

## Part III – Administrative, Procedural and Miscellaneous

### Guidance on Refunds and Credits Under Chapter 3, Chapter 4, and Related Withholding Provisions

Notice 2015-10

#### I. PURPOSE

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) are concerned about cases in which persons subject to withholding under sections 1441 through 1443 (herein referred to as chapter 3) or sections 1471 and 1472 (herein referred to as chapter 4) are making or will make claims for refunds or credits in circumstances where a withholding agent failed to deposit the amounts withheld as required under section 6302 (or otherwise pay such amounts to the Treasury Department). The Treasury Department and the IRS are aware that withholding agents may not always be compliant with the requirement to deposit amounts withheld under chapter 3 or 4 or reported as withheld on Form 1042-S. If a refund or credit is issued for an amount that has not been deposited, the IRS may not be able to recover that amount because the claimant and, in some cases the relevant withholding agent, may be outside the United States. The allowance of refunds or credits based on the amount reported as withheld on Form 1042-S subjects the Treasury Department to the risk that refunds or credits may be improperly granted for fictitious withholding or amounts that have not been deposited, for which collectability issues may arise. In light of these concerns, the Treasury Department and the IRS intend to issue regulations applicable to claims for refund or credit for amounts withheld under chapter 3 or 4. In general, these regulations will provide that an otherwise allowable claim for refund or credit made by a claimant that is the beneficial owner of a withheld payment is only available to the extent that the relevant withholding agent deposited the amount withheld.

Section II of this notice provides background on the statutory and regulatory rules governing refund and credit claims for amounts withheld under chapter 3 or 4.

Section III of this notice describes, in general, the regulations that the Treasury Department and the IRS intend to issue with respect to the treatment of refund and credit claims made by persons subject to withholding under chapter 3 or 4 when the amount withheld is not deposited with the Treasury Department by a withholding agent as required under section 6302 (or otherwise paid to the Treasury Department). The regulations will also provide for a pro rata allocation

of the amount available to the claimant for refund or credit when a withholding agent has partially satisfied its deposit requirements. These regulations will apply to claims for refund or credit for amounts withheld with respect to the 2015 calendar year and thereafter. No inference is intended with regard to existing law, and for all years, the IRS will continue to deny claims for refund or credit when appropriate, including for fictitious withholding and other fraudulent claims.

Section IV of this notice requests public comments regarding the administration of the pro rata allocation and procedural rules described in section III.B of this notice and on potential exceptions to the rules described in this notice.

## II. BACKGROUND

### A. General Requirement to Withhold, Deposit, and Report under Chapters 3 and 4

Chapter 3 generally requires withholding agents to collect the substantive tax liability of foreign persons that is imposed under sections 871(a), 881(a), and 4948 on certain payments of U.S. source fixed or determinable annual or periodical income through withholding requirements. Chapter 4 generally requires withholding agents to withhold tax on certain payments to foreign financial institutions (FFIs) that are nonparticipating FFIs and certain nonfinancial foreign entities (NFFE) that do not provide information regarding their substantial U.S. owners. Chapter 4 also generally requires participating FFIs to withhold tax on certain payments to accounts held by recalcitrant account holders and payees that are nonparticipating FFIs. The withholding required under chapters 3 and 4 is collected primarily by domestic withholding agents but is also collected by foreign withholding agents.

An amount withheld by a withholding agent is required to be deposited with the Treasury Department in accordance with section 6302. See Treas. Reg. §§ 1.1461-1(a) and 1.1474-1(b). The regulations also generally require a withholding agent to deposit withheld amounts within certain time periods that vary depending on the amount of deposits. See Treas. Reg. § 1.6302-2. A withholding agent is required to report its federal income tax liability for the amounts of tax it is required to withhold under chapters 3 and 4 on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, for the calendar year. If, at the end of a calendar year, the total amount of deposited tax is less than the amount of tax required to be reported as due on Form 1042, the withholding agent must pay the balance due when filing its Form 1042. See Treas. Reg. § 1.1461-1(a). If the total amount of deposits received by the Treasury Department is less than the withholding tax liability of the withholding agent, and the withholding agent has not paid the tax due with the filing of its Form 1042, the withholding agent remains liable for the taxes due under section 1461 (for amounts withheld under chapter 3) or section 1474(a) (for amounts withheld under chapter 4) and associated interest and penalties. See sections 6601, 6651(a)(2), and 6656.

A withholding agent is also required to file with the IRS and furnish to the recipient of the payment a Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, reporting any amount withheld with respect to amounts paid to the recipient. The aggregate amount reported as withheld or otherwise paid by the withholding agent on all Forms 1042-S should equal the federal income tax liability reported by the withholding agent on Form 1042.

