Information Reporting & Withholding

A Holiday Present from the IRS and Treasury, Proposed Regulations under FATCA and Chapter 3

Who is impacted

All parties dealing with the current rules under chapters 3 and 4 who have been waiting for guidance on many issues will be very interested in the proposed regulations aimed at reducing burdens under these chapters.

What changed

On December 13, 2018, the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) issued proposed regulations under chapters 3 (nonresident alien withholding and reporting) and 4 (Foreign Account Tax Compliance Act (FATCA)) of the Internal Revenue Code (Code). Aimed at reducing taxpayer burdens with respect to compliance under these sections, below is a summary of the key provisions:

<u>No Withholding on Gross Proceeds!</u>

Chapter 4 brought us the scary potential of a 30 percent FATCA withholding tax on payments of gross proceeds from the sale of any property that could produce U.S. source interest or dividends. Industry commented ad nauseum on the burden of implementing this requirement citing the length of lead time, incremental efforts to obtain reliable documentation for these payments, and that this type of withholding did not further the purpose of chapter 4.

After years of deferring the date when withholding on gross proceeds would begin, the IRS and Treasury finally eliminate this requirement in the proposed regulations and remove any mention of or provisions related to withholding on gross proceeds from chapter 4. Woo hoo!

<u>No Withholding on Non-Cash Value Insurance Premiums!</u>

The proposed regulations revise the definition of excluded nonfinancial payments. This definition now includes premiums for insurance contracts that do not have cash value. Chapter 4 withholding will not apply to these types of payments. Industry commented on the cumbersome process of collecting withholding certificates and withholding statements from carriers, syndicates, and other intermediaries for these premiums. As withholding on these types of payments did not further the purpose of chapter 4 and changes in the Tax Cuts and Jobs Act regarding passive foreign investment companies are expected to mitigate reporting on U.S. owners of these companies under chapter 4, the IRS and Treasury agree that withholding on non-cash value insurance premiums is not necessary.

Taxpayers may apply these proposed regulations for all open tax years until final regulations are issued.

<u>Another Deferral for Withholding on Foreign Passthru Payments</u>

Although withholding on foreign passthru payments was not eliminated (wishful thinking), the IRS and Treasury were kind enough to provide another deferral. In the proposed regulations, this type of withholding will not be required until two years after the date that final regulations defining the terms of foreign passthru payments have been published in the Federal Register.

Foreign passthru payments impact FFIs that have an agreement with the IRS. They will have to withhold on passthru payments they make to recalcitrant account holders or investors and nonparticipating FFIs.

One of the reasons that the IRS and Treasury did not eliminate this type of withholding is because it provides FFIs with a way to remain compliant even if some of its account holders or investors do not provide the details that FFIs will need in order to determine whether they need to report under FATCA. Another reason is that withholding on foreign passthru payments prevents nonparticipating FFIs from avoiding FATCA by investing in the United States through a participating FFI 'blocker.' This means that a participating FFI that is an investment entity could receive U.S. source FDAP income free of withholding under chapter 4 and then pay the amount to a nonparticipating FFI as a corporate distribution thereby changing the character and source to evade U.S. withholding and reporting.

The IRS and Treasury continue to request input on the methodology for determining a "passthru payment percentage." It is important that the industry takes them up on this offer and provides insight.

Alignment on the Definition of Investment Entity with the Common Reporting Standard (CRS)

Under chapter 4, the definition of financial institution includes investment entities with gross income that is primarily attributable to investing, reinvesting, or trading in financial assets and the entity is "managed by" another entity that is a depository institution, custodial institution, insurance company, or an investment entity. Industry commented that this definition was a bit too broad and that it should align with the definition set forth by the Organization for Economic Cooperation and Development (OECD) in the CRS. The proposed regulations clarify that an entity is not "managed by" another entity solely because the former entity invests in all or a portion of its assets in the latter, if such entity is a mutual fund, exchange traded fund, or a collective investment entity that is widely-held and is subject to investor protection regulation. The preamble to the proposed regulations warns that an investor in a discretionary mandate will be treated as "managed by" the financial institution.

Taxpayers may apply these proposed regulations for all open tax years until final regulations are issued.

