Attention Must Be Paid When Credit Is Due

By Fred Feingold

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In this report, Feingold argues that the proposed rules in Notice 2015-10 impermissibly conflate tax withholding with the payment of withheld taxes and that if promulgated as final regulations in their current form, the rules could cause considerable confusion and commercial disruption, requiring reconsideration of tax withholding provisions.

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Introduction

In general, when a tax is withheld from a payment under chapter 3 of the code, the payment’s beneficial recipient is treated as having received the withheld amount and receives a credit in the same amount. The credit is applied against the recipient’s tax liability. If the liability exceeds the credit amount, the recipient must pay the difference when filing its tax return. If the credit exceeds the liability, the recipient may claim a refund for the excess by filing a timely return. The person required to deduct and withhold a tax must deposit the withheld amount or otherwise pay the tax and can be held liable for the failure to do so. However, a recipient is entitled to a credit for any withheld tax even if the withholding agent has not deposited or otherwise paid it.

In Notice 2015-10, 2015-20 IRB 965 (the “Notice”), the IRS announced its intention to promulgate new regulations that would deny a beneficial recipient a credit for the portion of the aggregate taxes withheld by a withholding agent on all its payees that the IRS cannot determine was deposited or otherwise paid by the withholding agent as required. Under the notice, it would be irrelevant that a beneficial recipient could otherwise establish or trace that a tax had been withheld from its payment. The proposed rules are intended to apply for payments made in 2015 and thereafter.

If adopted, the new rules would likely be held to be invalid to the extent the new rules deny a credit for taxes determined to have been withheld from a beneficial recipient because they conflate the concept of tax withholding with the requirement of a withholding agent to deposit or pay the tax withheld. Nevertheless, if regulations were promulgated that are consistent with the notice, they could cause considerable disruption to everyday commerce.

Treasury might be able to more narrowly draft rules that would reduce the number of erroneous refunds or credits for amounts that were not withheld, even if reported by non-U.S. persons beyond the jurisdiction of the United States as withheld taxes. Narrowly crafted rules would not do violence to statutory provisions on which taxpayers have justifiably relied, and they wouldn’t materially harm ordinary commerce.

The Notice

On April 28, 2015, the IRS issued Notice 2015-10, advising it was concerned:

about cases in which persons subject to withholding under sections 1441 through
1443\(^1\) . . . or sections 1471 and 1472 . . . 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 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.\(^2\) [Emphasis added.]

Interestingly, the Notice assumes that a withholding agent\(^3\) (a) has withheld tax from a payment to a beneficial recipient (as opposed to paying only a net sum without withholding any tax), and (b) has not deposited (or otherwise paid) all the tax it has withheld as required. The Notice provides that when a withholding agent has actually withheld taxes but hasn’t deposited or paid all the withheld tax, the excess amount that the agent has withheld from all beneficial recipients over the amounts deposited or paid (the aggregate shortfall) will reduce the credit by a pro rata share of the aggregate shortfall, regardless of whether a beneficial recipient could otherwise establish that the withheld tax was deposited or paid.

In other words, regulations to be issued under the Notice intend to make a beneficial recipient’s proof that a tax was withheld from its receipt insufficient to establish its entitlement to a credit for the amount of the tax withheld, if the IRS provides notice of an aggregate shortfall and the percentage of the aggregate shortfall allocable to the beneficial recipient.

The Notice states that the IRS’s inability to trace deposits is the basis for apportioning rather than tracing any shortfall. The practical issues presented by those rules should cause greater concern than has thus far been expressed,\(^4\) particularly because they are intended to be effective for payments made in 2015.

