

LB&I International Practice Service Concept Unit

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Unit Name	FDAP Withholding Under Chapter 3
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General Overview

FDAP Withholding Under Chapter 3

In General

- FDAP Payments is one of five strategic priorities under the “Repatriation/Withholding” Volume of the Business Inbound face of the International Matrix. Fixed or determinable annual or periodical (FDAP) payments are generally the result of investments in the United States made by foreign persons, especially foreign corporations. Foreign persons plan and structure their U.S. investments to mitigate the effects of the repatriation and withholding tax rules. Once FDAP income earned in the United States is repatriated to its ultimate foreign owner, the IRS may have no practical recourse for collection of tax if the foreign individual or corporation does not have a trade or business in the U.S. Thus, the withholding regime often represents the most practical opportunity for the U.S. to assert its jurisdiction to tax such income.
- The concept of withholding tax on payments to nonresident alien individuals and foreign corporations applies to U.S. source FDAP income that is not effectively connected with a trade or business in the U.S. This is because FDAP income that is effectively connected with a U.S. trade or business of the foreign person is taxed as part of the net income of the U.S. trade or business.
- A withholding agent (WA) is required to file Form 1042-S information returns and a Form 1042 tax return and remit the correct amount of tax to the IRS. For purposes of chapter 3 of the Internal Revenue Code (IRC), most types of FDAP income are subject to the 30% statutory rate of withholding on gross income without deductions, unless an applicable income tax treaty provides for a reduced rate of tax. Typical examples of U.S. source FDAP income paid to foreign businesses include interest, dividends, royalties, rents, and specified natural resource income. FDAP income does not include any income embedded in the purchase of goods.

Information Gathering

- In addition to interviews, examiners may review the WA's books and records and any Forms 5471 and 5472 filed with the taxpayer's Form 1120 to determine if there are any U.S. source FDAP payments to foreign persons. Other sources of information may include withholding certificates and account opening identification documents provided to the WA, organizational charts, financial statements, Forms 10-K, 10-Q, and 8-K, bank statements, legal agreements, articles of incorporation, certificates of residence from a foreign country, and foreign tax returns.

General Overview (cont'd)

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Required Documentation

- A withholding agent that can reliably associate the payment with documentation that establishes that the payee is a U.S. person (such as Form W-9) is not required to withhold under NRA withholding rules. However, the payment may be subject to the withholding rules of another withholding regime, such as U.S. backup withholding. In addition, a withholding agent may apply a reduced rate of withholding tax, down to 0%, if the withholding agent receives valid documentation from a beneficial owner that is a foreign person entitled to a reduced rate of withholding under a provision of the IRC or a tax treaty. The underlined terms in this section are further defined in Treas. Reg. 1.1441-1(c).
- The payee may not be the beneficial owner if the payee is an intermediary or a flow-through entity. An intermediary may be either a qualified intermediary or a nonqualified intermediary. In summary the withholding agent will usually need a withholding certificate from the beneficial owner attesting to the beneficial owner's country of tax residency and its entity status as support for the tax rate applied. These certificates, also called W-8BEN's, establish the owner's claim to be an individual, partnership, corporation, trust, or an exempt recipient among other possible statuses. Different regulations or treaty provisions depend on these certifications. Regulations also specify the presumptions the WA must make in the absence of reliable documentation.

Also Found in this Unit

- The Relevant Key Factors page shows the logical filters required for a withholding agent to determine if it must withhold from a payment made to a non-U.S. person.
- The Diagram of the Concept page shows typical cash flow and the required reporting. It also shows the IRS symbol used to represent a withholding agent. ABC Broker makes a payment of U.S. source equity dividends that it receives through the Depository Trust Corporation and puts the money in a non-U.S. corporation's account while remitting 30% to the IRS.
- The Detailed Explanation of the Concept section discusses the liability of the WA. It discusses the amount, when and how to deposit the withheld tax, how to report withholding on Forms 1042-S, 1042-T and 1042, and which penalties apply for failure to file, failure to pay and failure to file correct information returns.

