Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LMSB:PHI:POSTF-149044-01
ATAckerman

date:

to: Internal Revenue Service
Philadelphia, PA
Attention: Johanna McGeady, International Manager
Email Copy: Linda Azen, International Examiner

from: Associate Area Counsel (LMSB:HMT) - Philadelphia

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subject: [redacted] - **Form 1042 and Six-year Statute of Limitations**

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to your request for assistance dated September 17, 2001. This memorandum should not be cited as precedent.

For purposes of this advice and recommendation, reference to "the taxpayer" includes both [redacted] and [redacted], the parties responsible for the withholding on the payments in/to Canada in [redacted] and [redacted], respectively.

ISSUE

Whether the six-year period for assessment of tax provided by Internal Revenue Code ("I.R.C.") § 6501(e)(1) applies when, because of the taxpayer's mischaracterization of dividends as interest income, there is an underpayment of withholding tax (as required by I.R.C. § 1442) of approximately thirty-three percent of the amount required to be shown on the Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons?

CONCLUSION

By its terms, the six-year period of limitations provided by I.R.C. § 6501(e)(1) applies only when there is an omission of gross income in an amount exceeding twenty-five percent of the

amount stated on the return. Since all of the income paid out by the taxpayer was reported, the six-year period of limitations does not apply to this case. Therefore, the period of limitations has expired with respect to the [redacted] and [redacted] tax years.

FACTS

It is our understanding that the taxpayer is subject to the U.S.-Canada Income Tax Treaty.

For the years in question, [redacted] and [redacted], the taxpayer responsible for withholding on the payments to Canada reported tax withheld on interest payments and withheld payments at a rate of ten percent. According to the International Examiner, the payments were actually dividends, not interest, and tax should have been withheld at a rate of fifteen percent. [1] Consequently, the mischaracterization resulted in an under-withholding of income tax by approximately thirty-three percent in each of the years in question.

The taxpayer has already been issued a thirty-day letter for the regular income tax liability for [redacted]. The taxpayer has not been issued any correspondence on any additional assessments for [redacted] and [redacted].

ANALYSIS

The Code requires foreign corporations to pay a tax of thirty percent on the amount of interest, dividends, and other income received from sources within the United States (not connected with the United States business). I.R.C. § 881(a)(1). Generally, the United States taxpayer who makes the interest or dividend payments is required to deduct and withhold the thirty percent tax owed by the foreign corporation. See I.R.C. §§ 1441 and 1442. If the United States taxpayer fails to deduct and

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[1]For the years in question, under a treaty between the United States and Canada, interest payments made by United States taxpayers to Canadian corporations are subject to tax at a rate not exceeding ten percent if the Canadian corporations are the beneficial recipients and owners of the interest income. See Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.-Can., art. XI, T.I.A.S. No. 11087, 1986-2 C.B. 258, as amended by protocol, June 14, 1983, 1986-2 C.B. 270, and by second protocol, Mar. 28, 1984, 1986-2 C.B. 274 (hereinafter Canada Convention) Under this same treaty, dividends paid by United States taxpayers to Canadian corporations are subject to tax at a rate of fifteen percent. See art. X, Canada Convention.

withhold the tax, he is personally liable for the tax due. I.R.C. § 1461. The income and tax referred to in the above Code sections are required to be reported annually on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.

Under I.R.C. § 894, United States treaty provisions may modify the Code. Moreover, Treas. Reg. § 1.1441-6 provides that the rate of withholding on a payment of income (subject to withholding) may be reduced to the extent provided by an income tax treaty in effect between the United States and a foreign country. One such treaty was in effect between the United States and Canada for the years in question.