**Practical Considerations**

For example, although an amount that has been deducted from a payment due will be visible to the beneficial recipient, the extent to which a withholding agent has duly deposited or otherwise paid the tax is unlikely to be immediately visible. Moreover, it will almost certainly be invisible to the beneficial recipient whether the withholding agent has an aggregate shortfall in tax deposits for tax withholding on all its beneficial recipients. Recognizing the difficulty a beneficial recipient would face in determining the credit amount to which he would ultimately be entitled, the Notice states that written procedures will be required regarding the deposit allocation rules to ensure that claimants are reasonably apprised of their status and that each claimant receives the proper amount of (the reduced) credit under the agreement.

Taken at face value, the view espoused by the Notice could cause a beneficial recipient to be unable to protect himself against an aggregate shortfall over which he has no control, other than by obtaining reimbursement from the withholding agent.

Because the IRS would not be apprised of an aggregate shortfall until the filing of Form 1042, “Annual Withholding Tax Return for U.S. Source Income of Foreign Persons,”\(^5\) any notice of a shortfall provided by the IRS would come a long time later.

\(^1\)Conspicuously omitted from Notice 2015-10 are the withholding provisions of sections 1445 and 1446, also in chapter 3, as well as the withholding provisions of chapter 24 relating to wage withholding.

\(^2\)Notice 2015-10, section III.C states that the IRS is considering exceptions for when the amount of the underdeposit of tax is de minimis (although de minimis is undefined in the notice) or when the withholding agent has a demonstrated history of compliance with its deposit requirements. For the compliance requirement, see section 7705(b) regarding the requirement to demonstrate that the person seeking to be considered a certified professional employer for purposes of section 3511 meets specified standards established by the IRS.

\(^3\)The term “withholding agent” is defined in section 7701(a)(16) as any person required to deduct and withhold any tax under section 1441, 1442, 1443, or 1461. Section 1461 and the regulations promulgated under section 1461 don’t impose an obligation to withhold any tax but establish the obligations of a withholding agent (i.e., a person obligated to deduct and withhold a tax under the sections referred to in section 7701(a)(16) that impose a withholding requirement). Thus, the reference in section 7701(a)(16) to section 1461 seems inartful at best. Section 1461 imposes liability for a failure to withhold a tax required to be withheld under chapter 3, and the regulations under section 1461 establish rules for persons required to withhold a tax. A better definition of withholding agent is in reg. section 1.1441-7(a) as any person having control, receipt, or custody, or making payment of an amount subject to withholding. Notice 2015-10 refers to a person required to deduct a tax under chapter 4 as a withholding agent, and the term “withholding agent” is used in section 1471(a) as the person required to deduct a withholdable payment. See reg. section 1.1473-1(d) for the definition of withholding agent for chapter 4 purposes.


\(^5\)It is unclear how the IRS would be aware of a shortfall if Form 1042 had not been filed. See infra discussion regarding the effect of a failure to file Form 1042.
after the withholding had taken place and therefore would delay when the beneficial recipient could first proceed against the withholding agent. Also, it is unclear whether the IRS’s advice that the portion of the aggregate shortfall to be borne by the beneficial recipient would of itself be sufficient to enable him to prove damages against the withholding agent absent a final determination of a loss of a credit occasioned by a shortfall resulting from the withholding agent’s action.

The Notice assumes the possibility that a late deposit or payment by the withholding agent would give rise to a reduction in the aggregate shortfall. In any case, adoption of the shortfall rule in the Notice might not enable beneficial recipients to protect themselves, even if security measures were adopted to ensure that tax withheld from the payments was properly deposited, because those measures are unlikely to provide security against the failure to deposit tax on other payments made by the withholding agent. If those rules were adopted, the only measure for protecting a beneficial recipient would be to “require” that payments due be paid without withholding tax, coupled with a secured obligation of the beneficial recipient to deposit the taxes in his own name. Of course, the well-advised withholding agent would vigorously object because that alternative would increase its exposure.

