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**Virtual Withholding:  
Expanding the Observable Universe of Withholding**  
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# Virtual Withholding - Expanding the Observable Universe of Withholding

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The primary purpose of imposing withholding tax is to shift the initial burden of collecting tax on U.S. source income belonging to foreign persons from the *recipients* of the income to the *payors* of the income. Since the recipients are foreign persons, it is often difficult to pursue them once the funds leave the United States. The payors are usually U.S. persons or at least persons

engaged in a trade or business within the United States. The withholding mechanism thus simplifies collection efforts by focusing first within the United States.

As our eye travels across the broad expanse of sky that constitutes the withholding universe, we find that withholding is typically required only when there is a payment of money. Issues arise as soon as either component, payment or money, is missing or not in standard form. In some cases, the United States correctly takes a hard line. For example, if a payment is made in some medium other than the U.S. dollar, the withholding agent is required to measure the amount of the payment by the fair market value of the property or services provided in lieu of U.S. dollars.<sup>1</sup> The withholding agent may either liquidate the property prior to payment in order to withhold the required amount of tax or obtain payment of the tax from an alternative source. However, even if no alternative source can be located, the obligation to withhold under Section 1441 is still not deferred.<sup>2</sup>

Another example of how the United States provides a bright-line rule with respect to withholding occurs when a payment is made in a foreign currency. A special rule permits withholding to be accomplished by applying the applicable rate to the amount of foreign currency and converting the foreign currency at the spot rate in effect on that date.<sup>3</sup> A withholding agent that makes regular or frequent payments in foreign currency may use a month-end spot rate or a monthly average spot rate; the convention for conversion used by the withholding agent must be applied on a consistent basis and may not be changed without IRS consent.

The universe of withholding, however, is not always confined to such readily observable phenomena. There are many cases where tax is imposed even when there is no payment. For example, income may be imputed under Section 482 (transfer pricing) or Section 7872 (below market loans), or it may arise from the cancellation of debt. A securities lending or sale-repurchase transaction may result in interest or dividend income. The amount and character of such payments (and thus the correct amount to withhold and the compliance requirements) may not be intuitively obvious, and even if they are obvious, the withholding agent may not have the means to fund the withholding. This article aims to expand the universe of observable withholding by examining issues that arise when withholding is imposed on recharacterized, imputed or constructive payments. In most, but not all cases, these issues are addressed or at least affected by the final withholding regulations issued on October 14, 1997 (the “final regulations”).<sup>4</sup>

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<sup>1</sup>Reg. Sec. 1.1441-2(e) (effective Jan 1, 2001; before then, *see* Reg. Sec. 1.1441-7(c)). All references to the I.R.C. are to the Internal Revenue Code of 1986, as amended through September 1, 1999.

<sup>2</sup>Reg. Sec. 1.1441-3(e)(1).

<sup>3</sup>Reg. Sec. 1.988-1(d)(1) for definition of spot rate.

<sup>4</sup>T.D. 8734, 62 FR 53387 (Oct. 14, 1997). Unless specifically stated to the contrary, all references to the regulations under Chapter 3 of the Code (Section 1441 et seq.) are to the regulations finalized by T.D. virtual\_withholding\_10-26-99

## 1. Virtual Payments.

### Constructive Payments.

**In General.** The Internal Revenue Code (“Code”) requires withholding agents to deduct and withhold tax on certain payments of money or property. A payment may be either an actual payment or a constructive payment. Under the regulations, a withholding agent not related<sup>5</sup> to the recipient or beneficial owner is required to withhold only to the extent it has control or custody over the money or property of the beneficial owner or recipient. This rule is subject to an anti-abuse rule where the lack of control or custody results from a pre-arranged plan known to the withholding agent to avoid withholding tax.<sup>6</sup> The final regulations provide that a payment is considered to be made when the amount would be includible in the income of the beneficial owner under the U.S. tax principles governing the cash method of accounting.<sup>7</sup> Although it has long been thought that the receipts basis of taxing foreign persons (the method historically used) was analogous to the cash method of accounting, the final regulations formally state this. Therefore, the general law concerning the cash method of accounting is now directly imported into the timing of withholding obligations and the rules related to constructive receipt.<sup>8</sup> The next portion of this article describes a variety of situations where a withholding obligation on a constructive payment may arise.

**Open Accounts.** An “open account” is essentially defined as an “unsettled debt arising from items of work and labor, goods sold and delivered, and other open transactions, not reduced to writing and subject to future settlement and adjustment.”<sup>9</sup> The account is typically credited or debited at the close of each year for amounts payable or receivable. Moreover, the rules for constructive receipt provide that income, although not actually reduced to a taxpayer’s possession, is constructively received in the taxable year during which it is credited to the taxpayer’s account, set apart for the taxpayer, or otherwise made

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8734, effective December 31, 2001. The effective date has been extended twice since T.D. 8734 was released. The original effective date of January 1, 1999 was changed to January 1, 2000 by Notice 98-16 (April 13, 1998) and then to January 1, 2001 by Notice 99-25 (May 17, 1999).

<sup>5</sup>“Related,” within the meaning of Section 482.

<sup>6</sup>Reg. Sec. 1.1441-2(d)(1).

<sup>7</sup>Reg. Sec. 1.1441-2(e)(1).

<sup>8</sup>Reg. Sec. 1.446-1(c)(i) (definition of cash method) and Reg. Sec. 1.451-2 (definition of constructive receipt).

<sup>9</sup> See *Kramer v. Gardner*, 104 Minn. 370 (S. Ct. Minn 1908).

available so that the taxpayer may draw upon it at any time or could have done so within the taxable year by giving any required notice.<sup>10</sup> Thus, where a U.S. and a foreign person maintain open accounts with each other, the crediting of an amount to the account of the foreign person is treated as an actual payment. This principle is illustrated in Revenue Ruling 70-251,<sup>11</sup> where *M*, an accrual method domestic corporation, maintained an open account with its foreign affiliates. Each year, various amounts payable or receivable were credited or debited as appropriate to the foreign affiliates' accounts. The ruling concludes that the interest was constructively received and paid. The ruling does not, however, stand for the proposition that, in the absence of any offsetting obligations by the foreign subsidiaries to *M*, withholding was required on *any* amount of interest accrued. Constructive payment by *M* to the foreign affiliates, not accrual of an obligation in their favor, appears to be the factor triggering *M*'s obligation to withhold. Amounts were currently due and payable in both directions. Therefore, it should be reasonable to view *M*'s offset of interest that it owed to the foreign affiliates with interest that the foreign affiliates owed to *M* as constructive payment. Accordingly, withholding was required on the interest that was constructively paid.

