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Foreign 'Blocker' Corporations with No FATCA Documentation

It is extremely common for non U.S. persons to invest in U.S. stocks, bonds, and other U.S.-situs assets (such as U.S. real estate) through a wholly owned, foreign corporation.

Such a foreign corporation, often called a "blocker," is usually incorporated in a no-tax jurisdiction that has no income tax treaty with the United States. This commentary discusses the FATCA rules that apply where a "blocker" owns only stock in U.S. corporations and debt obligations of U.S. persons. The stock or the debt obligations owned by the blocker might or might not be publicly traded.

The FATCA rules in §1471-§1474 (in Chapter 4 of the Code) require that a set of withholding rules which are roughly parallel to §1442 be applied where a "withholdable payment" (as specially defined) is paid to any foreign "entity" that has not provided the U.S. withholding agent with documentation that satisfies the FATCA requirements. Significantly, the term "withholdable payment" includes U.S.-source interest even if it otherwise qualifies for the portfolio interest exemption in §881(c) - unless the debt obligation is a pre-7/1/14 "grandfathered obligation" - and starting on January 1, 2017, the term also includes gross proceeds from the sale or exchange of U.S. stocks and debt obligations. In a manner similar to the backup withholding rules of §3406, FATCA withholding is imposed at the rate of 30% on gross income and, after December 31, 2016, on gross proceeds. Although in many cases the foreign entity may claim a refund of the FATCA-withheld tax if the amount withheld exceeds the amount that would have been withheld under §1442, as a general rule if the entity is a "nonparticipating foreign financial institution" (as defined in Reg. §1.1471-1(b)(82)), it may not be able to claim a refund unless it is resident in a tax treaty country.

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The first phase of the FATCA rules finally took effect on July 1, 2014. Except for gross proceeds from the sale of designated U.S.-situs assets, 30% withholding started on July 1, 2014, under §§1471 and §1472 with respect to "withholdable payments" for which the foreign entity realizing the income had not provided the U.S. withholding agent with documentation that complied with the FATCA rules.

The Form W-8BEN that a blocker corporation has historically completed required only that the entity certify that it was a "foreign person" that was classified as a "corporation." Because of the extreme complexity of the FATCA rules, however, effective July 1, 2014, a foreign corporation that wishes to comply with FATCA must determine its status either as a "foreign financial institution" (FFI) or as a "non-financial foreign entity" (NFFE) under §1471 and §1472, and also which one of the many FFI or NFFE categories it falls within. Depending on how the foreign corporation is classified, in many cases it must file additional documentation directly with the IRS and/or provide additional information about itself and about certain other persons (especially U.S. persons) who are related to it in some manner. Once a foreign corporation has completed a proper Form W-8BEN-E, that form will be effective for purposes of both §1442 (Chapter 3) and FATCA (Chapter 4), and if the corporation has previously filed a pre-FATCA Form W-8BEN with the particular withholding agent, the new Form W-8BEN-E will replace it.

It is clear under the law that where a foreign blocker has never provided proof of its foreign status to a withholding agent prior to July 1, 2014, but wishes to do so on or after that date, the new Form W-8BEN-E must be used for §1442 purposes as well as for FATCA purposes. In addition, if the blocker owns its U.S. securities through an account that is maintained with an FFI, in most cases the FFI will have been attempting to obtain the FATCA-required documentation from the blocker prior to July 1, 2014. But what happens if the blocker owns its U.S. securities directly in its own name or through an account with a U.S. financial institution, and has not provided the relevant U.S. withholding agents with Form W-8BEN-E in order to inform them of its status for FATCA purposes? The instructions to the pre-FATCA Form W-8BEN indicated that it was valid for three years, but that in many cases it was valid indefinitely if the foreign person provided a TIN. Did pre-existing Forms W-8BEN issued by foreign corporations (and other foreign "entities") become invalid on July 1, 2014, and, if so, did those foreign corporations become "undocumented" on July 1, 2014, and thus subject to backup withholding under §3406 not only on U.S.-source dividends and interest but also on gross proceeds from the sale or exchange of U.S. stocks and bonds?

The final FATCA regulations appear to deal with this issue indirectly, although they do not specifically state that a pre-existing Form W-8BEN that has not expired will continue to be valid for Chapter 3 (§1442) purposes. Reg. §1.1471-3(d)(1) provides that a pre-existing Form W-8BEN that has not expired may be relied upon for FATCA purposes if the withholding agent has certain additional documentation that is reliable concerning the foreign payee's probable FATCA status. The regulations do not say what happens for §1442 purposes if the withholding agent has no supplemental information at all from the foreign payee, but the strong implication is that the existing Form W-8BEN is still effective for §1442 purposes, even though in this situation it is clearly not effective for FATCA purposes. In addition, Reg.§1.1471-3(f)(4) establishes a presumption that if a withholding agent cannot determine on the basis of a "valid withholding certificate" (or other "valid documentary evidence") what status a foreign "entity" has for FATCA purposes, the entity is presumed to be a nonparticipating FFI - and not a completely undocumented entity that would thus be subject to backup withholding under §3406. Because the FATCA rules are so extraordinarily complex, however, undoubtedly there are many U.S. withholding agents who will be skittish about this issue and who may wish to apply the backup withholding rules of §3406 if they do not have a new Form W-8BEN-E from those foreign payees who indicated on their original Form W-8BEN that they were a "corporation." Unfortunately, the 2014 edition of IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities, has not yet been published as of this writing, and the 2013 edition contains only a brief mention of FATCA and a link to the FATCA portion of the IRS website. Not surprisingly, however, the FATCA portion of the IRS website contains numerous IRS documents, and in addition those documents do not appear to focus on this specific issue.