A related issue not raised by the Notice is how a beneficial recipient can establish that a tax has been withheld for which the code entitles him to a credit. In other words, without that requirement in the code, may a regulation dictate that the only way to prove tax withholding is by the withholding agent issuing a form, as the temporary regulations apparently require, when the beneficial recipient is claiming a refund for an overpayment? Under the regulations, a non-U.S. person must attach to its claim for refund, for chapter 3 or chapter 4 withholding, a Form 1042-S or Form 8805, “Foreign Partner’s Information Statement of Section 1446 Withholding Tax,” showing the tax withholding, suggesting that without those forms, there may be no other way to establish a tax has been withheld that could give rise to a refund claim for an overpayment concerning, in part, withheld taxes. Nothing in the code suggests that attaching either form is a prerequisite to the entitlement to the credit for withheld taxes if one could otherwise establish the amount of the tax withholding. It might be possible to read reg. sections 301.6402-3T(e) and 1.1446-3(d)(2)(ii) as merely providing a procedural rule for establishing a tax payment but not as providing a substantive rule that would deny a credit for tax withheld in the face of other sufficient evidence of tax withholding.

A non-U.S. person not engaged in a U.S. trade or business whose tax liability is fully satisfied by tax withholding at the source generally isn’t required to file a U.S. tax return, but it is required to file a tax return to claim a refund. If attaching Form 1042-S to his tax return is the only way for a beneficial recipient not seeking a refund regarding non-effectively connected U.S.-source income on which tax has been withheld to establish that he was entitled to a credit for the tax withheld, that requirement would run counter to the long-standing regulation that does not require a tax return by a beneficial recipient not engaged in a U.S. trade or business if his tax obligation has been fully satisfied by withholding at the source. The Notice, however, appears to suggest that the regulations to be promulgated would much more broadly deny a credit for a withheld tax when it has not been deposited or paid and, if so interpreted, would require the beneficial recipient to file a tax return if there has been an aggregate shortfall.

Basic Principles
Even assuming that one views the temporary regulations as merely establishing a valid procedural requirement for processing a refund claim (and not one that creates a substantive rule not found in the code), that rule suggests amounts set out in Form 1042-S are essentially reliable. Significantly, it would appear that the entire basis of the

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8But see Casa de La Jolla Park Inc v. Commissioner, 94 T.C. 384 (1990), in effect upholding a regulation (no longer in effect) requiring the furnishing of a withholding certificate before payment in order to perfect an entitlement to an otherwise applicable exemption from withholding; cf. Casanova Co v. Commissioner, 87 T.C. 214 (1986), not cited in Casa de La Jolla Park, reaching a different conclusion based on the rule that would have prevented the application of an otherwise applicable treaty exemption that had not been promulgated by regulation.

9See id. and cases cited therein.

10Reg. section 1.6012-1(b)(2); reg. section 1.6012-2(g)(2)(i) and -2(g)(2)(ii)(b)(2).
Notice, which assumes Form 1042-S has been filed, is that information concerning the allowable tax credit shown on Form 1042-S, while presumably reliable — at least for limiting the amount of a refund that can be claimed — may be unreliable for permitting a credit or refund. Indeed, the Notice suggests that any presumption of reliability can be overcome by the issuance of an IRS notice of its unreliability. It is unclear how a taxpayer may challenge that type of notice.11

With those practical issues in mind, one should take a step back to review some basic principles that are well-grounded in the applicable code provisions, which the notice seemingly ignores. Doing so makes clear that some of the problems the Notice would create might already exist, but to a lesser extent. So let us begin with principles grounded in the statutory provisions and the rationale on which the withholding provisions have long been based.

The Statutory Scheme

When one person pays the tax liability of another, the payee is considered to have income equal to the paid tax. So, too, when a person is required to deduct a tax from a payment to an income recipient and the payer does so. The tax so deducted and withheld would be treated as part of the income payment,12 with the tax deducted being credited as a tax paid on behalf of the beneficial recipient. That, of course, is what the code does.13 It has been so since the very advent of the tax withholding provisions.14 Under the applicable code provisions, to the extent a tax is withheld from a beneficial recipient, it is for the purposes of paying the tax that may be due from him15 and will be applied as such. Application of the tax withheld to the recipient as a tax payment by the recipient is therefore treated as both a payment to the recipient (as a benefit in kind) and a credit against the tax of that recipient.

