



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I International Practice Service Transaction Unit

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Sub-Chapter	8.1.1.4	FDAP Payments – FDAP v. ECI	–	–

Unit Name	Non-Services FDAP Income
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Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

General Overview

- [Issue and Transaction Overview](#)
- [Transaction and Fact Pattern](#)

[Summary of Potential Issues](#)

[Audit Steps](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Issues](#)

Issue and Transaction Overview

Non-Services FDAP Income

The U.S. taxes foreign corporations on their U.S. source FDAP income by either withholding on the gross amount paid or taxing it in accordance with graduated income tax rates, depending on whether the taxpayer derives the income from a U.S. trade or business. U.S. tax treaties may reduce the withholding rates if applicable, or exempt the income entirely if the trade or business income is not attributable to a permanent establishment of the foreign corporation in the U.S. Comparable rules apply to nonresident alien individuals.

In general, the concept of withholding tax on payments to nonresident alien individuals and foreign corporations applies to U.S. source income that is not effectively connected with a trade or business in the U.S. Without such withholding tax regime, the IRS would have no practical recourse for collection of tax if a taxpayer has no trade or business in the U.S. when the income is paid to a foreign individual or corporation. As such, this unit will consider how to tax non-business income or income that is not effectively connected income (ECI) and, therefore, subject to withholding under IRC § 1441 and IRC § 1442.

Specifically, the Repatriation/Withholding International Practice Network (IPN) will discuss how to determine when a taxpayer's activities create ECI pursuant to IRC § 864 and IRC § 882 as well as the different types of fixed or determinable annual or periodical (FDAP) income which are subject to withholding tax.

No withholding is required under IRC § 1441 and IRC § 1442 if the income received by a nonresident alien individual or foreign corporation is effectively connected with the conduct of a trade or business within the U.S. Additionally, under IRC § 882 foreign corporations are allowed to claim deductions which are attributable to ECI. However, for purposes of chapter 3 of the Code, most types of FDAP gross income are subject to the 30% statutory rate of withholding, provided applicable tax treaty does not provide a reduced rate.

As such, this unit will address a transaction that compares and contrasts the tax treatment of ECI and FDAP income received by a foreign corporation. The sample transaction focuses primarily on royalty income.

This unit should be used only for chapter 3 withholding. An update for the coordination between chapter 3 and chapter 4 withholding is forthcoming.

Transaction and Fact Pattern

Non-Services FDAP Income	
Diagram of Transaction	Facts
<p>The diagram illustrates the transaction flow between three entities: FC (Foreign Corporation), U.S. Brokerage Firm, and Financial Account. FC sends a 'License of software' to the U.S. Brokerage Firm and receives 'Royalties' in return. The U.S. Brokerage Firm then sends 'INTEREST DIVIDENDS' to the Financial Account.</p>	<ul style="list-style-type: none">▪ A foreign corporation (FC) receives dividends and interest from the U.S. Brokerage Firm for its investments and royalty income for the software package it licensed to the U.S. Brokerage Firm.▪ The U.S. Brokerage Firm is the withholding agent and files Form 1042 to report and pay withholding tax on the dividends and interest income.▪ FC claims that the royalty income is not subject to withholding under IRC §§ 1441 and 1442 since the income is effectively connected with a U.S. trade or business.▪ FC does not provide the U.S. Brokerage Firm with a Form W-8ECI.▪ FC has no sales office in the U.S.▪ FC rents a storage unit in the U.S. which is used to store computer components such as cables and peripheral devices.▪ FC is a corporation for U.S. tax purposes and has not elected to be a disregarded entity or partnership.

Summary of Potential Issues

Non-Services FDAP Income	
<u>Issue 1</u>	Is FC eligible for treaty benefits?
<u>Issue 2</u>	Is FC engaged in a trade or business within the U.S.?
<u>Issue 3</u>	Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?
<u>Issue 4</u>	What are the responsibilities of the U.S. Brokerage Firm with regards to its withholding obligations under IRC §§ 1441 and 1442?