**Interest Accrual.** Another area where there is some confusion over the imposition of withholding tax is the accrual of interest. Two issues related to this area are discussed below, book entries and the branch interest tax.

*Book Entries.* Practitioners have recently encountered IRS revenue agents who have sought to impose withholding tax on accrued but unpaid interest. While these agents have used a variety of arguments to support their positions, the most notable have been their references to TAM 9252004 and Revenue Ruling 70-251.<sup>12</sup> Essentially, the IRS appears to be arguing that the crediting of interest to the account of a lender requires withholding as if the interest had been paid in money.<sup>13</sup>

This position appears to be somewhat misconceived. The law requires interest to be included in the lender's income only upon receipt<sup>14</sup> and requires withholding by the withholding agent under

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<sup>10</sup>Reg. Sec. 1.451-2(a).

<sup>11</sup>1970-1 C.B. 182.

<sup>12</sup>See ¶ 1.1(b) above.

<sup>13</sup>Note how this viewpoint conflicts with other provisions of the Code which state that when an amount owed to the lender is not currently due, immediate taxation (and imposition of withholding) is deferred. One example of this can be seen in the case of OID. As discussed later in this article, tax on OID is only due when a payment is made under the obligation (or the obligation is sold) and therefore no withholding is required until payment is made. I.R.C. Sec. 871(a)(1)(C) and I.R.C. Sec. 881(a)(3).

<sup>14</sup>I.R.C. Sec. 871(a) and I.R.C. Sec. 881(a).

Sections 1441 and 1442 only upon payment. For purposes of withholding, a payment does not (and ought not to) include an accrual basis taxpayer properly recording in its books the accrual of a liability to pay interest.

TAM 9252004 examines a situation where *A*, a domestic corporation, accrued interest in favor of *FC*, a foreign corporation, and, in a separate transaction *A* became entitled to receive from *FC* a payment, the nature of which was not specified in the TAM. *A* paid an amount equal to the accrued interest less the amount due from *FC* and withheld 30% of this net amount. The IRS held that tax should have been withheld on the full amount which it credited to *FC*'s open account (and which was offset by the *FC*'s payment obligation to *A*) plus the amount of interest it actually paid. The point of the TAM is that *A* in fact paid *FC* partly by reducing *FC*'s liability to *A* on the other transaction and partly by an actual payment. The IRS argued that there was a constructive payment. In the case of *A* and *FC*, this position may be plausible, even compelling. However, it is quite different from the case where the borrower does not (by accruing the interest or otherwise) discharge, reduce or offset its obligation to the lender. In this latter situation, the borrower is merely acknowledging on its own books of account that it has accrued an obligation to pay the interest.

The IRS's reliance on Revenue Ruling 70-251 to support its position for withholding on accrued but unpaid interest is equally misplaced. This ruling involved a factual situation much different from the scenario suggested. In the ruling, withholding was required on interest that was constructively paid to the open accounts of foreign affiliates. A defining factor for the IRS was that the foreign affiliates could draw at will from their open accounts on any balance in their favor, much like that of a bank account to which a bank credits interest. An account holder has immediate use of the interest, and is thus required to include it in income immediately under the constructively receipt doctrine.<sup>15</sup> This is very different from the mere accrual of interest - the fact that interest is recorded in a taxpayer's books as having been accrued is not sufficient to create constructive receipt.

If the position taken by the IRS auditors were correct, it would provide a spectacular windfall for other taxpayers. For one thing, the distinction between accrual and receipts basis taxation would no longer have meaning. Moreover, Sections 163(e)(3) (deduction for OID accrued in favor of related foreign party deferred until paid) and 267(a)(2) and (3) (deduction of amount accrued in favor of related foreign party deferred until paid) would also be made irrelevant. This would have a significant cost to the government in the common situation where the lender is in a favorable tax position (such as a tax-exempt or treaty-protected related party), and an acceleration of a deduction by the borrower would be desirable but carry no U.S. tax consequences to the lender. Under the IRS's theory, the borrower would only have to record the liability for interest in its books to be treated as having paid it, the interest would be tax-free to the lender and the deferral of deductibility under the regulations under Sections 163(e)(3) and

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<sup>15</sup>Reg. Sec. 1.451-2(a).

267(a)(3) would not apply.

*Branch Level Interest Tax.* The branch level interest tax rules permit a taxpayer to treat excess interest as if it were paid in the year of accrual rather than the year of actual payment.<sup>16</sup> The final regulations treat any interest with respect to which such election is made as if the interest were paid on the last day of the year of accrual.<sup>17</sup>

**Triangulation, Pledges and Guarantees.** Another situation which triggers withholding on constructive payments is triangulation. This occurs when a withholding agent makes a payment directly to a third party for credit to a foreign person's account or in satisfaction of the foreign person's obligation to the third party. The appropriate treatment is to triangulate the payment and treated as a payment to the foreign person followed by a payment by the foreign person to the third party (it is the first of these payments that may attract a withholding requirement). In *Casa de la Jolla Park, Inc. v Commissioner*,<sup>18</sup> the corporation was indebted to its Canadian shareholder. A California bank collected proceeds from the corporation's time-share sales and, at the corporation's direction, remitted the net proceeds to a Canadian bank. The Canadian bank applied these proceeds against outstanding loans that it had made to a Canadian shareholder of the corporation. The Tax Court ruled that the shareholder had constructively received the interest income on his loan to the corporation at the time when the Canadian bank applied the time-sharing proceeds against his bank loan. It also found that the corporation had the required control or custody to withhold the tax from the amounts constructively paid to its shareholder. The Court rejected the taxpayer's argument that it did not have the requisite control over the funds because it had no choice but to give instructions to the California bank to pay the amounts to the Canadian bank.

The court distinguished *Tonopah & T.R. Co. v Commissioner*.<sup>19</sup> In *Tonopah*, the taxpayer (Tonopah) was a New Jersey corporation that was owned by an English company (Borax). Borax guaranteed bonds issued by Tonopah, some of which were held by nonresident aliens. When Tonopah was unable to meet its interest obligations, Borax paid the interest in England. The Ninth Circuit Court of Appeals held that Tonopah was not liable for withholding on the interest payments to the nonresident alien bondholders because Tonopah "never possessed the interest moneys from which [it] could withhold anything within the contemplation of the statute."

The court rejected Casa de la Jolla's argument that it could no more control the Canadian bank than Tonopah could control Borax and that, absent the required control or custody, it was not

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<sup>16</sup>Reg. Sec. 1.884-4(c).

<sup>17</sup>Reg. Sec. 1.1441-2(e)(5).

<sup>18</sup>94 T.C. 384 (1990).

