments that a U.S. branch of an FFI is paid for its own account that are not taken into account under Code Sec. 871(b)(1) or Code Sec. 882, and does not cover withholdable payments attributable to any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.

Payments Are Not Made for Goods or Services in the Withholding Agent's Trade or Business (Arm's-Length Exemption)

Code Sec. 1471(c)(2) and the JCT Report[201] prepared by the Staff of the Joint Committee on Taxation provide an exception to the 30-percent withholding tax for any class of payments or persons identified by the Secretary as posing a low risk of U.S. tax evasion. The JCT Report,[202] in the next sentence, provided, "It is anticipated that the Secretary may exclude certain payments made for goods, services or the use of property if the payment is made pursuant to an arm's length transaction in the ordinary course of business."

Notice 2010-60[203] states that the IRS has asked for comments relating to certain classes of payments, such as arm's-length payments made for goods or services in the ordinary course of the "withholding agent's" trade or business.

An example used to support the exemption which has repeatedly been given by commentators is that of a privately held U.K. company licensing software to U.S. users. Many foreign business enterprises such as a privately held U.K. company have a high volume of payments receivable from payors in the ordinary course of business that would be subject to increased documentation obligations under Code Sec. 1472(b), including broad disclosure of ownership information to payors or U.S. customers who may in some cases number in the thousands.

In the recent past, commentators have suggested that for purposes of the arm's-length exemption, regulatory guidelines be established as to what factors should be taken into account and explicit regulatory safe harbors be provided. Some of the factors that have been suggested include the following:

- Whether the payor and the payee are owned or controlled by the same interests for purposes of Code Sec. 482
- Whether the payor used competitive bidding or other reasonable methods with vendors to decide on the products or services purchased
- Whether the vendor provides the product or service to unrelated third parties
- Whether the payor routinely enters into contracts of a similar nature with a variety of providers for the same or a substantially similar product or service

In order that the withholding tax is applied sparingly, commentators have recommended the Treasury specifically exempt other types of payments or recipients that should appropriately be exempted from the withholding process (*e.g.*, bank-to-bank payments, cross-border wire transfers, overnight, short-term and demand credit facilities, letters of credit, revolving credit facilities, license agreements, *etc.*). In addition they have asked the Treasury to exclude accounts payable, installment obligations, commission and brokerage fees incurred in the ordinary course of business between unrelated parties at market rates on the basis that such payments pose a low risk of U.S. tax evasion.

Thus, under the arm's-length exemption (as may be provided in future guidance by the IRS) FATCA withholding may apply, unless all the payments are made for goods or services in the ordinary course of the "withholding agent's" trade or business.

Payor Is a Withholding Agent Under FATCA

Two masters. Professor Dale some 30 years ago nailed the issue on the head with the following unenviable position of a FATCA withholding agent:

> In resolving these uncertainties, the poor withholding agent is rarely a disinterested observer. Not for him the luxury of dispassionate scrutiny of the facts and the law! He is, for example, a tenant paying his landlord, a debtor paying his creditor; a licensee paying his licensor, a corporation paying its shareholder; or a fiduciary paying his beneficiary. To all of these payees he owes some duty. In all likelihood, he also has some relationship with them which prompts him to be very solicitous of their feelings, either out of fear of potential retaliation. If the withholding agent has his way, his loyalty would be straightforward and simple. He would serve only one master—the foreign payee.
>
> Unfortunately, in this life (at least under this Code), the withholding agent is by statute required to attend to the affairs of a second master. Chapter 3 [and now Chapter 4] of the Code mandates that a withholding agent pay over to the United States a portion of such payments made to foreign persons [or nonparticipating FFIs or other NFFEs in the case of Chapter 4]. The withholding agent is made personally and primarily liable for these amounts.[204] For failure to pay them, his liability under the Code is not limited to the amounts he should have paid. Rather, it is also includes interest, penalties, in appropriate cases, and perhaps even criminal sanctions in rare circumstances.[205]
>
> The withholding agent is thus always in tension. He is at the apex of a triangle, being pulled by the foreign payee and the United States, respectively, at the two corners. Facing possible areas of confusion, and held in severe tension between his two masters, a potential withholding agent must nevertheless act. His action (or inaction) will be either right or wrong. In the vast majority of cases, withholding agents are right. Although being right is healthy for them and for the revenue, it is boring here. Rectitude in withholding, like virtue, is its own reward. We will have nothing more to do with it. Pity the poor withholding agent who makes an error. It is his plight to withhold too little or too much … .[206]

Personal liability under chapter 4. Every withholding agent will be personally liable under chapter 4.[207] More specifically, every person required to deduct and withhold any tax under new withholding provisions of Chapter 4 will be personally liable for the tax, as well as interest and penalties.[208] Presumably, voluntary payment by a withholding agent of the tax due under Code Sec. 1471(a) or 1472(a) may mitigate liability for the tax and penalties.[209] However, such person will also be indemnified against claims and demands of any person for the amount of payments made in accordance with the new law.[210] Presumably, the withholding agent will be required to deposit any tax withheld and to file any returns required by the Treasury as part of its responsibilities under the Code Sec. 1471(b) agreement.[211]

Actual knowledge or reason to know. Under chapter 3 a withholding agent must withhold if it has actual knowledge or reason to know that claim of U.S. status or a reduced rate of withholding under Code Sec. 1441, 1442 or 1443 is unreliable or incorrect. A withholding agent will be liable for tax, interest and penalties to the extent provided under Code Sec. 1461 and 1463 if it fails to withhold the correct amount despite its knowledge or reason to know the amount required to be withheld. For purposes of the regulations under Code Secs. 1441, 1442 and 1443, a withholding agent may rely on information or certifications contained in or associated with a certificate other documentation furnished by or for a beneficial owner or payee unless the withholding agent has actual knowledge or reason to know that the information or certifications are incorrect or unreliable, and if based on such knowledge or reason to know it should withhold (under chapter 3 of the Code or another provision of the Code) an amount greater than would be the case if it relied on the information or certificate.[212] Presumably, the IRS will follow these rules for purposes of chapter 4.

Under FATCA, a withholding agent includes all persons, in whatever capacity acting, having the control, receipt, custody, disposal or payment of any withholdable payment.[213] This is expansive and can be interpreted to not only include U.S. payors as withholding agents but foreign entities as well.

In order to answer the question, is the payor or some other person in the transaction a "withholding agent," it is likely the Treasury will look to the existing rules under chapter 3 for purposes of FATCA absent good reasons to look elsewhere. Professor Dale perhaps stated the issue for chapter 3 purposes 30 years ago most succinctly: "Withholding agents, like rabbits, may multiply. For example, a corporation paying dividends may retain a paying agency to disburse its funds. Under appropriate circumstances, both the corporation and the paying agency may incur liability for withholding tax on payments of dividends to foreign persons."[214]

Withholding agents for purposes of chapter 3 rules include (i) a U.S. branch of a certain foreign banks and insurance companies;[215] (ii) controlled foreign corporations (CFCs);[216] (iii) other withholding agents (U.S. payors or U.S. middleman,[217] such as a non-FIs including U.S. persons (*e.g.*, a U.S. citizen or resident, U.S. partnership, U.S. corporation, U.S. estate and U.S. trust, including a foreign branch or office of such person);[218] (iv) qualified intermediaries (QIs); (v) non-QIs (NQIs); (vi) withholding partnerships and trusts (WHPs or WHTs); (vii) certain foreign partnerships;[219] (viii) foreign persons;[220] and (ix) the government of the United States or the government of any state or political subdivision thereof (or any agency or instrumentality of any of the foregoing).[221]

Domestic partnerships, trusts and estates. Under Code Sec. 1441 a domestic partnership, trust or estate is a payee[222] and no withholding will be required on a payment made to such partnership, trust or estate.[223] However, a domestic partnership must withhold when any distributions that include amounts subject to withholding (including guaranteed payments made by a domestic partnership) are made.[224] To the extent a foreign partner's distributive share of income subject to withholding has not actually been distributed to the foreign partner, the U.S. partnership must withhold on the foreign partner's distributive share of the income on the earlier of the date the K-1 is mailed or otherwise provided to the partner or the due date for the return.[225] If a partnership has ECI as defined under Code Sec. 1446(c) for any tax year, such partnership will be required to pay a withholding tax at the highest regular U.S. tax rates unless an exemption applies.[226] Similarly publicly traded partnerships as defined under Code Sec. 7704 that are not corporations that have such ECI will also be required to withhold from a distribution to a foreign partner under Code Sec. 1446.[227]

A U.S. simple trust will be required to withhold on the distributable net income includable in the gross income of the foreign beneficiary to the extent the distributable net income is an amount subject to withholding under Code Sec. 1441.[228] Similarly, a U.S. complex trust and U.S. estate is required to withhold under chapter 3 on the distributable net income includable in the gross income of the foreign beneficiary to the extent such income is subject to withholding under chapter 3 and must withhold even though an amount subject to withholding is not actually distributed.[229]

Although no guidance has been published yet, the Treasury may treat domestic partnerships as withholding agents for purposes of chapter 4, and require these partnerships to withhold on any withholdable payments made to a Nonparticipating FFI or other NFFE unless an exemption applies under Code Sec. 1471(a) or 1472(a).

Entities as withholding agents under chapter 4. Based on the definitional language in Notice 2010-60 a withholding agent may include the following:

- USFIs
- FFIs
- Nonparticipating FFIs
- Exempt FFIs
- Deemed-compliant FFIs
- Entities described in Code Sec. 1471(f)
- NFFEs
- Excepted NFFEs
- Territory-organized FIs[230]
- Other NFFEs
- Other withholding agents

While it is possible the Treasury provides guidance exempting one of more of these classifications of FEs, the Treasury has not given any indication it intends to do so. The regulations under chapter 3 seem to have no problem making a FE a withholding agent:

> FB is a bank organized in country x. FB has a branch in the U.S. FB's branch has customers that are foreign person who receive amount subject to withholding under Code Sec. 1441. FB is a withholding agent and is required to withhold and report for chapter 3 purposes.[231]
>
> USB is a bank organized in the U.S. FB is a bank organized in country x. X has a omnibus account with USB through which FB invests in debt and equity instruments that pay amounts subject to withholding under Code Sec. 1441. FB is non-QI. Both USB and FB are withholding agents.[232] If FB is a QI, same result.[233]
>
> X is a foreign corporation. X pays dividends to shareholders who are foreign persons. Under Code Sec. 861(a)(2)(B), a portion of the dividends are from sources within the U.S. and constitute amounts subject to withholding under Code Sec. 1441.[234]

Multiple withholding agents. Another problem area that the Treasury will likely have to address is what to do about multiple agents. For example, there may be multiple executors or executrixes in an estate or multiple trustees in a trust, multiple custodians, administrators in an investment fund as well as fund managers, brokers and other transfer agents all of whom may be viewed as withholding agents under FATCA absent guidance from the Treasury.