All Issues, Step 1: Initial Factual Development

Non-Services FDAP Income

As examiners, you must first identify the character and source of the income and whether the income is FDAP income or ECI. For purposes of this unit, the foreign corporation's (FC) dividend, interest, and royalty income is U.S. source income. In order to determine whether the income is ECI we will consider whether the taxpayer has a trade or business within the U.S. Additionally, this unit will consider whether the income is FDAP income and whether any FDAP income is eligible for treaty benefits.

Fact Element	Resources	6103 Protected Resources
<u>Audit of U.S. Brokerage Firm Withholding Agent</u> <ul style="list-style-type: none">▪ Verify that FC has a brokerage account in the U.S.▪ Determine if the royalty income is earned from the licensing of software that is used by U.S. Brokerage firm in the U.S. or outside the U.S.▪ Confirm that FC did not provide a Form W-8 for the royalty income.	<u>Request and/or review:</u> <ul style="list-style-type: none">▪ Supporting documentation used to prepare the Form 1042.▪ Obtain a copy of the software licensing agreement.▪ Inquire as to whether FC has provided any documentation, after the payments were made, which can support its claim for an exemption from withholding tax.	

All Issues, Step 1: Initial Factual Development (cont'd)

Non-Services FDAP Income

As examiners, you must first identify the character and source of the income and whether the income is FDAP income or ECI. For purposes of this unit, the foreign corporation's (FC) dividend, interest, and royalty income is U.S. source income. As such, it must be determined whether this U.S. source income is FDAP income or ECI. In order to determine whether the income is ECI we will consider whether FDAP income is ECI under the asset use test or business activities test. Additionally, this unit will consider whether the income (if FDAP or ECI) is eligible for treaty benefits.

Fact Element	Resources	6103 Protected Resources
<p><u>Audit of FC</u></p> <ul style="list-style-type: none">▪ Determine whether FC has an office in the U.S. through which it licenses software to other brokerage firms.▪ Determine if FC has employees in the U.S. who provide aftermarket technical services related to the software.▪ Confirm the software is licensed and not sold (sale of copyrighted articles). Sales income is not FDAP income.▪ Confirm that FC did not provide a Form W-8 for the royalty income.▪ If FC provided a valid Form W-8ECI, determine whether FC filed a Form 1120-F or a Protective Form 1120-F.	<p><u>Request and/or review:</u></p> <ul style="list-style-type: none">▪ Conduct research about FC using Capital IQ, online search engines, and other online resources.▪ Obtain a copy of the software licensing agreement and interview knowledgeable operating personnel.▪ Inquire as to whether FC has provided any documentation, after the payments were made, which can support its claim for an exemption from withholding tax.	

Issue 1, Step 2: Review Potential Issues

Non-Services FDAP Income

Issue 1

Is FC eligible for treaty benefits?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Whether a foreign entity is a foreign corporation and whether it is a resident of a foreign country depends on the law of the foreign jurisdiction. ▪ Generally, if a foreign corporation is not created, organized, or managed and controlled in a treaty country, it would not be a resident of a treaty country or entitled to treaty benefits.	<ul style="list-style-type: none">▪ IRC 7701(a)(4)▪ U.S. Model Treaty (2006), Art. 4▪ U.S. Model Treaty (2006), Art. 10▪ U.S. Model Treaty (2006), Art. 11▪ U.S. Model Treaty (2006), Art. 12	

Issue 1, Step 3: Additional Factual Development

Non-Services FDAP Income		
Issue 1		
Is FC eligible for treaty benefits?		
Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Identify the foreign country's criteria for tax residency (usually where it was created or organized or where it is managed and controlled). A majority of countries use both criteria. ▪ Determine if FC's country of residence has an income tax treaty with the U.S. which may provide for a reduced withholding rate for royalties. 	<ul style="list-style-type: none">▪ Obtain a copy of FC's articles of incorporation, certificate of residence from a foreign country, tax returns, or other documentation proving where FC was created or organized. ▪ Review research material obtained from Capital IQ, online search engines, and other online resources to determine the location where FC is managed and controlled.▪ Pub. 515▪ Pub. 901	

[Back to Table Of Contents](#)