<sup>19</sup>112 F.2d 970 (9th Cir. 1940), *rev'g*. 39 B.T. A. 1043 (1939).

responsible for withholding the tax from the amounts paid. The court pointed out that in *Tonopah*, the court held that Tonopah never possessed the interest moneys from which it could withhold anything and had found as a fact that Borax had not first loaned the funds to Tonopah and then paid the funds to the bondholders, as Tonopah's agent. In *Tonopah*, the payments at issue were made by a third party guarantor out of its own funds and after the default of the primary obligor. By contrast, in *Casa de la Jolla*, the funds used were the corporation's.

Perhaps a more general rule illustrated by *Casa de la Jolla* is that a withholding agent may not escape its withholding obligations by directly or indirectly pledging assets to a creditor or shareholder if by doing so it loses the ability to withhold when those assets are used to satisfy an obligation to the creditor (or dividend to the shareholder) payment of which requires withholding.

**Section 304.** In general, Section 304 provides that if one or more persons are in control of each of two corporations and, in return for property, one of the corporations (the "acquiring corporation") acquires stock in the other corporation (the "issuing corporation") from the person or persons so in control, then such property will be treated as a distribution in redemption of the stock of the corporation acquiring such stock.<sup>20</sup> The question has therefore arisen whether the deemed distribution is subject to withholding.

The interaction between Section 304 and the withholding rules was directly addressed in Revenue Ruling 92-85.<sup>21</sup> This ruling examines the question in the context of deemed distributions by both domestic and foreign corporations, and also analyzes the applicability of tax treaties in these situations. It is important to note that some of the rules relating to distributions by foreign corporations have been subsequently changed by the Taxpayer Relief Act of 1997.

In the ruling, the Service concludes that if a distribution treated under Section 304 as a redemption is also treated as a dividend under Section 302,<sup>22</sup> then the dividend will potentially be taxable under Sections 871(a) and 881(a). It will also be subject to withholding under Sections 1441 and 1442. Where the distribution is deemed to be made by a domestic corporation, the portion constituting a dividend is taxable at 30% or lower treaty rate; however, the whole of the distribution is subject to withholding, with any excess withholding being refundable to the foreign distributee. This rule is subject to the new provisions (discussed below) relating to the portion of the distribution that is or may be expected not to be a dividend because the acquiring and issuing corporations have or are projected to have insufficient earnings and profits ("E&P").

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<sup>20</sup>The term "issuing corporation" is not defined in Section 304; it refers to the corporation the stock of which is transferred. See, e.g., Reg. Sec. 1.304-4T(a).

<sup>21</sup>1992-2 C.B. 69.

<sup>22</sup>A distribution may be treated as a dividend under Section 302 for a variety of reasons, i.e., because it is essentially equivalent to a dividend or is not substantially disproportionate.



Revenue Ruling 92-85 also addressed deemed distributions from foreign corporations under Section 304. Such distributions may be deemed to occur when a foreign corporation acquires a domestic corporation from another foreign corporation that is under common control. The distribution is characterized as a dividend to the extent that the acquired domestic corporation has undistributed E&P (assuming that the foreign acquirer's E&P is exhausted<sup>23</sup>). However, the Taxpayer Relief Act of 1997 amended Section 304 by adding new subsection (b)(5) which provides that the only E&P of the acquirer to be taken into account by the distributing corporation are those that (a) are attributable to stock held by a United States shareholder (a holder of 10% of the stock) who is the transferor or is related to the transferor and (b) were accumulated during a period when the U.S. shareholder held the shares and the acquiring corporation was a controlled foreign corporation.

Significantly, the 1997 Act did not change the treatment of the issuing corporation's E&P. A Section 304 transfer of a domestic corporation's stock by a foreign corporation to its shareholder may still give rise to withholding tax by reference to the E&P of the domestic corporation; this result occurs even though a straight distribution of cash by the foreign corporation would not be subject to withholding. A seemingly unfair result may appear in the simple case where a non-controlled foreign corporation wants to exchange cash in its foreign subsidiary for stock in its U.S. subsidiary. The 1997 legislation was targeted towards more complex situations involving the reorganization of controlled foreign corporations and apparently did not consider the non-abusive situation where the foreign corporations involved are not U.S.-controlled.

**Cancellation of Indebtedness.** The last issue involving constructive payments that is examined in this article is the cancellation of indebtedness.<sup>24</sup> A lender of funds that forgives debt is, in many situations and subject to many exceptions, deemed to have made a payment of income to the borrower.<sup>25</sup> However, whether or not the lender is required to withhold on this payment depends, as we have seen in the discussion of the *Casa de la Jolla* and *Tonopah* cases, on the extent of its control.<sup>26</sup> If the lender has no control over any money or property of the borrower between the date of the forgiveness and the due date (including

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<sup>23</sup>Section 304(b)(2) requires that distributions are first treated as coming from the E&P of the acquirer. If the acquirer is foreign, there will by definition be no withholding requirement on a distribution of the acquirer's E&P to a foreign shareholder because such a distribution will be deemed to have a foreign source. I.R.C. Sec. 862(a)(2).

<sup>24</sup>For an in-depth analysis of cancellation of debt, see Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, Second Edition, chapter 7 (Income from Discharge of Indebtedness).

<sup>25</sup>Reg. Sec. 1.1441-2(e)(1).

<sup>26</sup>See text accompanying footnotes and .

extensions) for filing Form 1042 with respect to the year in which the forgiveness occurs, no withholding is required, regardless of the nature of the income in the hands of the borrower. For this purpose, a partial payment by the borrower is not treated as a payment over which the lender has control.<sup>27</sup>

This rule keys off the general rule provided in Regulation Section 1.1441-2(d)(1). This regulation explains that a withholding agent not related<sup>28</sup> to the recipient or beneficial owner is required to withhold *only to the extent it has control or custody* over the money or property of the beneficial owner or recipient. It should therefore be subject to the anti-abuse rule contained in that regulation where the lack of control or custody results from a pre-arranged plan known to the withholding agent to avoid withholding tax.

**Imputed Income.** In certain types of transactions, the IRS has the authority to alter the parties' underlying arrangement and impute income as it deems necessary. This next portion of the article delves further into three areas where withholding tax may be imposed on the imputed income.

**Section 482 Adjustments - French Mustard or Ay, Chihuahua!** Over the years, the Service has made a number of attempts to require that transfer pricing adjustments between related parties give rise to withholding where income is imputed or recharacterized. Imputed income would include such items as rental income for the use of real or personal property located in the United States and income for services performed for insufficient compensation. Where a payment is recharacterized as a dividend rather than, for example, a payment for inventory, the payment would be subject to withholding under the IRS approach unless there were some provision for its repayment. Thus, if the U.S. distribution subsidiary of a foreign corporation is found to have overpaid its foreign parent for product purchased for resale in the United States, the excess may be treated as a dividend; in turn, that dividend would be subject to withholding.

