A Matter of Semantics: *Validus Reinsurance* Invalidates Foreign-to-Foreign Withholding

President Bill Clinton famously attempted to come to terms with the meaning of the verb “is” when he was caught engaging in hanky-panky at the White House: “It depends on what the meaning of the word ‘is’ is. If the—if he—if ‘is’ means is and never has been, that is not—that is one thing. If it means there is none, that was a completely true statement.”1 Not to be outdone, albeit over 10 years later, the Federal Court of Appeals for the District of Columbia in *Validus Reinsurance, Ltd. v. United States*,2 struggled for the better part of 19 pages over the definition of the word “cover.” The court, much like our 42nd President, ultimately decided that linguistic contortions did not provide a basis for parsing through the intricacies of a particularly delicate situation. The Federal Court of Appeals instead annulled the application of the federal excise tax on reinsurance imposed by Code § 43713 on a foreign-to-foreign retrocession transaction on the ground that the statute did not have an extraterritorial reach. While the decision on its face appears to be of interest only to tax practitioners in a fairly obscure corner of cross-border insurance transactions and to linguists, the holding could reverberate across a wide swath of withholding issues.

I. Background on the Insurance Excise Tax

Code § 4371(1) imposes a four percent (4%) excise tax on the premiums paid to a foreign insurer on a policy of casualty insurance or an indemnity bond by either (i) a U.S. corporation or (ii) a foreign corporation engaged in a trade or business in the United States with respect to insurance or indemnity bond protecting against hazards, risks, losses or liabilities within the United States. For this purpose, a policy of casualty insurance means “any policy or other instrument by whatever name called whereby a contract of insurance is made.”4 An indemnity bond is “any instrument by whatever name called whereby an obligation of the nature of an indemnity, fidelity or surety bond is made.”5 Code § 4371(3) imposes a one percent (1%) excise tax on reinsurance of a casualty insurance policy or indemnity bond described above. The excise tax does not apply to the extent that the premium paid to the foreign insurer is effectively connected with the conduct of a U.S. trade or business by the insurer (unless the premium is exempted from U.S. tax pursuant to an income tax treaty).6 The excise tax is a transaction tax and is payable by “any person who makes, signs, issues, or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued or sold.”7 The liability to pay the tax arises when the insurance or indemnity bond premium is paid.8 In addition to the normal penalties for a failure to pay the tax, a person who fails to file an excise tax return and remit the tax “with intent to evade the tax” is liable for a penalty equal to double the tax itself.9
II. Cascading Imposition of Tax

The federal excise tax is said to “cascade” when it is imposed more than once on the same transaction. For example, assume that a U.S. insurer reinsures a U.S. risk with a non-U.S. reinsurer (“X”) that is not engaged in the conduct of a U.S. trade or business. The reinsurance would be subject to the one percent excise tax imposed by Code § 4371(3). Suppose further that X then retrocedes all or a portion of the risk to another non-U.S. insurer (“Y”). (The insuring of a reinsurer is referred to as retrocession, not reinsurance.) If the retrocession of the risk by X to Y, a foreign-to-foreign transaction, is also subject to the excise tax imposed by Code § 4371(3), the tax is said to “cascade,” that is, the tax applies to each transaction in which the U.S. risk is further reinsured.

Until the decision in Validus, supra, it was generally believed that the excise taxes on insurance, reinsurance and retrocession premiums could cascade, that is, be imposed on the laying off of the same risk via reinsurance and retrocession. In U.S. v. Northumberland Insurance Co., Ltd., Northumberland, an Australian insurance company that was not doing business in the U.S., reinsured and retroceded U.S. risks. Northumberland entered into a reinsurance and retrocession agreement with a Swiss reinsurance company, AIM Reinsurance Co., Ltd. (“AIM Re”). Like Northumberland, AIM Re did not do business in the U.S. Northumberland retroceded almost 100% of the U.S.-based reinsurance that it wrote, to AIM Re. Some of the risks that Northumberland ceded to AIM Re initially had been written by foreign insurance companies and assumed through retrocession by Northumberland. The opinion states that the insurance excise tax was paid on the reinsurance premiums paid to Northumberland by those foreign insurance companies. Northumberland did not report or pay excise tax on the reinsurance premiums that it paid to AIM Re from 1971 through 1973 because it had been advised that the excise tax did not apply to foreign-to-foreign transactions. The IRS disagreed and assessed excise tax on the reinsurance premiums that Northumberland paid to AIM Re.