Issue 1, Step 4: Develop Arguments

Non-Services FDAP Income

Issue 1

Is FC eligible for treaty benefits?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ If the evidence gathered shows that FC is not a resident of a treaty country it will not be entitled to treaty benefits for reduced withholding rates on interest, dividends, and royalties. If this is the case, FC would be subject to the statutory withholding rate of 30%, unless FC proves the income is ECI. ▪ For purposes of this unit it has been determined that FC is a resident of a non-treaty country and as such, this unit will only consider whether FC has a U.S. trade or business and ECI pursuant to IRC § 864. Accordingly, Article 5 – Permanent Establishment and Article 7 – Business Profits of the U.S. Model Treaty will not be considered.	<ul style="list-style-type: none">▪ IRC 882▪ IRC 864▪ IRC 1442▪ U.S. Model Treaty (2006), Art. 5, 7▪ Pub. 515▪ Pub. 901	

Issue 2, Step 2: Review Potential Issues

Non-Services FDAP Income

Issue 2

Is FC engaged in a trade or business within the U.S.?

Fact Element	Resources	6103 Protected Resources
Generally, if a FC performs an activity that is conducted on a regular, continuous, and substantial basis in the U.S., it is considered to be engaged in a U.S. trade or business.	<ul style="list-style-type: none">▪ IRC 864(c)(2)▪ Treas. Reg. 1.864-4(c)(2) and (3) (whether FDAP income is ECI)▪ IPS Unit - Gross effectively connected income (ECI) of a foreign corporation (non-treaty) UIL 9422.01-01▪ IPS Unit - Identification of a U.S. trade or business (or PE) - Protective returns UIL 9421.01-02▪ De Amadio v. Commissioner - 34 T.C. 894 (1960)▪ Lewenhaupt v. Commissioner - 20 T.C. 151 (1953)▪ U.S. v. Balanovski - 236 F.2d 298 (2d Cir.1956)▪ Pinchot v. Commissioner - 113 F.2d 718 (2d Cir. 1940)▪ InverWorld, Inc. v. Commissioner - T.C. Memo 1996-301	
It is generally not necessary for a foreign corporation to have an office or fixed place of business in the U.S. to be engaged in a trade or business in the U.S., if no treaty is involved.		
Confirm that FC rents a storage unit in the U.S. which is used to store computer components such as cables and peripheral devices.	<ul style="list-style-type: none">▪ Conduct a tour of the storage unit to determine which functions are performed by FC in the U.S.	

Issue 2, Step 3: Additional Factual Development

Non-Services FDAP Income

Issue 2

Is FC engaged in a trade or business within the U.S.?

Fact Element	Resources	6103 Protected Resources
<p>The term “engaged in trade or business” is not defined in the Code or Treasury Regulations but there are exceptions such as:</p> <ul style="list-style-type: none">▪ Performance of personal services by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate \$3,000, is not a U.S. trade or business.▪ Trading of stocks, securities, or commodities for your own account (“trader exception”) is not a U.S. trade or business.	<ul style="list-style-type: none">▪ IRC 864(b)(1)▪ IPS Unit - Services Income Concepts UIL 9424.01▪ IRC 864(b)(2)	

Issue 2, Step 3: Additional Factual Development (cont'd)

Non-Services FDAP Income
Issue 2
Is FC engaged in a trade or business within the U.S.?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Determine whether FC has software engineers, developers, or technicians in the United States who update or modify the software for customers pursuant to aftermarket services contracts with multiple third parties.▪ Determine whether FC offers customers technical services, but subcontracts those services out to related entities.▪ Determine whether there are any U.S. employees of FC who are engaged on a regular basis in negotiating contracts in the U.S.▪ Request copies of sales contracts for FC's customers.	<ul style="list-style-type: none">▪ Treas. Reg. 1.864-4(c)(3)(ii), Ex. 2	

Issue 2, Step 3: Additional Factual Development (cont'd)

Non-Services FDAP Income

Issue 2

Is FC engaged in a trade or business within the U.S.?