Section 33 provides that “there shall be allowed as a credit against the tax imposed by this subtitle the amount of tax withheld at source under” chapter 3. Although section 33 does not specify to whom the credit will be allowed, section 1462 states that the tax withheld from a payment to a beneficial recipient shall be credited against the amount of income tax of the recipient of the income. Section 1464 distinguishes between tax payments made by a withholding agent that were not actually withheld (providing those amounts are to be credited against or refunded to the withholding agent) and taxes actually withheld, for which a credit or overpayment is to be given to the income recipient. Reg. section 1.1464-1(a) makes this clear by providing that “the refund or credit under Chapter 65 of the Code of an overpayment of tax which has actually been withheld at the source under Chapter 3 shall be made to the taxpayer from whose income the amount of such tax was in fact withheld.”16 And if there was any remaining doubt, section 6513(b)(3) provides that a tax withheld at source is deemed paid by the recipient at the time the recipient’s return is due for purposes of section 6511.17

Section 31(a)(1) and (2), concerning credits for taxes withheld on wages,18 provides that the amount withheld as a tax under chapter 24 will be allowed as a credit to the income recipient for the year in which the tax was withheld. Reg. section 1.31-1(a) provides that: “If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer” (emphasis added).

While similar language permitting a credit without regard to a payment over the tax withheld is not in section 33, 1462, 6414, 6513(b)(3), or related

11Cf. reg. section 1.1441-7T(b) (regarding the effect of an IRS notice of unreliability of a certificate).
12Cf. reg. section 1.1441-3T(f)(1).
13See sections 31, 33, 1462, 1464, 6414, and 6513(b)(3); cf. section 1474(b).
15Sections 1471-1474 do not impose a substantive tax liability on the beneficial recipient of a withholdable payment. For an entitlement of a beneficial recipient to a tax credit or refund, see section 1474(b)(2)(A).
16See also reg. section 1.6414-1(c).
17If a tax was repaid to the recipient in accordance with reg. section 1.1461-2T(a)(1), it would not be considered a tax withheld within the meaning of sections 1464 and 6414. But what we do not necessarily know is whether a tax has been withheld when there has been no repayment under reg. section 1.1461-2T(a)(2).
18The Revenue Act of 1913 enacted a withholding regime on payments of interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual gains, profits, and income made to U.S. and non-U.S. persons. See Revenue Act of 1913, section II, ch. 16, 38 Stat. 144, 170. However, the Revenue Act of 1917 eliminated withholding for virtually all income except for FDAP gains, profits, and income of nonresident aliens and income from tax-free covenant bonds. See Revenue Act of 1917, sections 1204(2) and 1205(1), ch. 63, 40 Stat. 300, 332-333. Wage withholding was finally reintroduced after it was eliminated in 1917 through the following provisions: Social Security Act, sections 801, 802, 49 Stat. 620, 636-637 (enacting wage withholding of the Social Security tax); Revenue Act of 1942, P.L. 77-753, 56 Stat. 798, 884-894 (enacting wage withholding of the “victory tax”); and Current Tax Payment Act of 1943, P.L. 78-68, ch. 120, section 2(a), 1621-1622, 57 Stat. 126, 126-135 (enacting wage withholding of all income taxes).
regulations, significantly, the emphasized language is also not in section 31. Thus, while one could argue that the emphasized language in reg. section 1.31-1(a) is a revenue concession for wage withholding and shouldn’t be interpreted as broadly applying to all required tax withholding, no evidence exists that that type of limitation was intended — and the Notice does not suggest that it was. Rather, it would appear that the emphasized language merely reinforces that the statutory provisions allowing a credit for taxes withheld do not require that tax to be deposited or paid for the credit to apply. Because in all material respects the statutory language is the same for section 31 on one hand and sections 33, 1462, and 1474 on the other, omission of the emphasized language in either the statutory provisions or regulations under section 1462 or 1474 does not imply that a withholding agent’s failure to deposit or pay a tax that was withheld somehow affects the availability of a credit to the payment’s beneficial owner. Indeed, that observation has been the basis for most practitioners to presume sections 33, 1462, and 1474 operate as if the result under the emphasized language in the section 31 regulations applies equally to chapter 3 (or chapter 4) withholding provisions.