Relevant Key Factors

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Key Factors

Is FDAP Withholding Required?

- 1) Is the payment made to a foreign person?
- 2) Is the income FDAP income?
- 3) Is the income U.S. source income?
- 4) Is there any exemption available? (per IRC, e.g., paid to a Qualified Intermediary)
- 5) Is there a claim for a reduced tax rate under the IRC or an applicable income tax treaty?

Does the withholding agent have the documentation required for reduced withholding?

If withholding at source tax deposits are required, when are they required, and how?

What penalties should be assessed for failure to withhold and report payments and to withhold correctly?

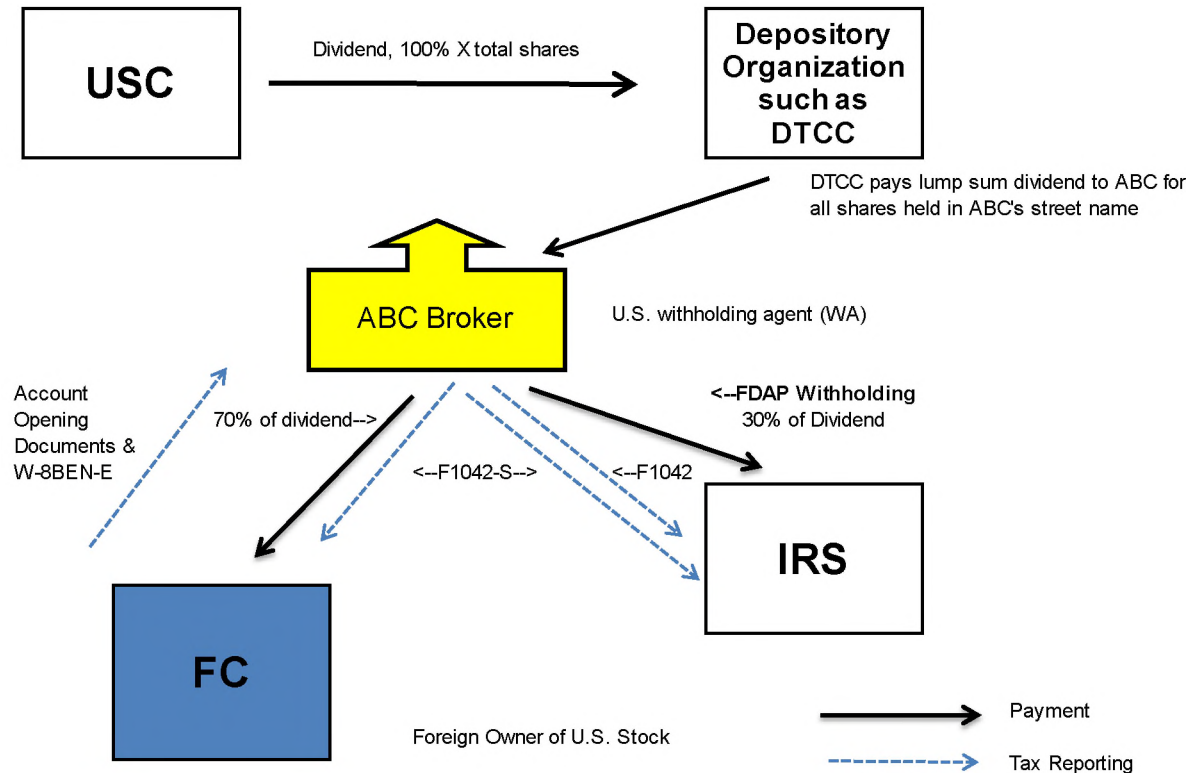
This unit addresses only U.S. source FDAP payments made to non-U.S. entities under Chapter 3. It does not cover FATCA withholding under Chapter 4.