Fact Element	Resources	6103 Protected Resources
▪ Determine whether the taxpayer's activities in the U.S. are regular, continuous, and substantial.	▪ Request copies of sales contracts to verify who executed the contracts. ▪ Request copies of travel expense records to determine where the sales contracts may have been signed and executed.	

Issue 2, Step 4: Develop Arguments

Non-Services FDAP Income

Issue 2

Is FC engaged in a trade or business within the U.S.?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ If the facts imply that FC's licensing activities do not rise to the level of being engaged in activities on a regular, continuous, and substantial basis, based on the references/resources reviewed, then the payments to FC should have been withheld upon. Accordingly, the withholding agent should have filed a Form 1042 to report and pay the withholding tax due. However, if the taxpayer asserts that they are engaged in a trade or business in the U.S. you should consult Counsel and the Jurisdiction to Tax IPN for guidance.	<ul style="list-style-type: none">▪ IRC 864(c)(5)(A)▪ Treas. Reg. 1.864-2(e)▪ IPS Unit - Gross effectively connected income (ECI) of a foreign corporation (non-treaty) UIL 9422.01-01	
 CONSULTATION: Counsel should be consulted when analyzing the facts and circumstances to determine whether there is a U.S. trade or business.		

Issue 2, Step 4: Develop Arguments (cont'd)

Non-Services FDAP Income

Issue 2

Is FC engaged in a trade or business within the U.S.?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ If the facts support that the taxpayer has a U.S. trade or business, the next step is to determine if the taxpayer has ECI, which requires the taxpayer to file a Form 1120-F and complete Section II of the form.	<ul style="list-style-type: none">▪ IPS Unit - Gross effectively connected income (ECI) of a foreign corporation (non-treaty) UIL 9422.01-01	
 CONSULTATION: Counsel should be consulted when analyzing the facts and circumstances to determine whether there is a U.S. trade or business.		

Issue 3, Step 2: Review Potential Issues

Non-Services FDAP Income

Issue 3

Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ FDAP income includes all income included in gross income per IRC §61 with some exceptions. The exceptions include capital gains and any other income the IRS may determine is not FDAP income.<ul style="list-style-type: none">– An item of income is fixed when it is to be paid in amounts definitely pre-determined.– An item of income is determinable if the amount to be paid is not known but there is a basis of calculation by which the amount may be ascertained at a later time.– The income need not be paid annually if it is paid periodically. Periodic payments do not have to be made at regular intervals.	<ul style="list-style-type: none">▪ IRC 61▪ Treas. Reg. 1.1441-2(b)(1)▪ Treas. Reg. 1.1441-2(b)(2)▪ Treas. Reg. 1.1441-4	

Issue 3, Step 2: Review Potential Issues (cont'd)

Non-Services FDAP Income

Issue 3

Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">Dividend, interest, and royalties are included among the types of gross income under IRC § 61. Additionally, the dividend, interest, and royalty income are fixed or determinable annual or periodical pursuant to Treas. Reg. § 1.1441-2. If the dividend, interest, and royalty income is not effectively connected with the conduct of a trade or business within the U.S., the U.S. source dividend, interest, and royalty income is FDAP income that is subject to withholding under IRC §§ 1441 and 1442. Otherwise, if the income is ECI no withholding is required if the withholding agent obtains the proper documentation.	Form W-8ECI Form W-8ECI Instructions	

Issue 3, Step 2: Review Potential Issues (cont'd)

Non-Services FDAP Income

Issue 3

Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ The interest, dividend, and royalty income may be ECI or FDAP income. The determination can be made by applying the asset-use test and the business activities test. Ultimately, the determination should be based on all the underlying facts and circumstances and Counsel should be consulted.	<ul style="list-style-type: none">▪ IRC 864(c)(2)(A)▪ IRC 864(c)(2)(B)	
<ul style="list-style-type: none">▪ If the royalty income from the software license is for software that was developed outside the U.S. and there is no U.S. office or other fixed place of business within the U.S. to which the royalty income is attributable, it would not be considered effectively connected with a U.S. trade or business. Accordingly, it would not be considered ECI due to the fact that the royalty income cannot be attributed to a U.S. business. However, it would be considered FDAP income subject to withholding. The royalty income is U.S. source income since the royalty is sourced where the intangible is used.	<ul style="list-style-type: none">▪ IRC 864(c)(4)(B)▪ Treas. Reg. 1.864-6(b)(2)(i)▪ Treas. Reg. 1.1441-2(a)▪ Treas. Reg. 1.1441-2(b)(1)▪ IRC 861(a)(4)	
 CONSULTATION: Counsel should be consulted when making determinations as to whether the income is ECI or FDAP income.		