According to the International Examiner, the taxpayer improperly identified dividends paid as interest paid, and the taxpayer's mistake resulted in a "substantial understatement" of income tax in each of the years in question, i.e., an understatement of tax of approximately thirty-three percent in [redacted] and [redacted] (see I.R.C. § 6662(d)(1)(A)). The six-year period of limitations, under I.R.C. § 6501(e)(1), is applicable where the taxpayer omits over twenty-five percent of the gross income shown on the return. However, mischaracterizing a payment as interest rather than a dividend, thereby generating a withholding liability at a lesser rate, does not constitute an omission of gross income. [2]

In *Northern Indiana Public Service Co. v. Comm'r ("NIPSCO")*, 101 T.C. 294 (1993), *rev'd on other grounds* 105 T.C. 341 (1995), *aff'd* 115 F.3d 506 (7th Cir. 1997), the Tax Court held that the six-year assessment period applied to a withholding agent's omission of gross income paid to nonresident aliens on Form 1042.

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[2] SEC. 6501 . LIMITATIONS ON ASSESSMENT AND COLLECTION.
(e) SUBSTANTIAL OMISSION OF ITEMS.--Except as otherwise provided in subsection (c)--
(1) INCOME TAXES.--In the case of any tax imposed by subtitle A--
(A) GENERAL RULE.--If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph--
* * *
(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

In *NIPSCO*, the taxpayer omitted from the Form 1042 all of the interest payments made to the nonresident alien. 101 T.C. at 296. In contrast, this case involves a mischaracterization of payments reported on the return, so I.R.C. § 6501(e)(1) does not apply. Only if the taxpayer had omitted gross income in excess of twenty-five percent from the Form 1042 could the Service extend the period for assessment and apply I.R.C. § 6501(e)(1).

Assuming arguendo that erroneously classifying dividends as interests payments somehow had the effect of omitting more than twenty-five percent of gross income from the return, the six-year period for assessment under I.R.C. § 6501(e)(1) still could not apply. The landmark case concerning the restricted scope of the longer period for assessment is *The Colony, Inc. v. Commissioner,* 357 U.S. 28 (1958). In that case the Supreme Court laid down the basic test which was codified in I.R.C. § 6501(e)(1)(A)(ii) . The Court stated:

> We think that in enacting [I.R.C.] § 275(c) [now I.R.C. § 6501(e)] Congress manifested no broader purpose than to give the Commissioner an additional two years [now three years] to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting "gross income" or one, such as overstated deductions, affecting other parts of the return. To ... impose a five-year [now six-year] limitation when such errors affect "gross income", but a three-year limitation when they do not, not only would be to read [I.R.C.] § 275(c) [now I.R.C. § 6501(e)] more broadly than is justified by the evident reason for its enactment, but also to create a patent incongruity in the tax law.

The Colony, Inc. v. Commissioner, 357 U.S. at 36.

In *Davis v. Hightower*, 230 F.2d 549 (5th Cir. 1956), the extended period for assessment did not apply where the taxpayer had omitted over twenty-five percent of his gross income, because he classified certain sales as producing capital gain rather than ordinary income. The court reasoned:

> It cannot be thought that if a taxpayer accurately fills in every blank space provided for his use in the income tax form, giving every "gross" or maximum figure called for, and arrives at an incorrect computation of the tax only by reason of a difference between him and the Commissioner as

> to the legal construction to be applied to a disclosed transaction, the use of a smaller figure than that ultimately found to be correct in one stage of the computation amounts to an omission from "gross income" of the difference between the correct and incorrect item.

Davis v. Hightower, 230 F.2d at 553. Based on the above cases, it cannot be said that mischaracterizing dividends as interest amounts to an "omission" of over twenty-five percent of the taxpayer's income, under I.R.C. § 6501(e)(1).

RECOMMENDATION

The period of limitations has expired with respect to the taxpayer's withholding tax liability for the tax years [redacted] and [redacted].

This concludes our advice in this matter. We are forwarding a copy of this advice to Senior Litigation Counsel (HQ) (CC:LMSB:SLC) and to our National Office for mandatory ten day post review. We will promptly advise if we receive contrary advice from our National Office.

Please feel free to call Attorney Trevor Ackerman at 215-597-3442, if you have any additional questions.

JAMES C. FEE, JR.
Associate Area Counsel (LMSB)