The current tax withholding provisions of chapters 3 and 4 are incorporated in sections 1441, 1442, 1445, 1446,21 and 1471. Consistent with the construct described above, when a tax is deducted and withheld from a beneficial recipient, it is included in the income of that recipient and credited against the tax due from him. In some instances the timing of, but not the entitlement to, the credit for tax withholding could be out of sync with the income inclusion. But when the code requires that a tax be deducted and withheld, the applicable code provision does not condition the availability of a credit to the beneficial recipient of the payment from which the tax was withheld on the deposit or payment of the tax by the withholding agent, but only on the withholding itself. The failure to deduct or withhold a tax as required will subject the person charged with the duty to withhold the tax to liability for the tax it has failed to deduct.

If a liability under section 1461 is assessed against a withholding agent for a failure to withhold a tax, payment of that liability is a payment of the withholding agent’s tax liability and not the beneficial recipient’s. Thus, any payment of the withholding agent’s own section 1461 liability does not literally require that payment to be treated as a tax payment by the beneficial recipient of its tax. Therefore, as a technical matter, the amount of that payment is not creditable or refundable to the beneficial recipient. Whether payment of the withholding agent’s liability under section 1461 would be treated as additional income to the beneficial recipient may depend on the circumstances. While the beneficial recipient of income is not credited with the section 1461 liability paid by a withholding agent, it has been the long-standing policy to not also collect from the beneficial recipient the amount of tax assessed against and paid by the withholding agent for its failure to withhold, even though the code doesn’t give the beneficial recipient a credit against his liability for the section 1461 liability imposed on and collected from the withholding agent.

The policy against collecting a second tax from the beneficial recipient suggests that payment of the withholding agent’s section 1461 liability is not an income event for the beneficial recipient and, therefore, that the usual gross-up rules do not apply to that payment, perhaps because the withholding agent may have a right of reimbursement against the beneficial recipient for the tax. That rule mirrors the case in which a tax isn’t deducted by the withholding agent but is later paid by the beneficial recipient.30

22See sections 3403, 1461, 1474(a), and 6672.
23See Coastal Chemical Corp. v. United States, 546 F.2d 110 (5th Cir. 1977); New York Guangdong Finance Inc. v. Commissioner, T.C. Memo. 2008-62, aff’d, 588 F.3d 889 (9th Cir. 2009); and G.D. Parker Inc. v. Commissioner, T.C. Memo. 2012-327. See also Ingersoll-Rand PLC Form 8-K dated July 17, 2015, detailing a settlement in the Ingersoll-Rand Tax Court case involving liability under section 1461.
24Sections 1464 and 6414.
25See section 6513(b)(3).
26Reg. section 1.1441-2(d)(3).
27For an application of this principle, see reg. section 1.1463-1(a): “If the tax required to be withheld under Chapter 3 . . . is paid by the beneficial owner or by the withholding agent, it shall not be recollected from the other, regardless of the original liability therefore.” See also Internal Revenue Manual section 42.3.9.13.3, dealing with the trust fund recovery penalty under section 6672: “The IRS’s policy is to collect the full tax only once; from the employer or from one or more of the responsible persons.”
28Reg. section 1.1441-3(f).
29But see reg. section 1.1441-2(d)(3).
recipient.33 In that case, section 1463 precludes the tax from also being assessed against the withholding agent for a failure to withhold, but no one has suggested that the operation of section 1463 requires an income inclusion by the withholding agent.