Chapter 3 Treaty Statement Relief

Chapter 3 generally requires a withholding agent to collect from beneficial owners a withholding certificate or documentary evidence and a treaty statement in order to grant treaty relief. In 2017, coordinating regulations included additional requirements that the industry saw as burdensome. One was the treaty statement that had a three year validity period for all entities and the transition rules for withholding agents to obtain Limitation on Benefits (LOB) information. As such, the proposed regulations seek to provide relief to those requirements.

The proposed regulations provide relief for certain entity beneficial owners providing a treaty statement with documentary evidence. There is now an exception to the three-year validity period for treaty statements provided with documentary evidence from tax exempt organizations (other than tax-exempt pension trusts or pension funds), governments, and publicly traded corporations, entities whose qualification under an applicable treaty is unlikely to change. The three-year validity period still applies in all other cases. The date withholding agents must obtain new treaty statements that comply with the LOB requirement for accounts or investments they documented with documentary evidence before January 6, 2017, has been pushed to January 1, 2020 (extended from January 1, 2019). Finally, a withholding agent may rely on the claim in a treaty statement regarding a specific LOB provision absent actual knowledge that such claim is unreliable or incorrect.

All of these changes will be incorporated into the 2017 Qualified Intermediary (QI) agreement and 2017 Withholding Partnership (WP) and Withholding Trust (WT)agreements, and a QI, WP, or WT may rely upon these proposed modifications until such time.

<u>Clarification on Permanent Addresses that are Hold Mail Addresses</u>

In the 2017 coordination regulations (and the 2017 chapter 4 regulations), even if there is a hold mail instruction for an account holder or investor, a withholding agent may rely on a permanent residence address if the account holder or investor provides documentary evidence establishing residence in the country in which it claims to be a resident for tax purposes. Industry commented that when the beneficial owner is not making a treaty claim, the requirement that documentary evidence must establish residence in a particular country is unnecessarily strict.

The proposed regulations distinguish documentary evidence that establishes non-U.S. status versus treaty eligibility. In order to treat an address that is subject to a hold mail instruction as a permanent residence address, the beneficial owner must provide documentary evidence that supports its claim of foreign status. If that beneficial owner is claiming treaty benefits, then the documentary evidence must support residence in the country where the beneficial owner claims treaty benefits. To avoid question, proposed regulations also clarify that a hold mail instruction does not include a request to receive all correspondence (including account statements) electronically (via e-mail).

These rules apply for purposes of chapters 3 and 4 and taxpayers may apply these proposed regulations for all open tax years until final regulations are issued. A QI, WP, or WT may rely upon these proposed modifications until they are incorporated into the 2017 QI agreement and 2017 WP and WT agreements.

<u>Removing the Lag Method for Partnerships and Coordinating with U.S. Withholding Agent Rules</u>

All U.S. partnerships are familiar with the lag method, which has been described in Instructions to Form 1042 and the WP and WT agreements. As a quick example, this method applies when a U.S. calendar year partnership receives U.S. source dividends in 2017, but does not make a distribution to its non-U.S. partners. The partnership must withhold on the non-U.S. partners' share of the dividend income by the time the partnership issues Schedules K-1, Partner's Share of Income, Deductions, Credits, etc. This form must be furnished to each partner on or before March 15 following the close of the taxable year, a due date that may be extended up to six months, which could be as late as September 15, 2018. Under the lag method, the U.S. partnership would report the withholding on Forms 1042-S and 1042 for the 2018 year, which are filed in 2019, and deposit the withholding in

2018. Because the extended due date for filing Form 1042-S generally occurs before the extended due date for furnishing a Schedule K-1 to a non-U.S. partner, a U.S. partnership may have to report amounts subject to withholding on a Form 1042-S before it actually performs the withholding.

Separately, withholding agents, in certain situations, have been able to adjust underwithholding simply by withholding the additional amount by the due date (without extensions) of Form 1042. Here, the withholding agent would designate the deposit and report the tax for the preceding year.

Commenters have long noted that the lag method presents issues for partners that claim a credit or a refund from the IRS. Because their Form 1042-S do not match Schedule K-1, the partner cannot support the claim until the following year when the latter Form 1042-S matches the prior Schedule K-1.

