I.R.S. PLAN TO REJECT FOREIGN TAXPAYERS' REFUNDS CRITICIZED BY I.R.S. ADVISORY COMMITTEE

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In the May 2015 issue of *Insights*, we reported that the I.R.S. announced in Notice 2015-10 (the "Notice") that it was considering issuing regulations to limit or deny withholding tax credit or refund claims when a withholding agent failed to deposit the amounts required to be withheld under Chapter 3 and Chapter 4 of the Internal Revenue Code (the "Code"), provisions that require withholding with respect to certain payments received by foreign taxpayers.[1]

Specifically, the I.R.S. stated that it intends to amend the regulations under Treas. Reg. §§1.1464-1(a) and 1.1474-5(a)(1) to provide that a credit or refund 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 I.R.S., the amount withheld and such amount is *greater than* the claimant's tax liability. It also intends to issue regulations under Code §33 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 I.R.S. the amount withheld.

In cases in which the withholding agent deposited a portion of the tax withheld, the new regulations would provide for a *pro rata* allocation method, so that a claimant would be entitled to an amount that takes into account the amount deposited.

The I.R.S. also mentioned that, although it considered the implementation of a tracing method under which a claimant could provide that a deposit of tax made by a withholding agent was specifically made with respect to an amount withheld from him, such a method seems impractical to implement, at least at the moment.

In a letter dated June 25, 2015 (the "Letter"), the Information Reporting Program Advisory Committee ("I.R.P.A.C.")[2] discussed the reasons why the Notice's proposal does not present a workable approach to addressing the issue of fraudulent credit or refund claims.

To begin, the I.R.S. does not seem to have the authority under the Code to hold a payee liable for a withholding agent's failure to deposit taxes withheld. Instead, it is required, under Code §1462, to credit the amount of tax withheld against a payee's tax paid without regard to whether the withholding agent in fact deposited the withheld taxes.

According to I.R.P.A.C., the I.R.S. also ignores the fact that the withholding agent has no legal duty to the payee, but instead has a legal duty to the I.R.S. to deposit the withheld taxes. Thus, the proposal could leave payees with legitimate withholding tax credit or refund claims without recourse since the withholding agent would

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1 See *Insights*, Vol. 2 No. 5, "A Foreign Taxpayer's Refund or Credit Could Be Limited by Upcoming Regulations."

2 I.R.P.A.C. is an advisory committee to the I.R.S., composed of individuals from various segments of the tax professional community, with the purpose of providing a forum for discussion of tax reporting issues.

have no duty to follow the payee's instructions to deposit the withheld tax and the I.R.S. would not issue the credit or refund unless the withheld tax is deposited.

The Letter also outlines many instances in which a withholding agent may have a legitimate shortfall in its tax deposits. For example, a withholding agent may intentionally deposit less than the full amount of the taxes it withheld in a particular year if it had excessive deposits in a previous year and is expecting a corresponding credit.

PRO RATA METHOD WOULD NOT PREVENT FRAUD

According to I.R.P.A.C., the I.R.S. seems to be "conflating the legitimate problem of fraudulent refund claims with [the] collection of shortfalls in withholding deposits."

It claims that fraudulent refund claims and associated phantom deposits are unlikely to be the result of a withholding agent's deposit shortfall.

And, if a fraudulent scheme somehow targeted a legitimate withholding agent's deposits, the *pro rata* method would not prevent the fraud because the claimant would receive the refund minus the *pro rata* portion of the overall shortfall.

TRACING METHOD & THE FUNGIBILITY OF MONEY

I.R.P.A.C. agreed that the tracing method is not administratively practical given the magnitude and frequency of tax deposits received by some withholding agents.

The tracing method is further made impractical by the fungibility of money. The Letter gives the example of a withholding agent that withholds and deposits with the I.R.S. excess tax from Payee A, but later uses its own funds to refund Payee A. If the withholding agent uses tax properly withheld, but not deposited, from Payee B to reimburse itself for the tax it refunded to Payee A, then although the tax withheld from Payee B was not deposited, the tax withheld and deposited from Payee A has been effectively credited to Payee B.

EXEMPTIONS RECOMMENDED

I.R.P.A.C. recommended that, to the extent the I.R.S. believes it is still appropriate to allocate (or trace) a withholding agent's shortfall to refund claims, the following exemption categories should be included in the contemplated regulations:

1. U.S. withholding agents, qualified intermediaries and other withholding agents with significant U.S. tax nexus;
2. Withholding agents that have an established history of compliance with tax withholding, depositing and reporting obligations, and withholding agents that deposit significant dollar amounts; and
3. *De minimis* refund claims, *e.g.*, a $1,000 refund claim should not be denied or prorated if the deposited amount is $9 million.

AN UNWORKABLE APPROACH?

I.R.P.A.C. summarized the I.R.S.'s proposal as an unworkable approach with broad exceptions for fact patterns that today reflect legitimate transactions and added that the broad exceptions provide wrongdoers with a roadmap for the next fraudulent refund scheme.