The court rejected Northumberland’s argument and focused on the definition of an insured. For purposes of the excise tax, an insured is any person, domestic or foreign, that insures a risk located in the United States. Once the transactions related to an insured (directly or through reinsurance or retrocession), the court reasoned that the excise tax was applicable:

There is no requirement that a reinsured qualify as an insured to be subject to the excise tax, so long as the underlying primary policies were issued to “insureds” under section 4372(d).

Thus, the excise tax on policies of reinsurance and retrocession applied even though the “reinsured” was a foreign entity that was not engaged in a U.S. trade or business, since the underlying policy was issued to an “insured” as defined in Code § 4372(d).

Northumberland also argued that the excise tax did not apply to its reinsurance contract with AIM Re because the excise tax was previously imposed on the policies of reinsurance issued by Northumberland on the same underlying risks. In other words, the taxpayer set up cascading as a defense to the imposition of the excise tax. The court rejected this argument as follows:

To the contrary, the plain language of section 4371 states that the tax is to be imposed on “each” policy of reinsurance issued by any foreign insurer . . . It applies to policies of reinsurance issued by a foreign insurer “to any person.”

As to imposing the reinsurance tax a second time, the court explained, that:

Reimposing the excise tax on the underlying premium accords with the . . . legislative
intent, namely, eliminating the competitive advantage afforded foreign insurance companies. In the first instance, the excise tax was withheld from the premiums ceded by the direct insurers to Northumberland as reinsurer. This served to equalize Northumberland’s position as a foreign reinsurer. In the second instance, the tax was imposed on the premiums as transferred to AIM Re as a separate foreign reinsurer. . . . Imposition of the tax to this transaction thus serves to further the legislative policy.16

Thus, the court held that the reinsurance premium paid by Northumberland, a foreign reinsurer, to AIM Re, another foreign reinsurer, was subject to the one percent reinsurance excise tax imposed under Code § 4371(3).

III. The Facts and Holding of Validus

The facts presented in Validus were not complex. In Validus, supra, the taxpayer was a Bermuda reinsurance company that was not engaged in the conduct of a trade or business in the United States. It reinsured U.S. risks written by a U.S. insurance company. The taxpayer itself obtained reinsurance of these assumed risks in a typical retrocession transaction, that is, the taxpayer purchased a retrocession policy under which it would receive payments if it was called upon to make payment under the initial reinsurance policies. Validus purchased the retrocession policies from other insurers not engaged in the conduct of a trade or business in the United States. If the holding of Northumberland, supra, applied to the retrocession policies, the federal excise tax on reinsurance would have applied to Validus’ purchase of retrocession.

The issue before the court was whether the excise tax on reinsurance applied to retrocessions. The trial court found that the excise tax only applied to reinsurance, not retrocessions. The trial court held that it was bound “to follow the plain language of the statute” and since the statute did not specifically impose the excise tax on retrocessions, it held that the excise tax did not apply to the retrocession obtained by the non-U.S. reinsurer. The trial court opinion does not address the fact that the payment of the excise tax on the retrocession would have resulted in a cascading of the excise tax.