To reduce burden, the proposed regulations allow partnerships and trusts that withhold in a subsequent year to designate the deposit as attributable to the preceding year and report the amount on Forms 1042 and 1042-S for the preceding year – aligning with the rule for withholding agents.

There is an exception to this rule for fiscal year partnerships, whereby they must designate a deposit as made for the subsequent year and report the amount on Forms 1042 and 1042-S for the subsequent year. This provides flexibility to fiscal-year partnerships, so that they may determine the year for reporting that will result in the best matching of the income and the related withholding.

The proposed regulations revise the date for a partnership to file and furnish Form 1042-S when it withholds tax after March 15 of the following year and designates as deposited for the preceding year. The date to file and furnish Forms 1042-S will be September 15 of the following year, which aligns with the date a partnership must file Form 1042 and the extension date for furnishing Schedule K-1.

The IRS and Treasury intend to:

- Remove the requirement that a partnership or trust apply the lag method and to incorporate these proposed regulations into the Instructions for the 2019 Form 1042.
- Amend the Instructions to the 2019 Form 1042-S to require that when a partnership is filing Form 1042-S after March 15 for a partner's distributive share of an amount received by the partnership in the preceding year, the partnership must file and issue a separate Form 1042-S for such amount for the preceding year (in addition to any Forms 1042-S filed and issued to the partner for amounts that are withheld when distributed to the partner before March 15 and reported for the preceding year).
- Amend the WP and WT agreements to incorporate the proposed regulations. Until then, a WP or WT may rely on the proposed modifications for its filing and deposit requirements.
- Modify Form 1042-S to add a check box to the form so that a partnership filer can indicate that it qualifies for the September 15 due date for filing the form.

Taxpayers may not rely on the proposed regulations until Form 1042 and 1042-S are updated for the 2019 calendar year.

Adjustments to Overwithholding Under the Reimbursement and Set-off Procedures

Under chapter 3 and 4 rules, a withholding agent that has overwithheld and deposited tax may adjust the overwithheld amount using either the reimbursement procedure or the set-off procedure.

The reimbursement procedure allows a withholding agent to repay the beneficial owner or payee the overwithheld tax and to reimburse itself by reducing its deposit of withholding tax by that overwithheld amount before the end of the calendar year following the year of overwithholding. The withholding agent must repay the beneficial owner or payee before March 15, which is the due date for filing Form 1042-S for the calendar year of overwithholding, or the date on which the Form 1042-S is actually filed with the IRS, whichever is earlier. Also, it must state on a timely filed Form 1042 (without extensions) for the calendar year of overwithholding that the filing constitutes a claim for credit.

The set-off procedure allows a withholding agent to apply the overwithheld amount against any amount which would be subject to withholding that is paid to the beneficial owner or payee. This amount must be paid before the earlier of March 15, which is the due date for filing Form 1042-S for the calendar year of overwithholding or the date that the Form 1042-S is actually filed with the IRS.

When a withholding agent cannot apply either of these procedures, the beneficial owner or payee must file a claim for credit or refund with the IRS for the overwithheld amounts. Commenters have requested to expand the instances where withholding agents may apply these procedures to reduce the need for claiming a credit or refund.

The proposed regulations allow withholding agents to use the extended due date for filing Forms 1042, (September 15) and 1042-S (April 15), to make a repayment and claim a credit. The proposed regulations remove the terms 'without extension' and replace 'including extensions' in both chapters 3 and 4. The proposed regulations also remove the requirement for a withholding agent to include a statement that the filing is a claim of credit when it uses the reimbursement procedures in the year after the year of overwithholding on Form 1042. New fields on the 2016 Form 1042 include adjustments to overwithholding and underwithholding. As such, the statement is unnecessary.

The proposed regulations provide that a withholding agent cannot apply the reimbursement and setoff procedures after the date when Form 1042-S has been furnished to the beneficial owner or payee. This way, a Form 1042-S furnished to a beneficial owner or payee reflects any repayments made under these adjustment procedures and are consistent with the associated Form 1042-S filed with the IRS.