Diagram of Concept

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Diagram of Concept

FDAP Withholding



- This diagram depicts a typical FDAP withholding scenario in which a foreign corporation (FC) receives a dividend payment from a US corporation (USC) that is taxed 30% at source. FC owns the USC shares through a U.S. brokerage account at ABC Broker. ABC Broker is the WA.

Detailed Explanation of the Concept

FDAP Withholding Under Chapter 3

Withholding at source requirements

Analysis	Resources
<p>Withholding Agent Liability</p> <ul style="list-style-type: none">▪ A withholding agent is a U.S. or foreign person that has control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding. A withholding agent may be an individual, corporation, partnership, trust, association, or any other entity, including any foreign intermediary, foreign partnership, or U.S. branch of certain foreign banks and insurance companies. An entity may be a withholding agent even if there is no requirement to withhold from a payment or even if another person has withheld the required amount from the payment.▪ Although several persons may be withholding agents for a single payment, the full tax is required to be withheld only once. Generally, the U.S. person who pays an amount subject to chapter 3 withholding to the non-U.S person is the person responsible for withholding. However, other persons may be required to withhold. For example, a payment made by a flow-through entity or nonqualified intermediary that knows, or has reason to know, that the full amount of chapter 3 withholding was not done by the person from which it receives a payment is required to do the appropriate withholding since it also falls within the definition of a withholding agent. In addition, withholding must be done by any qualified intermediary in accordance with the terms of its qualified intermediary agreement.▪ A withholding agent is personally liable for any tax required to be withheld. This liability is independent of the tax liability of the foreign person to whom the payment is made. If the WA fails to withhold and the foreign payee fails to satisfy its U.S. tax liability, then both the WA and the foreign person are liable for tax, as well as interest and any applicable penalties. The applicable tax will be collected only once. If the foreign person satisfies its U.S. tax liability, the WA may still be held liable for interest and penalties related to the failure to withhold.	

Detailed Explanation of the Concept (cont'd)

FDAP Withholding Under Chapter 3

Withholding at source requirements

Analysis	Resources
<p>FDAP Withholding is only one part of chapter 3</p> <ul style="list-style-type: none">▪ The term “NRA withholding” is used in this area descriptively to refer to withholding required under sections 1441, 1442, and 1443 of the IRC. Generally, chapter 3 or NRA withholding describes the withholding regime that requires 30% withholding on a payment of U.S. source FDAP income and the filing of Form 1042 and related Forms 1042-S. Payments to all foreign persons, including nonresident alien individuals, foreign entities and governments may be subject to NRA withholding. This unit will address only FDAP payments made to non-U.S. entities.▪ The term chapter 3 withholding generally does not include withholding done under section 1445 of the Internal Revenue Code (on dispositions of U.S. Real Property Interest) or under section 1446 of the Internal Revenue Code (Partnership Withholding on Effectively Connected Income).▪ Sections 861, 871 and 881 are referred to by Sections 1441 and 1442 and provide some of the supplemental authority for the sourcing and types of income that is either taxed or exempted from tax by Sections 1441 and 1442. While Section 1442 is the Section titled Withholding of Tax on Foreign Corporations and Section 1441 is titled Withholding of Tax on Nonresident Aliens, Section 1442 refers to Section 1441 for how the tax on foreign corporations will be applied.▪ IRM 4.10.21 describes audit techniques used for examining Forms 1042.	<ul style="list-style-type: none">• IRM 4.10.21

Detailed Explanation of the Concept (cont'd)

FDAP Withholding Under Chapter 3

Withholding at source requirements

Analysis	Resources
<p>Determination of Amount to Withhold</p> <ul style="list-style-type: none">▪ A WA making a payment to a non-U.S. entity must withhold on the gross amount subject to NRA withholding. The WA cannot reduce the gross amount by any deductions.▪ If the WA does not know the character or the source of the income at the time of payment, a USWA must withhold 30% of the payment until the tax liability is known. The regulations do, however, allow the USWA to place such amount into escrow for a limited period of time until known. Treas. Reg. 1.1441-3(d)(1).▪ The default 30% rate of withholding may be reduced by treaty provisions or by specific exemptions found in the IRC including portfolio, short term and deposit interest, as well as limitations on the definition of FDAP, such as for capital gains.	<ul style="list-style-type: none">• Treas. Reg. 1.1441-3(d)(1)