In *R. T. French Co. v Commissioner*, the Tax Court refused to address the “tantalizing question” of whether constructive dividends to a foreign parent corporation would be subject to FDAP income withholding since it was determined that no constructive dividend occurred.<sup>29</sup> However, in the felicitously named *Central de Gas de Chihuahua v Commissioner*, the Court directly faced the issue. In this case, the taxpayer was a Mexican corporation which provided a fleet of tractors and trailers rent-free to a commonly controlled Mexican corporation. The latter used the fleet to transport liquefied petroleum gas from the United States to the Mexican border. It was

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<sup>27</sup>Reg. Sec. 1.1441- 2(d)(2).

<sup>28</sup>Related, within the meaning of Section 482.

<sup>29</sup>*R. T. French Co. v Commissioner*, 60 T.C. 836, 856 (1973).

eventually determined that \$1.125 million should be allocated to the taxpayer as the fair rental value of the equipment. The IRS imposed tax at 30% under Section 881 tax on the amount of rents “received” by allocation. The Tax Court held that Section 881 does not require an actual payment for the 30% tax to be imposed on amounts “received” as rents by foreign corporations from sources within the United States. However, the court made it clear that Section 881 is not a mirror image of Sections 1441 and 1442, which require actual payment for withholding.

The final regulations confirm the Service’s position that a payment is considered made to the extent income subject to withholding is allocated under Section 482.<sup>30</sup> Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under Section 482 from a foreign person to a related U.S. person is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the IRS and the agreement eliminates the liability for withholding. The payment of income is deemed to have occurred on the last day of the taxable year in which the transactions that give rise to the allocation of income and the secondary adjustments, if any, took place. Pursuant to Revenue Procedure 99-32,<sup>31</sup> a corporate taxpayer whose taxable income is increased or decreased due to a Section 482 allocation may adjust its accounts to permit a payment to be made to an affected related party without triggering additional U.S. tax.<sup>32</sup> For example, income that is allocated under Section 482 from a foreign parent to its U.S. subsidiary results in a deemed distribution from the subsidiary to the parent (in an amount equal to the “primary adjustment”) in the year of the allocation. This deemed distribution is considered a dividend to the extent of the subsidiary’s E&P and is subject to U.S. taxation of 30% (unless reduced by a treaty). Since the U.S. subsidiary would be the withholding agent in this situation, the revenue procedure permits the subsidiary to repatriate cash attributable to the primary adjustment via an account without additional U.S. tax consequences.<sup>33</sup>

One interesting issue that arises with respect to withholding on Section 482 adjustments occurs where there is an adjustment made for an overaccrual of an expense, but there has not yet been a payment. Such a situation could arise where a domestic subsidiary (“DS”) agreed to pay its foreign parent (“FP”) a certain amount (*e.g.*, \$20,000) for a product that FP manufactured, and the IRS later adjusted this price to a lower amount (*e.g.*, \$18,000). In the absence of some agreement to adjust the price, the \$2,000 difference would be viewed as a deemed dividend from

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<sup>30</sup>See FSA 199922034 (March 3, 1999).

<sup>31</sup>1999 IRB LEXIS 297 (Aug. 3, 1999).

<sup>32</sup>This payment, *i.e.*, repatriation of cash, is done by means of an interest-bearing account receivable or payable in the amount of the Section 482 adjustment. In certain instances, the account may be treated as an offset by the amount of a bona fide debt, distribution or capital contribution between the taxpayer and the related person.

<sup>33</sup>*Id.* At \*12.

DS to FP.<sup>34</sup> This result should occur even if DS has not yet paid the \$20,000 to FP; however, it would be arguable that the IRS could not require withholding on the deemed dividend before payment was made. The preamble to the regulations makes clear that the relief for withholding agents where income is not represented by cash or property<sup>35</sup> does not apply to Section 482 adjustments. Such relief only applies when the parties are unrelated within the meaning of Section 482. But there is some question as to the IRS' authority to apply this rule in the absence of some form of actual or constructive payment.

**Original Issue Discount.** A debt instrument has original issue discount ("OID") to the extent that the instrument's stated redemption price at maturity exceeds its issue price.<sup>36</sup> The final regulations restate the substantive rules of taxation of OID on instruments held by foreign persons.<sup>37</sup> In general, the foreign beneficial owner of an OID obligation is subject to tax on OID upon a taxable sale or exchange of the obligation or when a payment is made on such obligation. The amount taxable is the amount of OID that accrued while the foreign person held the obligation up to the time that the obligation is sold or exchanged or up to the time that a payment is made on the obligation, reduced by any amount of OID that was taken into account prior to that time (due to a payment made on the obligation). In the case of a taxable event due to a payment made on the obligation, the tax due on the amount of taxable OID may not exceed the payment less the tax imposed thereon. In plain (or at least plainer) English, this means that if an obligation carries both stated interest and OID, any payment on the obligation is used first to pay the tax on the interest, then to satisfy any tax on the accrued OID.

The final regulations somewhat simplify the withholding rules for OID. In particular, withholding is required on a payment to the extent the withholding agent knows the amount of OID. The withholding agent will know this amount if it knows how long the beneficial owner has held the obligation, the terms of the obligation and the extent to which obligation was purchased at a premium. A withholding agent is treated as having this knowledge if information is obtainable upon exercising reasonable efforts.<sup>38</sup> Not surprisingly, the regulations provide that information is not considered obtainable in most cases of payments with respect to publicly traded securities where the withholding agent does not have a direct customer relationship with the person who does have the knowledge or has no access in the normal course of its business due to the manner in which the obligation is held (*e.g.*, in street name or through intermediaries). Nonetheless, withholding agents are permitted to rely on the most recently published "List of

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<sup>34</sup>See Reg. Sec. 1.482-1(g)(3)(i).

<sup>35</sup>See Reg. Sec. 1.1441-2(d) and ¶ 1.1(a) above.

<sup>36</sup>I.R.C. Sec. 1273(a)(1).

<sup>37</sup>I.R.C. Sec. 871(a)(1)(C) and I.R.C. Sec. 881(a)(3).

<sup>38</sup>Reg. Sec. 1.1441-2(b)(3)(i).

OID Instruments” or similar list published by the IRS.<sup>39</sup>

In addition, withholding is typically required with respect to OID that would qualify as portfolio interest. There is an exception, however, in the case of an instrument in registered form since no Form W-8 or substitute documentation is furnished to the withholding agent. In the absence of information regarding the amount of OID, the withholding agent may rely on the IRS’s “List of OID Instruments.”

