



International Tax ADVISORY ■

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IRS Guidance May Complicate Withholding Agents' Responsibilities

Every person required to deduct and withhold tax under Chapter 3 of the Code, relating to withholding on nonresident aliens and foreign corporations, is made liable for such tax pursuant to Section 1461. The Foreign Account Tax Compliance Act (FATCA, located in Chapter 4) has upped the stakes for many withholding agents with a parallel liability rule in Section 1474 with respect to Chapter 4 withholding. Consequently, withholding agents must be especially vigilant in their duties regarding the solicitation and receipt of appropriate withholding certificates and related documentation from foreign persons. Withholding agents should also familiarize themselves with the rules that entitle them to rely on certifications and documentation for both Chapter 3 and Chapter 4 withholding. In two recent Chief Counsel Advices (CCAs), the IRS discussed withholding agents' reliance on documentation under Chapter 3.

CCA 201434021 – Obtaining Documentation After Payment

Section 1441 (a part of Chapter 3) and its regulations generally require a withholding agent to withhold 30 percent of any payment of U.S. source fixed or determinable, annual or periodical income to a nonresident alien unless the agent can reliably associate the payment with documentation on which the agent can rely to treat the payment as made to a U.S. person or to a foreign person entitled to reduced withholding. In a perfect world, a withholding agent would always be able to establish whether a payee is entitled to a reduced rate of withholding based on documentation obtained prior to payment, but the world of withholding certificates is far from perfect. Indeed, the regulations allow for proof of reduced withholding to be established after payment is made. Nevertheless, the rules provide that additional proof may be required if "the delays in obtaining the withholding certificate affect its reliability."

Section 871(h) provides that no tax shall be imposed on U.S. source portfolio interest received by a nonresident alien. Similarly, Section 1441(c)(9) states that portfolio interest is generally not subject to withholding unless a withholding agent knows or has reason to know that the interest is not portfolio interest. Interest on registered obligations qualifies as portfolio interest and is not subject to withholding only if the withholding agent receives a withholding certificate or other documentation establishing the beneficial owner's foreign status. Under Section 1.871-14(c)(3)(i), the requisite withholding certificate or documentary evidence must be "furnished before the expiration of the beneficial owner's

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period of limitation for claiming a refund of tax with respect to such interest [on the registered obligation].”

Under Section 6511(a), the statute of limitations for a refund claim is the later of three years from the time the return was filed or two years from the time the tax was paid, or, if no return was filed, two years from the time the tax was paid. When tax is withheld under Chapter 3, tax is deemed paid by the recipient of the income on the last day prescribed for filing a return under Section 6012.

In CCA 201434021, the IRS addressed whether Section 1.871-14(c)(3)(i) could curb a withholding agent’s ability to obtain documentation for non-withholding on portfolio interest after the payment date if (1) the nonresident alien did not file a U.S. tax return or pay any tax the year of payment, or (2) the nonresident alien filed a U.S. tax return and paid tax unrelated to the interest payments for the year the payments were made. In the first scenario, the IRS concluded that withholding agents would not be barred from obtaining the documentation subsequent to the payment date, but noted that additional proof may be required if the delay affected the documentation’s reliability. In the second scenario, the IRS concluded that a withholding agent may be barred by Section 1.871-14(c)(3)(i) from obtaining documentation to support the portfolio interest claim because the filing of a return and the payment of tax trigger the start of the nonresident alien’s limitations period under Section 6511.

Under the CCA’s facts, the withholding agent, a financial institution, is under examination for a taxable year during which the agent made payments of interest to nonresident aliens A and B. The withholding agent treated the payments as portfolio interest and thus did not withhold or deposit tax under Section 1441, even though it did not have the required documentation to support such treatment at the time it made the payments. During audit, the withholding agent obtained sufficient documentation to treat the payments made to A and B as portfolio interest. The IRS explained that, at the time the withholding agent made the interest payments to A and B, the payments did not qualify as portfolio interest because the agent lacked the required withholding certificate or documentary evidence. The withholding agent would be liable for the tax it was required to withhold unless it obtains the documentation within the period prescribed by Section 1.871-14(c)(3)(i), i.e., before the expiration of each beneficial owner’s period of limitations for claiming a refund of tax with respect to the interest.