QIs, WPs, and WTs may rely on these proposed modifications until they are incorporated into the 2017 QI agreement and 2017 WP and WT agreements.

Nonqualified Intermediary (NQI) Reporting

Under chapter 3, a withholding agent that makes a payment to an NQI that is subject to withholding must obtain a reliable:

- Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding

- Withholding statement that allocates the payment among the payees, and
- Documentation for each payee.

Under chapter 4, a withholding agent making a payment to an NQI that is a participating FFI or a registered deemed-compliant FFI may rely on a withholding statement that includes an allocation of the payment to a chapter 4 withholding rate pool of payees, and must obtain payee specific documentation for payees that are not includible in a chapter 4 withholding rate pool to permit any reduced rate of withholding. If the withholding agent does not obtain reliable documentation, it must presume that the payment is made to a nonparticipating FFI and withhold 30 percent of the payment. The withholding agent must report the payment as a chapter 4 reportable amount made to an unknown recipient on a Form 1042-S that reports the nonqualified intermediary as an intermediary and the amount withheld as chapter 4 withholding. Where an NQI is required to report the same payments to its account holders on Forms 1042 and 1042-S under the chapter 3 or 4 regulations, the NQI does not have to withhold when chapter 3 or 4 withholding has already been applied by its withholding agent. It would prove withholding occurred by attaching to its Form 1042 a copy of the Form 1042-S furnished by the withholding agent.

Commenters explained that certain withholding agents charge fees for the administrative burden associated with reviewing documentation from NQIs. Further, certain NQIs may not be able to obtain required documentation from its account holders. In that case, the NQI provides withholding agents with a reliable Form W-8IMY to establish non-U.S. and chapter 4 status, without any underlying allocation information or documentation. Because the withholding agent is required to apply chapter 4 withholding, it is difficult for account holders and investors to claim foreign tax credits from other jurisdictions that do not view chapter 4 withholding tax as a creditable income tax. As such, commenters have requested that NQIs be allowed to report the withholding as chapter 3 withholding applied to its account holders or investors.

The proposed regulations address these comments providing that when an NQI receives a payment for which a withholding agent has already applied chapter 4 withholding and reported to an unknown recipient on Form 1042-S, the NQI that is a participating FFI or registered deemed-compliant FFI may report the withholding on a Form 1042-S to its account holders or investors as chapter 3 withholding. This applies only where the NQI determines that the account holder or investor is not subject to chapter 4 withholding. The NQI can now substantiate the credit and the account holders or investors are able to claim foreign tax credits in their respective jurisdictions.

Taxpayers may not rely on the proposed regulations until Form 1042 and 1042-S are updated for the 2019 calendar year.

Interesting Statistic Related Tax Form Counts from the IRS

	Number of respondents (estimated)
Total number of Form 1042 filers	45,000 - 50,000
Partnership filers of Form 1042	2,000 – 3,000
Form 1042 filers reporting adjustments to overwithholding	4,000 – 5,000
Nonqualified intermediary filers of Form 1042-S	500

How to Implement

Be sure to comment! The Treasury Department and the IRS request comments on all aspects of the proposed rules, particularly on the methodology for calculating foreign passthru payment withholding and the definition of investment entity. Make any written or electronic comments and requests for a public hearing on this proposed regulation within 60 days of publication in the Federal Register. Mail written comments to:

Internal Revenue Service, Room 5203,
PO Box 7604,
Ben Franklin Station, Washington, DC 20044.

In addition to exercising your right to comment, begin preparations for the final regulations:

- Confirm tax reporting vendors are aware of forthcoming updates to 2019 Forms 1042 and 1042-S.
- For partnerships, discuss underwithholding procedures with key stakeholders, and the elimination of the lag method. Identify where investors may need clarification and notification regarding the new process and how it impacts their claim for credit or refund positively.
- Discuss overwithholding procedures with relevant department heads (Tax, Legal, Risk, etc.).
- Update process and procedure manuals to incorporate any changes required.
- Update training materials and presentations to staff.

References

https://www.irs.gov/pub/fatca/NPRM%20re%20Sections%201441-1474%20Regulations%202018%201212.pdf