**Interest Imputed Under Section 7872 - *Climaco* Control.** In essence, Section 7872 is responsible for imputing interest on loans with below-market interest rates. Although the final regulations do not mention imputed interest under this section, it is the Service’s position that withholding is required on such interest imputed to a foreign person unless the exception to Section 7872 for many types of loans by foreign persons applies. This issue was considered in the case of *Climaco v IRS*.<sup>40</sup>

In *Climaco*, a U.S. individual was a shareholder of a Japanese corporation. The corporation made a \$200,000 interest-free demand loan to the shareholder and another individual. Under the below-market loan rules, the borrowers deducted the imputed interest payments. They also filed annual withholding tax returns, making tax payments at 10% under the U.S.-Japan income tax treaty on the interest imputed to the Japanese corporation. They then sued for a refund on the ground that they never made actual payments to the lender and were not required to withhold.

In granting summary judgment to the government, the court correctly analyzed the transaction as the payment by the lender to the borrowers of an amount equal to the imputed interest and the simultaneous retransfer of that amount as an interest payment to the lender. The second element of the transaction attracted the tax to the lender and, the court held, the withholding obligation on the borrowers.

The court’s reasoning on the imputation of income is clearly right and indeed the plaintiff borrower had effectively conceded this. The court could then simply have decided the withholding issue by reference to the open account offset rules noted earlier. Instead, it got sidetracked by IRS references to *Casa de la Jolla* and *Central de Gas de Chihuahua*, which the court characterized as not directly on point but persuasive. The plaintiffs had attempted to distinguish this case on the grounds that, unlike in *Casa de la Jolla*, the Japanese lender had not received any benefit. The court rejected this by noting that the lender had received a benefit (the imputed interest) that it had chosen to remit to a shareholder rather than to retain it. The court also stated that nothing in *Central de Gas de Chihuahua* suggests that the withholding requirements should not apply to imputed interest payments under Section 7872, although that

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<sup>39</sup>See *Publication 1212, List of Original Issue Discount Instruments*.

<sup>40</sup>Not officially published; reproduced at 96-1 USTC ¶ 50,153, 77 AFTR2d ¶ 96-563 (E.D. N.Y. 1996).

case was not about withholding but about the imputation of income under Section 482.

Strangely, neither the court (and, so far as we are aware, the IRS) focused on the key, and we would argue dispositive, weakness of the refund suit, namely that the wrong plaintiff was before the court. The tax that was withheld was tax due by the foreign corporation. Any refund should have been claimed by the foreign corporation, not the borrowers, who were merely withholding agents and thus mere stakeholders between the IRS and the true taxpayer.

It should also be noted that as a general rule, interest is not imputed to a foreign corporation, such as the Japanese corporation in *Climaco*, if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender would be effectively connected with the conduct of a U.S. trade or business and not exempt from U.S. income taxation under an applicable income tax treaty. However, this exception is not available when the loan is a compensation-related loan or a corporation-shareholder loan where the borrower is a shareholder that is not a C corporation. Unfortunately for the plaintiffs in *Climaco*, the loan was a corporation-shareholder loan (meaning a loan by a corporation to a shareholder and not *vice versa*).<sup>41</sup>

**Gross-Up.** Historically, if a withholding agent paid the foreign person in full and then paid the tax, the IRS took the position that the tax itself was a payment to the foreign person subject to tax.<sup>42</sup> This led to a repetitive cycle of deemed payments subject to tax which finally peters out when the amount of tax is reduced below \$.005.<sup>43</sup> In such circumstances, the amount deemed paid to the recipient is equal to the original payment times a gross-up factor of  $(1 + (R/(1-R)))$ , where R is the rate of withholding tax.<sup>44</sup> The calculation is a little more complicated if the rates are graduated, as in the case of wage withholding.

The final regulations confirm this approach in any case where satisfaction of the tax liability of a beneficial owner by a withholding agent constitutes income to the beneficial owner and such income is of a type that is subject to withholding.<sup>45</sup> In such case, the amount of the payment deemed made by the withholding agent is determined under the same gross-up formula,

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<sup>41</sup>Reg. Sec. 1.7872-5T(c)(2)(i).

<sup>42</sup>See Harvey Dale, *Withholding Tax on Payments to Foreign Persons*, 36 Tax L. Rev. 49, 89-95 (1980), and cases cited therein.

<sup>43</sup>I.R.C. Sec. 6313 (in the payment of any tax, fractional parts of a cent which are less than one-half of a cent are disregarded).

<sup>44</sup>For example, at a withholding rate of 30% the beneficiary will be deemed to have received \$1429 on a payment of \$1000 if the agent is deemed to have paid the U.S. taxes  $((1 + (.30/.70)) \times \$1000 = \$1429)$ .

<sup>45</sup>Reg. Sec. 1.1441-3(f).

expressed in the regulations as:<sup>46</sup>

$$\text{Payment} = \frac{\text{Gross payment without withholding}}{1 - (\text{tax rate})}$$

However, the final regulations also point out that whether the payment of the tax by the withholding agent constitutes a satisfaction of the beneficial owner's tax liability and whether, as such, it constitutes additional income to the beneficial owner, must be determined under all the facts and circumstances surrounding the transaction, including any agreements between the parties and applicable law. The facts and circumstances presumably would include whether, as a matter of applicable law (which may be state or foreign law), the withholding agent is entitled to make a claim against the payee or to reimburse itself for underwithheld tax out of future payments. This remains a matter on which the law is unclear.

There is one area, however, in which the final regulations do specifically relieve the withholding agent from gross-up liability. This is where the withholding agent uses the reasonable estimate procedure to determine that a portion of a corporate distribution will not be a dividend. The final regulations clarify that in this situation the amounts of tax that the withholding agent pays if underwithholding has occurred is not subject to withholding even if it constitutes a constructive dividend. This special rule applies irrespective of the fact that the satisfaction of the tax liability may be additional income to the shareholder, unless the additional payment results from a contractual arrangement between the parties regarding the shareholder's satisfaction of its tax liability by the distributing corporation. The final regulations eliminate, for this instance, the question as to whether a taxpayer realizes income when the withholding agent satisfies a tax liability under Section 1461.

**Blocked Income.** The final regulations confirm that income is not considered paid if it is blocked under executive authority, such as the President's exercise of emergency power under the Trading with the Enemy Act<sup>47</sup> or the International Emergency Economic Powers Act<sup>48</sup>. However, on the date that the blocking restrictions are removed, the newly unblocked income is considered constructively received by the beneficial owner and therefore paid and subject to withholding.<sup>49</sup>

### **Payments That Include an Undetermined Source or an Undetermined Amount of Income.**

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<sup>46</sup>Reg. Sec. 1.1441-3(f)(1).

<sup>47</sup>50 U.S.C. App. 5.