The Agency Rationale

The statutory scheme could be viewed as one in which a person required to deduct and withhold a tax has been appointed by statute as an agent34 to deduct, withhold, truthfully account for, and timely pay over to the treasury the tax required to be withheld. A question raised by the Notice is whether, in fulfilling the duties statutorily imposed on it, the withholding agent is acting as an agent for the treasury, the beneficial recipient of the income payment, or both. As far as I’m aware, that precise issue has not been the subject of any reported case, ruling, or other IRS pronouncement, perhaps because no one has thought it relevant.

Applying general principles, however, one could make an argument that the principal for whom the withholding agent is acting is the treasury35 because only the IRS can enforce the agent’s tax withholding obligation. The beneficial recipient would appear merely to be a statutory third-party beneficiary regarding the credit for the tax actually deducted and withheld. Assuming that is true, it would seem that any loss or shortfall arising from a failure by the withholding agent to deduct the tax or later make payment of that tax should require the beneficiary to receive no credit, but that once the tax is deducted, the failure to deposit or pay over the tax that has been deducted at source as mandated by the code should be debited solely to the treasury as the act of its agent, which shouldn’t adversely affect an innocent third-party beneficial recipient. But that simple way of looking at things, which has the benefit of being in accord with the statutory provisions, appears contrary to the new rules suggested by the Notice.

Because the Notice states that an aggregate shortfall will result in a loss of all or some of the credit to beneficial recipients of payments, it could be argued that the notice takes a view consistent with the withholding agent being considered the agent of its beneficial recipients rather than the treasury. Consistent with that view, the treasury would not be charged with bearing any portion of the loss caused by the acts or failures to act of the withholding agent. Those failures could include the failure to deposit a tax it has withheld, to pay over tax it has withheld, or to properly report the amount it has withheld and deposited or paid over.36 The construct for supporting the view that the withholding agent’s principal is the beneficial recipient of the income is somewhat strained but not impossible to fathom. The argument would be that Congress, by enacting the withholding provisions, required each beneficial recipient of income to appoint its contracting counterparty as its agent to withhold his tax. Indeed, it is the beneficial recipient, not the United States, who has selected his contracting counterparty, and the beneficial recipient could suffer the consequences of an imprudent choice.

On the other hand, a beneficial recipient could not be in a position to monitor the withholding requirements of the agent even to the extent that they pertain to it, let alone as they may pertain to others, and would not appear to have an obvious method for enforcing that obligation. Moreover, adopting the rules set out in the notice would be a disincentive for the IRS to seek to enforce its rights against the withholding agent for a failure to deposit a payment because the treasury wouldn’t be out of pocket if there was a dollar-for-dollar reduction in credits. While adopting a view that the withholding agent is the beneficial recipient’s agent could support a loss to a beneficial recipient as a result of the withholding agent’s failure to pay over tax withheld, it would hardly support a loss to a beneficial recipient of tax withheld but not paid over on another beneficial recipient as the notice would require. Therefore, it makes little sense, not

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33Under the applicable regulations, payment of the tax by the beneficial recipient may be proven by the filing of a Form 4669, “Statement of Payments Received,” signed by the beneficial recipient that shows the tax payment. See reg. section 1.1441-1T(b)(7)(D)(ii).

34Cf. section 7501; and IRPAC letter.

35As the IRS task force committee suggested in the IRPAC letter: “when the withholding agent withholds from a payment made to the Payee, the withholding agent is acting as the agent of the IRS, not the Payee.”
to mention it seems harsh to suggest that the beneficial recipient must bear the loss of unpaid withheld taxes, particularly when the code appears directly to the contrary. An unrelated beneficial recipient of the income generally would be unaware of any failures to deposit when it received the payment and would have no way of ensuring that the failures didn’t occur, and his only redress would be a claim under a contract or in tort against the withholding agent.

