

LB&I International Practice Service Concept Unit

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Shelf	N/A	Business Inbound	–	–
Volume	8	Repatriation / Withholding	Level 1 UIL	9424
Part	8.1	FDAP Payments	Level 2 UIL	9424.01
Chapter	N/A	N/A	Level 3 UIL	N/A
Sub-Chapter	N/A	N/A	–	–

Unit Name	FDAP Income
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General Overview

FDAP Income

- **Overview.** In general, a U.S. person is subject to U.S. tax on worldwide income. In contrast, the U.S. only taxes a foreign person (e.g., nonresident alien individuals and foreign corporations) on two categories of income: (1) income effectively connected with a trade or business in the U.S. (ECI); and (2) fixed, determinable, annual, or periodical income from sources within the U.S. that are not effectively connected with a trade or business in the U.S.(FDAP). FDAP income consists primarily of passive investment income, including interest, dividends, rents, royalties, etc. In contrast, ECI generally consists of income from active trade or business activities.
- **FDAP & ECI.** ECI and FDAP are subject to two different tax regimes. FDAP is taxed on a gross basis (gross income without deductions) at 30 percent whereas ECI is taxed on a net basis (gross income less allowable deductions) at graduated rates. The 30 percent tax rate on FDAP may be reduced (or eliminated) pursuant to an income tax treaty or under domestic law. Although not the focus of this concept unit, it is important to note that the 30% tax on FDAP income is collected by withholding at the source. Accordingly, the payer of the FDAP income is required to withhold and remit this tax to the IRS. The person who withholds and pays the tax is often referred to as the withholding agent.
- The withholding at source regime on nonresident alien individuals and foreign corporations is often called Chapter Three Withholding (CTW) for Chapter 3 of the IRC, Sections 1441 to 1464.
- **FDAP (Foreign Entities).** This International Practice Service (IPS) unit will focus on identifying the general types of FDAP income that may be paid to a foreign corporation. For a similar unit that focuses on identifying the types of FDAP income that are paid to nonresident alien individuals (NRAs), please refer to Overview of FDAP Income, WIT/PUO/P_15.1_01(2013). When payments are made to non-U.S. flow-through entities such as partnerships or trusts, or undocumented or tax exempt entities such as foundations or governmental bodies, the withholding agent must reliably identify the beneficial owner individual or corporation or follow the more conservative presumption rules. These will be discussed in future IPS unit “FDAP Payments – Undocumented NRA” RPW/CU/P_08.1_xx., or see Treas. Reg. 1.1441-1(b)(3).
- **Sourcing.** An important concept that is closely related to FDAP is sourcing. In particular, the U.S. only has jurisdiction to tax FDAP income if it is from “sources within the United States”. For an IPS Unit that focuses on source of income, please refer to Concept Unit FDAP Payments – Source of Income, RPW/CU/P_8.1_02(2014).

Relevant Key Factors

FDAP Income

Key Factors

There are factors that determine if a payment is FDAP and factors that determine if that FDAP is subject to withholding at source.

Is the payment FDAP? (Fixed or determinable, annual or periodical)?

- What is the character of the payment? E.g., dividends, interest, rents, royalties, services.
- Is the payment income to the recipient? E.g., redirected payments: If A pays C at the request of B, A is obligated to treat B as the beneficial owner of the payment, whether B is U.S. or foreign, if the payment is income to B under U.S. tax principals.
- Some payments are not income. E.g., payment for the sale of goods and return of an investor's capital.
- If the payment is FDAP, is this income named in the withholding regulations as an excluded type? E.g., capital gains, interest on debt with a term less than 6 months, accrued interest between bond payment dates, etc.
- If the payment is not FDAP, is this income named in the withholding regulations as an included type? E.g., distributions to publicly traded partnerships

To determine if FDAP payments are subject to withholding, ask:

- Is the FDAP payment made to a foreign person?
- Is the FDAP payment U.S. source?
- Is the FDAP payment exempt from withholding?

A FDAP payment that is exempt from withholding is usually still be subject to required reporting on Forms 1042-S and 1042.