Issue 3, Step 3: Additional Factual Development

Non-Services FDAP Income

Issue 3

Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?

Fact Element	Resources	6103 Protected Resources
▪ Determine whether the interest, dividend, and royalty income are ECI or FDAP income by applying the asset-use test and the business activities test. Ultimately, the determination should be based on all the underlying facts and circumstances and Counsel should be consulted.	▪ IRC 864(c)(2)(A) ▪ IRC 864(c)(2)(B) ▪ Financial statements of FC ▪ Interviews with FC regarding activities performed by FC in the U.S.	
▪ Verify that the software was used by the U.S. Brokerage Firm in the U.S. by reviewing the licensing agreement. Confirm that the royalty income from the software license is for software that was developed outside the U.S. and that there is no U.S. office or other fixed place of business within the U.S. to which the royalty income is attributable.	▪ IRC 864(c)(4)(B) ▪ Treas. Reg. 1.864-6(b)(2)(i)	
 CONSULTATION: Counsel should be consulted when making determinations as to whether the income is ECI or FDAP income.		

Issue 3, Step 4: Develop Arguments

Non-Services FDAP Income

Issue 3

Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ In order to determine whether the interest and dividend income is FDAP or ECI you must consider two principal tests: asset-use and business activities.		
<ul style="list-style-type: none">– The asset-use test ordinarily is applied when determining whether interest income is derived from sources within the U.S. If a taxpayer has assets that are used in, or held for use in, the conduct of a U.S. trade or business the interest income could be considered ECI. As such, if based upon the facts gathered in the interviews and a review of the financial statements reveal that FC has no assets that were used in a U.S. trade or business, the interest income is FDAP income.		

Issue 3, Step 4: Develop Arguments

Non-Services FDAP Income

Issue 3

Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">– The business activities test is applied to determine whether income, which is generally of the passive type, is effectively connected with a U.S. trade or business. When applying this test, examiners must consider whether the activities of the taxpayer were a material factor in the realization of the income. If the facts show that FC's activities were not a material factor the income would be FDAP income.	<ul style="list-style-type: none">▪ Treas. Reg. 1.864-4(c)(3)▪ IPS Unit - Gross effectively connected income (ECI) of a foreign corporation (non-treaty) UIL 9422.01-01	
<ul style="list-style-type: none">▪ Royalties are sourced where the intangible property is used or can be used. In this example the software license was used in the U.S. so it is U.S. source income. If the royalty income is U.S. source examiners must then determine if the income is ECI or FDAP income by applying the asset-use test and business activities test.	<ul style="list-style-type: none">▪ IRC 861(a)(4)	

Issue 3, Step 4: Develop Arguments (cont'd)

Non-Services FDAP Income

Issue 3

Is the income effectively connected income (ECI) or fixed or determinable annual or periodical (FDAP) income?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Apply the asset-use test and the business activities test to the facts to determine if the U.S. source royalty income is ECI. If the royalty income is ECI the taxpayer must file Form 1120-F and complete Section II of the form.	<ul style="list-style-type: none">▪ IRC 864(c)(2)(A)▪ IRC 864(c)(2)(B)▪ IRC 882(a)▪ Treas. Reg. 1.864-4▪ Treas. Reg. 1.864-6(b)(2)(i)	
<ul style="list-style-type: none">▪ If you find that the royalty income is not ECI then the U.S. source royalty income is FDAP income subject to withholding under IRC §§ 1441 and 1442. As such, the U.S. Brokerage Firm would be required to file Forms 1042 and 1042-S to report and pay withholding tax on the payments of royalty income to FC.	<ul style="list-style-type: none">▪ IRC 1441 and 1442▪ IRC 6651, 6656, 6662, and 6721▪ Form 1042-S	

