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International Tax ADVISORY ■

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IRS to Limit Credits and Refunds for Withheld Taxes to Amounts Deposited by Withholding Agents

In Notice 2015-10 (the "Notice"), the IRS announced that it and the Treasury will issue regulations to limit credits or refunds for certain withholding taxes to the amount actually deposited by withholding agents. The regulations would apply to withholding on foreign persons under Sections 1441 through 1443 (Chapter 3) and under Sections 1471 and 1472 (Chapter 4, also known as the Foreign Account Tax Compliance Act (FATCA)). The hope is that this "deposit limitation" will lessen the Treasury's financial risk of crediting or refunding more tax, based on Form 1042-S reporting, than it collects or can collect.

The government's concern over the gap between withholding reported and deposited is reasonable, especially when recovery of improperly granted credits or refunds is unlikely (e.g., given to persons outside the U.S.). The Notice, however, does not directly address deposit shortfalls or fraudulent claims. The Notice's rules would penalize taxpayers subject to withholding for the failures of withholding agents—with the implied expectation that affected taxpayers would pressure withholding agents to satisfy their deposit obligations. While that expectation may play out eventually, it seems unfair to deny an otherwise valid credit or refund claim in the meantime—particularly when the relevant noncompliant withholding agent is domestic.

Background

Chapter 3 generally requires withholding agents to collect tax on foreign persons imposed by Sections 871(a), 881(a) and 4948 on U.S.-source fixed or determinable annual or periodic income through withholding. Chapter 4 generally imposes withholding tax on certain payments to foreign financial institutions (FFIs) and certain nonfinancial foreign entities that do not meet FATCA's information reporting requirements. In addition, Chapter 4 requires participating FFIs to withhold tax on certain payments to recalcitrant accountholders and nonparticipating FFIs. Domestic withholding agents primarily collect these taxes, although foreign withholding agents are also subject to Chapters 3 and 4.

Section 6302 requires withholding agents to deposit amounts withheld with the U.S. Treasury. A withholding agent must report on Form 1042 its U.S. income tax liability for amounts that it is required to withhold under Chapters 3 and 4

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for the calendar year. Further, a withholding agent must report any tax withheld with respect to a payment on Form 1042-S, which is filed with the IRS and given to the payment recipient. The aggregate amount reported on all Forms 1042-S as withheld or paid by the withholding agent should equal the liability reported on Form 1042. A withholding agent remains liable for taxes under Chapters 3 and 4, as well as associated interest and penalties, if the withholding agent's liability exceeds its deposits and the agent has not paid the tax due with its Form 1042.

Sections 33 and 1462 and the regulations thereunder generally allow a credit for tax withheld at source under Chapter 3. Section 1474(b) and related rules permit a credit for tax deducted and withheld at source under Chapter 4 as if it were withheld under Chapter 3. Regulations under Chapters 3 and 4 also provide for a refund or credit under Chapter 65 (Sections 6401 through 6432) of an overpayment of tax actually withheld at source if certain requirements are met. To claim such credit or refund, the foreign income recipient or beneficial owner must follow certain procedural requirements, including attaching a copy of any relevant Form 1042-S to the income tax return on which the claim is made.

Notice 2015-10

The IRS and Treasury will amend regulations under Sections 33, 1462, 1464 and 1474 to provide that a credit or refund for withheld tax is available only to the extent that the relevant withholding agent has deposited or otherwise paid to Treasury the amount withheld. Subject to certain exceptions, including "potentially" those described in the Notice, no credit or refund will be allowed for Chapter 3 or 4 withholding to the extent there is a shortfall in deposits by the withholding agent.

In the case of partial deposits, the new regulations will use a pro rata method to determine the amount of credit or refund allowed to each claimant, based on the withholding agent's "deposit percentage." The deposit percentage equals the withholding agent's deposits to its Form 1042 account divided by the amount reported as withheld on all of its Forms 1042-S. For purposes of credit and refund claims related to Chapter 3 or 4, each claimant is treated as if the withholding agent made a deposit equal to the amount reported on the claimant's Form 1042-S multiplied by the deposit percentage. Only if the deposit allocated to a claimant exceeds the claimant's tax liability will a claimant be entitled to a credit or refund. The IRS deems the deposit allocation methodology as less burdensome than specific tracing or matching of deposits to reported withholding, given the existing withholding, reporting and deposit procedures.

