KPMG report: Final and temporary regulations under Chapters 3 and 61

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The Department of Treasury and IRS on December 30, 2016, released final and temporary regulations under chapters 3 and 61 of the Internal Revenue Code (Code).

- The regulations finalize the 2014 proposed regulations with "minor changes."
- The regulations incorporate the transitional guidance that has been released in the interim.
- Both sets of regulations contain modifications resulting from industry comments.

Specific highlights and discussion of these modifications are set forth below, in order of the Treasury regulation section.

Reg. section 1.1441-1

Numerous changes relating to a withholding agent's documentation requirements were incorporated into the regulations.

"Hold mail" instruction

Pursuant to the 2014 temporary regulations, a permanent residence address that was subject to a "hold mail" instruction was a fatal flaw that could not be cured. Consequently, a withholding agent was required to apply the presumption rules and impose the maximum rate of withholding on payments to any account holder who provided a hold mail instruction notwithstanding the fact that it had tax documentation on file for that account holder. This was particularly troublesome in private banking where hold mail instructions are common.

The new temporary regulations provide that a withholding agent can cure a permanent residence address that is subject to a hold mail instruction with documentary evidence that establishes residency in the country in which the account holder claims to be resident.

Requirements for electronic signatures

In the past, there has been significant controversy over the validity of an electronic signature on tax documentation. This was especially true for electronically signed tax documentation that a nonqualified intermediary was passing up to its withholding agent. While Treasury and the IRS had provided some guidance, the controversy remained.

To address this, a new temporary regulation has been added providing that a withholding agent can accept a withholding certificate if it "reasonably demonstrates" that it has been signed electronically by the person identified on the form (or a person authorized to sign for the person identified on the form). An example of such

demonstration is a signature block that contains the name of the beneficial owner, a time and date stamp, and a statement that the document had been signed electronically. Given this, a withholding agent may not treat a withholding certificate with a typed name in the signature line and no other information demonstrating an electronic signature as valid. Withholding agents using electronic systems need to ensure that the system's electronic signature function captures this information.

Foreign TIN requirement for accounts maintained in the United States

Beginning January 1, 2017, a U.S. financial institution (or U.S. branch of a foreign financial institution) must obtain a non-U.S. account holder's foreign taxpayer identification number (TIN) (and, for non-U.S. individual account holders, a date of birth, to the extent that information is not already on file) on the withholding certificate. While the IRS has indicated it will not publish a list of countries that issue tax identification numbers, many withholding agents have been using a list published by the OECD. In doing so, there has been push back from certain account holders claiming they do not have a foreign TIN notwithstanding the fact that their country of residence is delineated on the OECD list as one that issues TINs.

A temporary regulation has been added that requires the financial institution to obtain a reasonable explanation, beginning January 1, 2018, when a non-U.S. account holder does not provide a foreign TIN on the withholding certificate. An example of such reasonable explanation is that the country in question does not issue TINs.

KPMG observation

Given the example provided for a reasonable explanation, it doesn't appear that the new regulation will resolve the ongoing controversy between the OECD list and the account holder's assertion that he/she/it does not have a foreign TIN.

Indefinite validity periods

The 2014 temporary regulations allowed an indefinite validity period for a withholding certificate establishing non-U.S. status (absent a change in circumstance) when the certificate was provided together with documentary evidence. Many withholding agents interpreted this provision as requiring the two sets of documentation to be provided at the same time which made this provision was not as helpful as intended.

To remedy this, the final regulations provide that, for an individual, as long as the two pieces of documentation are provided within 30 days of each other, the requirements will have been satisfied.

For an entity, a withholding certificate establishing non-U.S. status will satisfy the indefinite validity requirements if the withholding agent receives both the certificate and the documentary evidence prior to the time that either would have otherwise expired.

KPMG observation

While the additional clarity is helpful, it remains unclear why the period for submitting individual documentation could not mirror the rules applicable to an entity such that a passport could be provided a year later, as long as it was provided before the Form W-8BEN had expired. For withholding agents that did not interpret the requirement to provide the two sets of documentation together to mean that the forms necessarily had to be provided at the same time, this 30-day requirement is actually a more stringent rule than previously provided under the temporary regulations.

Required use of new withholding certificates

Over the past several years, the IRS has made numerous changes to the various withholding certificates. These changes have caused compliance issues relating to the mandatory date that a withholding agent must use a newly revised form.