Cascading withholdable payments. Professor Dale also identified a potential problem where there are multiple payors in the chain based upon then tax law 30 years ago applicable to chapter 3 withholding by stating:

> Imagine a chain of unrelated foreign corporations, none of which is doing business within the United States. The first licenses a patent to the second, which sublicenses it to the third, which in turn sublicenses it to a domestic corporation for exploitation within the United States. When the domestic corporation pays royalties to the third foreign corporation, no one has any trouble finding the domestic corporation to be a withholding agent. Much tax planning involves selection of appropriate treaty jurisdictions to reduce or eliminate withholding on this first payment. Not nearly as much attention has been focused on the payments, in turn, by the third corporation to the second, or by the second to the first. Yet, each of these royalties, under our source rules, maintains its U.S. character. Read literally, the Code would impose a 30 percent tax on each of the foreign corporations in the chain, and would make each of the paying corporations, even though foreign, a withholding agent. In Rev. Rul. 80-362,[235] the Service has now confirmed what some had worried about before. Each of the foreign corporations may be a withholding agent despite the fact that it is not engaged in a trade or business within the United States.[236]

The New York State Bar Association Tax Section in its recent report entitled, *Guidance under U.S. Income Tax Treaties,*[237] identified Rev. Rul. 80-362 as an example of published ruling that may merit being revisited by the IRS. The Report points out that the ruling was issued before the adoption of the conduit financing regulations, which would generally treat back-to-back royalties as paid directly by the licensee to the licensor[238] and before the almost-universal inclusion of limitation of benefits articles in U.S. tax treaties. These changes provide substantial protection against the abuse perceived by Rev. Rul. 80-362. Additionally, the ruling was rejected by the Tax Court in the *SDI Netherlands, B.V.* case.[239]

Based upon the foregoing analysis the issue regarding cascading payments is not settled under chapter 3. Now withholding agents and the Treasury will likely have to address how withholding will apply to intermediate foreign entities, which many private equity and other investment funds have used in their portfolio acquisitions. If, as part of the structure there are non–publicly traded back-to-back loans and other arrangements using a special purpose entity in an intermediary jurisdiction (so-called financing arrangements),[240] the IRS may again seek to recharacterize the transaction and ignore the special purpose entities participation in the transaction, which can result in the loss of treaty benefits to claim a reduction in the withholding tax.

Under the existing conduit regulations,[241] a special purpose entity or another intermediate entity's participation in a transaction may be ignored if such participation reduces the withholding tax that would have applied in the absence of such participation, if the intermediate entity participates pursuant to a tax avoidance plan[242] (*i.e.,* a plan designed to avoid the withholding tax) and the intermediate entity is related to the financing entity, or the intermediate entity would not have participated in the transaction on substantially the same terms but for the fact that the financing entity engaged in the transaction with the intermediate entity.

For example, if a foreign investment fund desires as part of a portfolio acquisition to structure a back-to-back financing through a special purpose entity for nontax business purposes and the foreign investment fund also has investors in other jurisdictions that reduces but does not eliminate the U.S. withholding tax, while the special purpose entity is domiciled in a jurisdiction subject to a tax treaty with the U.S. that entitles it to a has a zero rate of withholding, how will the conduit regulations impact the result for purposes of the foreign account withholding provisions? If the transaction is scrutinized by the Treasury under these regulations and it finds tax avoidance constitutes the principal purpose of the financing it is likely that the intermediary would be disregarded for purposes of these provisions.

No Exception Applies

As suggested by Professor Dale,[243] there are likely both "false" and "true" exceptions which may result in a taxpayer being able to cut off FATCA withholding tax. Unfortunately, until the Treasury comes out with future guidance many of the issues discussed below will be unanswered questions.

Possible "True" Exceptions

U.S. source payments are subject to a flat 30-percent tax—not a true exception. Because FATCA is a new tax law there is likely some confusion about whether U.S. source payments will now be subject to a flat 30-percent withholding tax under Code Sec. 1471(a) or 1472(a). This is not the rule. That is, generally FATCA withholding tax will only apply if the income is U.S. source FDAP income, or gross proceeds from property that can produce U.S. source interest or dividends received by a Nonparticipating FFI or other NFFE. However, some U.S. source payments to such FEs may be subject to the ECI exclusion (*see* "Payments are effectively connected income") or may qualify for the arm's-length exemption, which may be provided in future guidance by the Treasury for payments found by the Treasury as posing a low risk of tax evasion (*see* "Payments are not made for goods or services in the withholding agent's trade or business (arm's-length exemption") and therefore not be subject to a 30-percent FATCA withholding, but taxed either on a net basis at the regular tax rates if such income is ECI,[244] or subject to U.S. withholding tax under chapter 3 unless an exemption applies. Presumably, the Treasury will provide guidance to prevent dual withholding taxes on the same income under FATCA (new chapter 4) and the withholding tax on nonresident aliens and foreign corporations (chapter 3).

Foreign source payments will not be a withholdable payment—likely true exception. True exceptions do exist to cut off the FATCA withholding imposed on withholdable payments received by a nonparticipating FFIs or other NFFE. For example, Code Sec. 1473(1)(A), which defines "withholdable payment," requires that the FDAP income and gross proceeds from property of a type that can produce interest or dividends be from sources within the United States.

Thus, one would think that any foreign source income or gross proceeds would not be a withholdable payment under the statute.[245] However, it is not yet clear whether a "passthrough" payment made by a PFFI to a recalcitrant account holder or a Nonparticipating FFI under Code Sec. 1471(b)(1)(D) or by a withholding agent under Code Sec. 1471(b)(3) will carve out foreign source payments, which are made to recalcitrant account holders and Nonparticipating FFIs. For this purpose, Code Sec. 1471(d)(7) defines a "passthrough payment" as "any withholdable payment or other payment to the extent *attributable* to a withholdable payment," and Code Sec. 1471(d)(6) defines a "recalcitrant account holder" as one who (i) fails to comply with reasonable requests for information necessary to determine if the account is a U.S. account; (ii) fails to provide the name, address and TIN of each specified U.S. person and each substantial U.S. owner of a U.S.-owned foreign entity; or (iii) fails to provide a waiver of any foreign law that would prevent the FFI from reporting any information required to be reported.

The FFI has no U.S. financial accounts—likely true exception. Code Sec. 1471(b)(1)(A) requires a FFI "to obtain such information regarding each holder of each account maintained by such institution as is necessary to determine which (if any) of such accounts are United States accounts." The accounts referenced in this provision are "financial accounts." While a full discussion of the meaning of this term is beyond the scope of this article because of its complexity, a follow-up article will provide details on the likely meaning of this term. Suffice it to say, under the statute a "financial account" is defined as follows:[246]

- Any depository account maintained by an FI
- Any custodial account maintained by an FI
- Any equity or debt interest in such FI (other than interests that are regularly traded on an established securities market

Presumably, if an FFI has no U.S. financial accounts or U.S. accounts,[247] it will not be subject to any withholding for the withholdable payments it receives under Code Sec. 1471(a), or for passthrough withholding under Code Sec. 1471(b)(1)(D), although it is possible the Treasury may nonetheless impose reporting or other responsibilities upon such entity as a withholding agent.

The NFFE does not have any substantial U.S. owners—likely true exception. Under Code Sec. 1472(b)(2) if an NFFE obtains certification from its beneficial owner or payee that the beneficial owner does not have any substantial U.S. owners no withholding will apply for any withholdable payments received under Code Sec. 1472(a) although it is possible the Treasury may nonetheless impose reporting or other responsibilities upon such entity as a withholding agent.

Payments made to foreign governments, foreign central bank of issue, certain international organizations or tax-exempt organizations are not withholdable payments—possibly true exception. Under chapter 3, payments to a foreign government, foreign central bank of issue or international organization that are excludable from gross income under Code Sec. 892(b) are exempt from withholding provided documentation establishing eligibility is obtained by the withholding agent.[248]

Reg. §1.1441-1(b)(4)(xvii) also provides an exemption from chapter 3 withholding under Code Sec. 1441, 1442 or 1443 for amounts paid to a foreign organization described in Code Sec. 501(c) to the extent the amount are not income includable under Code Sec. 512 in computing the organization's unrelated business taxable income and which are not subject to the tax imposed by Code Sec. 4948(a) (application of taxes and denial of exemption with respect to certain foreign organizations). In general, no withholding will be required provided the withholding agent obtains a valid W-8 from such organization and either attaches favorable determination letter that is currently in effect from the IRS, or an opinion from U.S. counsel concluding that the organization is described in Code Sec. 501(c) if the organization cannot certify that it has been issued a favorable determination letter.[249]

Under FATCA, payments to a "foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one or more of the foregoing, a foreign central bank of issue or any international organization or any wholly owned agency or instrumentality" will be exempt from tax under Code Secs. 1471(a) and 1472(a).[250] Notice 2010-60 has requested comments for entities identified as posing a low risk of tax evasion pursuant to Code Sec. 1471(f).[251] Presumably foreign tax exempt organizations may fall into this category when the IRS issues future guidance.