#### B. Claims for Refunds and Credits

Section 33 allows as a credit against the tax imposed by Subtitle A (income tax) the amount of tax withheld at the source under subchapter A of chapter 3. Section 1462 and Treas. Reg. § 1.1462-1(a) provide that the beneficial owner of the income may claim a credit of the amount of tax actually withheld under chapter 3 against the total income tax computed on the beneficial owner's return. For purposes of chapter 4, section 1474(b)(1) and the regulations thereunder allow a credit for the amount of tax deducted and withheld under chapter 4 as if such tax had been deducted and withheld under subchapter A of chapter 3. Treas. Reg. § 1.1474-3(a) provides that the amount of tax actually withheld shall be allowed as a credit against the total income tax computed in the beneficial owner's return.

Treas. Reg. § 1.1464-1(a) provides for a refund or credit under chapter 65 (section 6401 through section 6432) of an overpayment of tax that has actually been withheld at source under chapter 3 to be made to the taxpayer from whose income the amount of such tax was in fact withheld. For chapter 4 purposes, Treas. Reg. § 1.1474-5(a)(1) provides that a refund or credit of an amount of tax that has actually been withheld at source at the time of payment will be made to the beneficial owner of the payment to which the amount of withheld tax is attributable if such beneficial owner meets the requirements of chapter 65.

Generally, there is an overpayment when (i) there is a payment in excess of the tax due, (ii) pursuant to section 6401(a), there is a payment assessed or collected after the expiration of the statute of limitations, or (iii) pursuant to section 6401(b), there is an excess refundable credit because the amount allowable as a credit exceeds the tax imposed. Under a special rule in section 6401(b)(2), the credit under section 33 is treated as a refundable credit only in the case of a beneficial owner who is a nonresident alien and who has made an election to be treated as a U.S. resident under section 6013(g) or (h). In the case of an overpayment, section 6402(a) authorizes the IRS to credit the amount of such overpayment against any liability in respect of an internal revenue tax on the part of the person who made such overpayment and provides that the IRS shall, subject to certain offsets, refund any balance.

Treas. Reg. § 301.6402-3T(e) provides the procedural requirements applicable to a claim for refund or credit made by a nonresident alien individual or foreign corporation for amounts withheld under chapter 3 or 4. These regulations provide that, for an overpayment of tax that resulted from withholding under

chapter 3 or 4, the claimant must attach a copy of the relevant Form 1042-S to the income tax return on which the claim for refund or credit is made.

### III. GUIDANCE TO ADDRESS REFUND AND CREDIT CLAIMS WHERE THE DEPOSIT REQUIREMENT HAS NOT BEEN SATISFIED

#### A. General Rule

The Treasury Department and the IRS intend to amend the regulations under Treas. Reg. §§ 1.1464-1(a) and 1.1474-5(a)(1) to provide that a refund or credit will be allowed to a claimant with respect to an overpayment only to the extent the relevant withholding agent has deposited (or otherwise paid to the Treasury Department) the amount withheld and such amount is in excess of the claimant's tax liability, except as otherwise provided by section 6401(b)(2). Similarly, the Treasury Department and the IRS also intend to issue regulations under section 33 and amend the regulations under Treas. Reg. §§ 1.1462-1(a) and 1.1474-3(a) to provide that a credit for an amount withheld is only available to a claimant to the extent that the withholding agent has deposited (or otherwise paid to the Treasury Department) the amount withheld. Therefore, subject to certain exceptions, including, potentially, the exceptions referenced in section III.C of this notice, no refund or credit will be allowed under the regulations for an amount withheld under chapter 3 or 4 when there is a shortfall in the deposits required to be made by the withholding agent. While this notice focuses on regulations to be issued under sections 33, 1462, 1464, and 1474, the Treasury Department and the IRS may amend or issue other related regulations to carry out the objectives described in this notice.

#### B. Allocation of Partial Deposits to Refund or Credit Claims

The Treasury Department and the IRS recognize that a withholding agent may deposit a portion of the amount of tax that it has withheld under chapter 3 or 4. The Treasury Department and the IRS intend to issue regulations providing that, in such cases, the claimant is entitled to an amount of refund or credit, to the extent otherwise allowable, that takes into account that the withholding agent has deposited a portion of the required amount of tax. The regulations will adopt a pro rata method to allocate the amount available for refund or credit with respect to each claimant. Under this method, a withholding agent's deposits made to its Form 1042 account will be divided by the amount reported as withheld on all Forms 1042-S filed by the withholding agent to arrive at a "deposit percentage." Solely for purposes of refund and credit claims related to chapter 3 or 4, each claimant will be treated as though the withholding agent made a deposit equal to

- the amount reported as withheld on the Form 1042-S with respect to the claimant, multiplied by
- the withholding agent's deposit percentage.

The claimant will be entitled to a refund or credit of the amount withheld to the extent that the deposit amount allocated to the claimant exceeds the claimant's tax liability.