The final regulations permit a withholding agent to continue to use a prior version of a withholding certificate until the later of six full months after the release of a revised version, or the end of the calendar year in which the IRS made such a release. Significant to this, however, is the caveat that Treasury and the IRS may designate a shorter period, depending on the reason for the revision.

KPMG observation

Because implementing mid-year changes to diligence rules and procedures is very difficult for withholding agents, this change, which had been requested by the industry, is very positive in that it permits a withholding agent the option to generally implement all form changes at year-end.

Documentation and third-party repositories

While the IRS had issued guidance related to documentation provided to a withholding agent through a third-party repository, confusion within the industry continued. In response to this, Treasury and the IRS have provided additional clarity by issuing a temporary regulation on point. Specifically, the new rule provides that a withholding agent may rely on a valid withholding certificate provided electronically by a third-party repository if the form was uploaded or provided to the third-party repository and there are processes in place to ensure that the certificate can be reliably associated with a:

- Specific request from a withholding agent; and
- Specific authorization from the person (or agent) providing it.

An example of such a process is an email from a non-U.S. corporation to its withholding agent containing a link to its tax form held in a repository, including authorization for the withholding agent to access it, with respect to a contract the two had executed. Significant to this, the regulation provides that “each request and authorization must be

associated with a specific payment, and, as applicable, a specific obligation maintained by a withholding agent."

Finally, it is important to note that the regulation makes clear that the third-party repository is not an agent of a person providing the form to the repository or of a withholding agent receiving the form from the repository.

Withholding statement modifications

The regulations contain two changes relating to withholding statements requirements.

First, pursuant to the prior regulations, the requirements for a withholding statement that a nonqualified intermediary ("NQI") was required to provide with its Form W-8IMY were quite onerous and required the duplication of much of the information that the receiving withholding agent could discern from the underlying beneficial owner withholding certificates that the NQI passed up. Historically, this has been a significant issue because many NQI withholding statements do not meet the regulation requirements.

Under the new alterative withholding statement rules, much of the information that the withholding agent can obtain from the beneficial owner withholding certificates, including discerning the appropriate rate of withholding, no longer needs to be separately listed on the NQI's withholding statement as long as the withholding statement contains a certification that the information on the withholding certificates does not conflict with the information contained in the NQI's account.

KPMG observation

While this new alternative withholding statement provision was something the industry had repeatedly requested, one noted problem is the requirement that none of the underlying beneficial owner's tax documentation can contain information that conflicts with the intermediary's account file. This relief would have been more useful if the alternative withholding statement could continue to be relied upon in such a circumstance as long as the withholding statement also contained all of the information historically required for the beneficial owner in question. Thus, for a withholding statement for 100 different beneficial owners, if the intermediary had conflicting information for only one beneficial owner, arguably all of the historical information and a notation of the conflicting information should only be required with respect to that one beneficial owner, since the remaining 99 withholding certificates were correct. In such case, the certification could read that "except as separately noted above, the withholding agent has no conflicting information in its files." However, as the rule stands in the file regulations, it does not appear that the alternative withholding statement could be used for any of the beneficiaries despite there being conflicting information with respect to only one.

A second change relating to withholding statements is the addition of a new requirement for an NQI's U.S. payee pool. Specifically, when the NQI includes withholdable

payments that are also amounts subject to withholding allocable to U.S. persons for whom it has properly reported the documented U.S. person's account for FATCA purposes in its U.S. payee pool, it must now include a certification that these persons are described in Reg. section 1.1471-3(c)(3)(iii)(B)(2)(iii) or describe these U.S. payees in a manner consistent with that regulation. To give withholding agent's time to amend their processes relating to withholding statement validation, this new rule applies to payments made on or after April 1, 2017.

KPMG observation

While the regulation date for the new requirement relating to the U.S. payee pool indicates that withholding agents must have the new process in place by April 1, 2017, the preamble to the regulation contains a date that is one year later, April 1, 2018. Given that the regulations themselves state the April 1, 2017, tax professionals believe this is the date that should be followed.