If it is assumed, however, that a withholding agent is properly advised and continues to respect a foreign blocker's unexpired Form W-8BEN for §1442 purposes but not for FATCA purposes, what is the practical effect for a blocker whose only U.S. investments are in stocks and bonds?

U.S.-source dividends - 30% withholding will be imposed under FATCA, the same as the 30% rate that is imposed under §1442 (because the blocker is resident in a country without a U.S. income tax treaty). Because duplicate withholding cannot be imposed under both §1442 and under FATCA, there will be no additional U.S. tax on the blocker as the result of its undocumented FATCA status.

U.S.-source interest - Although FATCA can be imposed on U.S.-source "portfolio interest" that is exempt from §1442 withholding,

if the debt obligation qualifies as a pre-7/1/14 "grandfathered obligation," no FATCA withholding will be imposed.

However, if the blocker purchases newly issued debt obligations on or after July 1, 2014, or if a pre-7/1/14 debt obligation is "materially modified" on or after July 1, 2014, 30% FATCA withholding will be imposed on interest that is paid on that debt, even if it is portfolio interest for §881(c) purposes. If FATCA withholding is imposed on portfolio interest, the blocker will then want to consider filing a refund claim with the IRS, provided that, before doing so, it furnishes all its missing FATCA documentation to the IRS (and to any withholding agents who will continue to be making "withholdable payments" to the blocker). Based on the detailed refund procedures set forth in Reg. §1.1474-5, the only situation in which the blocker would be prevented from claiming a refund would be if it were a "nonparticipating FFI" that is not resident in a country having an income tax treaty with the United States.

Gross proceeds from the sale or exchange of U.S. stocks and bonds - Because FATCA withholding on gross proceeds from the sale or exchange of U.S. stocks and bonds will not begin until January 1, 2017, the blocker's existing Form W-8BEN can be relied upon to avoid both FATCA withholding and backup withholding under §3406. Note that the exemption from FATCA withholding will apply until January 1, 2017, even if the debt obligation is newly issued after June 30, 2014 (or is pre-7/1/14 debt that is "materially modified" after June 30, 2014), and thus is not a "grandfathered obligation," whether or not it also happens to be "portfolio debt."

In light of the massive publicity that has accompanied the introduction of FATCA, one might ask how there could be any foreign blockers that have not yet replaced their pre-FATCA Form W-8BEN with a new Form W-8BEN-E. As suggested by the examples immediately above, many foreign blockers may be fully informed about FATCA but may simply have delayed updating their documentation - especially since the examples just given suggest that for many blockers there may be little or no practical effect until at least January 1, 2017 (or until their existing Form W-8BEN expires, if sooner). But many blockers may simply not be aware of the new rules, including blockers that are managed by one or more foreign family members rather than by an institutional trust company. The U.S. payor may also be unaware of the FATCA rules, especially if the payor is a privately held U.S. company and/or a U.S. borrower that does not have a tax advisor that is familiar with international taxation.

Although a discussion of when a blocker might be classified as an FFI or as an NFFE (and into which category of FFI or NFFE the blocker fits) is beyond the scope of this commentary, it should be noted that the FATCA regulations appear to expand the scope of

the statute for many blockers that are owned solely by one or more members of a foreign family. Thus, while it might be assumed from the language of §1471 and §1472 that a closely held blocker that is owned and managed solely for the benefit of a single foreign family would be classified as a passive NFFE, if the blocker is "managed" by an entity that itself is an FFI - such as an institutional trust company - the regulations classify the blocker itself as also being an FFI. A blocker will also be classified in most cases as an FFI if it is owned by a foreign trust that has an FFI as its trustee.8 As discussed above, for the time being the FFI/NFFE distinction may not matter except for interest paid on "portfolio debt" that is newly issued (or materially modified) on or after July 1, 2014. However, the distinction will clearly become much more important on and after January 1, 2017, when gross withholding starts under FATCA, because a nonparticipating FFI with no tax treaty protection will not be able to recover the 30% withholding tax on gross proceeds that applies then.

In the meantime, however, it would certainly be helpful if the IRS could expedite the publication of its 2014 edition of Publication 515, and in addition make absolutely clear (perhaps in a special IRS Notice) that a pre-7/1/14 Form W-8BEN will continue to be effective according to its terms for §1442 purposes, even though it clearly will not be effective for FATCA purposes.