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International Tax ADVISORY ■

NOVEMBER 15, 2013

IRS Releases New FATCA Guidance, Including Draft FFI Agreement

In Notice 2013-69, the IRS introduced a long-awaited draft Foreign Financial Institution (FFI) Agreement and additional guidance under the Foreign Account Tax Compliance Act (FATCA). In addition to the draft FFI Agreement for participating FFIs and those FFIs subject to a Model 2 intergovernmental agreement (IGA), the Notice contains guidance on forthcoming revisions to the FATCA regulations.

Background

FATCA, added to the Code by the HIRE Act of 2010 as Chapter 4 of the Internal Revenue Code, is aimed at curbing offshore tax evasion by requiring FFIs and certain other entities to report information on U.S. accountholders and owners, or else be subject to a 30-percent withholding tax. Since 2010, a series of notices, regulations and two types of IGAs (Model 1 and Model 2) have helped define the contours of the law and account for practical difficulties in its execution. Notably, while the statutory provisions are generally effective for payments after December 31, 2012, implementation has been delayed and will be phased in over the next few years.

Chapter 4's withholding tax applies unless an FFI enters an agreement with the IRS to identify and report on its "U.S. accounts," to withhold on certain payments to nonparticipating FFIs and recalcitrant accountholders and to comply with certain other terms of the agreement. The final regulations issued in January 2013 set forth various substantive and procedural requirements applicable to such "participating FFIs." In addition to the regulatory regime, the U.S. Treasury has signed (and continues to negotiate) IGAs with other countries to facilitate FATCA implementation. A Model 1 IGA requires an FFI in a foreign country to report information to its own government, which then exchanges the information with the IRS automatically. In contrast, under a Model 2 IGA, a foreign country removes legal impediments and enables its FFIs to report directly to the IRS as under the regulations, subject to any modifications in the IGA. Additionally, a Model 2 IGA provides for supplemental information to be provided government-to-government upon request.

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Notice 2013-69 – Draft FFI Agreement and Other Guidance

The draft FFI Agreement set out in Notice 2013-69 largely encompasses the due diligence, reporting, withholding and other requirements of the regulations, specifically Treas. Reg. Section 1.1471-4. Additionally, the draft agreement incorporates modifications relevant to FFIs in Model 2 IGA jurisdictions. The Notice states that the FFI Agreement will be finalized by December 31, 2013. In addition to the draft FFI agreement, Notice 2013-69 promises a number of regulatory modifications.

The Notice previews regulatory updates to coordinate Chapter 4 with the Chapter 61 (Form 1099 reporting) and Section 3406 backup withholding regimes. A non-U.S. payor that is a participating FFI (including a reporting Model 2 IGA FFI) or a reporting Model 1 IGA FFI will be able to satisfy its Chapter 61 reporting obligations as to a non-exempt U.S. payee if the FFI reports the accountholder pursuant to an FFI agreement or an applicable Model 1 IGA. Also under the forthcoming rules, Section 3406 backup withholding will not apply to a reportable payment if a participating FFI (including a reporting Model 2 FFI) has withheld on the payment under Chapter 4. (Conversely, participating FFIs can satisfy Chapter 4 withholding duties for recalcitrant U.S. accountholders by withholding at the Section 3406 backup withholding rate.)

The IRS also plans to modify Chapter 4's transitional reporting requirements for calendar years 2014 and 2015 for foreign reportable amounts paid to nonparticipating FFIs. The modified rules will provide that a participating FFI is only required to report foreign reportable amounts paid to a financial account that it maintains for a nonparticipating FFI. (Currently, the rules require a participating FFI to report the aggregate amount of foreign reportable amounts to each nonparticipating FFI, whether or not associated with a financial account maintained by the participating FFI.) The new rules will ease this reporting requirement further in other ways (e.g., allow certain aggregate reporting).

