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IRS MAKES WITHHOLDING TAX ON CROSS-BORDER PAYMENTS A TIER I COMPLIANCE ISSUE

On May 26, 2009, the IRS amplified its initiative to enforce withholding tax obligations by designating withholding tax on cross-border payments as a Tier I compliance issue. This designation reflects a determination by the IRS's Large and Mid-Size Business Division (the "LMSB") that cross-border withholding issues should be given priority in directing relevant technical guidance to field personnel. Tier I issues are of high strategic importance to the LMSB and have a significant impact on one or more industries. Tier I issues can include areas involving a large number of taxpayers, significant dollar risk, and substantial compliance risk or visibility. According to IRS Commissioner Douglas Shulman: "The tier issue process will provide the needed organizational priority and coordination to ensure taxpayer compliance with the U.S. withholding tax provisions."

Even though cross-border withholding was only recently made a Tier I issue, it has been a very important concern of the IRS during the past year. On July 29, 2008, the IRS supplemented the Internal Revenue Manual (the "IRM") to provide better guidance to IRS agents on how to examine U.S. persons' withholding tax obligations with respect to payments to foreign persons. Given the heightened priority the IRS has placed on foreign withholding, individuals and businesses must be more aware now than ever about their potential foreign withholding obligations when they make payments to foreign persons.

Foreign Withholding Requirements

In general, U.S.-source fixed or determinable annual or periodic ("FDAP") income paid to a foreign person is subject to a 30 percent gross-basis U.S. federal withholding tax. FDAP income generally includes passive investment income such as interest, dividends, royalties, and some rents. Under IRC Sections 1441 and 1442, a person who makes a payment of U.S.-source FDAP income to a foreign person (referred to as a "withholding agent") is required to withhold a 30 percent tax unless an exemption or reduced rate applies. For example, if a U.S. corporation ("U.S. Co") makes a dividend payment of \$100 to a resident of Canada, U.S. Co is treated as a withholding agent and generally must withhold \$30 and pay that amount to the IRS.

Withholding is not required on certain U.S.-source FDAP income, such as interest qualifying under IRC Sections 871 or 881 as "portfolio interest" or bank deposit interest. FDAP income may also be excluded from, or subject to a reduced rate of, withholding under a U.S. income tax treaty. To obtain treaty benefits, the foreign beneficial owner of the payment must meet the specific treaty qualification requirements and provide the withholding agent with a beneficial owner withholding certificate ("W-8BEN") prior to payment. For example, Canada has a tax treaty with the U.S. under which the rate of withholding on dividends is generally reduced to 5 percent in the case of dividends from a U.S. subsidiary to its Canadian parent corporation, provided that the parent qualifies for treaty benefits and delivers to the subsidiary a properly completed W-8BEN prior to the time payment is made.

Withholding obligations also arise in situations other than the payment of investment income. For example, reallocations made pursuant to the transfer pricing regulations may be considered payments subject to withholding. Also, when a lender forgives any portion of a loan to a foreign person, it may be obligated to withhold on the amount the foreign person realizes as income from the cancellation of indebtedness in certain cases.

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Withholding Agent Responsibilities

A withholding agent must withhold 30 percent of any payment subject to withholding made to a foreign payee unless it can associate the payment with documentation upon which it can rely to treat the payment as made to a U.S. person or as made to a foreign person entitled to a reduced rate of withholding. Further, a withholding agent must obtain the documentation prior to making the payment. The reliability and timing of documentation are very important to a withholding agent's liability. A withholding agent who fails to withhold the proper amount of tax will be personally liable for the requisite tax, penalties, and interest. Moreover, while penalties may be avoided if the taxpayer can show reasonable cause, ignorance of the law is generally not accepted as reasonable cause.

Conclusion

By designating foreign withholding as a Tier I issue, the IRS clearly indicated that it intends to aggressively enforce cross-border withholding obligations. In fact, the IRS plans to "begin initial taxpayer contact this summer" based on computer-generated matches of certain tax forms and potential outbound payments. Many individuals and businesses are often unaware of their foreign withholding obligations. However, given the IRS's increased compliance efforts, coupled with withholding agents' potential liability, it is imperative that individuals and businesses be aware of their foreign withholding obligations and that they ensure they have proper procedures in place to meet such obligations.

Readers of this Alert should feel free to contact the authors of this Alert to discuss their potential foreign withholding obligations.

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