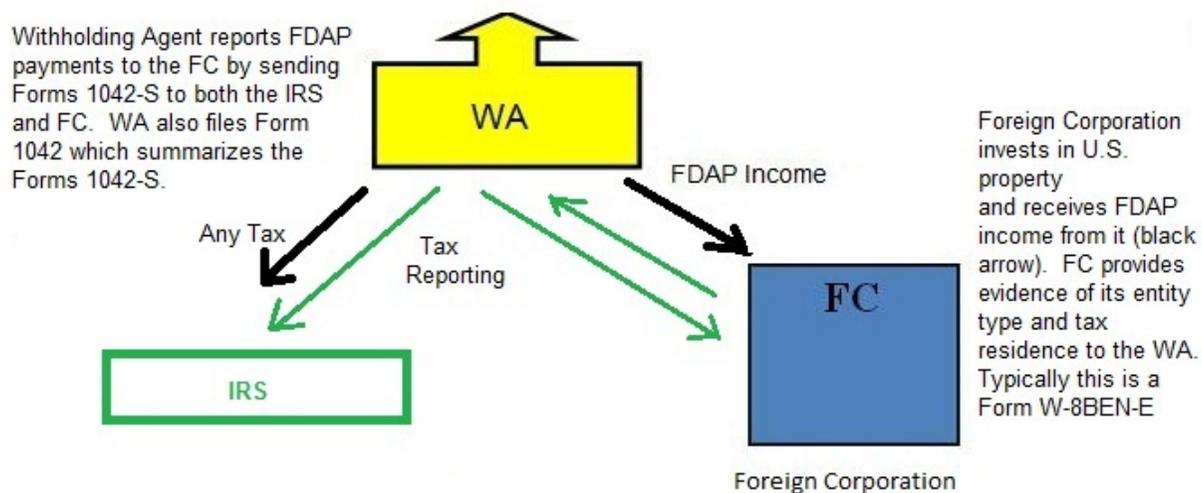
An item that is not FDAP for purposes of Chapter 3 may still be considered FDAP for purposes of Chapter 1, and be subject to tax if U.S. source, but not FDAP for purposes of withholding.

Diagram of Concept

FDAP Income

Diagram of Concept

- Most organizational charts of entity ownership structures show the owner at the top and the companies owned below them.
- Beneficial owners (“BO’s”) in CTW often receive dividends or interest as parent corporation owner or as a parent corporation lender. That is, the BO normally invests in the U.S. The BO owns assets in the U.S., such as securities, real property or intangible property. The FDAP income the BO receives is a repatriation of the foreign person’s (inbound) investment in the U.S.
- Other times the withholding agent (“WA”) payor is just an intermediary between the U.S. stock or bond issuer and the BO, such as a broker so the USWA is insignificant for ownership purposes.
- Beware: diagrams of payments from USWA to intermediaries and BOs often show the USWA at the top and the BO at the bottom as is shown below. This convention is the opposite of the normal one with the owner(s) at the top.



Facts of Concept

FDAP Income

Facts of Concept

- This concept “FDAP Income” is relevant for this unit only if both of the additional criteria below are met. These 2 criteria are covered in other units.

Criteria

- The corporation receiving the U.S source FDAP income is not created or organized in the U.S. and is thus a foreign person.
 - IRC § 1442
 - Treas. Reg. 1.1441-1(c)(2) & (4)
 - Publication 515 - Foreign Persons
- The source of the FDAP income received by a non U.S. person is U.S. source
 - IRS.gov – Nonresident Aliens - Source of Income
 - IRS.gov - Sourcing Personal Service Income
 - FDAP Payments - Source of Income - RPW/CU/P_08.1_02(2014)

Detailed Explanation of the Concept

FDAP Income

Analysis	Resources
<ul style="list-style-type: none">▪ FDAP income is defined very broadly and generally includes all U.S. source income except gains derived from the sale of real or personal property and income specifically excluded from gross income such as tax-exempt interest.▪ FDAP income generally includes any noneffectively connected U.S. source income earned by a foreign person▪ FDAP does not include items of income that are excluded from gross income under a provision of law without regard to the U.S. or foreign status of the owner of the income▪ An example of a payment that is not FDAP, where reporting is not required, is interest excluded from gross income under IRC § 103(a), interest on any State or local bonds.▪ Two examples of payments that are FDAP, where reporting is required even if withholding is not, are income under IRC § 892 (income of foreign governments) or IRC § 115 (income of a U.S. possession). Portfolio interest under IRC § 871(h) is also FDAP.▪ FDAP income normally includes income that is fixed or for which the amounts to be paid are known ahead of time; is determinable or there is a basis for figuring the amount to be paid; is annual or paid yearly; or is periodical or paid from time to time not specifically in regular intervals	

Detailed Explanation of the Concept (cont'd)

FDAP Income

Analysis	Resources
<ul style="list-style-type: none">▪ CTW is imposed through withholding at source by withholding agents. Non U.S. partnerships and trusts and other flow through entities are obligated to identify and document the tax residence of their beneficial owners so that the withholding at source on the beneficial owners' FDAP income can be accomplished correctly by the withholding agents. Presumption rules determine how withholding agents must treat undocumented payees regarding their U.S. versus non-U.S. residence. When the character of income or the source of the income is mixed or uncertain presumption rules also default to all FDAP and all U.S. source.	