Issue 4, Step 2: Review Potential Issues

Non-Services FDAP Income

Issue 4

What are the responsibilities of the U.S. Brokerage Firm with regards to its withholding obligations under IRC §§ 1441 and 1442?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ If it has been determined that FC is not engaged in a U.S. trade or business, and it has no ECI, consider what responsibilities the U.S. Brokerage Firm, as the withholding agent, has with regards to the filing of Forms 1042 and 1042-S and the respective payments of tax to the IRS.	<ul style="list-style-type: none">▪ IRC 1461▪ Treas. Reg. 1.1461-1▪ Treas. Reg. 1.1441-7	
<ul style="list-style-type: none">▪ In order for the U.S. Brokerage Firm to qualify as a withholding agent it must have had the control, receipt, custody, disposal, or payment of the income to FC. Generally, withholding agents are required to withhold at the statutory rate of 30% and must deposit any tax withheld and file Forms 1042 and 1042-S with the IRS. If the U.S. Brokerage Firm failed to withhold the correct amount of tax or file the respective returns it is liable for the tax, interest, and penalties with regards to the payments.	<ul style="list-style-type: none">▪ Treas. Reg. 1.1441-7(a)▪ Treas. Reg. 1.1441-7(b)▪ Treas. Reg. 1.1461-1(a)▪ Treas. Reg. 1.1461-1(b)	

Issue 4, Step 3: Additional Factual Development

Non-Services FDAP Income

Issue 4

What are the responsibilities of the U.S. Brokerage Firm with regards to its withholding obligations under IRC §§ 1441 and 1442?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Confirm whether the U.S. Brokerage Firm determined that the portfolio debt exemption did not apply to the interest payment.▪ Verify whether this determination resulted in the U.S. Brokerage Firm withholding 30% and depositing that tax with the IRS; filing Forms 1042 and 1042-S to report the withheld tax on the dividend and interest income it paid to FC; and issuing Forms 1042-S to FC.	<ul style="list-style-type: none">▪ Treas. Reg. 1.1441-7▪ IRC 1442 and 1441(a)▪ IPS Unit - Portfolio Debt Exemption – Requirements and Exceptions UIL 9424.01-01	

Issue 4, Step 3: Additional Factual Development (cont'd)

Non-Services FDAP Income

Issue 4

What are the responsibilities of the U.S. Brokerage Firm with regards to its withholding obligations under IRC §§ 1441 and 1442?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Verify whether the U.S. Brokerage Firm filed a Form 1042 to report and pay withholding tax on the royalty payments made to FC.▪ Additionally, confirm that the U.S. Brokerage Firm did not receive a Form W-8ECI from FC, prior to, or at the time of, payment. The U.S. Brokerage Firm may accept late documentation and the IRS may consider the late documentation as valid.	<ul style="list-style-type: none">▪ Review the supporting documentation for the Forms 1042 and 1042-S to verify the amounts deposited with the IRS and withheld from FC's payments of dividend and interest income.▪ IRC 1461 and 1463▪ Treas. Reg. 1.1461-1▪ Treas. Reg. 1.1441-4(a)(2)▪ IRC 6651, 6656, 6662, and 6663▪ IRC 6721▪ IRC 6722▪ IRC 6723▪ IRM 20.1.5.14 – IRC 6663 Civil Fraud Penalty▪ IPS Unit - Payee Documentation for Treaty Benefits UIL 9424.01-01	

Issue 4, Step 3: Additional Factual Development (cont'd)

Non-Services FDAP Income

Issue 4

What are the responsibilities of the U.S. Brokerage Firm with regards to its withholding obligations under IRC §§ 1441 and 1442?

Fact Element	Resources	6103 Protected Resources
	<ul style="list-style-type: none">▪ Integrated Data Retrieval System (IDRS) reports including:▪ Business Master File On-Line Tax Module (BMFOLT),▪ Tax Module A (TXMODA),▪ Payer Master File On-Line Summary (PMFOLS),▪ Payer Master File On-Line Detail (PMFOLD),▪ Information Returns Processing Transcript Requests – Information Returns Processing On-Line Summary Request (IRPTRL),▪ Information Returns Processing Transcript Requests – Payee On-Line Transcript Request (IRPTRO), and▪ Information Returns Processing Transcript Requests – Payer Hardcopy Transcript Request (IRPTRR).	