The Internal Revenue Service (the “IRS”) appealed the trial court decision. Although the taxpayer urged the Court of Claims to follow the holding of the trial court, the Court of Claims decided to pursue other routes. It began by examining the fact that the excise tax on reinsurance applies to any reinsurance “covering” an insurance policy insuring against U.S. risks.17 The court then undertook an extensive examination as to whether the word “cover” extended to retrocession inasmuch as a retrocession policy directly covers reinsurance and not the original insurance policy. (It is worth noting that if the retrocession provides for a cut-through, the original insurer can pursue claims directly against the retrocessionaire.) Given that the court did not rest its holding on the meaning of the word “cover,” this part of the opinion may be of interest only to linguists and Clintonian scholars. The appellate court also rejected the reasoning of the trial court and held that retrocession and reinsurance should both be encompassed by the definition of reinsurance in the statute.

The actual basis of the appellate holding in Validus, supra, however, is much more interesting. The court based its decision on the judicial doctrine of the “presumption against extraterritoriality.” The court, quoting from Morrison18 and EEOC v. Arabian Am. Oil Co.,19 defined this doctrine as follows:

It is a longstanding principle of American law “that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.”

A court must apply the presumption “unless there is the affirmative intention of Congress clearly expressed to give a statute extraterritorial effect.” The court placed the burden on the IRS to establish that Congress intended the insurance excise tax to have extraterritorial application. The court held that there must be “clear and independent textual support – rather than mere inference – to justify . . . application abroad.”

The doctrine of the presumption against extraterritoriality is well-illustrated by a recent case involving the Dodd-Frank Wall Street Reform and Consumer Protection Act. In *Liu Meng-Lin v. Siemens A.G.*, a Taiwanese resident employed in China by the Chinese subsidiary of a German manufacturing company was fired for reporting that the Chinese subsidiary made illegal bribes to Chinese and North Korean officials. The employee sued its employer in the United States alleging that the firing violated the anti-retaliation provisions of the Dodd-Frank Act. The court dismissed the complaint finding that this provision of the Dodd-Frank Act did not have extraterritorial application:

We have read *Morrison* to “wholeheartedly embrace . . . application of the presumption against extraterritoriality, finding that ‘unless there is the affirmative intention of the Congress clearly expressed to give a statute extraterritorial effect, we must presume it is primarily concerned with domestic conditions.’” *Norex Petroleum Ltd. v. Access Indus., Inc.*, 631 F.3d 29, 32 (2d Cir. 2010), quoting *Morrison*, 561 U.S. at 255, 130 S.Ct. 2869. We will “thus look for a ‘clear’ and ‘affirmative indication’ that a statute applies to conduct occurring outside the territorial jurisdiction of the United States before concluding that the presumption has been overcome.” *United States v. Weingarten*, 632 F.3d 60, 65 (2d Cir.2011), quoting *Morrison*, 561 U.S. at 265, 130 S.Ct. 2869 (citations and internal quotation marks omitted).

The court in *Validus* found that the IRS did not identify any Congressional intent that the excise tax should apply to wholly foreign retrocession transactions. Furthermore, the court cited to the fact that the tax could cascade as a basis for concluding that extraterritorial application of the tax was not intended by Congress. The court specifically noted that extraterritorial application of the excise tax would allow the “tax to compound into perpetuity with creation of every new reinsurance contract after the first-level reinsurance contract, despite the absence of a contractual or other legal relationship with any U.S. entity.” While this fact was relegated to a footnote in *Northumberland*, the fact that the tax could cascade was found to be fatal to the reimposition of the same tax in *Validus*.

The IRS pointed to the fact that Code § 4371, on its face applies to “each” policy covering “any” of the insurance contracts covering U.S. risks. The court found this language, standing on its own, did not justify extending the insurance excise tax to foreign-to-foreign reinsurance transactions. The court noted that the Supreme Court had already held that the use of broad words of application did not justify extraterritorial application of a civil action statute in *Kiobel v. Royal Dutch Petroleum Co.* The legislative history behind the enactment of the use of these words tax did not “evidence an unambiguous congressional intent to apply the excise tax to wholly foreign retrocessions.” The *Validus* court refused to follow the holding of *Northumberland*, because *Northumberland* did not address the presumption against extraterritoriality and the deference that the *Northumberland* court gave to the IRS’s interpretation of the excise tax “was inappropriate absent consideration of the presumption.”