Applying this rule to payments received on or after April 1, 2017, requires more than merely having processes in place by that date, but would also require a complete review and remediation of all affected withholding statements prior to this date. As withholding agents generally are not required to re-solicit withholding statements, this is a substantial remediation requirement being added to final regulations without any notice and without a lot of time to comply. For withholding agents that store this information electronically, they should be able to use their systems to track down the affected withholding statements; but for withholding agents that are still storing data manually, they will likely need to rely on reporting outputs (which they may not have for accounts on-boarded in 2016 until mid-March) in order to avoid a manual review. It is unclear why Treasury and the IRS felt this change warranted a complete remediation of withholding statements and could not be done on a going-forward basis (i.e., for forms provided on or after April 1, 2017, rather than for payments made on or after April 1, 2017). Nevertheless, given the deadline in the regulations, withholding agents should begin a review of these withholding statements immediately to ensure that unnecessary withholding does not result on April 1, 2017.

Ability to cure documentation problems retroactively—modifications

The 2014 temporary regulations explicitly provided a withholding agent with an ability to obtain retroactive tax documentation after it had made a payment. Those rules also permitted a withholding agent to obtain tax documentation via facsimile or scanned PDF sent by email. This latter change was effective for payments made after the regulations were published in the Federal Register (March 6, 2014). Because of that limitation, withholding agents that were obtaining retroactive tax documentation to cover payments made prior to March 6, 2014, were forced to obtain original paper forms. As an accommodation, Treasury and the IRS modified the regulations to permit the electronic transmission of retroactive forms without any date restrictions.

As it relates to retroactive documentation, a new temporary regulation includes additional requirements when a withholding agent is soliciting a retroactive Form W-8ECI, *Certificate of Foreign Person's Claim that Income is Effectively Connected With the Conduct of a Trade or Business in the United States*. Under the new rule, a beneficial owner that is providing a retroactive Form W-8ECI must include, in the affidavit of unchanged status, an additional certificate that he/she/it has included (or will include, if before the extended due date) the income on its U.S. tax return for the taxable year.

KPMG observation

The ability to collect a retroactive form electronically will help reduce compliance burdens for withholding agents and will be viewed favorably. The requirement to modify the retroactive affidavit for Forms W-8ECI is a bit baffling. The IRS matches Forms 1042-S that contain a "01" exemption code (effectively connected income) with the beneficial owner's U.S. tax return. Given this, it is unclear what is gained by the additional certification that the beneficial owner has (or will) report the income on a return.

U.S. branches

Pursuant to the 2014 temporary regulations, a U.S. branch of certain non-U.S. financial institutions and insurance companies could elect to be treated as a U.S. person as long as the non-U.S. person of which the branch was a part was a participating foreign financial institution (FFI), registered deemed-compliant FFI, or NFFE.

Due to the removal of the limited branch and limited FFI categories from the FATCA regulations and the increased difficulty that FFIs in non-IGA countries may experience remaining compliant as a result, the final regulations have removed all requirements related to the FATCA status of the U.S. branch making an election to be treated as a U.S. person. The regulations further remove the requirement that the U.S. branch making such an election certify its FATCA status on the Form W-8IMY that it provides.

Presumption rule and per se list of foreign corporations

Finally, the final regulations modify, slightly, the rules relating to when a withholding agent must presume an undocumented exempt recipient to be foreign because its name indicates it is the type of entity that is on the per se list of foreign corporations. Specifically, under the prior rule, the foreign presumption would not apply if the name of the entity included "company" or "corporation."

Under these final regulations, a withholding agent may continue to treat such a payee as foreign if it also has a document (e.g. a formation document) that reasonably establishes that the entity was organized in the applicable jurisdiction.

Inconsequential errors

The final regulations change the example of an inconsequential error to apply only to ambiguous abbreviations of countries on the Forms W-8. Therefore, the implication, which is supported by the preamble, is that a country abbreviation that is not ambiguous would not be an error at all and, thus, would not require curative documentation.

KPMG observation

While this change is definitely a positive one, in that it should reduce the amount of curative documentation that must be obtained, it does raise questions regarding when an abbreviation is ambiguous. For example, "UK" is generally used to apply to the United Kingdom but could also be used for the Ukraine. When presented on a form with an address in London, it seems clear that the intent of the abbreviation is to apply to the United Kingdom but that may be less apparent for more obscure addresses.

Reg. section 1.1441-2

One minor clarification was made to this section of the regulations. Specifically, a temporary regulation was added to make clear that U.S. source gross transportation income that is subject to the 4% excise tax is not an amount subject to withholding under section 1441. This exception is due to the fact that transportation income taxed pursuant to section 887(a) is not subject to gross basis taxation under sections 871 or 881. Treasury and the IRS have requested comments as to what documentation requirements should be imposed for the exception.

