

# A FOREIGN TAXPAYER'S REFUND OR CREDIT COULD BE LIMITED BY UPCOMING REGULATIONS

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## Tags

Foreign Taxpayers  
Foreign Income  
Form 1042  
Form 1042-S  
Tax Credit  
Tax Refund  
Withholding Agent  
Withholding Tax

In Notice 2015-10 (the “Notice”), issued on April 28, 2015, the I.R.S. stated that it was concerned about cases in which persons subject to withholding under Code §§1441-1443 (“Chapter 3”) or Code §§1471 and 1472 (“Chapter 4”) are making or will make claims for refunds or credits in circumstances where a withholding agent failed to deposit the amounts required to be withheld under §6302.

If a withholding agent fails to deposit an amount withheld under Chapters 3 or 4, or reported as withheld on Form 1042-S, and the I.R.S. issues a refund or credit for the amount, the I.R.S. may not be able to recover that amount because the claimant, and in some cases the relevant withholding agent, may be outside the United States. The new regulations aim to reduce the risk that the I.R.S. may issue improper refunds or credits for fictitious withholding or amounts that have not been deposited and are difficult to collect.

As will be seen below, the new regulations would limit a foreign taxpayer’s refund or credit to the amount deposited by the withholding agent. Though collecting undeposited amounts from withholding agents located outside the United States may be difficult for the I.R.S., one wonders about the fairness of limiting a foreign taxpayer’s refund or credit when the I.R.S. could use its greater resources to collect against the withholding agent.

## WITHHOLDING, DEPOSITING, AND REPORTING REQUIREMENTS UNDER CHAPTERS 3 & 4

Chapter 3 generally requires withholding agents to collect the substantive tax liability of a foreign person’s U.S.-source income. Enacted as part of the Foreign Account Tax Compliance Act (“F.A.T.C.A.”), Chapter 4 generally requires withholding agents to withhold tax on certain payments to foreign financial institutions (“F.F.I.’s”) that are nonparticipating F.F.I.’s and certain nonfinancial foreign entities (“N.F.F.E.’s”) that do not provide information regarding their substantial U.S. owners.

An amount withheld by a withholding agent is required to be deposited, at certain time periods, with the Treasury Department in accordance with §6302.<sup>1</sup>

The withholding agent’s income tax liability for the amounts of tax it is required to withhold under Chapters 3 and 4 must be reported on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, for the calendar year. But if the amount of tax deposited is less than the amount due on Form 1042, the withholding agent must pay the balance at the end of a calendar year when filing the

<sup>1</sup> Treas. Reg. §§1.1461-1(a), 1.1474-1(b), 1.6302-2.

Form 1042.<sup>2</sup> If the withholding agent does not pay, it will remain liable for the unpaid tax, including interest and penalties.

The withholding agent is also required to file with the I.R.S. and give to the recipient of the payment the Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, which reports any amount withheld with respect to payments made to the recipient under Chapters 3 and 4.



## CURRENT RULES FOR REFUNDS AND CREDITS

Code §33 allows the amount of tax withheld at source to be credited against the income tax liability of a nonresident alien or foreign corporation. Furthermore, Code §1462 and Treas. Reg. §1.1462-1(a) provide that the beneficial owner of the income may claim a credit of the amount of tax actually withheld under Chapter 3 against the total income tax computed on the beneficial owner's return.

For purposes of Chapter 4, §1474(b)(1) and the regulations allow a credit for the amount of tax deducted and withheld under Chapter 4 as if such tax had been deducted and withheld under the provisions relating to the withholding of tax of a nonresident alien or foreign corporation. Treas. Reg. §1.1474-3(a) provides that the amount of tax actually withheld shall be allowed as a credit against the total income tax computed in the beneficial owner's return.

Treas. Reg. §1.1464-1(a) provides for a refund or credit under Chapter 65 (§6401-§6432) of an overpayment of tax that has actually been withheld at source under Chapter 3 to be made to the taxpayer from whose income the amount of such tax was in fact withheld.

For Chapter 4 purposes, Treas. Reg. §1.1474-5(a)(1) provides that a refund or credit of an amount of tax that has actually been withheld at source at the time of payment will be made to the beneficial owner of the payment to which the amount of tax withheld is attributable if such beneficial owner meets the requirements of Chapter 65.

## NO REFUND OR CREDIT WILL BE ALLOWED FOR AN AMOUNT WITHHELD WHEN THERE IS A SHORTFALL IN DEPOSITS MADE BY THE WITHHOLDING AGENT

The I.R.S. says that it intends to amend the regulations under Treas. Reg. §§1.1464-1(a) and 1.1474-5(a)(1) to provide that a refund or credit will be allowed to a claimant with respect to an overpayment *only to the extent* the relevant withholding agent has deposited, or otherwise paid to the Treasury Department, the amount withheld and such amount is *greater than* the claimant's tax liability.<sup>3</sup>

<sup>2</sup> Treas. Reg. §1.1461-1(a).