**IV. The U.S. Withholding Tax on FDAP Income**

Code § 1441(a) provides that “all persons, in whatever capacity acting . . . having the control
... of any of the items” of FDAP income from United States sources shall deduct and withhold 30 percent of the amount of the income when paid to nonresident alien individuals and foreign partnerships.24 Code § 1442(a) requires U.S. tax withholding on the payment of items of FDAP income to foreign corporations, but the statute is written in the passive voice and does not make reference to who is required to withhold. FDAP income refers to the items of U.S.-source income that are subject to a 30 percent tax, unless reduced by treaty, and includes interest, dividends, rents, salaries and other fixed or determinable annual or periodical gains, profits and income.25 In 1997, the IRS amended the definition of a withholding agent to specifically state that a person required to withhold on FDAP income includes “any person, U.S. or foreign, that has the control . . . of an item of income of a foreign person subject to withholding.”26 Thus, this regulation makes clear that the IRS believes that foreign-to-foreign withholding applies in the case of FDAP income. In addition, the IRS has expressed the view in litigation, a Revenue Ruling and a regulation that foreign-to-foreign withholding of FDAP is permissible.

SDI Netherlands B.V. v. Comm’r,27 skirted the issue as to whether Code § 1442 permits foreign-to-foreign withholding. In this case, a Bermuda corporation owned intellectual property that it licensed to the Taxpayer, a Dutch affiliate, for use anywhere in the world. The Taxpayer sublicensed the software to SDI USA, a U.S. affiliate, for use in the United States. There was “no dispute” that the royalty payments by SDI USA to the Taxpayer were U.S.-source royalties, potentially subject to withholding. The United States – Netherlands Income Tax Treaty, however, exempted such royalties from United States withholding taxes. The IRS asserted that a portion of the royalty payments by the Taxpayer to the Bermuda owner of the software were subject to U.S. withholding taxes on the ground that the Taxpayer was a withholding agent and that the portion of the royalties attributable to the sublicense provided to SDI USA were U.S.-source income. The court held that the royalties paid by the Taxpayer to its Bermuda affiliate were not U.S.-source items of income and therefore did not provide a holding as to whether Code § 1442 permitted foreign-to-foreign withholding.28 The court invalidated Revenue Ruling 80-362,29 which reached a contrary conclusion, as not being a valid interpretation of the law.

In addition to Revenue Ruling 80-362, the IRS has promulgated a regulation under the anti-conduit rules that states that foreign-to-foreign withholding can be imposed on FDAP income.30 In this example, FP, a foreign parent company, licensed software to FS, a foreign subsidiary. FS, in turn, licensed the software to DS, a U.S. affiliate. As in SDI Netherlands B.V. v. Comm’r, supra, the royalty payments from DS to FS were exempt from U.S. withholding taxes pursuant to the provisions of an income tax treaty. The example states:

[T]he royalty payments between FS and FP are income from U.S. sources under section 861(a)(4) subject to the 30 percent gross tax imposed by § 1.881-2(b) and subject to withholding under § 1.1441-2(a).

Apart from the erroneous conclusion on the source of the royalties after SDI Netherlands B.V. v. Comm’r, supra, the example is just a reiteration view of the IRS view that Code §§ 1441 and 1442 permit foreign-to-foreign withholding on FDAP income.

Leaving aside cascading royalties, such as the case presented by SDI Netherlands, supra, foreign-to-foreign withholding on FDAP income has not been a significant issue to date because when U.S.-source FDAP income has been generated, it generally has been paid by a U.S. person (or the U.S. branch of a non-U.S. person).31 The possibility that there could be significant consequences of a foreign-to-foreign withholding requirement has been highlighted
by the enactment of Code § 871(m) (sometimes referred to as the HIRE Act). Under Code § 871(m), dividend equivalents are sourced to underlying U.S. stocks, rather than residence of the payer. For example, assume that a Chinese bank issues a financial product to a Singapore company that pays a yield that is determined in whole or in part by a dividend paid by a U.S. company. In this example, if the financial product is encompassed by Code § 871(m) (an issue beyond the scope of this article), the Chinese bank would be required to withhold and remit U.S. federal income tax to the IRS on the payment of the dividend equivalent to the Singapore company.