Because A did not file a U.S. tax return or pay any tax for the year at issue (and A was not deemed to have paid tax because no tax was withheld), A’s limitations period has not started and thus cannot have expired, and the withholding agent is not precluded from subsequently obtaining the supporting documentation. The withholding agent may be required to furnish additional proof to support the claim for reduced withholding or else be liable under Section 1461 for any deficiency.

In contrast, B filed a U.S. tax return and paid tax for the taxable year at issue, albeit unrelated to the interest income. Because these acts start the limitations period of Section 6511(a), the withholding agent would be barred by Section 1.871-14(c)(3)(i) from obtaining documentation to support the portfolio interest claim after the later of three years from the time B filed the tax return or two years from the time B paid tax. Even if the withholding agent secures the required documentation within this time, it may have to furnish additional proof to support the claim for reduced withholding. If the withholding agent cannot obtain the proper documentation within B’s limitations period, or cannot provide additional proof as required under the regulations, the withholding agent is liable under Section 1461 for any deficiency.

Withholding agents may have no idea whether or when recipients of portfolio interest file U.S. tax returns or pay taxes for a given taxable year and thus have no way of determining their respective limitations period for refund claims. The IRS’s position that a withholding agent’s ability to subsequently secure required documentation may be

time-barred counsels timeliness in obtaining withholding certificates and documentary evidence from beneficial owners, lest the withholding agent be left on the hook.

CCA 201428007 – Reliance on Form W-8ECI

Income that is effectively connected with a U.S. trade or business (ECI) is generally included in a beneficial owner's gross income under Section 871(b)(2) and therefore not subject to withholding under Section 1441(c)(1). The regulations generally entitle a withholding agent to rely on a claim of exemption if, prior to the payment of income to the foreign beneficial owner, the withholding agent can reliably associate the payment with a properly executed Form W-8 withholding certificate. For example, a Form W-8ECI withholding certificate is valid only if it is properly and fully complete, including the signed certification under penalties of perjury that the beneficial owner is a non-U.S. person and that the income at issue is ECI includible in the payee's (or beneficial owner's) gross income for the taxable year.

This entitlement to rely, however, does not cover a withholding agent that has actual knowledge or reason to know that a claim for reduced withholding is unreliable or incorrect. If the withholding agent has such knowledge, it must withhold at the full 30 percent statutory rate. Further, if the withholding agent receives notification from the IRS that a claim of reduced withholding is incorrect, the agent is considered to have actual knowledge beginning 30 calendar days after the date such notice is given.

The issue raised in CCA 201428007 is whether the IRS's authority to require withholding is limited to cases where the IRS has sufficient facts to prove that the information provided by the beneficial owner on the Form W-8 ECI is incorrect. Unsurprisingly, the IRS concluded that its authority is not so limited. According to the CCA's facts, during a withholding tax audit the IRS determined that a beneficial owner who had submitted Forms W-8ECI had not filed a U.S. federal income tax return for the audit years at issue or for any subsequent year. Such returns would have been required to report the income claimed to be ECI and not subject to withholding. The withholding agent maintained that it was entitled to continue to rely on the beneficial owner's certifications on Form W-8ECI because the form was complete and appropriately executed.

First, the IRS pointed to the fact that the statute, regulations and Form W-8ECI all refer to ECI as income that is included in the beneficial owner's gross income for the taxable year. A claim for exemption from withholding on ECI thus incorporates a beneficial owner's representation that U.S. income tax returns are being filed. Second, the IRS noted that the Form W-8ECI bears a notation near the top of the form stating that persons submitting Form W-8ECI must file U.S. income tax returns to report the ECI. On these grounds, the IRS concluded that it had properly determined the Form W-8ECI exemption claim to be incorrect and validly served notice on the withholding agent. Consequently, the withholding agent then had actual knowledge that it could no longer rely on the foreign beneficial owner's withholding certificate.

Interestingly, the CCA states that it expresses no opinion on whether the notice proposed to be sent by the auditor to the withholding agent raises any confidentiality or disclosure issues under Section 6103. That's an issue for another day.

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