<sup>3</sup> Except as otherwise provided by §6401(b)(2), which provides a special rule that treats a credit under §33 as a refundable credit only in the case of a beneficial owner who is a nonresident alien and who has made an election to be treated as a U.S. resident under §§6013(g) or (h).

It also intends to issue regulations under §33 and amend the regulations under Treas. Reg. §§1.1462-1(a) and 1.1474-3(a) to provide that a credit for an amount withheld is only available to a claimant *to the extent* that the withholding agent has deposited, or otherwise paid to the Treasury Department, the amount withheld.

In cases in which the withholding agent deposited a portion of the tax withheld under Chapters 3 or 4, the new regulations would entitle the claimant to an amount that takes into account that the withholding agent did in fact deposit a portion of the required amount of tax. The amount available for refund or credit with respect to a claimant would be determined using a *pro rata* allocation method.

Under the *pro rata* allocation method, a withholding agent's deposits made to its Form 1042 account will be divided by the amount reported as withheld on all Forms 1042-S filed by the withholding agent to arrive at a "deposit percentage." Solely for purposes of refund and credit claims related to Chapters 3 or 4, each claimant will be treated as though the withholding agent made a deposit equal to (i) the amount reported as withheld on the Form 1042-S with respect to the claimant multiplied by (ii) the withholding agent's deposit percentage.

The claimant will be entitled to a refund or credit of the amount withheld to the extent that the deposit amount allocated to the claimant exceeds the claimant's tax liability.

The I.R.S. gives the following example:

A withholding agent pays a \$100 dividend to each of ten nonresident aliens and withholds tax at 30% from each dividend, in accordance with Chapter 3. The withholding agent is required to deposit \$300 of tax but instead deposits only \$225 of the tax that it withheld. The withholding agent reports on a Form 1042-S issued to each nonresident alien and filed with the I.R.S. that it paid to that nonresident alien a \$100 dividend and withheld \$30 of tax. In this case, the withholding agent's deposit percentage is 75% (*i.e.*, \$225/\$300, or the amount of the deposits reflected in the withholding agent's Form 1042 account divided by the amount reported as withheld on all Forms 1042-S filed by the withholding agent). If one of the nonresident aliens properly claims that, under an income tax treaty with the United States, he is entitled to a 15% withholding tax rate and claims a \$15 refund, he is allocated \$22.50 of the deposit (75% of the \$30 reported as withheld on the claimant's Form 1042-S). Since the nonresident alien's tax liability is \$15, there is an overpayment of \$7.50, and he will be entitled to a refund or credit for that amount.

Under the existing information reporting, withholding, and deposit procedures, a withholding agent does not indicate to which beneficial owner the deposit of tax relates, and such information is not reported on Form 1042 or Form 1042-S. Therefore, an amount deducted by the withholding agent with respect to a beneficial owner cannot be matched with an amount of tax deposited in the withholding agent's Form 1042 account.

In the Notice, the I.R.S. stated that it considered whether to implement a tracing or specific identification methodology under which a claimant who is a beneficial owner could prove that the deposit of tax made by a withholding agent was specifically made with respect to an amount withheld from the claimant. However, because the obstacles to developing and implementing a specific tracing methodology (*e.g.*, withholding agents such as large banks may process many thousands of payments per year) are unlikely to be overcome in the foreseeable future, it intends to adopt the *pro rata* allocation method discussed above.

***“The claimant will be entitled to a refund or credit of the amount withheld to the extent that the deposit amount allocated to the claimant exceeds the claimant’s tax liability.”***

Nonetheless, the I.R.S. is seeking comments on the feasibility of developing and implementing a more precise methodology at some future date.

## OTHER ISSUES BEING CONSIDERED

Other issues discussed in the Notice included:

- When to compute the initial deposit percentage for a withholding agent and how frequently to re-compute it to reflect additional deposits made by the withholding agent after Form 1042 has been filed, and after the amount available for a claim is first determined;
- The manner in which withholding agents and affected claimants will be informed of a deposit percentage (whether initial or recomputed) that is less than 100%, and the process under which additional refund or credit amounts will be paid or allowed to a claimant when a withholding agent takes steps to increase its deposit percentage; and

Whether to include an exception if the under-deposited amount is *de minimis* or if the withholding agent has a demonstrated history of compliance.