Detailed Explanation of the Concept (cont'd)

FDAP Withholding Under Chapter 3

Withholding at source requirements

Analysis	Resources
<p>When to Withhold</p> <ul style="list-style-type: none">▪ Any required withholding is generally deducted from a payment before it is made to the foreign person.▪ Withholding is required at the time a USWA makes a payment of an amount subject to withholding. A payment is made to a person if that person realizes income (applying U.S. tax principles of cash basis accounting), regardless of whether or not there is an actual transfer of cash or other property. A payment is considered made to a person if it is paid for that person's benefit. For example, a payment made to a creditor of a person in satisfaction of that person's debt to the creditor is considered made to the person. A payment is also considered made to a person if it is made to that person's agent. For treatment of a payment made to the U.S. agent of a foreign person, refer to Identifying the Payee, U.S. Agent of Foreign Person in Publication 515.▪ A U.S. partnership is required to withhold on the FDAP amount includible in the distributive share of a foreign partner.▪ A U.S. trust is required to withhold on the amount includible in the gross income of a foreign beneficiary to the extent the trust's distributable net income consists of an amount subject to withholding. To the extent a U.S. trust is required to distribute an amount subject to withholding but does not actually distribute the amount, it must withhold on the foreign beneficiary's allocable share at the time the income is required to be reported on Form 1042-S.▪ For questions related to payments to or the withholding obligations of Qualified Intermediaries, Withholding Foreign Partnerships or Withholding Foreign Trusts refer to Publication 515.	<ul style="list-style-type: none">• Pub. 515

Detailed Explanation of the Concept (cont'd)

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Withholding at source requirements

Analysis	Resources
<p>Depositing Withheld Taxes</p> <ul style="list-style-type: none"> ▪ This section discusses the rules for depositing income tax withheld on FDAP income to the IRS. ▪ The amount of tax a WA is required to withhold determines the frequency of a WA's deposits. The rules in Publication 515 describe how often deposits must be made. If the total amount withheld by that USWA exceeds \$1, \$200, or \$2,000 the USWA has to make a deposit to the IRS using the Electronic Federal Tax Payment System (EFTPS) either annually, monthly or quarter-monthly (weekly), respectively. ▪ Electronic deposit requirement. A WA must deposit all withheld taxes by electronic funds transfer. In most cases, electronic funds transfers are made using EFTPS. For more information see www.eftps.gov or Publication 966, Electronic Federal Tax Payment System - A Guide To Getting Started. All payments should be stated in U.S. dollars and should be made in U.S. dollars. ▪ A deposit required for any period occurring in one calendar year must be made separately from a deposit for any period occurring in another calendar year. A deposit of this tax must be made separately from a deposit of any other type of tax. ▪ The deposit rules above do not apply to the following items: taxes on payroll, pensions and annuities, partnership ECI, and dispositions of U.S. real property interests by foreign persons. 	<ul style="list-style-type: none"> • Pub. 515

Detailed Explanation of the Concept (cont'd)

FDAP Withholding Under Chapter 3

Withholding at source requirements

Analysis	Resources
<p>Information Reporting on Forms 1042-S, 1042-T and 1042</p> <ul style="list-style-type: none">Withholding agents should pay attention to details on Forms 1042-S and 1042-T for successful processing. For additional information, refer to Returns Required and the instructions to Forms 1042, 1042-S and 1042-T. Separate Forms 1042-S are provided to both the beneficial owner and the IRS for the calendar year total of each income type paid to each beneficial owner. March 15 is the due date for all forms. Extensions of time to file are described in the instructions to Forms 1042 and 1042-S.	