<sup>48</sup>50 U.S.C. 1701 et seq.

<sup>49</sup>Reg. Sec. 1.1441-2(e)(3).

**Miller Time.** In *Albert J. Miller v Commissioner*, the Tax Court ruled that an amount whose source cannot be determined at the time paid is sourced outside the United States for substantive tax and withholding tax purposes.<sup>50</sup> In the case, the taxpayer, a U.S. inventor, transferred his inventions into limited partnerships which paid a Hong Kong company to perform research and development. The Hong Kong corporation then subcontracted all of its research and development contracts, in varying proportions, to wholly owned U.S. and Hong Kong corporations and to independent subcontractors. The IRS claimed that a 30% tax was due on that portion of the amounts paid by the limited partnerships which reentered the United States under a subcontract. It also claimed that the taxpayer, as general partner of each limited partnership, was personally liable for the withholding tax due because he was a withholding agent.

The Tax Court ruled that the activities performed by the subcontractor could not be attributed to the parent for purposes of determining where the services were performed. The fact that a lower tier corporation performed some services in the United States was held insufficient to support a conclusion that its higher tier parent corporation also performed services in the United States. The two corporations were separate persons and not shams. The Court then went on to rule that even if a portion of the payments made by the limited partnerships were U.S. source, it was not FDAP because it was unascertainable during the year of payment what portion of the contract would be performed in the United States. The court noted that the existing regulations did not, in the case of services, require tax to be withheld in such cases. Nevertheless, this rule was recently changed.

**Final Regulations.** The final regulations overrule the Tax Court's holdings in *Miller* and require that an amount can be sourced within the United States irrespective of the fact that the source is undetermined at the time of payment.<sup>51</sup> Instead, withholding on the full amount is required where the withholding agent does not know at the time of payment the amount subject to withholding because the source or the amount subject to tax depends upon facts not known at the time of payment. Alternatively, the withholding agent may make a reasonable estimate of the amount from U.S. sources or of the taxable amount and set aside a corresponding portion of the amount due under the transaction and hold such portion in escrow until the amount from U.S. sources or the taxable amount can be determined, at which point withholding becomes due. The regulations do not specify how such escrows are to operate but the wording appears to imply that the withholding agent may be the escrow holder.

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<sup>50</sup>T.C. Memo. 1997-134 (March 21, 1997), *aff'd*, 1998 U.S. App. LEXIS 31341 (9<sup>th</sup> Cir. 1998).

<sup>51</sup>Reg. Sec. 1.1441-2(a) (second sentence) and Reg. Sec. 1.1441-3(d); T.D. 8734 Supplementary Information, Explanation of Provisions and Revisions, C.1. (Comments and Changes to Reg. Sec. 1.1441-2 – Amounts subject to withholding).



This same rule also applies where the amount of income is undetermined; however, the rules do not apply to the extent a specific provision for such uncertainties is made elsewhere in the regulations.

**Conduit Financing Arrangements.** The last area discussed in this article where withholding on “virtual payments” may arise is in the context of conduit financing arrangements. Such arrangements are defined as a series of transactions in which one person (the financing entity) advances money or property, or grants rights to use property, and another person (the financed entity) receives the money or property, or rights to use property, and the advance and receipt are effected through persons (intermediate entities) that link the financing entity and financed entity.<sup>52</sup>

**Current Law.** A financed entity or other person required to withhold tax with respect to a conduit financing arrangement is required to withhold as if the district director had determined under the conduit financing regulations that all conduit entities that are parties to the conduit financing arrangement should be disregarded. The conduit financing regulations explain and illustrate in copious detail how the amount to be taxed and withheld should be determined.<sup>53</sup> The withholding agent may withhold tax at a reduced rate if the financing entity establishes that it is entitled to the benefit of a treaty that provides a reduced rate of tax on a payment of the type deemed to have been paid to the financing entity.

A withholding agent will not be liable for failing to deduct and withhold with respect to a conduit financing arrangement unless the agent knows or has reason to know that the arrangement is a conduit financing arrangement.<sup>54</sup> This standard is satisfied if the withholding agent knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. It is not, however, satisfied if the withholding agent knows only of the financing transactions themselves. This standard is ripe for controversy; one can too easily visualize withholding agents professing degrees of ignorance, unawareness and credulity in the face of inconvenient facts that make them look just like political fundraisers explaining away contributions from dubious sources.

**Decline and Fall of the Cascading Royalty - *SDI Netherlands*.** Another interesting issue presented by conduit arrangements is that of the “cascading royalty,” a royalty payment that travels through a series of entities by means of various licenses and sublicenses.

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<sup>52</sup>Reg. Sec. 1.881-3(a)(2)(i)(A). See Reg. Sec. 1.881-3(a)(2) for definitions of other terms used in relation to conduit financing arrangements.

<sup>53</sup>Reg. Sec. 1.881-3(d).

<sup>54</sup>Reg. Sec. 1.1441-3(g) and Reg. Sec. 1.1441-7(f).

When this arrangement involves both domestic and foreign entities, a question arises as to the source of each royalty payment. In general, royalties are sourced according to the place of use of the intellectual property for which the royalties are paid.<sup>55</sup> Thus, royalties paid for the use or right to use property (including patents, copyrights, trademarks and other intangible property) in the United States usually constitute U.S. source income whether the licensee is a U.S. person or a foreign person. However, when the licensor subsequently pays the same royalty to another entity under another licence, the question becomes whether or not the royalty payment retains its original source.

In Revenue Ruling 80-362,<sup>56</sup> the IRS applied the statutory rules to a situation where a resident of a country without an income tax treaty with the United States, licensed the United States rights to a patent to an unrelated Netherlands corporation, which in turn sublicensed those rights to an unrelated U.S. corporation. The IRS determined that the Netherlands corporation was a bona fide corporation entitled to the benefits of the then applicable U.S.-Netherlands income tax treaty. Under that treaty, the royalty payments made by the United States sublicensee to the Netherlands corporation were exempt from U.S. tax. However, the ruling concluded that the royalty payments made by the Netherlands corporation to the unrelated foreign person were not protected by any treaty provision and accordingly were subject to 30 percent U.S. tax on the gross amount of the royalties, because they were “paid in consideration for the privilege of using a patent in the United States”.

*SDI Netherlands B.V. v Commissioner*<sup>57</sup> was the first reported case to consider this argument. The Tax Court, in a decision by Judge Tannenwald, decided that royalty payments made by a Netherlands corporation licensee/sublicensor did not constitute U.S. source income and, accordingly, the Netherlands corporation was not required to withhold U.S. tax with respect to the payments. The facts of the case were very similar to those of the ruling and the IRS decided not to appeal the case.