Detailed Explanation of the Concept (cont'd)

FDAP Income

Analysis	Resources
<ul style="list-style-type: none">▪ The types of FDAP income seen most frequently with some notes on the major exceptions are listed below. Also see the Overview for IPS Part 8.1 FDAP Payments and Treas. Reg. 1.1441-2(a). These are types of FDAP commonly paid to foreign entities such as corporations, complex or grantor trusts, and governments. These payments are also made to individuals, partnerships, simple trusts and other intermediary or flow through entities, but the rules that establish the character of the income are common.▪ Interest – on bonds, loans, syndicated loans, private placements, notes, OID when realized under IRC § 871 (g)<ul style="list-style-type: none">– But not: interest from foreign borrowers (foreign source), interest on obligations of less than 6 months.– Special Rule: portfolio interest (as defined in 881(c)(2)), mortgage interest, collateralized mortgage obligations, money market fund Interest, payments for guarantees of indebtedness. Portfolio interest is discussed in Portfolio Debt Exemption – Requirements and Exceptions, RPW/9424.01_01(2013). Bank deposit interest paid to individuals is now generally subject to reporting. Instructions to form 1042-S for further information.▪ Dividends: regular or special, and substitute dividends such as those paid to a stock lender for the use of his stock.	

Detailed Explanation of the Concept (cont'd)

FDAP Income

Analysis	Resources
<ul style="list-style-type: none">– But not: most dividends from foreign corporations (foreign source except see IRC § 861(a)(2)(B)), substitute for dividends paid under a notional principal contract (NPC) before 2016, unless one of 4 criteria are met. See IRC § 871(m), 1.1441-2(b)(4) and T.D. 9648.– Proposed regulations include as substitute dividends payments on certain NPC's that reference U.S. equities and whose payments are at least 70% correlated to price and dividend performance of those equities. REG-120282-10▪ Royalties: for artistic works (books, movies, plays), technology (patents, licenses, right to use software)<ul style="list-style-type: none">– But not: payments made for use of property outside of the U.S. (foreign source)▪ Rent: for property used in the U.S.<ul style="list-style-type: none">– But not: If owner has elected to treat real property rent as ECI. See IRC § 882 (d), Treas. Reg. 1.871-10 and 1.882-1.– Special: utilities or taxes included in rent payments.▪ Capital Gains: only on gains on timber, coal, iron ore. See Treas. Reg. 1.1441-2(c)(1).<ul style="list-style-type: none">– Not: Broker proceeds, which, in the case of the proceeds from the sale of a stock or a bond by a non-U.S. person, is usually return of capital plus capital gain/loss, neither of which is included in FDAP.– Special: Gain derived from the sale of real property (but see IPS Part 8.4 FIRPTA Overview)	

Detailed Explanation of the Concept (cont'd)

FDAP Income

Analysis	Resources
<p>In addition to the above common types, FDAP income generally includes U.S. source income of these less common types including:</p> <ul style="list-style-type: none">▪ The distributable net income of an estate or trust that is FDAP income and must be distributed currently, or has been paid or credited during the tax year.▪ FDAP income distributed by a partnership that, or such an amount that, although not actually distributed, is includible in the gross income of a foreign partner.▪ Publication rights.▪ Gains realized on the disposition of timber, coal or domestic iron ore, with a retained interest covered by IRC § 871(a)(1)(B) and IRC § 631(b).▪ Realized interest income in the form of original issue discount (OID), as defined in IRC § 871(g). This means that OID interest is normally reportable and taxable when the OID note is redeemed and the interest is paid by the issuer. Tax is frequently reduced, however, because many marketable OID investments by foreign investors qualify for the portfolio interest exemption.▪ Gains from the sale of copyrights, patents and similar types of intellectual property where the payments are contingent on productivity, use, or disposition of the property IRC § 871(a)(1)(D).▪ Taxes, mortgage interest, utilities or insurance premiums paid to or for the account of, a foreign corporate landlord by a tenant under the terms of a lease.	

Detailed Explanation of the Concept (cont'd)

FDAP Income

Analysis	Resources
<p>Below are other types of FDAP payments that can be paid to foreign entities but are more commonly paid to nonresident alien individuals.</p> <ul style="list-style-type: none">▪ Payments for Services. See RPW/9424.01_xx(201x) Note: xx in an IPS citation means the unit is planned or expected but not yet approved with a DCN.<ul style="list-style-type: none">– Not: those performed outside the U.S. (foreign source)– If equipment set-up labor costs are included with capital item purchases, an allocation to the labor component may be required.▪ Payment received for a promise not to compete is generally FDAP income. Its source is the place where the promisor forfeited his or her right to act. Amounts paid to a nonresident alien individual for his or her promise not to compete in the United States are subject to withholding at source.▪ Gambling or lottery winnings Lottery winnings though some games are excepted. See WIT/CU/P_15.1_01(2014). <p>Income distributions from publicly traded partnerships are required to be reported on Form 1042-S and Form 1042 as if they are FDAP. The character of such partnership distributions is not changed, however.</p>	