Likely "False" Exceptions

Payments exempt under tax treaty will be exempt for FATCA withholding. Under Code Sec. 894 certain payments may be exempted from or subject to a reduced rate of withholding under a treaty obligation of the United States.[252] The United States is a party to at least 57 comprehensive income tax treaties. The regulations under chapter 3 provide procedures on how to claim a reduced (or exempt) rate of withholding under such treaties.[253] In general, a payment to a foreign person is eligible for a reduced rate of withholding under an income tax treaty only if the payment is derived by a resident of a treaty country, such resident is the beneficial owner of the payment and all the other requirements imposed by the income tax treaty are met (*e.g.*, limitation of benefits provisions).[254] For this purpose, a validly completed Form W-8BEN contains the information necessary to support such claim of reduced withholding tax at source.[255]

FATCA provides the following general rule in Code Sec. 1474(b)(1) for purposes of obtaining credits or refunds: "… Except as [otherwise provided], the determination of whether any tax deducted and withheld under this chapter results in an overpayment by the beneficial owner of the payment to which such tax is attributable shall be made as if such tax had been deducted and withheld under subchapter A of chapter 3. " However, it does not permit a withholding agent who pays a withholdable payment to a Nonparticipating FFI or other NFFE to avoid FATCA withholding at source under Code Sec. 1471(a) or 1472(a). Thus, unlike other U.S. withholding tax regimes such as chapter 3 (withholding tax on nonresident aliens and foreign corporations), chapter 61 (Form 1099 reporting and backup withholding of U.S. persons) and chapter 25 (federal income tax withholding), which generally permit a withholding agent to obtain relief from a withholding tax liability, FATCA has no similar provision.[256]

Instead, FATCA generally permits a beneficial owner of a payment who is entitled under a U.S.

treaty obligation to a reduced rate of withholding tax on the payment to be eligible for a credit or refund of the excess of the amount withheld over the amount permitted to be withheld under the treaty. However, this will require at a minimum that the foreign beneficial owners identify themselves and file U.S. income tax returns with the IRS and potentially subject themselves to audit and enforcement proceedings against them by the IRS.[257]

Income exempt under other Code sections will be exempt from FATCA—portfolio interest. Since 1984, the United States has not imposed withholding tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States.[258] Portfolio interest generally includes any interest (including original issue discount) other than interest received by a 10-percent shareholder,[259] certain contingent interest,[260] interest received by a controlled foreign corporation or from a related person,[261] and interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[262]

Under the statute, portfolio interest includes (i) interest paid on any obligation that is in bearer form[263] (not in registered form) and is described in Code Sec. 163(f)(2)(B);[264] and (ii) interest paid on an obligation that is in registered form and with respect to which the U.S. person receives a statement that the beneficial owner is not a U.S. person.[265]

An obligation is not in registered form described in Code Sec. 163(f)(2)(B) if there are arrangements reasonably designed to ensure that such obligation will be sold (or resold) in connection with the original issue) only to a person who is not a U.S. person and interest on the obligation is payable outside the United States and its possessions and the face of the obligation is a statement that any U.S. person who holds the obligation will be subject to limitations under U.S. tax laws.

An obligation is in registered form if the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument, and by either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the holder.[266] The term "portfolio interest" has several exceptions which if applicable may trigger withholding under chapter 3.

Portfolio interest does not include interest received by 10-percent shareholder. First, the term does not include any interest described above which is received by a 10-percent shareholder.[267] For this purpose a 10-percent shareholder means in the case of any obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation and in the case of an obligation issued by a partnership any person who owns 10 percent or more of the capital or profits interest in such partnership after application of Code Sec. 318 as modified by Code Sec. 871(h)(3)(C).[268]

Portfolio interest not to include certain contingent interest. Second, portfolio interest does not include (i) any interest if the amount of such interest is determined by reference to (a) any receipts, sales or other cash flow of the debtor or a related person, (b) any income or profits of the debtor to a related person, (c) any change in the value of any property of the debtor or a related person, or (d) any dividend, partnerships distributions or similar payments made by the debtor or a related person; or (ii) any other type of contingent interest that is indentified by the Treasury where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of federal income tax.[269] "Related person" for this purpose means any person who is related within the meaning of Code Sec. 267(b) or 707(b)(1) or who a party to any arrangement undertaken for a purpose of avoiding this rule.

However, interest will not be treated as contingent interest to any amount of interest (i) solely by reason of the fact that the timing of any interest or principal payment subject to a contingency; (ii) solely by reason of the fact that the interest is paid with respect to nonrecourse debt; (iii) all or substantially all of which is determined by reference to any other amount of interest not described as contingent interest; (iv) solely by reason of the fact that the debtor or a related person enters into a hedging transaction to manage the risk of interest rate or currency fluctuations with respect to such interest; (v) any amount of interest determined by reference to changes in the value of property, the yield on property, changes in any index of the value of the property; or (vi) any other type of interest identified by the Treasury.[270]

Interest received by a bank under a loan agreement in the ordinary course of business. Third, under Code Sec. 881(c)(3)(A) the term "portfolio interest" will not include portfolio interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business, with the exception for an obligation of the United States.[271]

Interest in REMICs. In general, a REMIC is a holding company for mortgages and certain other real property.[272] Interest received on a regular or residual interest in a REMIC qualifies as portfolio interest under Code Sec. 872(h)(2) or 881(c)(2) if the interest satisfies certain conditions under Reg. §1.871-14. A regular interest in a REMIC is not considered interest on any mortgage obligations held by a REMIC. This rule, however, applies only to payments made to the holder of a regular interest from the REMIC and does not apply to payments made to the REMIC. A residual interest in the REMIC is considered to be interest on or with respect to the REMIC and not on or with respect to the residual interest.[273] However, Reg. §1.1441-2(b)(iii)(v) provides that excess inclusion income as described in Reg. §1.860G-3(b)(2) is subject to withholding under Code Sec. 1441.

Interest received by a controlled foreign corporation from a related corporation. Fourth, portfolio interest will not include any portfolio interest received by a controlled foreign corporation from a related person within the meaning of Code Sec. 864(d)(4).[274]

Application of portfolio interest exemption to chapter 4. It is possible the Treasury in future guidance will not apply the portfolio interest exemption or will chose to apply only portion of these exemption rules. Thus, interest which is exempt under the chapter 3 withholding tax rules may be treated as a withholdable payment to a Nonparticipating FFI or other NFFE unless the Treasury provides prescribes guidance otherwise.

Interest paid on registered bonds or bonds held in a dematerialized book entry system. Under chapter 3 the portfolio interest exemption is available for interest paid on a debt obligation that is in registered form,[275] only to the extent that the withholding agent has received a statement made by the beneficial owner of the obligation (or a securities clearing organization, bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business) that the beneficial owner is not a U.S. person.[276]

In addition, under the tax law prior to the HIRE Act the portfolio interest exemption was available for interest paid on an obligation that was not in registered form if it met the foreign targeting requirements of Code Sec. 163(f)(2)(B). Obligations are "foreign targeted" if there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons, interest is payable only outside the U.S. and its possessions, and the face of the obligation contains a statement that any U.S. person holding the obligation will be subject to limitations under U.S. tax law.[277]

The HIRE Act repealed the above treatment of interest paid on bonds that are not in registered form that meet the foreign targeting requirements of Code Sec. 163(f)(2). Thus, interest paid to a foreign person on such obligation is subject to a 30-percent withholding tax under chapter 3, unless the withholding agent can establish that the beneficial owner is entitled to a exemption or reduced rate of withholding under a treaty. The new law also provides that a debt obligation held through a dematerialized book entry system or other book entry system specified by the Treasury will be treated for purposes of Code Sec. 163(f) as held through a book entry system for the purpose of treating the obligation as in registered form and permits the Treasury to exempt bonds for purposes of chapter 3 that are legally in bearer form from U.S. withholding tax.[278]

It is presently an unanswered question whether interest paid on registered bonds or on bearer bonds that are held through a book entry system will obtain relief from FATCA withholding tax if paid to a Nonparticipating FFI or other NFFE.

Interest on bank deposits and interest (and OID) on short-term obligations. For chapter 3 purposes, interest on deposits with foreign branches of domestic banks and savings and loan associations was not treated as U.S. source income, and was thus exempt from U.S. withholding tax (regardless of whether the recipient was a U.S. or foreign person.[279] In addition, interest on bank deposits, deposits with domestic savings and loan associations, and certain amount held by insurance companies were not subject to U.S. withholding tax when paid to a foreign person, unless the interest is ECI.[280]

Similarly, interest and OID on certain short-term obligations are also exempt from U.S. withholding tax when paid to a foreign person.[281] For this purpose, a short-term obligation is defined as any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).[282]

Code Sec. 1473(1)(C) contains a special rule for sourcing interest paid by foreign branches of domestic financial institutions. Under this rule interest paid by foreign branches of domestic financial institutions will be U.S. source for purposes of FATCA. Thus, such interest will likely be treated as a withholdable payment to Nonparticipating FFIs or other NFFEs.

It is presently unclear whether the Treasury will provide an exemption for interest (including OID) on short-term obligations similar to the rule under chapter 3.

No withholding between interest payment dates. Under chapter 3 a withholding agent is not required to withhold upon interest accrued on the date of a sale or exchange of a debt obligation when that sale occurs between two interest payment dates (even though the amount is treated as interest under Reg. §1.61-7(c) or (d) and is subject to tax under Code Secs. 871 or 881.[283] However, this rule does not apply if the sale or securities are part of a plan the principal purpose of which is to avoid tax by selling and repurchasing securities and the withholding agent has actual knowledge or reason to know of such plan.[284] At present it is not clear whether the Treasury will provide a similar exemption for this interest under FATCA.

Rules relating to the 80/20 regime. Prior to the enactment of the Education, Jobs and Medicaid Assistance Act (P.L. 111-226),[285] which was signed into law by President Obama on August 10, 2010, Code Sec. 861(a)(1)(A) provided a special rule that treats interest from a resident alien individual or domestic corporation that meets the 80-percent foreign business requirement as foreign source income and therefore not subject to U.S. withholding tax under chapter 3. In addition, under Code Sec. 871(i)(2)(B), a percentage of any dividend paid by a domestic corporation meeting the foreign business test was also exempt from the 30-percent withholding tax under chapter 3.[286] For this purpose, Code Sec. 861(c)(1) provides a individual or corporation meets the 80-percent foreign business requirements if at least 80 percent of the gross income from all sources of such taxpayer during the three-year testing period is active foreign business income. The term "active foreign business income" is defined as gross income that (i) is derived from sources outside the United States, or in the case of a corporation, that is attributable to income so derived by a subsidiary of the corporation; and (ii) is attributable to the active conduct of at trade or business in a foreign country or possession of the United States by the individual or corporation, or by a subsidiary of the corporation.[287] The three-year testing period is defined as the three-year period ending with the close of the tax year of the individual or corporation preceding the payment, or such part of the three-year period as may be applicable.[288]

P.L. 111-226 repeals the prior law rule that treats as foreign source income all or a portion of any interest paid by a resident alien or domestic corporation that meets the foreign business test. The provision also repeals the present law rule that exempts from U.S. withholding tax all or a portion of any dividends paid by a domestic corporation that meets the foreign business test. The policy rationale for the repeal of the 80/20 regime, which was initially proposed by the administration in 2009, was expressed by the Treasury that the 80/20 regime was subject to manipulation.[289]

80/20 grandfather rule. The provision also provides a grandfather rule for any domestic corporation that (i) meets the foreign business test for the last tax year beginning before January 1, 2011 ("an existing 80/20 company); (ii) meets a new 80/20 test with respect to each tax year beginning after December 31, 2010; and (iii) has not added as substantial line of business with respect to such corporation after the date of enactment of this provision.[290] Any payment of dividend or interest after December 31, 2010, by an existing 80/20 company that meets the grandfather rule is exempt from withholding tax to the extent of the existing 80/20 company's active foreign business percentage. Nonetheless, any payment of interest will be treated as U.S. source income. Commentators have suggested that the grandfather rule provides significant relief from the impact of the repeal of the 80/20 regime for existing, qualifying 80/20 corporations.

