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Insights Into Recent Regulatory, Judicial and Legislative Developments

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The Sourcing of Guarantee Fees under U.S. Income Tax Treaties

Section 861(a)(9)

The recently enacted Small Business Jobs Act of 2010, P.L. 111-240, added section 861(a)(9), which effectively reverses the Tax Court's holding that guarantee fees are sourced to the residence of the guarantor.

The Tax Court held earlier this year in *Container Corp. v. Comm'r*, 134 T.C. No. 5 (2010), that guarantee fees paid by a U.S. company to its Mexican parent were foreign source income and, therefore, not subject to U.S. withholding taxes. The court determined that the guarantee fees at issue were more analogous to payment for services (source of income from services is determined by reference to the service provider's location) than to interest (source of interest income is determined by reference to the obligor's place of residence) and, therefore, should be sourced as foreign source income.

The amendment applies to guarantees issued after September 27, 2010, and received directly or indirectly from "a noncorporate resident or domestic corporation for the provision of a guarantee of any indebtedness of such resident or corporation." It treats the fees as U.S.-source income subject to a 30 percent withholding tax. The statute does not deal with the characterization of the guarantee payment as either a payment in respect of services rendered or as interest for other purposes.

Most U.S. income tax treaties do not have specific rules on the treatment of guarantee payments, but include a treaty article governing the treatment of "other income" not subject to a specific provision in the treaty. Some treaties provide an exemption from source country tax on other income. The other income article would likely prohibit U.S. tax on guarantee fees paid by a U.S. subsidiary to a resident of the other treaty country, unless they were associated with a permanent establishment.

Robert Driscoll, withholding technical advisor for IRS Large Business and International Division, confirmed this reasoning; he was recently quoted as suggesting that guarantee fees would likely fall under the "other income" article of a relevant treaty if the guarantor is a qualified resident of a treaty country and, thus, would not be considered U.S.-source income subject to withholding.

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Next Steps for FATCA

The Foreign Account Tax Compliance Act (FATCA) provisions will take effect January 1, 2013. The IRS released Notice 2010-60 on August 27, 2010. The Notice provides a general framework for how the Treasury and the IRS will begin to approach the expanded reporting requirements under FATCA. However, the full impact of the compliance burden of FATCA will not be clear until regulatory guidance is issued by the U.S. tax authorities.

The main provision of FATCA is a new U.S. withholding tax regime that requires foreign financial institutions (FFI) and non-financial foreign entities (NFFE) to disclose financial information to the U.S. tax authorities about certain U.S. clients or face a 30 percent withholding tax on the receipt of "withholdable payments." FATCA will directly impact foreign banks and investment management firms, including QIs and non-QIs, as well as hedge funds and private equity funds.

The IRS is presently considering how to coordinate Chapter 3 withholding (related to 30 percent gross withholding on U.S. source investment income and limited foreign source income of non-resident aliens and foreign corporations) and Chapter 4 (related to withholding on FFIs and NFFEs under FATCA on withholdable payments) and simultaneously (1) balance its interest in accessing information about U.S. persons seeking to avoid U.S. compliance via foreign financial systems and (2) ensure that the new FATCA regime is not overly burdensome. Recent comments made by various IRS officials make clear that it intends to focus on some of the following issues in the upcoming regulations:

- Responding to concerns that Chapter 3 and Chapter 4 withholding regimes overlap. The IRS will focus on fleshing out these overlaps, but officials insist that the two withholding systems serve different U.S. tax compliance interests.
- Whether to automate the QI regime in response to the expanding withholding requirements for foreign financial intermediaries under the FATCA regime.
- Extending the QI agreement expiration dates ending in 2012 so that foreign financial intermediaries seeking to renew such agreements can do so in conjunction with registration as FFIs in 2013.
- Coordinating the FFI agreement under FATCA with other agreements such as foreign withholding partnership and trust agreements and QI agreements.
- Making guidance regarding what payments are "attributable" to withholding payments and, thus, subject to FATCA, a top priority in order for FFIs and NFFEs to be able to administer the FATCA rules.
- The release of a draft FFI agreement is in the works and expected after the IRS releases proposed regulations on FATCA.
- Responding to concerns that the identification procedures of U.S. persons outlined in the Notice are too burdensome.

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