Detailed Explanation of the Concept (cont'd)

FDAP Withholding Under Chapter 3

Withholding at source requirements

Analysis	Resources
<p>Penalties for Failure to Make Deposits on Time.</p> <ul style="list-style-type: none">▪ The following slide shows penalties applicable to CTW information and tax returns for failure to file, failure to file correctly and failure to pay. Intentional failure to file correctly can result in a penalty of 10% of gross income even when no tax is due.▪ If a WA fails to make a required deposit within the time prescribed, a penalty is imposed on the underpayment (the excess of the required deposit over any actual timely deposit for a period). The Service Center imposes penalties for discrepancies between when a liability is declared on Lines 1 to 60 on Form 1042 and when deposits are received. The examiner should confirm that the liabilities are declared on the correct dates on the Form 1042. The WA can avoid penalties if it can show that the failure to deposit was for reasonable cause and not because of willful neglect. Also, the IRS may waive penalties if certain requirements are met.▪ The penalty rates escalate from 2% to 10% for failure to make timely deposits during the year. If the deposit is:<ul style="list-style-type: none">– 1 to 5 days late, the penalty is 2% of the underpayment,– 6 to 15 days late, the penalty is 5%, or if– 16 or more days late, the penalty is 10%.▪ However, if the deposit is not made within 10 days after the IRS issues the first notice demanding payment, the penalty is 15%.▪ If a WA owes a penalty for failing to deposit tax for more than one deposit period, and it makes a deposit, the deposit is applied to the most recent period to which the deposit relates unless the USWA designates otherwise.	

Detailed Explanation of the Concept (cont'd)

FDAP Withholding Under Chapter 3

Withholding at source requirements

Analysis			Resources
IRC Section	NRA Withholding Tax Penalty Description	IRM	
6651(a)(1)	Failure to File: Up to 25% (when 5 months late) on amount not filed on Form 1042	20.1.2.2	
6651(a)(2)	Failure to Pay: Up to 25% (when 50 months late) of amount not paid on Form 1042	20.1.2.2	
6655	Levied by Ogden Service Center (SC) even if paid tax, but not during the year.	20.1.3	
6656	Failure To Make Deposit Of Taxes: Up to 15% Levied on Underpayment over 15 days late.	20.1.4.1	
6662(a)	Accuracy-related Penalty on Underpayments: Up to 20% of amount not disclosed on Form 1042	20.1.5.9.1	
6663	Civil Fraud: 75% of underpayment due to fraud	20.1.5.14	
6721	Failure to File Correct Forms 1042-S to the IRS: \$100 for each incorrect 1042-S sent to IRS, unless intentional. then 10% of gross income	20.1.7.3	
6722	Failure to Furnish Correct Payee 1042-S's: \$100 for each incorrect 1042-S sent to BO, unless intentional, then 10% of gross income.	20.1.7.4	

Examples of the Concept

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Examples

Without reliable documentation such as Forms W-8 in the WA's possession, the WA would have to withhold and deposit and report 30% tax when the payment is made on:

1. Interest on a bond issued by large U.S. computer service company through a U.S. brokerage is paid to a French Individual who lives in Michigan. The individual provided a W-8BEN and opened the account with his French passport. The brokerage books its CTW tax liability on the day it credits the net amount to the individual's account. The brokerage frequently shows both gross and net amounts on the individual's monthly statement but is required to provide the individual and the IRS with a 1042-S showing the gross interest and the amount withheld by March 15th of the following year.
2. Dividends on large U.S. internet company stock paid to a Egyptian Corporation through a Turkish brokerage. The Turkish brokerage has an account at a U.S. brokerage. The U.S. broker collects withholding certificates and a withholding statement from the Turkish broker. The U.S. broker, who has control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding, not the upstream internet company nor the Depository Trust Corp., is the withholding agent. The Turkish broker, as a non qualified intermediary, is also a withholding agent but need not file a Form 1042 provided the U.S. broker does so and has properly withheld. If the U.S. broker's total tax withholding for the week exceeds \$2,000, the U.S. broker must transfer the amount accumulated since the last deposit at the end of the "quarter monthly" period.
3. Royalties paid by a large U.S. hamburger seller for the use the use of a German company's general ledger software in the U.S. Only the royalties associated with use of the software in the U.S. are subject to CTW tax. If the royalty payments are trued-up based on annual worldwide sales, the hamburger company must withhold on a conservative estimate of the U.S. source portion of the royalties. If the royalty agreement were to specify that the software user was responsible for the withholding tax (i.e., the withholding tax cannot be withheld from the seller's royalty payments), there is gross up formula to account for the agreement of the buyer to pay the tax owed by the seller, because the tax paid for the seller is also income to the seller. Treas. Reg. 1.1441-3(f)