According to the Notice, new Chapter 4 regulations will provide that passive nonfinancial foreign entity (NFFE) excludes "direct-reporting NFFEs" or "sponsored direct-reporting NFFEs." A direct-reporting NFFE elects to report information about its substantial U.S. owners directly to the IRS, rather than to withholding agents or participating FFIs. A direct-reporting NFFE will register for a global intermediary identification number (GIIN) and comply with modified Chapter 4 reporting requirements. Withholding agents and participating FFIs will identify and document direct-reporting NFFEs similarly to participating FFIs (i.e., verifying the GIIN). An account held by a direct-reporting NFFE will not be treated as a U.S. account or reported by a participating FFI. Updates to the regulations will also allow an entity to sponsor one or more direct-reporting NFFEs ("sponsored direct-reporting NFFEs"), whereby the sponsoring entity reports the relevant information for each sponsored NFFE to the IRS.

Further, modified regulations will provide that a passive NFFE will not include an NFFE that acts as a qualified intermediary (QI). Pursuant to an updated QI agreement, an NFFE-QI that receives withholdable payments on behalf of a passive NFFE will have to report to the IRS information on the passive NFFE and its substantial U.S. owners (in addition to the QI's other withholding agent obligations). Similar provisions will be added for NFFEs that are withholding partnerships or withholding trusts. Finally, the IRS intends to change the definition of "U.S. person" in the Chapter 4 regulations to include a Section 953(d) foreign insurance company (i.e., a non-specified insurance company that elects to be subject to U.S. income tax as if it were a U.S. insurance company).

Chief Counsel Addresses Character, Source and Withholding for Income of Multilevel Marketing Company Distributors

CCA 201343020 (the "CCA"), released on October 25, 2013, addressed the treatment of income paid by a U.S. multilevel marketing company (MLM) to foreign distributors of its products. The CCA first concludes that a foreign distributor's earnings based on purchases by "lower-tier distributors" in its "sponsorship chain" constitute personal services income sourced where the services are performed. Further, the U.S. MLM is required to withhold tax on such income paid to a foreign corporation or nonresident alien (NRA) for services performed in the United States, unless an exception or U.S. income tax treaty provides otherwise.

Background

The taxpayer, a U.S. company, produces and sells products to U.S. and foreign distributors through an MLM arrangement. The distributors are treated as independent contractors for U.S. tax purposes (which the CCA assumes to be true). In an MLM arrangement, distributors of a company's products earn income based on their own sales of products and the sales of distributors that they personally recruit, sponsor and train ("lower-tier distributors"). Lower-tier distributors may in turn recruit more distributors, creating a "sponsorship chain" in which all distributors may purchase products directly from the taxpayer and resell them (or keep them for personal use). Distributors earn income in two ways: (1) buying products from the taxpayer and reselling them at a profit to customers and (2) earning income based on purchases from the taxpayer by lower-tier distributors in their sponsorship chain. The CCA only addresses the second stream of income.

Character and Source of Foreign Distributor's Earnings

The CCA concludes that MLM distributors' income based on purchases by lower-tier distributors in their sponsorship chains represents compensation for the distributors' services recruiting, sponsoring and training lower-tier distributors—not income from the sale of the taxpayer's products. The CCA relied primarily on the decision in ***British Timken Ltd v. Commissioner***, 12 T.C. 880 (1949). In that case, a U.K. corporation ("Timken") appointed distributors to handle sales of goods of a U.S. manufacturer (USM) in Timken's territory. Eventually, Timken directed its distributors and customers to place orders and receive goods directly from USM (with title passing in the United States). USM paid Timken a portion of the sales collected from Timken's distributors and customers. The tax court rejected that Timken's income from USM was from the sale of personal property, which is generally sourced to the place of sale.

The CCA observed that the taxpayer's higher-tier distributors do not take title to the taxpayer's products on behalf of lower-tier distributors. Rather, the lower-tier distributors purchase directly from the taxpayer, and the taxpayer pays the higher-tier distributors an amount based on the lower-tier distributors' purchases. As in ***British Timken Ltd***, this income to higher-tier distributors should be considered compensation for "activities associated with the sale[s]"—i.e., recruiting, sponsoring and training lower-tier distributors.

