Ton Daniels and
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# Investing in US Securities

## An Introduction to US Withholding Taxes, Qualified Intermediary and FATCA

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# Investing in US Securities: An Introduction to US Withholding Taxes, Qualified Intermediary and FATCA

**Why this book?**

The sheer complexity of the framework that the United States has created to levy US withholding tax on income from US securities owned by foreigners makes it difficult to obtain insight into the key relevant items, the logic behind the framework and the decision points and consequences for the tax operations of a non-US financial institution. Yet, since the US stock market is nearly one half of the global market by market capitalization, there is no escape for internationally diversified investors from investing in the US equity market and for their non-US banks or asset managers to help them in doing so. For the US government, there is an incentive to create a framework that both encourages foreign capital to be invested in the United States and ensures that the proper taxes are paid within a framework that is understandable and reasonable, from a cost perspective, to comply with.

In clarifying this framework in the context of the tax operations of a non-US financial institution, this book intends to provide a general overview and a mix of high-level insights into the logic behind the framework (including for FATCA, qualified intermediaries, dividend equivalent payments under 871m and qualified derivatives dealers) and, where appropriate, takes a deeper dive into detailed compliance rules.

The book addresses issues relevant for the tax operations departments of non-US financial institutions, qualified intermediaries and their tax advisers.

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# Chapter 1

# Introduction

*"Whenever an executive department or agency … promulgates a new regulation, it shall identify at least two existing regulations to be repealed"*[1]

This book intends to provide guidance to non-US banks with respect to US withholding taxes that are levied from their customers that wish to invest in the US equities markets. When reviewing the tax compliance implications for a foreign bank that wishes to help its clients with investing in US equities, the above executive order from US President Trump comes to mind. The sheer complexity of the framework that the United States has created to levy US withholding tax on income from US securities owned by foreigners makes it difficult to obtain insight in the key relevant items, the logic behind the framework and the decision points and consequences for the tax operations of a foreign bank that wishes to comply and stay within the framework. Yet, since the US stock market is nearly one half of the global market by market capitalization, there is no escape for internationally diversified investors to invest in the US equity market and for their foreign banks to help them in doing so. For the US government there is an incentive to create a framework that both encourages foreign capital to be invested in the United States and that ensures that proper taxes are paid within a framework that is understandable and reasonable from a cost perspective to comply with. There are many reasons for the complexity, but one fundamental reason is the twofold tax policy objective behind the framework. With this framework the United States seeks to:

- levy a 30% withholding tax on US dividends paid to foreigners; and
- tax US citizens (wherever they are resident) and US residents on financial income earned in foreign bank accounts by obtaining relevant information from the foreign bank.

In clarifying this framework in the context of the tax operations of a foreign bank, this book intends to provide a mix of high-level insights in the logic behind the framework (including for Qualified Intermediaries and Qualified Derivatives Dealers) and where appropriate take a deeper dive into detailed compliance rules.

1. President Trump's Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs issued on 30 January 2017.

## 1.1. Withholding tax on US dividends paid to foreign investors and relief at source for tax treaty investors

In Chapter 2 we start with explaining the concept of levying a 30% withholding tax on US dividends paid to foreign persons and the mechanisms how that tax can be reduced under a relevant tax treaty to, say, 15% or 0%. In order to save the foreign investor in a tax treaty jurisdiction the cost of filing annually a US tax return to request for the refund, the framework intends to allow for relief at source. Under the relief-at-source mechanism the 30% withholding rate is replaced by the applicable 15% or 0% tax treaty rate for that investor. Relief at source has the additional benefit for the Internal Revenue Service (IRS) that it should avoid that the IRS receives massive numbers of tax refund requests from foreign investors, claiming that they are entitled to a tax refund and with the inherent risk of wrong or fraudulent refund requests. Chapter 2 therefore discusses the framework that has been put in place by the United States to ensure that withholding and the relief-at-source principle is applied properly. This framework is normally referred to as “chapter 3 withholding”.

## 1.2. No withholding tax on US dividends paid to US persons and US corporations; reporting instead

At the same time the framework adds a complexity and seeks to ensure that US dividends paid to US persons and US corporations that invest via a foreign bank are not subject to US withholding tax. Instead, the IRS wishes to receive information on the foreign accounts of those US investors to ensure compliance with the obligation to annually file a US tax return that includes the income earned from the US securities in the foreign bank account. This is generally referred to as the “chapter 61 reporting framework”.