While the details of the application of the grandfather rule (and a transitional rule, which is embedded in this rule) are beyond the scope of this discussion, suffice it to say, that this legislation has further muddied the waters. For FATCA purposes, until the Treasury provides guidance it is unclear whether the rules for interest and dividend payments subject to the 80/20 regime, as amended by the P.L. 111-226 grandfather rule will be followed to carve out a portion of such payments as foreign source income for purposes of the FATCA as well. In such case, such payments may be excluded from withholdable payments made to Nonparticipating FFIs or NFFEs.

Insurance premiums subject to excise tax. Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt under Reg. §1.1441-2(a)(7) from chapter 3 withholding if the insurance contract is subject to the excise tax under Code Sec. 4371. Until the Treasury provides guidance it is unclear whether insurance premiums which are subject to the Code Sec. 4371 excise tax will also be subject to tax under Code Sec. 1471(a) or 1472(a) if received by a Nonparticipating FFI or other NFFE.

Transportation income. Code Sec. 887(a) provides that there will be a tax equal to four percent of any nonresident alien individual or foreign corporation's U.S. source gross transportation income. For this purpose, "United States source gross transportation income," or "USSGTI" generally means any gross income that is transportation income to the extent such income is treated as from sources in the United States (excluding U.S. possessions) other than ECI as determined under Code Sec. 887(b)(4).[291]

"Transportation income" is defined as any income derived from or in connection with (i) the use (or hiring or leasing for use) of a vessel or aircraft, or (ii) the performance of services directly related to the use of a vessel or aircraft (or any container used in connection with such vessel or aircraft.[292] Transportation income attributable to transportation that begins and ends in the United States will generally be treated as U.S. source income.[293] Code Sec. 887(b)(4) provides that USSGTI will be ECI unless the (i) taxpayer has a fixed place of business in the United States involved in the earning of the USSGTI, or (ii) substantially all of the USSGTI is attributable to regularly scheduled transportation (or in the case of income from leasing of a vessel or aircraft is attributable to a fixed place of business in the United States.

Importantly, any income taxable under this provision will not be taxable under Code Sec. 871, 881 or 882. It is presently unclear whether the Treasury will permit USSGTI to be exempt from FATCA under the rationale that it is subject to a four-percent excise tax or on the basis that all or a portion of the income is treated as ECI as defined under Code Sec. 887(b)(4).

Distributions of Code Sec. 306 stock. Under Reg. §1.306-3(h) gain on a sale or exchange of Code Sec. 306 stock of a domestic corporation is FDAP income to the extent Code Sec. 306(a) treats the gains as ordinary income. Code Sec. 306 provides that the proceeds from the sale or redemption of Code Sec. 306 stock will be treated as ordinary income or as a distribution of property to which Code Sec. 301 applies.[294] Code Sec. 306 stock is defined under 306(c) and is usually preferred stock received either as a nontaxable dividend or in a transaction in which no gain or loss is recognized.[295] It is presently unclear whether FATCA will follow the chapter 3 rule and include such income as a withholdable payment to a Nonparticipating FFI or other NFFE.

Certain dividends paid by a foreign corporation treated as U.S. source. For purposes of chapter 3 a dividend paid by a foreign corporation that is treated as U.S. source income by reason of Code Sec. 861(a)(2)(B) will be exempt from withholding under Code Sec. 884(e)(3) to the extent the dividend is paid out of earnings and profits for a year in which the foreign corporation was subject to branch profits tax.[296]

While still an unanswered question, it may make some sense for the Treasury to exclude such dividends for FATCA inasmuch as FATCA was not intended to impose a dual tax—in this case the 30-percent branch profits tax and the 30-percent FATCA withholding tax under Code Secs. 1471(a) or 1472(a).

Compensation for personal services. Under chapter 3, FEs that provide personal services that is treated as U.S. source FDAP will be subject to a 30-percent withholding tax unless a treaty otherwise applies or another exception applies.[297] It is possible that the Treasury will follow this rule for purposes of FATCA unless an exemption applies.

Annuity payments. Under chapter 3 withholding is not required in the case of any amount received as an annuity if the amount is exempt from tax under Code Sec. 871(f).[298] For purposes of this provision gross income does not include any amount received as an annuity under a qualified annuity plan described in Code Sec. 403(a)(1) or from a qualified trust described in Code Sec. 401(a) that is exempt under Code Sec. 501(a) if all of the personal services by reason of which the annuity is payable were either (i) personal services performed outside the United States by an individual who at the time of performance of such personal services was a nonresident alien or such personal services described in Code Sec. 864(b)(1) (performance of personal services for foreign employer); and (ii) at the time the first amount is paid as an annuity under the annuity plan or by the trust, 90 percent or more of the employees for whom contributions or benefits are provided are citizens or residents of the United States.[299]

It is presently unclear whether the Treasury will exempt U.S. source annuity payments which are received by a Nonparticipating FFI or other NFFE under Code Sec. 1471(a) or 1472(a).

OID and market discount. Under chapter 3 a withholding agent must withhold on the taxable amount of the OID paid on the redemption of an OID obligation, unless an exception applies (*e.g.*, portfolio interest or treaty relief) and is required on the sale of exchange of such obligation other in redemption to the extent the withholding agent has actual knowledge or reason to know that the sale or exchange is part of a plan the principal purpose of which is to avoid tax.[300] Market discount and option premiums are not FDAP income and are akin to gains on the sale of property under chapter 3. It is unclear whether the Treasury will follow these rules for purposes of FATCA.

Interest on federal and state and local bonds. Under the chapter 3 rules, interest is U.S. source if it is paid by the United States or any agency or instrumentality thereof (other than a possession of the U.S. or an agency or instrumentality thereof), or a state or any political subdivision thereof or the District of Columbia.[301] However, tax-exempt interest under Code Sec. 103 will not be treated as FDAP.[302] It is unclear whether the Treasury will follow these rules and whether it will treat the disposition of such obligations as gross proceeds for purposes of Code Sec. 1473(1)(A)(ii).

Guarantee fees. Under chapter 3 the treatment of guarantee fees as U.S. or foreign source has been a hotly contested issue. In *Container Corp.,* the IRS argued that guarantee fees are in the nature of interest and should be sourced according to the residence of the obligor,[303] while taxpayers have argued that such fees should be treated as the performance of services and sourced based on where such service are performed.[304] Congress overturned this decision in the Small Business Jobs Act of 2010 and effective for a guarantee issued after September 27, 2010, new Code Sec. 861(a)(9) will source such guarantees as U.S. source if paid by a domestic corporation or noncorporate resident or a foreign person if such amount is ECI. For FATCA purposes, it is possible that the Treasury will issue guidance which is consistent with the new source rule under Code Sec. 861(a)(9) to avoid Nonparticipating FFIs or other NFFEs from characterizing such guarantee fees as foreign source and therefore not a withholdable payment.

Certain dividends of regulated investment companies. Code Sec. 881(e)(1)(A) provides that no tax under Code Sec. 881(a)(1) will be imposed on an interest-related dividend received from a regulated investment company (RIC). An interest-related dividend generally means any dividend (or part thereof) that is designated by the RIC as an interest-related dividend in a written notice to shareholders not later than 60 days after the close off the tax year.[305] In addition, no tax will be imposed under Code Sec. 881(a)(1) on any short-term capital gain dividend as defined in Code Sec. 871(k)(2).[306] It is presently unclear for purposes of FATCA if either of these exemptions may apply as applicable to distributions from RICs to Nonparticipating FFIs or other NFFEs.

REIT distributions of or ordinary income and income from REMIC regular and residual interests. Withholding is required under chapter 3 on the portion of the distribution from a REIT that is not designated as a capital gain dividend, a return of basis or a distribution of excess of a shareholder's adjusted basis in the stock of the REIT that is treated as a capital gain under Code Sec. 301(c)(3). A distribution in excess of a shareholder's adjusted basis in the stock of the REIT is, however, subject to withholding under Code Sec. 1445, unless the interest in the REIT is not is a USRPI (*e.g.,* an interest in a domestically controlled REIT under Code Sec. 897(h)(2). In addition, withholding is required under Code Sec. 1445 on the portion of the distribution designated by a REIT as a capital gain distribution.[307] As noted, special rules permit a REMIC to exclude income from a regular or residual income received from a REMIC if certain conditions are met.[308] It is presently unclear how the Treasury will treat distributions from a REIT or interest income from a REMIC regular or residual interests to a Nonparticipating FFI or other NFFE under Code Secs. 1471(a) or 1472(a).

Withholding requires a cash payment—likely false. Under Reg. §1.1441-2(d) a lender of funds who forgives any portion of the loan is deemed to have made a payment of income to the borrower under Reg. §1.61-12 at the time the event of forgiveness occurs. However, the lender will have no obligation to withhold on such amount to the extent that it does not have custody over money or property of the borrower at any time between the time that the loan is forgiven and the due date. A payment received by the lender in partial settlement of the debt obligation does not for this purpose constitute an amount of money or property belonging to the borrower from which the withholding tax liability can be settled.

However, Reg. §1.1441-2(e) adopts a cash-basis rule for purposes of a payment subject to withholding under chapter 3. A payment is considered made to a person if that person realizes income whether or not such income results in an actual transfer of cash or other property. For example, realization of income from COD results in a deemed payment. A payment is considered made when the amount would be made when the amount would be includable in the income of the beneficial owner under the U.S. tax principles governing cash basis method of accounting. A payment is considered made whether it is made directly to the beneficial owner or to another person for the benefit of the beneficial owner (*e.g.*, to the agent of the beneficial owner). Thus, a payment of income is considered made to a beneficial owner if it is paid in complete or partial satisfaction of the beneficial owner's debt to a creditor.[309] The regulations under chapter 3 also provide guidance for specific categories of income to determine if a payment subject to withholding has been made.

