The U.S. Payer's Guide to Cross-Border Withholding and Reporting

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Enforcement of the tax withholding and reporting obligations imposed upon U.S. entities, with respect to outbound payments, has unquestionably become one of the hottest topics at the IRS. Many of the individuals who are responsible for ensuring compliance with this regime, however, are either unfamiliar with the applicable rules, or unaware of the significant risks of noncompliance. Accordingly, a discussion of the obligations imposed under the cross-border withholding and reporting rules, the recently increased IRS enforcement activity in this area, and "best practices" to help ensure compliance, is particularly timely.

Current Rules Under Code Sec. 1441

Code Sec. 1441 generally requires U.S. "withholding agents" to withhold and deposit 30 percent of certain payments those agents make to foreign persons. A "foreign person" in the context of a multinational corporate enterprise includes, in addition to foreign vendors, foreign subsidiary companies or foreign parents. The term "withholding agent" is broad, and encompasses all persons who have control, receipt, custody, payment or disposal of a foreign person's income. The income subject to withholding, "FDAP income," is also a rather expansive term that generally includes all payments that would be includible in gross income under Code Sec. 61, that are paid in an amount that is known ahead of time (fixed), or for which there is a basis for calculating the amount to be paid (determinable). If income falls within the category of FDAP, it is irrelevant whether the payments are made in a series of installments or one lump sum. The payments also need not be made annually or at regular intervals, as long as they are paid from time to time.[1] Common examples of FDAP income

include interest and original issue discount (OID), dividends, rents, royalties, salaries, wages, premiums and annuities. Any U.S. person who makes a payment of FDAP income to a foreign person (including a foreign vendor, subsidiary, or parent) may have withholding tax liability.

Withholding agents who fail to withhold or properly document why they did not withhold can be personally liable for the underwithheld tax.[2] Withholding agents also have reporting requirements. They must annually file Form 1042 to report their total withholding tax liability, amounts withheld, reportable amounts paid to foreign persons and other relevant information, and file (with the IRS) and issue (to each foreign recipient of the payments) Forms 1042-S showing the amounts and types of income paid to each recipient, the taxes withheld, and any applicable withholding exemptions.[3]

The standard 30-percent withholding rate may be reduced or eliminated based on an applicable treaty or Code provision[4] but there are stringent documentation requirements associated with claiming those exemptions. Specifically, the 30-percent rate applies to all applicable FDAP payments unless the foreign party submits to the withholding agent (and the U.S. party retains) documentation—usually a withholding certificate—that establishes that the person who must include the payment in gross income under U.S. tax principles (also known as the "beneficial owner" of the payment) is entitled to a reduced rate. There are various types of withholding certificates, each for a specific purpose:

- **Form W-8BEN.** This form is used to establish entitlement to a reduced withholding rate or exemption under an applicable treaty.
- **Form W-8IMY.** A foreign intermediary or flow-through entity that receives FDAP payments on behalf of a beneficial owner may use this form to claim a withholding exemption. For example, foreign financial institutions—such as broker dealers that receive payments on behalf of their account holders—use this form.
- **Form W-8ECI.** This form may be used to claim that FDAP income is effectively connected with a U.S. trade or business, and thus includible in the beneficial owner's gross income under U.S. tax principles and exempt from Code Sec. 1441 withholding.
- **Form W-9.** This form is used to certify that a payee is a U.S. person, and thus that Code Sec. 1441 does not apply.

Although all of the withholding certificates listed above are relevant with respect to FDAP payments made to foreign vendors and other recipients, the most common certificate in the context of payments made by a multinational corporation is the Form W-8BEN. As noted above, a properly completed Form W-8BEN that certifies that the foreign party derives the income at issue and satisfies any limitations of the applicable treaty can substantiate entitlement to a reduced treaty withholding rate.[5] But, in order to do this, the form must be complete and accurate. It must provide the foreign party's name, permanent residence address, taxpayer identification number (which means the foreign party must, in most circumstances, apply for and receive such a TIN) and, with respect to a foreign entity, the type of entity and country of organization.[6] The limited exceptions to the TIN requirement include receipt of dividends and interest on actively traded stocks and bonds and certain "unexpected" payments.[7] A withholding agent may generally rely upon all claims made in a properly completed Form W-8BEN, unless the form contradicts or is inconsistent with other information that the withholding agent knows or should know. In this regard, a withholding agent *must* rely on contradictory or inconsistent information that it knows or should know, if such reliance would result in a higher withholding tax rate than would apply by relying solely on the Form W-8BEN.[8]