Code § 871(m) is a source rule. Using the example in the preceding paragraph, the statute treats the payment by the Chinese bank to the Singapore company as the payment of U.S.-source income. The statute that would require the Chinese bank to withhold U.S. tax on such payment is Code § 1441 or Code § 1442 (depending on whether the Singapore company is treated as a corporation or a partnership for U.S. tax purposes.) Code § 871(m)(6), obliquely, does seem to acknowledge that there could be foreign-to-foreign withholding. This Code section provides that the IRS can by regulation provide relief from cascading withholding. Although the legislative history of Code § 871(m) is silent on the direct issue as to whether foreign-to-foreign withholding is required under Code § 871(m), it is hard to imagine a situation in which Code § 871(m)(6) has any meaning other than to relieve a withholding burden on a foreign person. In our example, the question is posed as to whether the presumption against extraterritoriality allows the IRS to treat the Chinese bank as a U.S. withholding agent. In contrast to the situation in SDI Netherlands B.V. v. Comm’r, supra, there is no question that the income is U.S.-source income.

A. LANGUAGE IN THE STATUTE

Following the pattern of analysis set forth in Validus, supra, the first issue is whether the reference to “all” persons having control over “any” item of FDAP income in Code § 1441(a) is sufficient evidence of Congressional intent to impose foreign-to-foreign withholding. Validus, citing Kiobel, supra, makes clear that the use of sweeping language, in and of itself, is not sufficient to impute a Congressional intent to override the presumption against extraterritoriality. The IRS could point to the grant of authority in Code § 871(m)(6) as evidence of Congressional intent that foreign-to-foreign withholding was contemplated. Since this section only could have operative effect if there is foreign-to-foreign withholding, the argument follows that such withholding was contemplated by Congress.

B. LEGISLATIVE INTENT

Given that the words of Code § 1441 and Code § 1442 on their face are insufficient to override the presumption against extraterritoriality and the lack of any direct Congressional authority under Code § 871(m) to require foreign-to-foreign withholding, the next issue is whether there is any indication in the legislative history of the withholding Code sections that would support the conclusion that Congress intended to override the presumption against extraterritoriality. While the excise tax on reinsurance was originally enacted in 1942, the genesis of current Code §§ 1441 and 1442 is somewhat older. Versions of these statutes first appeared in the Revenue Bill of 1936. (Other statutes required withholding on certain FDAP payments as early as 1913, but these rules were special taxes to reduce the cost of various war efforts.)

As best as we have been able to discern, withholding on FDAP income of nonresidents
was first enacted pursuant to the Revenue Bill of 1936. This provision, then denominated as Section 144 of the Tax Code, was the predecessor to current Code § 1442. The legislative history of this section stated that the “tax [is] being collected in the usual case by withholding at source.” This language supports the conclusion that Congress envisioned that FDAP withholding would be undertaken by U.S. persons because the source rules then dictated that U.S. source income would arise exclusively from sources within the United States. There is no evidence that Congress intended to override the presumption against extraterritoriality. We did not locate any further legislative histories that bore on the issue as to whether Congress intended to override the presumption against extraterritoriality in the context of FDAP income withholding taxes.