The Notice acknowledges that written procedures will be needed to ensure that claimants are apprised of the status of their claims and receive the proper amount of credit or refund. The IRS is considering, for example, when to compute a withholding agent's initial deposit percentage and how frequently to update the percentage for deposits made after Form 1042 is filed. The IRS is also considering how withholding agents and claimants will be informed of the deposit percentage (initial or recomputed) and the process by which additional credit or refund may be allowed if and when the deposit percentage increases.

IRS and Treasury are evaluating "potential" exceptions to the general rules described in the Notice, specifically whether exceptions are administrable and minimize the potential for fraud or the intentional underdeposit of withholding taxes. For example, an exception to the deposit limitation may apply if the deposit shortfall is de minimis or if the withholding agent has a demonstrated history of compliance with its deposit obligations. The Notice clarifies that exceptions would treat a claimant as if a full deposit had been made only for purposes of a credit or refund claim under Chapter 3 or 4. Exceptions would not treat the withholding agent as having satisfied its deposit requirements; withholding agents would remain liable for the tax required to be deposited as well as associated interest and penalties.

Rare PFIC Letter Ruling Applies Look-Through Rules

PLR 201515006 addressed the application of two look-through rules under the Code's passive foreign investment company (PFIC) regime. Under Section 1297(a), a foreign corporation is a PFIC if either 75 percent or more of its gross income is passive (the "income test") or the average percentage of its assets which produce or are held to produce passive income is at least 50 percent (the "asset test"). Section 1297(b)(1) generally defines "passive income" by reference to Section 954(c).

If a foreign corporation owns, directly or indirectly, at least 25 percent of the stock of another corporation, Section 1297(c) treats the foreign corporation as directly holding and receiving its proportionate share of the assets and income, respectively, of the subsidiary corporation (the "subsidiary look-through rule"). Moreover, for purposes of the income and asset tests, the foreign corporation's stock in the subsidiary and dividends from the subsidiary are disregarded. Likewise, debt obligations of the subsidiary which are held by the foreign corporation, and interest thereon, are disregarded in applying the income and asset tests.

Section 1298(b)(7) provides another look-through rule (the "domestic look-through rule"). If a foreign corporation owns 25 percent or more (by value) of the stock of a domestic corporation ("first-tier domestic corporation") and the foreign corporation is either subject to the accumulated earnings tax or waives any treaty benefit that would prevent imposition of such tax, then for purposes of determining whether the foreign corporation is a PFIC, (1) the stock of a domestic corporation other than a real estate investment trust or regulated investment company ("second-tier domestic corporation") held by the first-tier domestic corporation is not a passive asset and (2) any amount included in the gross income of the first-tier domestic corporation with respect to the stock of the second-tier domestic corporation is not passive income. Under Section 532, a foreign corporation (other than a PFIC) that has any U.S. shareholders is subject to accumulated earnings tax.

The letter ruling considered the determination of the PFIC status of a publicly traded foreign corporation ("X"), which was resident in a treaty jurisdiction and had some U.S. shareholders. X wholly owned a domestic subsidiary ("Y"), which in turn wholly owned a domestic subsidiary ("Z"). X also held an obligation of Y, on which Y paid or accrued interest. X's board of directors passed a resolution to waive irrevocably any protection under the relevant treaty against the imposition of accumulated earnings tax. The facts also state that X does not own any PFIC stock and that, taking into account only income earned and assets owned by X and Y, X would not be a PFIC.

Relying on legislative history under Section 1298(b)(7), the IRS concluded that, for purposes of determining whether X was a PFIC, the subsidiary and domestic look-through rules treat X as directly holding the stock of Z, which is not a passive asset for purposes of the asset test. Further, X is treated as directly receiving dividends paid by Z, which do not constitute passive income for purposes of the income test. In applying the asset and income tests, the stock of Y held by X, and dividends thereon, and the obligation of Y held by X, and interest thereon, would be disregarded.

The PFIC rules can carry significant tax consequences for U.S. investors in foreign corporations, yet formal guidance is sorely lacking. Most of the substantive PFIC regulations exist only in proposed form, with glaring holes in coverage. Letter rulings, which cannot be relied on as precedent, rarely address the PFIC rules, apart from responding to late election requests. Even the conclusions in PLR 201515006 rest on legislative history dating back to 1988, as no regulations address the coordination of the look-through rules. While the recent ruling offers some insight, the PFIC rules warrant much more definitive guidance.

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