In the absence of a valid withholding certificate, withholding agents generally must rely on specific presumptions contained in the regulations under Code Sec. 1441. For example, if a foreign party claims a reduced treaty withholding rate but refuses to furnish a Form W-8BEN, or furnishes an incomplete Form W-8BEN (*e.g.,* by erroneously omitting a TIN), the withholding agent must withhold at the standard 30-percent rate. The same is true where a U.S. corporation pays a dividend to a shareholder whose address is outside the United States, and the corporation is otherwise unaware of the shareholder's status. If the address is within the United States, the shareholder will be presumed to be a U.S. person; however, as with the standard applicable to the Form W-8BEN, a withholding agent must rely on its knowledge (or reason to know), instead of such a presumption, if such reliance would result in a higher amount of withholding tax.[9]

For a payment to a foreign partnership, entitlement to treaty benefits is generally determined at the *partner* level. If a partner is, itself, a partnership, the partners of the second partnership will be treated as the payees.

Withholding is not required on payments to a U.S. partnership, regardless of who is treated as the beneficial owner of the amount. Rather, the U.S. partnership is responsible to withhold on the distributive share and guaranteed payments of its foreign partners.[10] For example, if a FDAP payment is made to a foreign partnership of which a U.S. partnership is a 50-percent partner, no withholding will be required on the 50-percent portion of the payment allocable to the U.S. partnership.

Audit Issues and Activity

Foreign withholding has become the audit issue "de jure" for the IRS. Over the past several years, it has become apparent that compliance on many fronts with the Code Sec.1441 reporting and withholding regime—whether intentional or inadvertent, and whether by financial institutions or multi-national corporations—has been lacking. In early 2007, one IRS official reported that at that time, over 400 withholding agents had filed in excess of 1,200 delinquent or amended Forms 1042 in an attempt to bring themselves into compliance.[11] To combat this compliance shortfall, another IRS official reported that the agency was increasing its number of examinations and extending the breath of this audit activity beyond interest and dividend payments by the financial services industry.[12] In other words, all FDAP payments, including rents, royalties, wages, commissions and the like, are in play.

Further evidence of the seriousness with which the IRS is approaching compliance in this area is its designation of withholding and reporting on U.S. source FDAP income as a Tier I issue. This occurred in June 2009. Among the transactions being analyzed for Code Sec. 1441 purposes are securities lending and total return swaps. More relevant for multinationals, guidelines were issued for use by examiners in their audits of U.S. withholding agents, along with recommended language for Information Document Requests (IDRs), to determine the adequacy and reliability of a withholding agent's systems.

At this time, attention is also being focused on the IRS's Qualified Intermediary (QI) Program and the extent to which flaws therein were contributing to an estimated loss of tax revenues of $100 billion annually due to offshore tax abuses, according to a recent Senate Permanent Subcommittee on Investigations Report.[13] This Program, established by the IRS in 2001, allows an approved foreign financial institution or foreign clearing organization to certify to a U.S. withholding agent the eligibility of its customers for an exemption from, or a reduced rate of, U.S. withholding tax without having to provide the U.S. withholding agent any supporting documentation as to the beneficial owner of a payment of U.S. source income that it receives. IRS Commissioner Douglas Shulman has acknowledged the need for enhancements to this Program to increase the breadth of the information reporting that it generates.[14] Actions are being taken both administratively and legislatively to address these issues. Most recently, legislation has been introduced, The Foreign Account Tax Compliance Act of 2009, which would, in part, lift some of the existing legal barriers that currently thwart the IRS's efforts to obtain information about the beneficial owners of offshore accounts.

While changes to the current practices and procedures with respect to the enforcement of Code Sec. 1441 withholding and reporting will aid compliance, they alone will not guarantee success in stemming the loss of tax revenues attributable to the abuse of these rules. The current Administration recognizes this. In his remarks before the Organization for Economic Co-Operation and Development (OECD) in June of this year, Commissioner Shulman noted that as part of the President's 2010 budget, 800 new employees would be hired to bolster the IRS's international enforcement efforts.[15]

Given this institutional focus, both from a programmatic as well as resource perspective, multinational corporations with outbound foreign payments to third-party vendors, subsidiaries or parent companies would be well-advised to review what they have done in the past with respect to their Code Sec. 1441 withholding and reporting responsibilities and what they plan for the future. For it is safe to say that the likelihood that "the tax man cometh" is more fact than fiction in this area.