In *Tonopah and T.R. Co. v. Comm’r*, the court seemed to accept that the presumption against extraterritoriality applied to withholding under Section 144 of the Revenue Act of 1936. In *Tonopah*, a U.S. corporation issued a debt instrument to a foreign person. The foreign bondholder did not hold the bond in connection with the conduct of a U.S. trade or business. The bond was guaranteed by the foreign parent of the U.S. debtor. The U.S. issuer became insolvent and the foreign parent made an interest payment on the bond to the foreign holder on behalf of the U.S. issuer. The IRS asserted that the interest paid by the foreign parent was U.S.-source interest and the guarantor was under an obligation to withhold under the 1936 Tax Act version of current Code § 1442. The court refused to find a withholding obligation on the part of the foreign guarantor. Nothing further transpired for 30 years, at which time the IRS issued a Revenue Ruling with facts identical to those in *Tonopah*, which held that the foreign guarantor would have a withholding tax obligation. The Ruling does not mention the contrary holding in *Tonopah*.

If these lines of inquiry were the sole path to determining whether FDAP income should be subject to foreign-to-foreign withholding, the conclusion should be that Code § 1441 and Code § 1442 should not be read to support such withholding. First, the words of the statute are insufficient to mandate foreign-to-foreign withholding, even though they are broad. Second, the legislative history does not support the conclusion that Congress intended to override the presumption against extraterritoriality. The conclusion on the legislative history is supported by the holding of *Tonopah*, supra.

V. **Does Chevron Override the Presumption Against Extraterritoriality?**

In *Validus*, supra, the IRS urged the court to give deference to its interpretation of the application of the insurance excise tax pursuant to the *Chevron* doctrine. The court refused to do so for two reasons. First, it expressed the view that the Supreme Court’s interpretation of the presumption against extraterritoriality requires a finding that unless there is a clear expression that a U.S. statute should apply outside of the United States, it does not. Second, the court held that because there was no clear evidence that the IRS considered the presumption against extraterritoriality in developing its position, it was not entitled to deference in its view. In contrast, with respect to withholding on FDAP income, the 1997 amendments to the regulatory definition of a withholding agent clearly indicate that the IRS interprets the FDAP withholding statute to require foreign-to-foreign withholding. Accordingly, it is worth examining whether the IRS could successfully invoke the *Chevron* doctrine to support its position that foreign-to-foreign withholding is required on FDAP income.

In *Chevron*, the issue before the Supreme Court was whether Environmental Protection Agency (“EPA”) industry-friendly regulations that
allowed industrial facilities that generated pollutants to aggregate harmful emissions was a permissible interpretation of a federal statute. An environmental group challenged the regulations and won in the appellate court below the Supreme Court. The Supreme Court framed the issue as to whether the “agency’s construction of the statute which it administers” was valid. In the view of the Supreme Court, if the intent of Congress was not clear, the regulation would be valid if it was based “on a reasonable construction of the statute.” In this case, the Court held that it would not disturb a regulation “unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned.”

The Court then applied these standards to the EPA regulations that allowed aggregation of emissions. It found that the environmental laws, in general, delegated substantial discretion to the EPA as well as the states. The statutory language itself was inconclusive. The Court found that the legislative history did not address whether aggregation (referred to as the “bubble concept”) was appropriate or not. The Court sustained the regulation:

[T]he Administrator’s interpretation represents a reasonable accommodation of manifestly competing interests, and is entitled to deference; the regulatory scheme is technical and complex, the agency considered the matter in a detailed and reasoned fashion, and the decision involves reconciling competing policies.

It is clear that the Chevron standard applies to Treasury Regulations. Chevron is interpreted as imposing a two-part analysis as to whether a regulation is valid. First, an inquiry is made as to whether Congress spoke directly to the issue. If the answer is “yes,” then the regulation must conform to the Congressional mandate. If the answer is “no,” the court must inquire as to whether the regulation is based upon a permissible construction of the statute. And of course, if a court has previously held that a particular result is mandated by a statute, a regulation may not dictate a contrary result.