Technically, the IRS was right and the late Judge Tannenwald, not normally a pro-taxpayer judge, misread the royalty source rule, which plainly indicates that the royalties paid by the Netherlands licensee to the foreign licensor (located in Bermuda) had a U.S. source. The result, the so-called cascading royalty, can cause the same stream of income to be taxed multiple times, is unjust and anomalous, but the IRS indicated that if withholding were imposed on first level of royalty payments, it would not seek to impose a withholding tax on the “second level” of royalty payments. Perhaps it is not desirable for bad law to not be reversed by administrative grace but it

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<sup>55</sup>I.R.C. Secs. 861(a)(4) and 862(a)(4).

<sup>56</sup>1980-2 C.B. 208.

<sup>57</sup>107 T.C. 161 (1996).

would not be the first time nor the last.<sup>58</sup> However, the IRS was not prepared to give way where the taxpayer had interposed a treaty-based licensee/sublicensor, although in the *SDI Netherlands* case, it did not raise conduit issues, perhaps because the spread earned by the intermediary company, an average of 4% to 6%, was much higher than in the loan conduit cases (although in the *Northern Indiana* case cited by Judge Tannenwald, the Eurobond holders of the Netherlands Antilles finance subsidiary received \$94.59 for every \$100 of interest payments paid by the U.S. parent).<sup>59</sup>

Nevertheless, this is a case where the IRS lost the battle but won the war. SDI B.V. was a treaty shopper and in most similar cases, it would probably not be able to satisfy the limitation on benefits of Article 26 of the 1992 treaty between the United States and the Netherlands, which, after a transitional period, entered into full force on January 1, 1995.

It has been suggested that the decision may cause the IRS to rethink Example 10 of Regulation Section 1.881-3(e), part of the “anti-conduit” regulations finalized in 1995. This example discusses a back-to-back licensing arrangement similar to that in Revenue Ruling 80-362 (and in *SDI Netherlands B.V.*). The example concludes that the tax treaty entity serving as licensee/sublicensor is *not* a conduit entity *because* license payments made by that entity to the ultimate licensor are subject to U.S. withholding tax at the 30 percent rate. If Judge Tannenwald’s decision stands, the IRS may be expected to revise Example 10 to treat the licensee/sublicensor in the arrangement as a conduit entity.

## 2. Withholding of Tax on Corporate Distributions.

**Current Law.** Section 871 imposes tax on payments that are dividends or certain other types of gross income, and similarly Section 1441 requires withholding on payments that are dividends or other types of gross income. However, the current withholding regulations require that when a corporation makes a distribution, it must withhold on the full amount of the distribution even though a portion of the distribution may not be a dividend or any other type of income.<sup>60</sup> There is an exception if the distribution is either a nontaxable distribution payable in stock or stock rights or a distribution is treated as a distribution in part or full payment in exchange for stock. The IRS has ruled that the exception does not apply to a nonliquidating distribution.<sup>61</sup>

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<sup>58</sup>See, e.g., in the international arena, the complete termination rules of Reg. Sec. 1.884-2T (for which there is no immediately obvious statutory authority).

<sup>59</sup>*Northern Indiana Public Service Co. v Commissioner*, 105 T.C. 341 (1995).

<sup>60</sup>Reg. Sec. 1.1441-3(b).

<sup>61</sup>Rev. Rul. 72-87, 1972-1 C.B. 274.

Although it may be difficult to defend the expansion of the statutory provisions by regulation, if the regulation were to be promulgated for the first time today, it might have attained the status of law. Congress has amended Sections 871, 881, 1441 and 1442 quite frequently and has not disapproved the regulation.<sup>62</sup>

Moreover, the rationale for the regulation is clear. The definition of a dividend under U.S. law is a payment by a corporation with respect to its shares out of E&P, and to make this determination, the Code has adopted a “nimble dividend” rule.<sup>63</sup> That is, a distribution is treated as being made out of E&P if (a) the corporation has E&P accumulated after February 28, 1913 through the end of the year in or with respect to which the distribution is made or (b) it has E&P during the year of the distribution irrespective of whether on an accumulated basis there is a deficit. Under this definition, it is not possible for a corporation to know when it makes a distribution whether, by the end of the year, there will be E&P under either of these two tests. Even a corporation which has vast accumulated losses may make a profit in any particular year and the amount of that profit cannot, technically, be predicted with absolute certainty. From a tax collection standpoint, it obviously makes sense to require withholding on the full amount of the distribution and allow the foreign taxpayer to claim a refund if, when all the facts are known, some or all of the distribution turns out not to be a dividend and not otherwise subject to tax.<sup>64</sup>

#### **The Problem - Overwithholding on Nontaxable Distributions.** Although the

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<sup>62</sup>For a full discussion of the validity of the regulation and its interpretation by Rev. Rul. 72-87, see Wasserman, *International Withholding on Corporate Capital Distributions*, 7 Intl. Tax J. 27 (1980). Wasserman argues that the regulation, as so interpreted, is invalid. He also suggests that for planning purposes it would be preferable for the foreign shareholder rather than the corporation to pay the tax. However, this suggestion has probably been overtaken by the 1989 changes to Section 1463 discussed in ¶ 2.2 below.

<sup>63</sup>I.R.C. Sec. 316(a).

<sup>64</sup>There are only two circumstances in which a distribution by a domestic corporation which is not a dividend can be subject to tax in the hands of a foreign person. The first is if a nonresident alien individual is present in the United States for 183 days or more during the taxable year and any portion of the distribution represents a capital gain. This has become increasingly unlikely to occur since the enactment of Section 7701(b), because under that Section an alien present in the United States for 183 days or more during a calendar year will probably be a U.S. resident (although not necessarily if either a treaty tie-breaker rule applies or the 183 days spans two calendar years and the alien’s taxable year is not the calendar year). The second possibility is that all or a portion of the distribution is or is treated as gain which is effectively connected with the conduct of a trade or business within the United States (ECI). This is not likely unless the shares are treated as a U.S. real property interest under Section 897(c)(1). Such a gain is treated as ECI but in the case of a non-liquidating distribution, no withholding is required under Section 1445 (see Reg. Sec. 1.1445-5(b)(1)) and withholding, if any, is required under Sections 1441 and 1442. Such withholding, although excessive to the extent that there is no dividend, can be used to offset the foreign person’s liability to tax on the capital gain.

rationale for the rule appears unobjectionable, the rule is capable of working significant hardship. There are frequently situations where the theoretical possibility that there might be E&P sufficient to cause the entire distribution to be treated as a dividend is completely at odds with economic reality.