Income allocated under Code Sec. 482. A payment is considered made to the extent income subject to withholding is allocated under Code Sec. 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under Code Sec. 482 from a foreign person to a related U.S. person is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the IRS and the agreement eliminates the liability for withholding under Code Sec. 1441. For purposes of determining the liability for withholding, the payment of income is deemed to have occurred on the last day of the tax year in which the transactions that gave rise to the allocation of income and the secondary adjustments, if any took place.[310]

Blocked income. Income is not considered paid if it is blocked under executive authority, such as the President's exercise of emergency power. However, on the date that the blocking restrictions are removed, the income that was blocked is considered constructively received by the beneficial owner and therefore paid for purposes of Code Sec. 1441.[311]

Special rules for dividends. In the case of stock for which the record date is earlier than the payment date, dividends are considered paid on the payment date. In the case of a corporate reorganization, if a beneficial owner is required to exchange stock held in a former corporation for stock in a new corporation before dividends that are to be paid with respect to the stock in the new corporation will be paid on such stock, the dividend is considered paid on the date that the payee or beneficial owner actually exchanges the stock and receives the dividend.[312]

Certain interest accrued by a foreign corporation. A foreign corporation will be treated as having a payment of interest as of the last day of the tax year if it has made an election under Reg. §1.884-4(c)(1) to treat the accrued interest as if it were paid in that tax year.[313]

Application of cash basis principles to chapter 4. As a general matter, the Treasury may follow cash basis principles in determining if a withholdable payment has been received by a Nonparticipating FFI or other NFFE. However chapter 3 extends these principles to include the conveyance of property or rights to control property (or money) directly or through an agent or other intermediary to trigger withholding liability under Code Sec. 1441. Similarly, if the income allocated under Code Sec. 482 or blocked income is released payment is deemed made for chapter 3 withholding purposes based on other tax accounting rules or constructive receipt principles.

Conclusion

While it is not anticipated dual withholding will be required under new chapter 4 (taxes to enforce reporting on certain foreign accounts) and chapter 3 (withholding of tax on nonresident aliens and foreign corporations of the Code, it is likely the Treasury will prescribe coordination rules between the new regime and the earlier U.S. tax withholding rules to avoid duplication of the withholding taxes in the case of any overlap. It is also likely new Code Secs. 1471–1474 will be integrated into the existing reporting and withholding regimes. Thus, to the extent FATCA withholding is not required because one or more of the touch points are not answered in the affirmative in the above described analysis under the "new" rules, taxpayers will still have to continue to apply the "old" U.S. withholding tax rules.

However, it is also likely the information reporting under chapter 3 of the Code will be revamped and integrated into the new chapter 4 information reporting regime. No doubt the Treasury will have to consider each of the relevant reporting and withholding rules under Code Secs. 1441–1443 (dealing with withholding of tax on nonresident alien and foreign corporations), Code Sec. 1445 (dealing with withholding on the disposition of U.S. real property interests), Code Sec. 1446 (dealing with withholding on foreign partners' share of effectively connected income), Code Sec. 3406 (backup withholding) and Code Secs. 6001–6116 (information and returns) as it integrates the new regime into the Code and regulations.

ENDNOTES

* Dean Marsan was a participant on the American Bar Association Tax Section ad hoc committee for the "Comments on H.R. 3933 (H.R 3933, S. 1934) Foreign Account Tax Compliance Act of 2009 (FATCA)," which was submitted by the American Bar Association Tax Section on December 3, 2009, to the U.S. Senate Finance Committee and the House Ways and Means Committee and most recently a participant on the American Bar Association Tax Section FATCA comment committee which submitted "Comments on Foreign Account Tax Compliance Offset Provisions of the HIRE Act," which was submitted to the U.S. The Treasury and the IRS on October 22, 2010 and on the American Bar Association Tax Section ad hoc committee for the "Comments on Dividend Equivalent," submitted to the IRS on October 22, 2010, and on the New York State Bar Association Tax Section "Report on Notice 2010-60," which was submitted to the U.S. The Treasury and the IRS on November 16, 2010.

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1 Letter from Warren Buffett, Chairman of the Board, Berkshire Hathaway, Inc., to shareholders of Berkshire Hathaway Inc. (March 2, 1990).

2 Hiring Incentives to Restore Employment Act (P.L. 111-147) Section 501 (hereinafter, "HIRE Act").

3 H.R. 3933; S.1934 (Oct. 27, 2009).

4 Which is not an excluded FFI, entity described in Code Sec. 1471(f), deemed-compliant FFI, an excepted NFFE or other NFFE.

5 Code Sec. 1471(a).

6 Which is not an excepted NFFE, excluded FFI, entity described in Code Sec. 1471(f), deemed-compliant FFI, nonparticipating FFI or participating FFI.

7 Code Sec. 1472(a), unless the payment is within a class of payments described in Code Sec. 1472(c)(2) (*e.g.*, any class of payments identified by The Treasury as posing a low risk of tax evasion).

8 Code Sec. 1473(4).

9 Code Sec. 1473(1)

10 Harvey P. Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX LAW REV. 49 (1980) (hereinafter referred to as Dale Article).

11 Code Sec. 1441-1464.

12 Dale Article, *supra* note 10, at 53.

13 *See* HIRE Act, *supra* note 2,at Section 501(d)(2).

14 Notice 2010-60, IRB 2010-37, 329 (Sept. 13, 2010).

15 A debt obligation will be treated for U.S. tax purposes as if it has been retired and reissued on the day when the significant modification occurs.

16 *SIFMA Comments on Notice 2010-60,* SIFMA (October 29, 2010), at 30–31.

17 *Id.*, at 31.

18 Reg. §1.1441-1(b).

19 Reg. §1.1441-1(c)(2). Solely for purposes of the regulations under chapter 3, the term foreign person also means, a foreign branch of a U.S. person that furnishes an intermediary withholding certificate described Reg. §1.1441-1(e)(3)(ii) (*e.g.*, Form W-8). Such a branch continues to be a U.S. payor for purposes of chapter 61 of the Code. *See* Reg. §1.6049-5(c)(4).

20 *Id.; see also* Code Sec. 7701(a)(4). Reg. §301.7701-7(a)(2) provides a trust is a U.S. person on any day that the trust meets both the court test and the control test.

21 Code Sec. 7701(30).

22 Code Secs. 1471(d)(4), 1472(d), 1473(5).

23 Reg. §301.7701-2(a).

24 Reg. §301.7701-3.

25 Reg. §301.7701-1(a)(1), (2).

26 *Id.*

27 Reg. §301.7701-1(a)(3).

28 *Foreign Account Tax Compliance Act Provisions in the Hiring Incentives to Restore Employment Act of 2010 ("FATCA") Additional Comments Following Meeting of July 7, 2010*, RBC Financial Group (Sept. 3, 2010).

29 Reg. §1.1441-5(e)(3)(i).

30 Reg. §1.1441-5(e)(3)(ii).

31 Reg. §1.1441-5(e)(2).

32 Reg. §1.1441-5(c)(1)(i).

33 Reg. §1.1441-5(c)(1)(ii).

34 Reg. §1.1441-5(c)(2).

35 Reg. §1.1441-5(c)(2)(iii).

36 *See* Code Sec. 851(a).

37 *Notice 2008-19 and Protected Cell Companies Outside of the Insurance Arena*, New York State Bar Association Tax Section Report (May 2, 2008) (hereinafter, "NYSBA Cell Companies Report"), at 4.

38 *See* James M Peaslee and Jorge G. Tenreiro, *Tax Classification of Segregated Portfolio Companies*, TAX NOTES (Oct. 1, 2007) (hereinafter, "Peaslee & Tenreiro.") Peaslee and Tenreiro note that the Cayman Islands statute explicitly provides that each segregated portfolio is not a separate legal entity, while the Luxembourg statute treats them as separate legal entities.

39 *See, e.g.*, DEL. CODE ANN. §12-3806(b) (statutory trusts); DEL. CODE ANN. §18-215(a) (limited liability companies).

40 NYSBA Cell Companies Report, *supra* note 37, at 9.

41 NYSBA Cell Companies Report, *supra* note 37, at 10; Anguilla (protected cell company), Protected Cell Companies Act, 2004, Barbados (segregated cell company), Division G of the Companies Act Cap. 308. Bermuda (segregated accounts company), Segregated Accounts Companies Act 2000, British Virgin Islands (segregated portfolio company), Part VII of the BVI Business Companies Act, 2004, Cayman Islands (segregated portfolio company), Part XIV of the Companies Law (2007 Revision), Gibraltar (protected cell company), Protected Cell Companies Act 2001. Guernsey (protected cell company), incorporated cell company, Protected Cell Companies Ordinance, 1997, as amended. Isle of Mann (protected cell company), Part VII of the Companies Act 2006, Jersey (protected cell company), incorporated cell company) Companies (Jersey) Law (Amendment No. 8). Mauritius (protected cell company), Protected Cell Companies Act of 1999.

42 *Id.*, at 10. Under Code Sec. 7701(i) a taxable mortgage pool shall be treated as a separate corporation. A taxable mortgage pool is generally any entity (other than a REMIC) if (i) substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein), (ii) such entity is the obligor under debt obligations with two or more maturities, and under the terms of the debt obligations, payments on such debt obligations bear a relationship to payments on the debt obligations referred to in (i).

43 IRB 2008-5, Sept. 13, 2010.

44 Code Sec. 7701(a)(3) and Reg. §301-7701`-2(b)(4) provide that an arrangement that qualifies as an insurance company is a corporation for federal income tax purposes. Code Secs. 816(a) and 831(c) define an insurance company as any company more than half the business of which during the taxable is issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. *See also* Reg. §1.810-3(a)(1).

45 Reg. §1.1446-1(c).

46 Rev. Rul. 71-523, 1971-2 CB 326, *Kohler Co.*, CA-FC, 97-2 USTC ¶50,673, 124 F3d 1451; *Coordinated Issue Maquiladora Industry I.R.C.§1504(d)* (Feb. 25, 1998) .