With reliable documentation from payee, the WA may be able to reduce the tax rate to a lower amount, though reporting is usually still required.

Training and Additional Resources

FDAP Withholding Under Chapter 3		
Type of Resource	Description(s) and/or Instructions for Accessing	References
IRS.gov	<ul style="list-style-type: none"> ▪ Hyperlinked pages on numerous “NRA Withholding” topics ▪ International Tax Topic Index – Links for information on issues related to international issues including FDAP 	<ul style="list-style-type: none"> ▪ Audit Tool – 1441-NRA Withholding http://www.irs.gov/Individuals/International-Taxpayers/NRA-Withholding ▪ Audit Tool - International Tax Topic Index http://taxmap.ntis.gov/taxmap/international/index.htm
CENTRA Sessions	<ul style="list-style-type: none"> • 2015 Foreign Payment Practice “New Hires” Training. The “Agenda” file has details for playing back the recorded presentations. • 2013 Foreign Payments Practice Live Training Decks, especially Lesson 2 “Withholding Agent Duties and Responsibilities” • 2012 Foreign Payments Practice, especially Lesson 703 “Withholding Agent” 	<ul style="list-style-type: none"> • 2015 (IBC) CPE - FPP New Hires - Live Training Decks • 2013 (IBC) CPE - Listing and links to 2013 FPP Lessons • 2012 (IBC) CPE - Non Resident Alien Withholding Form 1042 Audit Techniques- August, 2012

Glossary of Terms and Acronyms

Acronym	Definition
BO	Beneficial Owner
CTW	Chapter Three Withholding – IRC 1441 - 1464
DCN	Document Control Number
ECI	Effectively Connected Income – IRC 871(b)
FDAP	Fixed Determinable Annual Periodical - IRC 871(a)
IIC	International Individual Compliance
IDRS	Integrated Data Retrieval System – IRM 2.9.1
IPS	International Practice Service
IRC	Internal Revenue Code – Title 26
IRM	Internal Revenue Manual
NRA	Nonresident alien individual, but in this unit also refers to non U.S. entities - IRC 7701(b)(1)(B)
RA	Resident Alien - IRC 7701(b)(1)(A)

Index of Related Issues

Issue	Associated UIL(s)	References
<ul style="list-style-type: none"> ▪ FDAP Payments – FDAP Income 	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding – FDAP Payments 	<ul style="list-style-type: none"> ▪ RPW/CU/P_08.1_02(2016)
<ul style="list-style-type: none"> ▪ FDAP Payments - Source of Income 	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding – FDAP Payments 	<ul style="list-style-type: none"> ▪ RPW/CU/P_08.1_04(2016)
<ul style="list-style-type: none"> ▪ FDAP Payments Overview 	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding – FDAP Payments 	<ul style="list-style-type: none"> ▪ https://organization.ds.irsnet.gov/sites/lbiintl/INTL_IPS/Parts%20Library/Part_08_01.aspx
<ul style="list-style-type: none"> ▪ Payee Documentation for Treaty Benefits 	<ul style="list-style-type: none"> ▪ 9424.01 Repatriation / Withholding FDAP Payments 	<ul style="list-style-type: none"> ▪ RPW/9424.01_03(2015)