The difficulty about excess withholding is that it cannot be recovered by the foreign shareholder until after the close of the taxable year when a tax return can be filed making a claim for a refund. Further, a foreign shareholder not engaged in a U.S. trade or business is not entitled to interest on any refund until six weeks after the due date for filing its return which is June 15, not March 15 or April 15 as it is for U.S. shareholders. At the extremes, a domestic corporation might make a distribution on January 1 and no refund would be obtainable by the foreign shareholder for at least a year. Technically, the IRS would not have to make the refund (or at least start paying interest on the refund) until July 31, some 19 months after the distribution was made.

Before 1990, it was common for withholding agents not to withhold the full amount of tax if they were sure that, whatever the theoretical possibilities, there was no actual possibility that the whole or an identifiable portion of a distribution would constitute a dividend. At that time, there was no adverse consequence if it turned out that the amount of tax which was payable by the recipient was zero. Section 1463, as then in effect, provided that if the recipient of income paid tax required to be deducted and withheld, it could not be re-collected from the withholding agent. Moreover, no penalty could be imposed or collected from the withholding agent for failure to file a return or pay the tax, unless the failure was fraudulent and for the purpose of evading payment.

However, the Omnibus Budget Reconciliation Act of 1989 amended Section 1463 to provide that although tax could not be collected from a withholding agent who failed to withhold, penalties and interest could be collected.<sup>65</sup> The legislative history of the amendment to Section 1463 made it clear that the intention was for withholding agents under Chapter 3 to be treated like employers who fail to deduct income tax and FICA.<sup>66</sup> Withholding agents are therefore subject to significant penalties for failure to withhold, regardless of the taxable income of the recipient. Penalties for underwithholding can be as much as 100% of the amount of the underwithholding.<sup>67</sup> All of the civil penalties have criminal counterparts: I.R.C. Sec. 7201 (willful

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<sup>65</sup>Pub. L. No. 101-239, Sec. 7743, 103 Stat. 2106 (1989).

<sup>66</sup>See H.R. Rep. No. 101-386 (Conf. Rep.), 101st Cong. 2d Sess., 648, 650 (1989).

<sup>67</sup>The statutory provisions imposing civil penalties include: I.R.C. Sec. 6672 (100% penalty for failure to collect and pay over tax); I.R.C. Sec. 6663(a) (75% fraud penalty); I.R.C. Sec. 6662(a) and (b)(1) (20% negligence penalty); I.R.C. Sec. 6656(b)(1)(A) (10% - 15% late deposit penalty); the \$50 penalty for each failure to file a correct information return or payee statement: *see* I.R.C. Secs. 6722, 6723, 6724(d)(1) (information return includes any form with respect to which tax was required to be deducted and withheld under Chapter 3) and 6724(d)(2) (payee statement similarly defined).  
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attempt to evade or defeat the payment of tax - felony; 5 years/\$100,000 or \$500,000 if a corporation); I.R.C. Sec. 7202 (willful failure to collect or pay over tax - felony; 5 years/\$10,000); and I.R.C. Sec. 7203 (willful failure to pay a tax, make a return, keep required records or supply information - misdemeanor; 1 year/\$25,000 or \$100,000 if a corporation). Even before 1990, withholding agents were in an uncomfortable but not intolerable position; but after 1989, a withholding agent would be ill-advised to fail to withhold even on the last day of the year when all the facts might theoretically be known and the withholding agent was absolutely certain that there were no E&P.

### **Final Regulations.**

#### **Corporations Permitted to Make Reasonable Estimate of Dividend.**

The final regulations include a new rule relating to corporate distributions which, in the IRS's words in the Background Information to the proposed regulations, substantially relieves the withholding burden imposed under the existing regulations on these distributions. Under the regulations, a corporation is permitted to determine the amount of a distribution subject to withholding based on a reasonable estimate of available E&P for the taxable year.<sup>68</sup> A corporation that makes a reasonable estimate, but nonetheless underwithholds, remains liable for the amount of tax underwithheld (and interest), but not penalties.

In addition, an intermediary, such as a paying agent, is permitted to rely on a reasonable estimate represented by the distributing corporation.<sup>69</sup> The distributing corporation is liable for any underwithholding where the withholding agent had relied on a representation based on an estimate which had not been reasonably determined.

The regulations make clear that the use of the reasonable estimate procedure is voluntary and a withholding agent is not required to put itself at risk.

**Definition of Reasonable Estimate.** Prior to the issuance of the final regulations, the proposed regulations had used the "reasonable estimate" standard provided under the back-up withholding rules. Under this definition, a payor's estimate is considered reasonable if (i) the estimate does not exceed the proportion of the distributions made by the payor during the most recent calendar year for which a Form 1099 (presumably this should be read as Form 1042) was required to be filed that was not reported by the payor as a dividend; and (ii) the payor has no reasonable basis to expect that the proportion of the distribution that is not a dividend will be substantially different for the current year. This formulation was ambiguous as to whether it was the only standard for determining if an estimate was reasonable; if so, it was far too narrow.

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<sup>68</sup>Reg. Sec. 1.1441-3(c)(2).

<sup>69</sup>Reg. Sec. 1.1441-3(c)(2)(ii) cross-referring to Reg. Sec. 31.3406(b)(2)-4(c).

Accordingly, the final regulations clarify the proposed regulations by defining a reasonable estimate as a determination made by the distributing corporation at a time reasonably close to the date of payment of the extent to which the distribution will constitute a dividend. The determination is to be based upon the anticipated amount of accumulated E&P and current E&P for the taxable year in which the distribution is made, the distributions made prior to the distribution for which the estimate is made and all other relevant facts and circumstances. The reasonable estimate standard provided under the back-up withholding rules remains but its status plainly is that of a safe harbor.

**Other Exceptions to the Corporate Distribution Rules.** In addition to the reasonable estimate standard, a few other exceptions to the withholding rules for corporate distributions deserve mention. First, a distributing corporation or intermediary may elect to not withhold on a distribution to the extent it represents a nontaxable distribution payable in stock or stock rights or a distribution in part or full payment in exchange for stock.

In addition, a regulated investment company or intermediary may elect to not withhold on a distribution representing a capital gain dividend.

Lastly, a U.S. real property holding corporation or a real estate investment trust or intermediary may elect not to withhold on a distribution to the extent it is subject to withholding under Section 1445 and the regulations thereunder.

### **3. Conclusion**

This article has reviewed a wealth of selected situations where withholding is less straightforward than one would initially expect. Although the final regulations clarify these situations many instances, they do not address all of them. Moreover, the IRS needs to guide its agents on the difference between accrual of income and constructive payment. Certainly withholding, like the size of the universe, seems to be expanding steadily. Indeed the universe of virtual withholding poses plenty of traps for the unwary traveler and challenges to the compliance efforts of even the well informed who boldly go where only a few taxpayers have been before.