47 *Id.*

48 Code Sec. 269B(a)(1); Reg. §1.269B-1(a).

49 Code Sec. 269B(e).

50 Code Sec. 269(c)(2),(3).

51 Code Sec. 269(c)(1).

52 Reg. §1.1441-1(b)(2)(ii); Rev. Rul. 69-255, 1969-2 CB 168.

53 Reg. §1.1441-1(b)(2)(iii).

[54] Under Reg. §301.7701-4(e)(5) provides a business entity such a partnership or corporation that is created or organized under the laws of both the United States and in a foreign jurisdiction will be treated as a domestic entity. A business entity is any entity recognized for federal tax purposes that is not properly classified as a trust under Reg. §301.7701-4 or otherwise subject to special treatment under the Code regarding the entity's classification. *See* Reg. §301.7701-2(a).
[55] *Id.*
[56] Reg. §1-1563.
[57] Dale Article, *supra* note 10, at 57.
[58] *E.g.*, Rev. Rul. 55-540, 1955-2 CB 39. The IRS ruling guidelines confirm this difficulty. Rev. Proc. 75-21, 1975-2 CB 715, modified by Rev. Proc. 76-30, 1976-2 CB 647, and Rev. Proc. 79-48, 1979-2 CB 529.
[59] Code Sec. 862(a)(3).
[60] Reg. §1.863-3(b)(2) Ex. 2, implementing Code Sec. 863(b)(2).
[61] Reg. §1.1441-2(a).
[62] Reg. §1.861-2(a)(1) and (2).
[63] *Id.*
[64] Code Sec. 861(a); Reg. §1.861-2(a)(1). Interest paid by the U.S. branch of a foreign corporation is also treated as U.S. source interest under Code Sec. 884(f)(1).
[65] Reg. §1.861-2(a)(2).
[66] Reg. §1.861-2(a)(3).
[67] Reg. §1.861-2(a)(6).
[68] Code Sec. 1232(a).
[69] Reg. §1.861-2(a)(4).
[70] Reg. §1.861-2(a)(5).
[71] Reg. §1.862-1(a)(1).
[72] Code Sec. 861(a)(1)(C).
[73] Code Sec. 861(a)(1)(B); Reg. §1.1441-1(b)(4)(iii).
[74] Code Sec. 1473(1)(C).
[75] Reg. §1.861-2(a)(7); Reg. §1.862-1; Reg. §1.864-5(b)(2)(iii); Reg. §1.871-7(b)(2) and Reg. §1.881-2(b)(2).
[76] *Id.*
[77] Code Sec. 861(a)(2), 862(a)(2).
[78] Code Sec. 861(a)(2)(A); Reg. §1.861-3(a)(2).
[79] Code Sec. 861(a)(2)(B).
[80] Reg. §1.861-3(a)(4).
[81] Reg. §1.861-3(a(5).
[82] Reg. §1.863-7(b)(1).
[83] Reg. §1.863-7(a)(1); Reg. §1.446-3(c)(1).
[84] Reg. §1.861-3(a)(6). This regulation defines a "substitute dividend payment" as a payment made to the transferor of a security in a securities-lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.
[85] For purposes of the imposition of the 30-percent withholding tax, substitute dividend payments (and substitute interest payments) received by a foreign person under a securities lending or sale-repurchase transaction have the same character as dividend (and interest) income received in respect of the transferred security. Reg. §1.871-(7)(b)(2), Reg. §1.881-2(b)(2).
[86] Reg. §1.861-3(a)(6); Reg. §1.862-1, Reg. §1.864-5(b)(2)(iii), Reg. §1.871-7(b)(2).
[87] Code Sec. 871(m)(1).
[88] Staff of the Joint Committee Technical Explanation for the Extenders Act (hereinafter "JCT Report"), at 168.
[89] *Id.*
[90] *Id.*
[91] Code Sec. 871(m)(3)(A)(i).
[92] Code Sec. 871(m)(3)(A)(ii).
[93] Code Sec. 871(m)(3)(A)(iii).
[94] Code Sec. 871(m)(3)(A)(iv).
[95] Code Sec. 871(m)(3)(A)(v).
[96] Code Sec. 861(a)(4).
[97] Reg. §1.861-5.
[98] *Id.*
[99] JCT Report, *supra* note 88, at 22–23; Reg. §1.861-5.
[100] United States Model Technical Explanation accompanying the United States Model Income Tax Convention (Nov. 15, 2006).
[101] Reg. §1.861-18.
[102] Reg. §1.861-4(a).
[103] *Id.*
[104] Code Sec. 861(a)(3).
[105] Code Sec. 861(a)(3) (flush language).
[106] Reg. §1.861-4(b)(1).
[107] Reg. §1.861-4(b)(2)(ii)(E).
[108] Rev. Rul. 89-91, 1989-2 CB 129.
[109] *Container Corp.*, 134 TC No. 5, Dec. 58,131 (2010), *gov't notice of appeal filed* (5th Cir. June 1, 2010).
[110] Code Secs. 861(a)(1) and 862(a)(1).
[111] Under Code Secs. 861(a)(3) and 862(a)(3) payments for the performance of services are generally sourced where the services are performed.
[112] Small Business Jobs Act (P.L. 111-240).
[113] A transaction will be treated as attributable to a QBU if it satisfies the principles of Reg. §1.864-4(c)(5)(iii) substituting QBU for U.S. office. Reg. §1.863-10T(b)(4).
[114] Reg. §1.861-7(a).
[115] *Id.*
[116] Code Sec. 861(a)(5); Reg. §1.861-6.
[117] *OID* as defined in Code Sec. 1273 (determination of the amount of original issued discount).
[118] Reg. §1.1441-2(b)(1).
[119] Reg. §1.1441-2(b)(1)(i), -2(b)(2); Rev. Rul. 2004-75, 2004-2 CB 109 (holding that the income of a nonresident alien individual under a life insurance or annuity contract issued by a foreign branch of a U.S. life insurance company is FDAP income from U.S. sources); Rev. Rul. 2004-97, 2004-2 CB 516 (stating that Rev. Rul. 2004-75 does not apply to payments made before January 1, 2005, pursuant to binding life insurance or annuity contracts issued by a foreign branch on or before July 12, 2004). However, gain on a sale or exchange of Code Sec. 306(a) treats the gain as ordinary income. Reg. §1.306-3(h).
[120] Payments Directed Outside the United States—Withholding and Reporting Provisions under Chapters 3 and 4, Tax Management 915-3rd.
[121] Reg. §1.1441-2(b)(1).
[122] *Id.*
[123] Reg. §1.1441-4(a)(3).
[124] Rev. Rul. 64-51, 1964-1 CB 322.
[125] IRS Publication 515 (Feb. 2010), at 15.
[126] An OID obligation is defined as a bond or other evidence of indebtedness having OID (within the meaning of Code Sec. 1273). *See* Code Sec. 871(g)(1)(A).
[127] Reg. §1.1441-2(a)(6, (b)(3).
[128] Code Sec. 881(a)(3); 871(a)(1)(C).
[129] Reg. §1.1441-2(a)(6).
[130] IRS Publication 1212 (Rev. March 2010).
[131] Code Sec. 871(a)(1)(B), (D); Code Sec. 881(a)(2); Reg. §1.1441-2(c).
[132] Reg. §1.631-2(a)(1).
[133] Reg. §1.631-3(a)(1).
[134] Code Sec. 881(a)(1)(4)); Code Sec. 871(a)(1)(D). Reg. §1.881-2(c)(1), Reg. §1.871-11and Reg. §1.1441-2(b)(2)(i).
[135] Reg. §1.1441-4(d); Reg. §1.1441-1(b)(4)(x).
[136] *Bank of America*, CtCls, 82-1 ustc ¶9415, 680 F2d 142.
[137] Reg. §1.1441-2(b)(2)(i).
[138] *Korfund Co.*, 1 TC 1180 (1943), and Rev. Rul. 74-108, 1974-1 CB 248.
[139] IRS Publication 515, *supra* note 125, at 15.
[140] Rev. Rul. 64-53, 1966-1 CB 206.
[141] *Bowlen*, 4 TC 486 (1944).
[142] Reg. §1.1441-2(b)(iii).
[143] Reg. §1.1441-3(d)(i).
[144] Reg. §1.1441-2(b)(1)(ii).
[145] Reg. §1.1441-2(e)(6).
[146] The JCT Report, *supra* note 88, at 44–45, tracks this language exactly.
[147] Reg. §1.861-7(a).
[148] Code Sec. 1473(1)(A)(ii).
[149] Reg. §1.897-1(d)(2).
[150] *Id.*
[151] Notice 2010-67, IRB 2010-43, at 89, defining the term "gross proceeds" for purpose of basis reporting by securities brokers.
[152] JCT Report, *supra* note 88, at 45.
[153] Laurie Hatton-Boyd, July 26, 2010 Web cast sponsored by KPMG LLP. *See also* Marie Sapirie, *The Treasury Expected to Address FATCA Definitions*, TNT, July 26, 2010.
[154] Reg. §1.1441-3(c)(2)(C).
[155] Reg. §1.1441-3(c)(2)(B).
[156] Rev. Rul. 92-85, 1992-2 CB 69.
[157] Reg. §1.1441-3(c)(2)(A).
[158] Reg. §1.1441-3(c)(2)(D); the amount to be withheld with respect to a distribution by a REIT under Code Sec. 1445 will be equal to 35 percent (or the highest rate specified by Code Sec. 1441(e)(1)) of the amount described in Reg. §1.1441-8(c)(2)(ii). Under this regulation the amount subject to withholding is the amount of any distribution determined with respect to each share or certificate of beneficial interest designated by the REIT as a capital gain distribution multiplied by the number of certificates of beneficial interest owned by the foreign person. If a REIT makes an actual designation of prior distribution in whole or

in part as a capital gain dividend such prior distribution will not be subject to withholding under Code Sec. 1445. Reg. §1.1441-8(c)(2)(C).

[159] Reg. §1.1441-3(c)(2)(E).

[160] *E.g.*, Code Sec. 108(a)(1).

[161] Under Code Sec. 707(a)(2)(B) if there is a (i) direct or indirect transfer of money or other property by a partner to a partnership, (ii) a related direct or indirect transfer of money or other property by the partnership to such partner for another person, and (iii) the transfers described in clauses (i) and (ii), when viewed together are properly characterized as a sale or exchange of property, such transfers will be treated as a sale of property in whole or part to a partner. Reg. §1.707-3 and -6.