## 1.3. Foreign banks as intermediary

Foreign banks that help their customers to invest in the US equities markets normally open an account at a US custodian bank that participates as participant in the system of the Depository Trust Company (DTC). US equities are then held by the foreign bank as agent for their customers through an account at the US custodian. The US custodian bank is a so-called withholding agent and needs to withhold 30% US withholding tax on US dividends or provide for a reduced rate under an applicable tax treaty. When things go wrong – there is under-withholding because of the unjustified application of a reduced tax treaty rate – the US custodian bank is exposed to the risk of being liable for the underpaid withholding tax on dividends paid to the foreign bank. That would be the general framework when the foreign bank is a so-called non-qualified intermediary or NQI. Chapter 3 clarifies how that should function from a tax operations point of view.

## 1.4. Foreign banks as Qualified Intermediary

Considering the magnitude of the US equities markets and the relevance of foreign capital flowing into it, US custodian banks and the IRS must have recognized by the end of the 1990s the significant exposures and risks for US custodian banks with respect to US tax liability for underpaid withholding taxes. The question was whether that liability should be at the US custodian bank. The reasoning is that the foreign bank is closest to the customer and should have all the information to ensure a proper application of reduced tax treaty rates for its customers. It was concluded that it would be improper to impose liability on the US custodian for things that go wrong at the foreign bank. Consequently, on 1 January 2001 the so-called qualified intermediary regime was introduced by the IRS under which the foreign bank can enter into an agreement with the IRS under which the foreign bank will act as a qualified intermediary. In exchange for facilitating US withholding tax enforcement, foreign banks would be provided certain cost savings for reporting taxable US income to their upper-tier US custodians and the US custodians would be relieved from their liability risk when doing business with a foreign bank that is a qualified intermediary. Apparently, there are some 7,000 foreign banks that have concluded a QI agreement with the IRS. The QI regime is discussed in more detail in Chapter 4.

## 1.5. Two holes in the QI regime trigger the introduction of FATCA

One of the key elements of the QI regime focusses on the reporting of income from US securities received by US persons. This has resulted in perceived abuse of the regime that came to light in 2008. The focus on US securities is based on the concept that the regime is intended to facilitate the proper compliance for levying US withholding tax. Consequently, the regime does not address income from non-US securities earned by US persons in foreign bank accounts. Under the QI regime there is no reporting requirement for the foreign bank for income from non-US securities earned by US persons. The QI regime would therefore not prevent tax evasion by US persons that earn income from non-US securities in their foreign bank account.

Secondly, the focus of the QI regime on foreign accounts of US persons means that accounts of a non-US entity that is wholly owned by a US person are not covered by the QI reporting regime because the direct account holder is not a US person. Consequently, US persons investing in US securities indirectly through a foreign entity would not be covered by the QI reporting regime. These two elements of the QI regime have led to the introduction of the Foreign Account Tax Compliance Act (FATCA) in 2010. FATCA introduces a reporting requirement for foreign banks on:

– all accounts held by US persons; and
– all accounts held by passive foreign entities with a US controlling person; and
– the FATCA reporting requirement is not limited to qualified intermediaries but applies to all foreign banks.

Banks that do not comply with FATCA are exposed to a 30% FATCA withholding tax as of 1 July 2014; generally referred to as "chapter 4 withholding". In this book we discuss FATCA in Chapter 2 and throughout the book where appropriate, including the interaction and coordination of chapter 3 withholding and FATCA withholding.

## 1.6. A third loophole triggers withholding on payments with respect to derivatives that reference US equities

Chapter 5 discusses the intricacies of so-called "section 871(m)", referring to a section in the Internal Revenue Code (IRC). In the same legislation that introduced FATCA, specific rules were introduced that address avoidance of US withholding tax by foreign investors that invest in derivatives that replicate the performance of an investment in underlying US equities. A concept that is sometimes also referred to as "dividend stripping". Starting with addressing the tax consequences of securities lending involving US equites, these rules and regulations now introduce a withholding tax on a wide range of so-called dividend equivalent payments made to foreign persons under derivatives contracts referencing US equities. At the same time, the QI framework is expanded with the concept of the foreign bank that is a QI and that is also acting as a Qualified Derivatives Dealer.

## 1.7. Relief of withholding tax and the OECD initiative: TRACE

Chapter 6 discusses the initiative taken at international level that addresses the levying of withholding tax on cross-border dividends and applying tax relief under tax treaties: the OECD Treaty Relief and Compliance Enhancement (TRACE) initiative. This initiative is based on the recognition that the vast majority of publicly traded securities is held through a complex network of domestic and foreign intermediaries and consequently it is in many cases difficult, impossible or not cost effective to make a claim for withholding tax relief. The concept of Authorised Intermediary (AI) is developed in the TRACE initiative.

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