The authorities discussed above may preclude the application of the Chevron doctrine to foreign-to-foreign withholding on FDAP income. First, the statutes themselves are not explicit and the sweeping words requiring withholding cannot be construed as a Congressional intent that foreign-to-foreign withholding on FDAP income is required. In the absence of a Congressional intent to extend the reach of Code §§ 1441 and 1442 to foreign-to-foreign transactions, the question is whether the IRS’s attempt to require such withholding is a rational construction of the statute. A court could rationally find the presumption against extraterritoriality should apply and Treasury Regulation § 1.1441-7(a) should not be given effect to the extent that the IRS attempts to require non-U.S. payers of income to withhold U.S. federal income tax. Concomitantly, attempting to require foreign-to-foreign withholding of U.S. federal income tax could be construed to be an impermissible construction of the relevant statutes.

VI. Code § 871(m) and Extraterritoriality

As noted above, Code § 871(m) sources dividend equivalents paid on derivatives based upon the underlying equity and not the residence of the payer. Code § 871(m)(3)(B) provides that dividend equivalents paid on all notional principal contracts (“NPCs”) will be treated as dividend equivalents unless the IRS designates an NPC as not having a potential for the avoidance of federal income tax. Code § 871(m) thus presents the possibility of cascading withholding taxes and extraterritoriality.

To illustrate the problem, assume that U.S. Bank writes an equity swap over a U.S. stock (“X”) to Foreign Bank. Under the swap, U.S. Bank must withhold on dividend equivalents that it pays with respect to the X stock to Foreign Bank. Assume further that Foreign Bank uses the
equity swap that it acquired from U.S. Bank as a hedge of its obligations under an equity swap over X stock to Foreign Hedge Fund. If the IRS does not provide a credit to Foreign Bank for the withholding that Foreign Bank suffered on the swap with U.S. Bank, the withholding taxes due to the IRS would cascade. U.S. Bank would be required to withhold on dividend payments on the equity swap with Foreign Bank. Concomitantly, Foreign Bank would be required to withhold on dividend equivalent payments made on the equity swap with Foreign Hedge Fund. Obviously, if the IRS provides a credit against the Foreign Bank’s withholding obligation for amounts held by U.S. Bank, there would not be cascading. (Proposed regulations do not provide a credit for upstream withholding.) It is worth noting that the same challenge exists if Foreign Bank were to hold the stock directly. *Validus*, supra, held that the imposition of cascading withholding taxes in and of itself was a basis upon which to conclude that the tax was impermissibly asserted. In addition, the imposition of U.S. withholding taxes on foreign-to-foreign transactions violates the presumption against extraterritoriality.

**VII. The Foreign Account Tax Withholding Act (“FATCA”)**

The FATCA provisions, contained in Code Sections 1471 through 1474 contain an extraordinary set of penalty tax rules on foreign financial institutions (FFIs) that do not (i) conduct due diligence on their account holders, equity holders and debt holders to ferret out U.S. persons that are holding assets outside of the United States and (ii) disclose the identity of such persons to the IRS. Specifically, if the FFI does not comply with the FATCA rules, then “withholdable payments” to it for its own account are, and payments on behalf of its customers may be, subject to U.S. federal income tax withholding. Withholdable payments include items of U.S.-source income, such as interest and dividends, as well as gross proceeds “from the disposition of any property of a type which can produce interest or dividends from sources within the United States.” If the payment is made for the account of a non-participating FFI, “no credit or refund shall be allowed or paid with respect to such tax.” In other words, if an FFI does not comply with the FATCA rules, it will be subjected to gross proceeds withholding on its U.S.-source income and will not be able to recover the withheld amounts.

FATCA coerces FFIs to comply with the due diligence and reporting rules through the threat of withholding on U.S.-source income. The FATCA statute requires the reporting to be undertaken by “withholding agents.” FATCA contains a definition of withholding agent, but this definition does not explicitly treat a foreign person as a withholding agent. Nonetheless, regulations issued by the IRS specifically state that withholding agents include foreign persons. Thus, like FDAP withholding, the issue is posed as to whether the FATCA regulation violates the presumption against extraterritoriality.