[162] William Young, Rom P. Watson and Robert Church, *Securities Lending, Repos, and Derivatives after FATCA,* Executive Enterprise Institute 22nd Annual Forum on International Tax Withholding and Information Reporting, June 17–18, 2010 (New York, New York).

[163] Code Sec. 871(b)(1) provides that a nonresident alien individual engaged in a trade or business within the United States during the tax year shall be taxable as effectively connected with the conduct of a trade or business within the United States.

[164] Code Sec. 882(a)(1) provides a foreign corporation engaged in trade or business within the United States during the tax year shall be taxable on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

[165] Code Sec. 1473(1)(B).

[166] *See* Code Sec. 871(b) for nonresident alien individuals and Code Sec. 882 for foreign corporations; *see also* Code Sec. 884 for branch profits tax. Branch profits tax generally applies at a flat rate of 30 percent and may be reduced or eliminated by an applicable treaty.

[167] Code Sec. 864(c)(2); Reg. §1.864-4(c)(5).

[168] Rev. Rul. 88-3, 1988-1 CB 268, *de Amodio*, 34 TC 894, (06 (1960), *aff'd*, CA-3, 62-1 USTC ¶9283, 299 F2d 623.

[169] *See* JOSEPH ISENBERGH, 2 INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶20:51 (3d. 2002), *C.P. Snell*, CA-5, 38-2 USTC ¶9417, 97 F2d 891, 892.

[170] *Pinchot*, CA-2, 40-2 USTC ¶9592, 113 F2d 718, 719; *Spermacet Whaling & Shipping Co.*, 30 TC 618, 634 (1958), *aff'd,* CA-6, 60-2 USTC ¶9645, 281 F2d 646.

[171] Code Sec. 875(1).

[172] Code Sec. 876(2).

[173] *New York City Bar Report Offering Proposed Guidance Regarding U.S. Federal Income Tax Treatment of Certain Lending Activities Conducted within the US*, New York City Bar Committee on Taxation of Business Entities (May 3, 2007) (hereinafter cited as "NYC Bar Report."), at 3.

[174] *Linen Thread Co.*, 14 TC 725 (1950), compare *Blalanovski*, CA-2, 56-2 USTC ¶9832, 236 F2d 298, *cert. den'd*, SCt, 352 U.S. 986 (1957).

[175] *Scottish American Investment Co.*, 12 TC 49 (1949); *Spermacet Whaling & Shipping Co.*, *supra* note 170.

[176] *Lewenhaupt.*, 20 TC 151 (1953); *Adda*, 10 TC 273 (1948), *aff'd*, CA-4, 49-1 USTC ¶9109, 171 F2d 457, *cert. den'd*, 336 U.S. 952 (1949)

[177] Code Sec. 864(b)(2)(B) provides similar rules to exclude from the definition of ETB (i) trading in certain commodities through a resident broker, commission agent, custodian, or other independent agent; and (ii) trading in such commodities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. This provision shall not apply in the case of a dealer in commodities.

[178] NYC Bar Report, *supra* note 173, at 8.

[179] LTR 8807004 (Nov. 10, 1987).

[180] LTR 8652072 (Sept. 26, 1986).

[181] LTR 8704006 (Oct. 15, 1986).

[182] LTR 8527041 (Apr. 8, 1985).

[183] *See* Paul D. Schumann, *Section 864(b)(2) Safe Harbor Protects Foreign Investors in U.S. Markets*, 6 J. INT'L TAX'N 418.

[184] LTR 9041011 (Jul. 6, 1990).

[185] LTR 8527041 (Apr. 8, 1985). *See* NYC Bar Report, *supra* note 173, at 8.

[186] Proposed Reg. §1.864(b)-1(b)(2).

[187] *See* Code Sec. 864(c)(3). Reg. §1.864-4(b).

[188] Code Sec. 864(c)(2)(A).

[189] Code Sec. 864(c)(2)(B).

[190] Reg. §1.864-4(c).

[191] Reg. §1.864-4(c)(1).

[192] *Id.*

[193] Reg. §1.871-10, Reg. §1.882-2.

[194] Reg. §1.871-10(b)(2).

[195] Reg. §1.871-12.

[196] JCT Report, *supra* note 88, at 45.

[197] Code Sec. 887(b) provides that U.S. gross transportation income does not include any income taxable under Code Secs. 871(b) or 882.

[198] Notice 2010-60, IRB 2010-37, 333 (Sept. 13, 2010).

[199] Code Sec. 871(b)(1) provides that a nonresident alien individual engaged in a trade or business within the United States during the tax year shall be taxable as effectively connected with the conduct of a trade or business within the United States.

[200] Code Sec. 882(a)(1) provides a foreign corporation engaged in trade or business within the United States during the tax year shall be taxable on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

[201] *See Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, The "Hiring Incentives to Restore Employment Act," under consideration by the Senate*," Staff of the Joint Committee on Taxation, JCX-4-10 (February 23, 2010).

[202] *Id.*

[203] Notice 2010-60, IRB 2010-37, at 344 provides, "The Treasury and the IRS contemplate permitting U.S. withholding agents other than USFIs to rely on a foreign entity's certification as to its classification for chapter 4 purposes, absent reason to know that such certification is unreliable or incorrect. These requirements would also apply with respect to withholdable payments made by FFIs and USFIs to NFFEs that are not holders of financial accounts maintained by the financial institution. The Treasury and IRS request comments on the form of such certifications, their renewal provisions, and circumstances under which a withholding agent should not be required to solicit such certifications from certain classes of persons or with respect to certain classes of payments, such as arm's length payments made for goods or services in the ordinary course of the withholding agent's trade or business."

[204] Code Sec. 1461.

[205] If the amounts had actually been withheld by the withholding agent, who then fails to pay them over, the withholding agent will be in possession of a "special fund" in trust to the United States. Code Sec. 7501. For failure, ultimately to pay that trust fund over, criminal liability may sometimes result. Code Sec. 7502.

[206] Dale Article, *supra* note 10, at 76–77.

[207] Code Sec. 1461.

[208] Code Secs. 3406, 6041–6049.

[209] Code Sec. 1463; Reg. §1.1463-1.

[210] Code Sec. 1474(a).

[211] Reg. §1.1461-1(a) and (b).

[212] Reg. §1.1441-7(b).

[213] Code Sec. 1473(4). *See* JCT Report, *supra* note 88, at 44.

[214] Dale Article, *supra* note 10, at 64.

[215] Reg. §1.6049-5(c)(5)(vi) includes a U.S. branch of a foreign bank or a foreign insurance company described in Reg. §1.1441–1(b)(2)(iv) as a payor.

[216] CFCs are U.S. payors as defined in Reg. §1.6049-5(c)(5)(iii).

[217] The terms "payor" and "middleman" have the meanings ascribed to them under Reg. §1.6049–4(a) as:

> Every person who makes a payment of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter) to any other person during a calendar year and every person who collects on behalf of another person payments of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter), or who otherwise acts as a middleman (as defined in paragraph (f)(4) of this section) with respect to such payment.

Reg. §1.6049-4(f) provides the term "middleman" means any person. including a financial institution as described in paragraph (c)(1)(ii)(M) of this section, a broker as defined in section 6045(c), or a nominee, who makes payment of interest for, or collects interest on behalf of, another person, or otherwise acts in a capacity as intermediary between a payor and a payee. For example, a person (other than an issuer of an obligation) who makes payment on an interest coupon of the obligation to another person is a middleman, irrespective of whether such person purchases the coupon for his own account, accepts the coupon as agent for the payee, or otherwise deals with the coupon. The term "middleman" also includes a trustee, including a corporate trustee of a trust where the trust is the payee. *See* Reg. §1.6049–4(c)(2) providing that the trustee does not have to make an information return on Form 1099 to a beneficiary if the trustee is required to file Form 1041 and furnishes Form K–1 to the beneficiary showing the information required to be shown on the form, including amounts withheld under Code Sec. 3406. A person shall be considered to be a middleman as to any portion of an interest payment made to such person which portion is actually owned by another person, whether or not the other person's name is also shown on the information return filed with respect to such interest payment, except that a husband or wife will not be considered as acting in the capacity of a middleman with respect to his or her spouse. A person who, from within the United States, forwards an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States is also a middleman for purposes of this section (but the transfer, although subject to information reporting under this section, does not make the payment subject to backup withholding under Code Sec. 3406). A non-U.S. payor or non-U.S. middleman means a payor or middleman other than a U.S. payor or U.S. middleman.

[218] Code Sec. 7701(30); Reg. §1.6049-5(c)(5)(i).

[219] Reg. §1.6049-5(c)(5)(iv) includes a foreign partnership as a payor, if at any time during its tax year, one or more of its partners are U.S. persons (as defined in Reg. §1.1441–1(c)(2)) who, in the aggregate hold more than 50 percent of the income or capital interest in the partnership or if, at any time during its tax year, it is engaged in the conduct of a trade or business in the United States.

[220] Reg. §1.6049-5(c)(5)(v) includes a foreign person as a payor, if a foreign person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of its tax year preceding the collection or payment (or such part of such period as the person has been in existence), was effectively connected with the conduct of trade or business within the United States.

[221] Reg. §1-6049-5(c)(5)(ii).

[222] Reg. §1.1441-1(b)(2).

[223] Reg. §1.1441-5(b)(1).

[224] Reg. §1.1441-5(b)(2)(i).

[225] *Id.*

[226] Reg. §1.1441-5(b)(2)(i)(B); Code Sec. 1446.

[227] Reg. §1.1446-4.

[228] Reg. §1.1441-5(b)(2)(ii).

[229] Reg. §1.1441-5(b)((2)(iii).

[230] Notice 2010-60, IRB 2010-37, 332 (Sept. 13, 2010). A financial institution organized under the laws of a U.S. territory.

[231] Reg. §1.1441-7(a)(2), Example 4.

[232] Reg. §1.1441-7(a)(2), Example 2.

[233] Reg. §1.1441-7(a)(2), Example 3.

[234] Reg. §1.1441-7(a)(2), Example 5.

[235] Rev. Rul. 80-362, 1980-2 CB 208.

[236] Dale Article, *supra* note 10, at 66.

[237] *Guidance under U.S. Income Tax Treaties*, New York State Bar Association Tax Section Report (May 28, 2010).

[238] Reg. §1.881-3.