Issue 4, Step 3: Additional Factual Development (cont'd)

Non-Services FDAP Income

Issue 4

What are the responsibilities of the U.S. Brokerage Firm with regards to its withholding obligations under IRC §§ 1441 and 1442?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Ascertain whether the U.S. Brokerage Firm correctly applied the reliance rules and presumption rules relative to FC's claim that the royalty income is ECI. Under the reliance rules a withholding agent may rely on information and certifications of the payee/beneficial owner unless it has actual knowledge or reason to know that the claim is incorrect. In the absence of documentation, a withholding agent must make certain presumptions with regards to a payee/beneficial owner's classification (corporation, partnership, etc.) and status as a foreign or U.S. person.	<ul style="list-style-type: none">▪ Treas. Reg. 1.1441-7(b)(1)▪ Treas. Reg. 1.1441-1(b)(1)▪ Treas. Reg. 1.1441-1(e)(4)(viii)▪ Treas. Reg. 1.1441-1(b)(3)▪ IPS Unit - Payee Documentation for Treaty Benefits UIL 9424.01-01	

Issue 4, Step 4: Develop Arguments

Non-Services FDAP Income

Issue 4

What are the responsibilities of the U.S. Brokerage Firm with regards to its withholding obligations under IRC §§ 1441 and 1442?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ If the facts show that the U.S. Brokerage Firm had actual knowledge that FC is a foreign corporation and it did not have a Form W-8ECI, it should have filed Forms 1042 and 1042-S to report and pay the withholding tax for the royalty payments. Additionally, the U.S. Brokerage Firm was required to withhold 30% from the royalty payments since it could not reliably associate the payments with documentation on which it could rely to treat the payments as entitled to a reduced withholding tax. In the event that the taxpayer and/or the withholding agent file amended returns to claim a refund or credit refer to the “FDAP Payments – Refunds to Withholding Agents” IPS Unit for guidance.	<ul style="list-style-type: none">▪ IRC 1461▪ Treas. Reg. 1.1441-7(b)(1)▪ Treas. Reg. 1.1441-1(b)(1)▪ IPS Unit - FDAP Payments – Refunds to Withholding Agents UIL 9424.01-01	

Training and Additional Resources

Chapter 8.1.1 Financial Intermediary Payor - U.S. Withholding Agent

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none">▪ 07/21/2010 - FIN Withholding on Foreign Payments Auditing Technique▪ 06/21/2011 - CAS Withholding on Foreign Payments▪ 07/12/2012 - IBC-CPE Non-Resident Alien Withholding	
Podcasts / Videos	<ul style="list-style-type: none">▪ IBC 2011 CPE: Withholding	
Other Training Materials	<ul style="list-style-type: none">▪ 2014 FPP Live CPE Training▪ “Personal Services Compensation Subject to Withholding and/or Employment Taxes”▪ Nonresident Alien Withholding Form 1042 Audit Techniques Class Materials from August 2012	

Glossary of Terms and Acronyms

Acronym	Definition
BMFOLT	Business Master File On-Line Tax Module
CPE	Continuing Professional Education
ECI	Effectively Connected Income
FC	Foreign Corporation
FDAP	Fixed or Determinable Annual or Periodical
IDR	Information Document Request
IDRS	Integrated Data Retrieval System
IPN	International Practice Network
IPS	International Practice Service
IRM	Internal Revenue Manual
IRPTRL	Information Returns Processing Transcript Requests – Information Returns Processing On-Line Summary Request
IRPTRO	Information Returns Processing Transcript Requests – Payee On-Line Transcript Request
IRPTRR	Information Returns Processing Transcript Requests – Payer Hardcopy Transcript Request
NRA	Nonresident Alien
PMFOLD	Payer Master File On-Line Detail
PMFOLS	Payer Master File On-Line Summary