The source of services income is where the services are performed. If a foreign distributor performs services both inside and outside of the United States, income for the services must be reasonably split between U.S. and foreign sources based on the facts (e.g., time or days spent recruiting, sponsoring and training in the United States). The CCA expressly notes that the location of the higher-tier distributor's services—not of the lower-tier distributors' activities—determines the source of the higher-tier distributor's services income.

Tax and Withholding on Foreign Distributor’s Earnings

NRAs and foreign corporations are generally subject to tax at 30 percent on U.S. source fixed or determinable, annual or periodic income (FDAP) that is not effectively connected with the conduct of a U.S. business. In contrast, NRAs and foreign corporations are taxed at graduated U.S. tax rates on income effectively connected with a U.S. business. Sections 1441 and 1442 generally require any person making a payment of U.S. source FDAP to an NRA or foreign corporation, respectively, to withhold tax of 30 percent of the gross income. Income from services performed in the United States is typically U.S. source FDAP subject to withholding, unless exempted.

A foreign person that performs services in the United States is considered engaged in a U.S. business and the income for those services is effectively connected to that business. (Under Section 864(c)(6), deferred compensation for a foreign person’s U.S. services will be taxable as if received in the year of service, even if the person is no longer engaged in a U.S. business when the income is received.) The regulations provide an exception from the 30-percent withholding tax for *most* effectively connected income. For example, a foreign *corporate* distributor would be exempt from the withholding tax on U.S. source services income as long as the foreign corporation provides a Form W-8ECI to the taxpayer.

There is no similar exemption from withholding on U.S. source services income of NRAs (i.e., individuals) unless the income is subject to wage withholding under Section 3402 (or certain exceptions not discussed in the CCA). But because MLM distributors are not “employees” of the taxpayer, payments from the taxpayer to distributors are not taxable under Section 3402. Consequently, the CCA concludes, services income paid to an NRA distributor is subject to 30-percent withholding tax. Moreover, the taxpayer has the burden of determining how much of the income is U.S. source (i.e., for services performed in the United States) prior to payment, or else risks over-withholding. If the taxpayer has insufficient facts to determine the source of a foreign distributor’s services income, the taxpayer generally must treat the entire amount as U.S. source and withhold the maximum 30 percent, subject to rate reduction under a Treaty or the Code. (Alternate procedures under the regulations allow a taxpayer to place the withholding tax in an escrow account until the proper source can be determined.)

If a foreign distributor is a resident of a country with which the United States has an income tax treaty in force, the CCA acknowledges that such treaty may modify the tax treatment above. For example, many U.S. treaties provide that non-employment personal services income (or, in newer treaties, “business profits”) is not taxable in the United States, unless the NRA either spends a certain number of days in the United States or has a fixed base (or permanent establishment) in the United States to which the income is attributable. NRA distributors without a fixed place or permanent establishment in the United States could thus be exempt from withholding if they provide a completed Form 8233 to the U.S. MLM company prior to payment. Likewise, foreign corporate distributors that are eligible for U.S. income tax treaty benefits and do not have a permanent establishment in the United States to which their earnings are attributable would not be subject to U.S. tax. Foreign corporate distributors should provide Form W-8BEN to the U.S. MLM company prior to payment to prevent withholding.

Conclusion

MLM companies have been around a long time, garnering praise and criticism for their recruitment methods and purported profitability. Only fairly recently have MLMs sprawled into multinational operations with distributors around the globe. For MLMs that are U.S. companies, CCA 201343020 presents (or reminds them of) significant issues about income characterization, sourcing and withholding. Foreign distributors of U.S. MLM companies should be aware of the documentary mechanisms potentially available to avoid the 30-percent withholding tax—and possibly U.S. tax altogether. Independent contractors are thought not to cause as much U.S. tax trouble for taxpayers as employees, but this CCA proves that foreign independent contractors, such as MLM distributors, may come with special tax complications.

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