Best Practices for Cross-Border Withholding Compliance

If a U.S. withholding agent wants to avoid withholding at the standard 30-percent rate on FDAP payments to foreign recipients, it should take several steps to help ensure compliance with the cross-border withholding regime under Code Sec. 1441. All U.S. payers of foreign-recipient FDAP income (including withholding agents) are well-advised to follow these "best practices," in light of the IRS's enhanced focus on cross-border withholding, and increased Form 1042 audit activity. In addition,

since it is usually a U.S. payer's accounts payable department that issues FDAP payments to foreign vendors, individuals within these departments—who probably have no regular involvement with the entity's withholding taxes—should be properly trained by the tax department to bring any issues to the attention of the tax department for analysis and resolution.

Determine Which Vendors or Other FDAP Recipients Are Foreign Persons

The logical first step is to ensure that procedures are in place to accurately determine which recipients of FDAP income are nonresident alien individuals, or foreign corporations, partnerships, trusts or estates. All information contained in the withholding agent's files, in combination with the applicable withholding certificate (*see* below), should be reviewed for this purpose.

Determine Which FDAP Payments to Such Foreign Persons Are Sourced in the United States

Code Sec. 1441 withholding only applies to U.S. source FDAP income. Therefore, withholding agents must analyze and determine under Code Secs. 861, 863 and 865 (as applicable) the source of each specific payment. For example, payments for personal services are sourced to the country of performance (with certain exceptions); the sourcing of dividends and interest payments generally depends on the country of the payer's incorporation; rental income is sourced by reference to the location of the relevant property; *etc.* These and similar sourcing rules should be systematically applied to the various types of payments made by the multinational corporation so as to allow consistent treatment for similar payments.

Obtain a Complete and Accurate Withholding Certificate

One of the most crucial steps is to obtain a complete and accurate Form W-8 from all foreign recipients of FDAP income. This may prove to be a difficult task, particularly in the context of the Form W-8BEN. Foreign vendors and other FDAP income recipients often demand the benefit of a reduced treaty withholding rate, but refuse to provide a Form W-8BEN. Moreover, even if a foreign payee submits a Form W-8BEN, it may refuse to include necessary information, such as a TIN. The foreign entity may fear that it will not be able "fly under the IRS's radar" if it applies for and discloses a TIN, or simply may not want to take the time to apply for one. As noted above, however, a Form W-8BEN that does not include the foreign beneficial owner's TIN will usually be invalid with respect to most payments. If a withholding agent fails to secure—or relies on an invalid or incomplete—Form W-8BEN, but withholds at a reduced rate nonetheless, the withholding agent itself may be liable for the amount of the standard 30-percent tax that it fails to withhold, plus interest and potential penalties. Note that even if the foreign entity ends up paying the full amount of tax owed, the U.S. payer can remain liable for interest and penalties.[16]

Foreign vendors and other FDAP recipients often push back against requests to provide accurate and complete Forms W-8, citing to the fact that *other* U.S. clients do not require them to do so. In conducting these conversations with foreign payees, U.S. entities and their withholding agents should emphasize the tremendous tax risk they are undertaking to withhold at a reduced rate despite failing to secure complete and accurate withholding certificates. In the end, it is a business judgment to determine whether to do business with such a foreign party, but the risks to the withholding agent are great.

Confirm That the Withholding Certificate Is Valid

As discussed above, simply obtaining a Form W-8 or W-9 is insufficient to escape withholding tax liability. The regulations under Code Sec. 1441 apply a "knowledge or reason to know" standard in determining whether a withholding agent knows of information that is inconsistent with (and thus may invalidate) a Form W-8. Accordingly, U.S. payers should establish the following procedures to validate and monitor their withholding certificates:

- Review each Form W-8 upon receipt to ensure completeness and consistency on its face.
- Ensure that the listed permanent residence address is located in the country where the payee claims to be a resident. If the address line is defective in this respect, the Form W-8 may still be relied upon to establish foreign status if the withholding agent obtains specified additional documentation.[17] In addition, for Forms W-8BEN, ensure that the foreign payee's residence country is determined in accordance with the applicable treaty.[18]
- Compare all information supplied in the Forms W-8 with all relevant information contained in the

withholding agent's files. For example, if the U.S. payer's files indicate that the payee resides in a country other than that listed in the Form W-8BEN, this could potentially invalidate the withholding certificate and require 30-percent withholding. The IRS's Form 1042 audit guidelines place special emphasis on this type of inconsistency.[19]

- Continue to monitor all withholding certificates to ensure that they remain effective with respect to future payments. A Form W-8 that does not (and need not with respect to a specified payment) include a TIN generally will expire at the end of the third full calendar year after it is signed, or upon an earlier change in circumstances that makes *any* information in the form incorrect. If the Form W-8 contains a TIN, it will be effective indefinitely but only if all of the information contained therein remains accurate *and* at least one payment to the foreign payee is reported each year on a Form 1042-S.[20] If a year goes by without such a payment, even this type of Form W-8 can expire.

As a matter of basic internal controls, the individual who validates the Forms W-8, in accordance with the procedures described above, ideally should be different from the individual who solicits the forms from the entity's foreign payees.

Correct Any Withholding Certificate Errors

If a withholding agent applies a reduced rate of withholding in reliance on an inaccurate or missing Form W-8, it may be able to minimize any potential tax consequences by obtaining a corrected withholding certificate as soon as possible. This is clearly not the ideal situation. That said, a subsequently-provided or corrected Form W-8 can support a reduced withholding rate if the new Form W-8 is consistent with the information that was already in the withholding agent's files, and merely establishes facts that were in existence at the time that previous payments were made, and the withholding agent can show that the correct amount of tax was actually withheld and paid to the IRS.[21]

Conclusion

U.S. entities that make overseas payments are well-advised to familiarize themselves with their withholding and reporting obligations. Moreover, given the IRS's current focus on Code Sec. 1441 compliance, these entities should ensure adherence to as many "best practices" as possible, to avoid and minimize the risk of potentially significant tax exposure.

Endnotes

1 Reg. §1.1441-2(b)(1).
2 Code Sec. 1461.
3 Reg. §§1.1441-7(a)(1); 1.1461-1(b), (c).
4 Code Sec. 1441; Reg. §1.1441-1.
5 Reg. §§1.1441-1(e)(2); -6(b)(1).
6 *See* Reg. §1441-1(e)(2).
7 Reg. §§1.1441-1(e)(4)(vii); -6(c), (g). A foreign person's TIN is usually an IRS-issued Employer Identification Number (EIN) or Individual Taxpayer Identification Number (ITIN). Form SS-4 is used to apply for an EIN; Form W-7 is used to apply for an ITIN.
8 *See* Reg. §1.1441-7(b).
9 *See* Reg. §1.1441-1(b)(3).
10 Reg. §1.1441-5(b).
11 *See* Dustin Stamper, *IRS Beefing Up Focus on Multinational Withholding Agents,* 117 Tax Notes 427 (Oct. 29, 2007).
12 *Id.*
13 Staff of Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs, 110th Cong., Tax Haven Banks and U.S. Tax Compliance 1, 17 (Staff Rept.) (July 17, 2008).
14 *See* Tax Haven Financial Institutions: Their Formation and Administration of Offshore Entities and Accounts for Use by U.S. Clients: Hearings Before the Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs, 110th Cong. (written testimony of IRS Commissioner Douglas Shulman) (July 17, 2008).
15 IRS Commissioner Douglas Shulman, Prepared Remarks Before the Organization for Economic Co-Operation and Development, Washington, D.C. (June 2, 2009) (available at 2009 TNT 104-36, Doc 2009-12458 (June 2, 2009)).
16 Reg. §1.1441-1(b)(7)(iii).
17 *See* Reg. §1.1441-7(b)(5)(i). Such additional documentation includes, for example, an individual's valid and recently issued passport or driver's license, along with a written explanation of his or her foreign status, or an entity's articles of incorporation, partnership agreement, *etc.*
18 *See* Reg. §1.1441-6(b)(1).
19 *See* Internal Revenue Manual (I.R.M.) § 4.10.21.8.4.4 (July 2008).
20 Reg. §1.1441-1(e)(4)(ii).
21 *See* I.R.M. §4.10.21.8.4.5 (July 2008).