Glossary of Terms and Acronyms

Acronym	Definition
TXMODA	Tax Module A
UIL	Uniform Issue List

Index of Related Issues

Issue	Associated UIL(s)	References
When a foreign corporation (FC) conducts limited activities in the U.S. it may be unsure of whether it has a U.S. trade or business, since the determination is so factual. The Service encourages such corporations to file a “protective return”, which both creates a record of its existence for later audit, and also protects an FC’s right to claim deductions and credits, and it triggers the running of the statute of limitations.	9421.01 -02– Identification of a U.S. Trade or Business (or PE) - Protective Return Filer	<ul style="list-style-type: none"> ▪ Subchapter 5.1.1.1 – Protective Returns ▪ DCN: JTI/9421.01_03(2013)
Determination of the taxable income of a foreign corporation which is effectively connected with a U.S. trade or business (non treaty jurisdiction).	9422.01-01 – Determination of Proper Income Allocation	<ul style="list-style-type: none"> ▪ Gross effectively connected income (ECI) of a foreign corporation (non-treaty) ▪ DCN: ISI/9422.01_01(2013)

Index of Related Issues

Issue	Associated UIL(s)	References
This unit focuses on withholding on foreign payments for services pursuant to IRC §§1441 and 1442 and considers when employment taxes and exceptions may apply.	9424.01 – FDAP Payments	<ul style="list-style-type: none"> ▪ Services Income Concepts ▪ DCN: TBD
Discussion of requirements for qualification for the portfolio debt exemption.	9424.01-01 – Financial Intermediary Payor – U.S. Withholding Agent	<ul style="list-style-type: none"> ▪ Subchapter 8.1.1.1 – FDAP Payments – Portfolio Debt Exemption ▪ DCN: RPW/9424.01_01(2013)
Determine what types of payee documentation are acceptable for allowing treaty claims.	9424.01-01 – Financial Intermediary Payor – U.S. Withholding Agent	<ul style="list-style-type: none"> ▪ Subchapter 8.1.1.3 – FDAP Payments – Payee Documentation ▪ DCN: RPW/9424.01_03(2013)
Discussion of refund procedures; who claims credit: withholding agent or beneficial owner/payee; statutes of limitation.	9424.01-01 – Financial Intermediary Payor – U.S. Withholding Agent	<ul style="list-style-type: none"> ▪ FDAP Payments – Refunds to Withholding Agents ▪ DCN: TBD
Discussion of various types of corporate distributions and the withholding consequences.	9424.01-03 – Non-Financial Intermediary Payor – Repatriation	<ul style="list-style-type: none"> ▪ Subchapter 8.1.3.1 – FDAP Payments – Corporate Distributions ▪ DCN: TBD

Index of Related Issues (cont'd)

Issue	Associated UIL(s)	References
This unit provides an overview of the types of fixed or determinable annual or periodical (FDAP) income (IRC §871(a) earned or received by nonresident aliens (IRC 7701(b)(1)(B) which is generally may be taxed by the U.S.	9442.01 – Non-Resident Alien Claims for Refunds of Withheld FDAP Amounts	<ul style="list-style-type: none"> ▪ Overview of FDAP ▪ DCN: WIT/CU/P_15.1(2014)
Determination of appropriate treaty withholding rate: Character of Payment	9450.07 – Determination of Appropriate Treaty Withholding Rate	<ul style="list-style-type: none"> ▪ DCN: TBD
Determination of appropriate treaty withholding rate: Royalties: Definition of Royalties	9450.07 – Determination of Appropriate Treaty Withholding Rate	<ul style="list-style-type: none"> ▪ DCN: TBD
Determination of appropriate treaty withholding rate: Dividends	9450.07 – Determination of Appropriate Treaty Withholding Rate	<ul style="list-style-type: none"> ▪ DCN: TBD
Using alternative means to obtain foreign based evidence.	9460.02 – Information Gathering Activities	<ul style="list-style-type: none"> ▪ Issuing a Formal Document Request When a U.S. Taxpayer is Unresponsive to an IDR ▪ DCN: IGA/9460.02_02(2013)