

# The UK/US IGA and passthru payments

## What is attributable?

Helen Parry, a senior regulatory intelligence expert at [Thomson Reuters](#), outlines the process for meeting Foreign Account Tax Compliance Act compliance and reporting standards, addresses the impact of intergovernmental agreements and provides explanations of some key rules

### The role of the Organisation for Economic Co-operation and Development (OECD)

In July 2012, the US Department of Treasury released two versions of a model intergovernmental agreement (IGA) designed to ease the implementation of the Foreign Account Tax Compliance Act (Fatca) and improve tax compliance. Based on the approach discussed in the Joint Statement between the US and the Group of Five (G-5) countries – the UK, France, Germany, Italy and Spain – the IGA was warmly welcomed by the OECD. The IGA is a significant step towards the organisation’s goal, which is the creation of a common tax compliance system to help reduce costs and increase benefits for both governments and business, and would include the development of due-diligence standards for financial institutions.

### The Fatca reciprocal model agreement

Fatca requires financial institutions outside the US to report information on US account holders to the US Internal Revenue Service (IRS). Those that fail to comply may be subject to a 30% withholding tax, and account holders who fail to provide the information sought by such institutions may be liable to a 30% withholding tax on certain types of US sourced income.

The UK/US agreement is based on the reciprocal IGA between the US and the G-5 countries, which was one of the two variants of model agreement, the other being a non-reciprocal model agreement.

### Benefits of the UK/US agreement

A consultation document issued by the British tax agency, HM Revenue and Customs (HMRC), highlights a number of benefits that will help ease the compliance burden for UK financial institutions, including:

- Deadline for new account opening procedures pushed back by one year
- Legal barriers to compliance addressed
- Due-diligence requirements aligned to existing obligations
- Withholding tax not imposed on income received by UK financial institutions

- Financial institutions not required to withhold tax on payments they make
- A wider scope of institutions and products effectively exempt from Fatca requirements
- HMRC to receive additional information from the IRS to enhance its compliance activities.

### New account opening timeline put back one year

The IGA has delayed the deadline for implementing new account opening procedures to enable foreign financial institutions (FFIs) to conform to Fatca reporting obligations by one year to January 1, 2014. It states that, with regard to accounts that are opened on or after January 1, 2014, a financial institution must determine whether an individual or an entity falls into a reportable category. Following this agreement, the IRS has announced that this delay will apply across the board and not just to UK financial institutions.

### Reporting to the domestic fiscal authority

The IGA permits FFIs to report directly to their respective tax authorities instead of reporting on their US accounts to the IRS. This addresses legal obstacles to implementation deriving from legislation such as the Data Protection Act.

### Grandfathering of foreign passthru payments

The IRS received comments to the effect that obligations that may give rise to foreign passthru payments but not to withholdable payments should be treated as grandfathered obligations if they were executed prior to the issuance of final regulations defining foreign passthru payments. This would exempt interest and gross proceeds from the sale or other disposition of such obligations from Fatca requirements.

### Passthru payments

Passthru payments defined as any withholdable payment or other payments to the extent attributable to a withholding payment, include:

- payments of interest
- dividends
- rents
- salaries
- wages
- other fixed or determinable annual or periodical (FDAP) gains profits and income, if such income is from sources within the US.
- premiums
- annuities
- compensations
- remunerations
- emoluments

The notion of withholdable income also covers gross proceeds from the sale or other disposition of any property that can produce interest or dividends from sources within the US.

### Foreign passthru payments – still undefined

The Fatca draft regulations provide that foreign passthru payments are passthru payments that are not withholdable payments. This must mean, therefore, that they are payments to the extent attributable to passthru payments. However, there is no definition of ‘attributable to’ in the Fatca legislation and no definition of ‘foreign passthru’ payments in the draft regulations.

### Directly traceable concept rejected

Notice 2011-34 states that the US Department of Treasury and the IRS sought feedback from the industry on possible methods that could be used to determine whether payments were attributable to withholding payments. Proposals included a suggestion that payments attributable to a withholdable payment should include only a payment directly traceable to a withholdable payment, such as a credit default swap where the reference entity is a US corporation. This would still permit investors to avoid Fatca’s withholding tax by directly investing in a non-participating FFI (non-PFFI) that, in turn, had invested in a ‘blocker’ participating FFI (PFFI) that derived US source income from, for example, investment in US securities.

### What is a blocker entity?

In the Fatca context, a blocker can be broadly defined as an entity of which the primary business is to re-characterise US source income as foreign source income. For example, the hypothetical Corniche hedge fund, an offshore fund and PFFI, invests in US securities. In this context, it has entered into an agreement with the IRS to supply the required information about the US source income of its investors. Another offshore fund, the hypothetical Côte d’Azur hedge fund, invests in Corniche and a putative US tax evader invests in the Cote d’Azur fund.

Any payments from Corniche to the Côte d’Azur would be foreign-to-foreign payments not subject to withholding under Fatca. Similarly, any payment of interest or dividend from Côte d’Azur to the US tax evader would also come from a foreign source. The concern was that such blocker structures could be set up by tax planners using a PFFI blocker between US investments, non-PFFIs and US tax cheats. The passthru provision is designed to address such concerns.

### A blocker structure set up to avoid Fatca requirements

It has the potential to describe as US sourced income that which would

otherwise be a foreign source payment as it passes through to a non-PFFI or a recalcitrant account holder within such a blocker structure. The participating offshore fund may, however, not hold only US assets but may hold a portfolio of a variety of US and non-US assets.

### The passthru payment percentage

Institutions will not be obliged to trace passthru payments specifically to recalcitrant account holders or non-PFFIs. The amount of the passthru payment will be based on a passthru payment percentage, which is calculated by dividing the sum of the FFI’s US assets held on each of the last four quarterly testing dates by the sum of the FFI’s total assets on those dates. In the example, the calculation of passthru payments made by a PFFI where a payment to a non-PFFI consists of some withholdable and some non-withholdable payments would be  $W + (PP \times PPP)$  where:

- *W* is the amount of the payment that is a withholdable payment
- *PP* is the amount of the payments that is not a withholdable payment
- *PPP* is the passthru percentage.

### Withholdable payments under the IGA

Under Article 4 of the IGA, reporting financial institutions will be treated as complying with Fatca and not subject to withholding with regard to FDAP income if such an institution complies with the reporting requirements under Paragraph 2. Furthermore, such institutions will not be required to withhold tax with regard to an account held by a recalcitrant account holder. If a reporting financial institution makes a payment of US source withholdable income, it must provide the immediate payer of such a source payment with the information required for withholding and reporting to occur.

### Gross proceeds and passthru payments

The notion of a withholdable payment contains three elements – FDAP income, foreign passthru payments and gross proceeds from the sale or other disposition of any property that can produce interest or dividends from sources within the US. The IGA has specifically reached an arrangement to address only the FDAP element of the definition. However, Article 6.2 provides that the parties are committed to work together, along with other partners, to develop a practical and effective alternative approach and to achieve the policy objectives of foreign passthru payment and gross proceeds withholding that minimises the burden on firms. This is linked to the reporting requirements, which do not mandate the reporting of gross proceeds until some point in 2017, under Article 2.

### Fatca preparation – start now

The advantage of the model IGA is that it can be applied by other jurisdictions, and further agreements with the US is expected. However, it is important to note that, although these agreements will help to significantly reduce the reporting and compliance obligations under the Fatca requirements, stand-alone FFIs and other multinationals may still find it a challenge to meet all the requirements of Fatca within the required time frame. Despite the pushing back deadlines and easing of compliance processes, they are advised to begin preparation as soon as possible.