Reg. section 1.1441-3

Reg. section 1.1441-3T(c)(4) contains coordination rules when a withholding agent is required to impose withholding under sections 1441 and 1445. These provisions were updated to reflect the section 1445 rate increase (10% to 15%) for certain dispositions from qualified investment entities and U.S. real property holding companies as mandated by the *Protecting Americans from Tax Hikes Act of 2015.* The new rate applies to dispositions after February 16, 2016.

Reg. section 1.1441-4

A non-U.S. individual that is claiming treaty benefits on independent personal services must provide the withholding agent with a Form 8233 in order to obtain the reduced rate of withholding at source. The regulations make clear that a withholding agent can develop a system to obtain Forms 8233 electronically. Unfortunately, however, Treasury and the IRS continue to maintain that a U.S. TIN should be provided on that form (notwithstanding the 2014 changes that make clear that a Form 8233 is one of the types of withholding certificates for which a foreign TIN is now permissible for a treaty claim).

KPMG observation

While the regulations do provide some welcomed relief, the preamble is confusing as it relates to the TIN requirement. The preamble to the regulations indicate that a U.S. TIN is required with the rationale being the "general" rule that the person providing independent personal services in the United States must file a U.S. tax return so they would need to obtain a U.S. TIN regardless. This reasoning, however, fails to recognize that many non-U.S. independent contractors do not have a return filing obligation because of their income thresholds and the fact that they owe no additional tax. This oversight is particularly troublesome given the difficulty that non-U.S. individuals have been experiencing in obtaining ITINs.

Reg. section 1.1441-6

As discussed by IRS personnel at various "withholding conferences," new temporary regulations have been added regarding the due diligence standards for treaty claims. Specifically, the new regulations contain an unusual due diligence rule relating to a withholding agent's reason to know of an improper treaty claim when the beneficial owner is claiming a treaty benefit under a treaty that does not exist. The regulations further add the imposition of an actual knowledge standard relating to the new Limitation on Benefits (LOB) certification.

KPMG observation

As indicated previously, tax professionals are not aware of situations when withholding agents have granted treaty benefits under a treaty that was non-existent or not in force. Instead, the general practice has been to verify the existence of both the treaty and the particular article claimed and to only accept the documentation to establish non-U.S. status when the treaty claim related to a treaty that was not in existence or not in force. Further, the actual knowledge standard relating to the LOB certificate indicates that a lesser due diligence applies than would otherwise apply to the treaty claim in general. It further suggests that a withholding agent is not required to research whether the LOB provision claimed is one that is relevant to the particular treaty under which the claim is made, though this remains unclear.

Reg. section 1.1441-7

The final regulations modified the prior due diligence rule with respect to a Form W-8ECI to clarify that a withholding agent will not be considered to have reason to know that a claim of foreign status on a Form W-8ECI is invalid due to the existence of U.S. indicia.

KPMG observation

Because U.S. indicia is common for a person that generates income that is effectively connected to a U.S. trade or business (especially since a U.S. address is generally a

requirement of the form), the clarification to the due diligence rules for Forms W-8ECI will provide needed assurance to withholding agents who were concerned that the rules appeared to require curative documentation for a non-U.S. person that is already certifying to have a location in the United States.

The final regulations also clarify that a withholding agent only needs to file a Form 8655, *Reporting Agent Authorization*, if its agent will be filing a Form 1042 under its own name and EIN to report payments made by one or more other withholding agents for which it acts as an agent.

KPMG observation

This revision means that an agent that merely completes the form on behalf of the withholding agent but lists the withholding agent as the filer will not be required to submit a Form 8655 to the IRS. This is a welcome change as agents have not historically been notifying the IRS when merely completing forms on behalf of withholding agents and there is no IRS compliance objective being furthered by identifying agents that are not functioning as withholding agents.

Reg. section 1.1461-1

Finally, the final regulations include a new cross-reference to the rules that permit a withholding agent to furnish the recipient copy of the Form 1042-S electronically. This new rule is effective for calendar year 2016 returns. Also, as it relates to reporting, the preamble to the regulations provide that the IRS will amend the instructions to the Form 1042-S to permit a withholding agent to truncate a foreign TIN for circumstances when it is required to be included on the form.

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