The FATCA statutes operate in marked contrast to the FDAP income withholding rules. Specifically, the FATCA rules specifically require FFIs to withhold on U.S.-source income and passthru payments made to other foreign entities as a condition to being treated as FATCA-compliant. Thus, the statute itself envisions conditions under which there will be foreign-to-foreign withholding. While the legislative history does not contain any direct references to non-United States withholding agents, the fact that there are statutory foreign-to-foreign withholding requirements supports the conclusion that Congress intended to override the presumption against extraterritoriality with respect to FATCA.
For more information about the topics raised in this legal update, please contact any of the following lawyers.47

Mark Leeds
+1 212 506 2499
mleeds@mayerbrown.com

George W. Craven
+1 312 701 7231
gcraven@mayerbrown.com

James R. Barry
+1 312 701 7169
jbarry@mayerbrown.com

Lucas Giardelli
+1 212 506 2238
lgiardelli@mayerbrown.com

Endnotes

3 All “Code §” references are to the Internal Revenue Code of 1986, as amended.
4 Code § 4372(b)(parenthetical omitted).
5 Code § 4372(c); see also Treas. Reg. § 46.4371-2(a).
6 Code § 4373(1).
7 Code § 4374; Treas. Reg. § 46.4374-1(a).
8 Treas. Reg. § 46.4374-1(b).
9 Treas. Reg. § 46.4374-1(d).
11 Northumberland, supra at fn. 16.
12 Code § 4372(d).
13 Id. at 76.
14 See also Rev. Rul. 58-612, 1958-2 C.B. 850 (policy of reinsurance issued by a foreign insurer covering any of the hazards, risks, losses, or liabilities covered by contracts taxable under Code §§ 4371(1) and (2) are subject to the excise tax imposed on reinsurance policies, regardless of whether the primary insurer is a U.S. company).
15 Id. at 78.
16 Id.
17 Code § 4371(3).
21 Validus at 14, quoting Kellner Found./Case Foundry v. Tracy, 696 F.3d 835, 845 (9th Cir. 2012), itself citing Morrison, supra.
22 763 .3d 175 (2nd Cir. 2014)
24 Parenthetical omitted.
25 Code § 871(a). Code § 871(a) only applies to individuals and partnerships. An identical list of items of income subject to the 30% withholding tax when paid to foreign corporations is contained in Code § 881(a). See Treas. Reg. § 1.1473-1(1)(2).
26 Treas. Reg. § 1.1441-7(a), as amended by T.D. 8734 (Oct. 1997). T.D. 8734, however, does not provide any explanation for the addition of the words, “U.S. or foreign.”
27 107 T.C. 161 (1996)
28 See Fn. 15.
29 1980-2 C.B. 208
30 Treas. Reg. § 1.881-3(e) (Ex. 11)
31 Under IRS rules, cascading withholding can also arise in securities lending transactions because substitute dividend payments are also sourced to the loaned stock, not the residence of the stock borrower. Treas. Reg. § 1.864-3(a)(6). The IRS, however, largely eliminated the problem of cascading withholding by providing a credit for upstream withholding taxes. Notice 2010-46, 2010-24 I.R.B. 757.
32 Senate Report No. 2156, reprinted in 1939-1 C.B.
33 112 F.2d 970 (9th Cir. 1940).
37 National Cable & Telecommunications Association et al. v. Brand X Internet Services et al., 545 U.S. 967 (2005) (Administrative law principle of Chevron deference to statutory interpretations by administrative agencies tasked with executing the statute trumped the precedents of the United States Courts of Appeals unless the Court of Appeals found that the statute was "unambiguous" under Chevron).
38 See Code § 1471(d)(2) (financial accounts include depository accounts, custodial accounts and debt and equity investments in the FFI).
39 Code § 1471(a).
40 Code § 1473(1)(A).
41 Code § 1474(b)(2)(a)(ii).
42 Code § 1471(a).
43 Code § 1473(4).
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