[239] *SDI Netherlands B.V.*, 107 TC 161 (1996). The IRS has not acquiesced in SDI Netherlands and Rev. Rul. 80-362 remains outstanding. The language of the typical U.S. tax treaty, which taxes royalties "arising in" the US(and thus differs from the place of use test in sections 861(a)(4) and 862(a)(4)) provides a possible basis for following the SDI Netherlands case in appropriate circumstances. We do not believe that the IRS' position that the Code Sec. 4371 excise tax is a cascading tax (*see* Rev. Rul. 2008-15; and Announcement 2008-18) requires it to take the same position with respect to royalties.

[240] Willys H. Schneider, *Selected United States Tax Issues in Cross Border Securitizations*, 8 Duke J. Comp. & Int'l L. 453 (hereinafter referred to as "Schneider Article"); Reg. §1.881-3(a)(2)(i) defines "financing arrangement" as a series of transactions by which one person (the "financing entity") advances money other property or grants rights to use property and another person (the "financed entity") receives money, other property or rights to use property if the advance and receipt are effected through one or more intermediate entities and (except certain cases involving two or more related persons), there are "financing transactions" including certain debt and equity linking the three entities.

[241] Reg. §1.881-3. Only the IRS may use these rules because taxpayers are not permitted to disregard the form of their transactions. Reg. §1.881-3(a)(3)(iii).

[242] Reg. §1.881-3(b). Tax avoidance will be deemed a principal purpose under the conduit regulations even if it is outweighed by other purposes, and regardless of whether the plan is formal or informal, written or oral. However, the plan must be in existence as of the date the relevant transactions are entered into, and all relevant evidence is weighed in determining whether there is a tax avoidance plan. This evidence includes (i) taking into account whether the participation of the intermediate entity results in a significant reduction of tax; (ii) whether the intermediate entity had sufficient funds available to make an advance without regard to any advance to it; (iii) the time period between the steps in a transaction; and (iv) if the parties are related whether the financing transaction occurs in the ordinary course of integrated trade or business conducted by such parties.

[243] Dale Article, *supra* note 10, at 67–70.

[244] For chapter 3 purposes certain income that is ECI is exempt from withholding under Code Sec. 1441(a). *See* Reg. §1.1441-1(b)(4)(viii).

[245] Under chapter 3, income from foreign sources is exempt from withholding under Code Sec. 1441(a). *See* Reg. §1.1441-1(b)(iv), (v).

[246] Code Sec. 1471(d)(2).

[247] Code Sec. 1471(d)(1) defines the term "U.S. account" to mean any financial account which is held by one or more specified U.S. persons or United States owned foreign entities. Under Code Sec. 1471(d)(3) a "United States owned foreign entity" means any foreign entity which has one or more "substantial United States owners." For this purpose a foreign entity is any entity that is not a "U.S. person." See Code Sec. 1473(5). Under Code Sec. 1473(2) the term "substantial United States owner" means with respect to (i) any corporation, any specified U.S. person which owns, directly or indirectly more than 10 percent of the stock of such corporation (by vote or value); (ii) any partnership, any specified U.S. person which owns directly or indirectly more than 10 percent of the profits or capital interests in such partnership; (iii) any trust, any specified U.S. person treated as an owner of any portion of such trust under the grantor trust rules (Code Secs. 671–679, and to the extent provided by the Secretary, any specified U.S. person that holds directly or indirectly more than 10 percent of the beneficial interests of such trust. In the case of a foreign investment vehicle there is no ownership threshold. For this purpose, such entity is defined under Code Sec. 1471(d)(5)(C) to include any financial institution which is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (as defined in Code Sec. 475(e)(2) without regard to the last sentence thereof), partnership interests, commodities (as defined in Code Sec. 475(e)(2), or any interest (including a futures or forward contract or option) in such securities, partnership interests or commodities. Thus, the 10-percent threshold will be reduced to zero percent under Code Sec. 1473(2)(B).

[248] Reg. §1.1441-1(b)(4)((xi),(xii),(xiii) and (xiv).

[249] Reg. §1.1441-9(a), (b).

[250] Code Secs. 1471(f); 1472(c).

[251] Notice 2010-60, IRB 2010-37.

[252] Reg. §1.1441-1(b)(4)((xv).

[253] Reg. §1.1441-6.

[254] Reg. §1.1441-6(b)(1).

[255] *Id.*

[256] Code Sec. 1463.

[257] Code Secs. 6301 (collection provisions), 6303 (notice and demand), 6321 (liens) and 6331 (levies).

[258] Code Secs. 871(h), 881(c). Congress believed

that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of domestic corporations to raise capital in the Eurobond market (*i.e.,* the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the Treasury direct access to the Eurobond market. *See also* Code Sec. 1441(c)(9), Reg. §1.1441-1(b)(4)(i).

[259] Code Sec. 871(h)(3). A 10-percent shareholder includes any person who owns 10 percent or more of the total combined voting owner of all classes of stock of the corporation (in the case of a corporate obligor), or 10 percent or more of the capital or profits interest of the partnership (in the case of a partnership obligor). The attribution rules of Code Sec. 318 apply for this purpose, with certain modifications.

[260] Code Sec. 871(h)(4). Contingent interest generally includes any interest if such interest is determined by reference to any receipts, sales or other cash flow of the debtor or a related person; any income or profit of the debtor or a related person; any change in the value of any property of the debtor or a related person; any dividend, partnership distributions or similar payments made by the debtor or a related person; and any other type of contingent interest identified by the Treasury regulation. Certain exceptions also apply.

[261] Code Sec. 881(c)(3)(C). A related person includes, among other things, an individual owning more than 50 percent of the stock of the corporation by value, a corporation that is a member of the same controlled group (defined using a 50-percent common ownership test), a partnership if the same persons own more than 50 percent in value of the stock of the corporation and more than 50 percent of the capital interests in the partnership, any U.S. shareholder (as defined in Code Sec. 951(b) and generally including any U.S. person who owns 10 percent or more of the voting stock of the corporation), and certain persons related to such a U.S. shareholder.

[262] Code Sec. 881(c)(3)(A).

[263] Reg. §1.1471-14(c)(1)(i) defines a bearer obligation as an obligation that is not in registered form. *See also* Reg. §5f.103-1(c).

[264] Code Sec. 871(h)(2)(A), Reg. §1.1471-14(b)(1).

[265] Code Sec. 871(h)(2)(B). Reg. §1.1471-14(c)1)(ii).

[266] Code Sec. 881(c)(7); Reg. §1.1471-14(c)(1)(i)(A).

[267] Code Sec. 871(h)(3); Code Sec. 881(c)(3)(B).

[268] Code Sec. 871(h)(3)(B),(C); Reg. §1.871-14-(g).

[269] Code Secs. 871(h)(4)(A),(B); Code Sec. 881(c)(4).

[270] Code Sec. 871(h)(4)(C).

[271] Code Sec. 881(c)(3)(A).

[272] Code Secs. 860A-860G.

[273] Reg. §1.871-14(d)(2).

[274] Code Sec. 881(c)(3)(C).

[275] An obligation is in registered form if (i) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder; (ii) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent; or (iii) the obligation is registered as to both the principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Reg. §5f.103-1(c).

[276] Code Sec. 871(h)(2)(B), (5); Reg. §1.871-14(e). The certification is most commonly made on Form W-8.

[277] Reg. §1.163-5(c)(2)(i)(C) and (D). Reg. §1.1441-2(1).

[278] This rule will also apply to Code Secs. 165(j), 312(m), 871(h), 881(c), 1287 and 4701.

[279] Code Sec. 861(a)(1)(B); Reg. §11441-1(b)(4)(iii).

[280] Code Sec. 871(i)(2)(A), 881(d), Reg. §1.1441-1(b)(4)(ii) and Reg. §1.1441-2(a)(2). If the bank deposits interest is ECI it is subject to regular U.S. income tax rather than withholding tax.

[281] Code Sec. 871(g)(1)(B), Code Sec. 881(a)(3), Reg. §1.1441-1b)(4)(iv); Reg. §1.1441-2(a)(3).

[282] Code Sec. 871(g)(1)(B)(i).

[283] Reg. §1.1441-3(a)(2)(i); Reg. §1.1441-2(a)(5).

[284] Reg. §1.1441-3(a)(2)(ii).

[285] P.L. 111-229.

[286] Reg. §1.1441-1(b)(4)(vi).

[287] Code Sec. 861(c)(1)(B).

[288] Code Sec. 861(c)(1)(C).

[289] *The Treasury Releases Explanation of Obama Administration Revenue Proposals,* 2009 TNT 89-44 (May 12, 2009).

[290] Code Sec. 871(l)(1)(A)

[291] Code Sec. 887(b)(1), (2).

[292] Code Sec. 863(c)(3).

[293] Code Sec. 863(c)(2). There are special source rules for other transportation having a U.S. connection.

[294] Reg. §1.306-1(a).

[295] *Id.*

[296] Code Sec. 1441(d)(1); Reg. §1.1441-1(b)(4)(vii).

[297] Code Sec. 881(a), 871(a); Reg. §1.4441-2(a). Under Reg. §1.1441-4(b) compensation for personal services of a nonresident individual will generally not be subject to withholding if the compensation is ECI and such compensation is (i) subject to withholding under Code Sec. 3402 (relating to withholding on wages), or (ii) another exemption applies.

[298] Reg. §1.1441-1(b)4)(x).

[299] Code Sec. 871(f).

[300] Reg. §1.1441-2(b)(2)(ii).

[301] Reg. §1.861-2(a)(1)(2).

[302] Reg. §1.1441-2(b)(1).

[303] Code Sec. 861(a)(1) and 862(a)(1).

[304] Code Sec. 861(a)(3) and 862(a)(3).

[305] Code Sec. 871(k)(1)(C).

[306] Code Sec. 881(e)(2).

[307] Reg. §§1.1441-3(c)(4)(C) and 1.1445-8.

[308] Reg. §1.871-14(d)(2).

[309] Reg. §1.1441-2(e)(1).

[310] Reg. §1.1441-2(e)(2).

[311] Reg. §1.1441-2(e)(3).

[312] Reg. §1.1441-2(e)(4).

[313] Reg. §1.1441-2(e)(4). If branch interest is paid in one or more tax years before or after the year in which the interest accrues, a foreign corporation may elect to compute its excess interest as if such branch interest were paid on the last day of the tax year in which it accrues, and not in the tax year in which it is actually paid. Reg. §1.884-4(c)(1).