As an example, consider a case in which a withholding agent pays a \$100 dividend to each of ten nonresident aliens and withholds tax at 30 percent from each dividend under chapter 3. The withholding agent is required to deposit \$300 of tax, but instead deposits only \$225 of tax that it withheld. The withholding agent reports on a Form 1042-S issued to each nonresident alien and filed with the IRS that it paid to that nonresident alien a \$100 dividend and withheld \$30 of tax. In this case, the withholding agent's deposit percentage is 75 percent (\$225, the amount of deposits reflected in the withholding agent's Form 1042 account, divided by \$300, the amount reported as withheld on all Forms 1042-S filed by the withholding agent). If one nonresident alien properly claims that, under an income tax treaty with the United States, he is entitled to a 15 percent withholding tax rate and claims a \$15 refund, he is allocated \$22.50 of the deposit (the \$30 reported as withheld on the claimant's Form 1042-S, multiplied by the withholding agent's deposit percentage of 75 percent). Since the nonresident alien withholding tax rate is 15 percent, he has a \$15 tax liability. Therefore, there is an overpayment of \$7.50, and the nonresident alien will be entitled to a refund or credit for that amount.

Permitting a partial refund or credit under this methodology ensures that a claimant's refund or credit claim will not be denied in its entirety due to the failure of the relevant withholding agent to fully deposit or otherwise pay the required amount of tax and serves to allocate amounts available for refund or credit proportionately to claimants.

The Treasury Department and the IRS considered whether to permit a claimant that is the beneficial owner to prove that the deposit of tax made by a withholding agent was specifically made with respect to an amount withheld from the claimant (i.e., under a tracing or specific identification methodology). Under the existing information reporting, withholding, and deposit procedures, a withholding agent does not indicate to which beneficial owner the deposit of tax relates, and such information is not reported on Form 1042 or 1042-S. Under the existing procedures, therefore, an amount deducted by the withholding agent with respect to a payment to the beneficial owner cannot be matched with an amount of tax deposited in the withholding agent's Form 1042 account. Moreover, implementing a tracing or specific identification methodology that would permit this matching could present a significant administrative burden for withholding agents who process substantial volumes of payments and for the IRS. Because Treasury and the IRS believe that the obstacles to developing and implementing a specific tracing methodology are unlikely to be overcome in the foreseeable future, they intend to adopt the pro rata allocation method described earlier in this notice. Treasury and the IRS request comments, however, on the feasibility of developing and implementing a more precise methodology at some future date.

The IRS recognizes the need for written procedures with respect to the deposit allocation rules described in this section III.B to ensure that claimants are reasonably apprised of the status of their claims and to ensure that each claimant receives the proper amount of refund or credit under these rules. For example, the IRS is considering both when to compute the initial deposit percentage for a withholding agent and how frequently to re-compute the deposit percentage to reflect additional deposits made by the withholding agent after Form 1042 has been filed, and after the amount available for a claim is first determined. The IRS is also considering the manner in which withholding agents and affected claimants will be informed of a deposit percentage (whether initial or recomputed) that is less than 100 percent, and the process under which additional refund or credit amounts will be paid or allowed to a claimant when a withholding agent takes steps to increase its deposit percentage. For these purposes, the IRS intends to establish procedures (in, for example, the Internal Revenue Manual) in connection with these allocation rules.

### C. Exceptions

The Treasury Department and the IRS are considering exceptions to the general rules described in sections III.A and III.B of this notice that are administrable by the IRS and minimize the potential for fraud or the intentional under-deposit of withholding taxes. For example, the Treasury Department and the IRS are considering whether to provide an exception if the amount of the under-deposit of tax is de minimis or if the relevant withholding agent has a demonstrated history of compliance with its deposit requirements. The exceptions would treat a claimant that is the beneficial owner of the withheld payment as if a full deposit had been made, but only for purposes of a claim for refund or credit of an amount withheld under chapter 3 or 4. To the extent that any exceptions are adopted, they would not deem a withholding agent that fails to satisfy its deposit requirements as satisfying those requirements. Therefore, the withholding agent would remain liable for the amount of tax required to be deposited and associated interest and penalties.

## IV. REQUEST FOR COMMENTS

This notice requests public comments regarding the allocation of partial deposits and procedural rules described in section III.B of this notice, the potential exceptions described in section III.C of this notice, and other potential exceptions consistent with the purposes of the guidance described in this notice. This notice solicits written comments from affected persons by June 29, 2015. Written comments should be sent to: CC:PA:LPD:PR (NOT-2015-10), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (NOT-2015-10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224 or sent electronically via the Federal eRulemaking Portal at

Notice.Comments@irsounsel.treas.gov (NOT-2015-10). Please insert "Notice 2015-10" in the subject line of any electronic communications. All comments will be available for public inspection and copying.

#### V. DRAFTING INFORMATION

The principal author of this notice is Michael Kaercher of the Office of Associate Chief Counsel (International). However, other personnel from Treasury and the IRS participated in its development. For further information regarding this notice, contact John Sweeney or Michael Kaercher at (202) 317-6942 (not a toll-free call).