Detailed Explanation of the Concept (cont'd)

FDAP Income

Analysis	Resources
<p>Certain types of interest income are FDAP but usually exempt from taxation (reporting requirements vary):</p> <ul style="list-style-type: none">▪ Portfolio Interest per Treas. Reg. 1.1441-1(b)(4)(i)▪ Interest on deposits in U.S. financial institutions including insurance companies per Treas. Reg. 1.1441-1(b)(4)(ii)▪ The active foreign business percentage of interest paid by grandfathered 2010 U.S. 80/20 company (wherein 80% of the gross income is from foreign operations) per Treas. Reg. 1.1441-1(b)(4)(vi) and IRC § 871(i)(2)(B)(ii)▪ The active foreign business percentage of dividends paid by a grandfathered 2010 U.S. 80/20 company, IRC § 871(i)(2)(B)(i)▪ Annuities from a qualified annuity plan, per IRC § 871(a)(1)(f) and Treas. Reg. 1.1441-1(b)(4)(x)	

Detailed Explanation of the Concept (cont'd)

FDAP Income

Analysis	Resources
<p>Certain U.S. source income that is specifically identified as not FDAP includes:</p> <ul style="list-style-type: none">▪ Effectively connected income (ECI) from a U.S. trade or business. per Treas. Reg. 1.1441-1(b)(4)(viii).▪ Rental income treated as ECI via the election in Reg. Sec. 1.871-10.▪ Most gains derived from the sale of personal property (including securities) including market discount and option premiums.▪ Gains derived from the sale of real property (but see FIRPTA).▪ Short term interest paid between coupon dates of bonds per Treas. Reg. 1.1441-1(b)(4)(iv).▪ Short term OID per Treas. Reg. 1.1441-1(b)(4)(iv).▪ Items of income excluded from gross income without regard to U.S. or foreign status of the owner of the income, such as tax-exempt municipal bond interest and qualified scholarship income.	

Training and Additional Resources

FDAP Income		
Type of Resource	Description(s) and/or Instructions for Accessing	References
IRS.gov	<ul style="list-style-type: none"> Hyperlinked pages on numerous “NRA Withholding” topics 	
CENTRA Sessions	<ul style="list-style-type: none"> 2015 (IBC) CPE – FPP New Hires –Live Training Decks, Lesson 01a and CENTRA session of 3/24/2015 “NRA Withholding – Taxation of Foreign Person FDAP vs ECI (KJP731135)” 	
ELMS	<ul style="list-style-type: none"> Withholding at Source 	<ul style="list-style-type: none"> ELMS course 40962

Glossary of Terms and Acronyms

Term/Acronym	Definition
CTW	Chapter Three Withholding
DCN	Document Control Number
ECI	Effectively Connected Income – IRC § 871(b)
FDAP	Fixed Determinable Annual Periodical - IRC § 871(a)
IIC	International Individual Compliance
IPS	International Practice Service
IRC	Internal Revenue Code – Title 26
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
NRA	Nonresident alien individual - IRC § 7701(b)(1)(B)
Rev. Rul.	Revenue Ruling
Treas. Reg.	Treasury Regulation

Index of Related Issues

Issue	Associated UIL(s)	References
Source of Income	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding FDAP Payments 	<ul style="list-style-type: none"> ▪ RPW/CU/P_08.1_02(2014)
FDAP Withholding	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding FDAP Payments 	<ul style="list-style-type: none"> ▪ RPW/CU/P_08.1_03(2014)
FDAP Payments	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding FDAP Payments 	<ul style="list-style-type: none"> ▪ Part 8.1 Overview
IIC - Overview of FDAP Income	<ul style="list-style-type: none"> ▪ 9442.01 Withholding (Individual Inbound) 	<ul style="list-style-type: none"> ▪ WIT/CU/P_15.1_01(2014)
FDAP Payments - Payee Documentation for Treaty Benefits	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding FDAP Payments 	<ul style="list-style-type: none"> ▪ RPW/9424.01_03(2013)
FDAP Payments - Portfolio Debt Exemption - Requirements and Exceptions	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding FDAP Payments 	<ul style="list-style-type: none"> ▪ RPW/9424.01_01(2013)
ECI Fundamentals	<ul style="list-style-type: none"> ▪ 9421.01 Jurisdiction to Tax 	<ul style="list-style-type: none"> ▪ TBD