Self-Help Measures Not Very Helpful

In its contractual dealings with third-party payers, a beneficial recipient may condition a deduction for withholding tax as being treated as a credit against the amounts due under a contract only if (a) that tax is or appears to be permitted to be deducted in accordance with law, taking into account any applicable certification that has been timely provided that would permit a payment to be made without withholding or at a reduced rate of withholding;37 and (b) the withholding agent pays over the tax as required and timely files and provides the appropriate withholding form (Form 1042-S). Despite that contractual right, the beneficial recipient couldn’t seek reimbursement from the withholding agent for any tax actually withheld,40 nor to restrain it from withholding taxes. 41 It is questionable whether an income tax return is required to be filed for a beneficial recipient not engaged in a U.S. trade or business.43 Significantly, the notice goes further than the temporary regulations: Even if a Form 1042-S were received showing the tax withholding credit, under the notice the amount of the credit shown on the form would be reduced by a percentage of the aggregate shortfall if the IRS were to issue a notice to that effect. Yet apart from any entitlement to the reimbursement of the shortfall from the withholding agent, the IRS alone can enforce the withholding agent’s obligation to deposit or pay the tax withheld.44 A beneficial recipient could not seek to enjoin the tax withholding. 45

A Theory Based on the Statutory Provisions

Thus, it appears the view that the withholding agent isn’t the agent of the treasury is unappealing. Perhaps the thread that holds together under the statutory scheme is that the withholding agent is an agent of the beneficial recipient only for the purpose of the withholding and is an agent of the treasury regarding the deposit or payment of the tax that has been withheld. Under that theory, once a tax is withheld, the withholding agent is acting solely for the treasury. That theory puts pressure on whether a tax has been withheld, an issue of threshold significance and to which the IRS’s concern should not know that the withholding agent has failed to fulfill the statutory requirements until the time has passed for it to have received Form 1042-S, generally on the March 15 following the year of payment. And even then, the beneficial recipient wouldn’t be apprised of a shortfall not reflected in the Form 1042-S he has received. Only upon receipt of Form 1042-S could a beneficial recipient even be aware the tax that was withheld from him had not been credited to him. Moreover, if Form 1042-S isn’t received, according to the temporary regulations, the beneficial recipient’s claim for refund of any overpayment caused by the tax withholding will seemingly not be processed without regard to the introduction of any other evidence showing the tax withholding. 42 However, even in that case, under the current regulations, there doesn’t appear to be a loss of credit for the purpose of determining whether an income tax return is required to be filed for a beneficial recipient not engaged in a U.S. trade or business.43

37 For example, required certifications eliminating that withholding have not been provided.
38 See sections 1464 and 1461.
39 When a credit is given for the taxes withheld, it does not appear that there could be a successful claim for damages.
40 At least as far as the tax was withheld in accordance with the applicable provisions. See section 1461.
41 Section 7421(a).
42 See supra note 8. Whether the cited regulations would be upheld in the face of reliable secondary evidence of the tax withholding is unclear. Cf. Casa de La Jolla de Park, supra note 8.
43 See reg. section 1.6012-1(b)(2).
44 See, e.g., sections 1461, 6672, and 7501. In general, attribution of an agent’s acts to its principal appears to be premised on the control a principal has over its agent. It is unclear what control the beneficial recipient has over a withholding agent.
45 See Section 7421(a).
more properly be addressed when there is a shortfall. If a tax is withheld, the applicable code provisions provide no discretion regarding the allowance of the credit for the tax. Nor is there anything in the code that would require as a prerequisite for obtaining a credit for a withheld tax that the tax withheld actually be deposited or paid over. As previously described, for section 31 wage withholding, the applicable regulation makes this clear. Nothing in the Notice suggests a proposed change to the result under section 31.

In other words, there is a clear difference between the withholding of a tax and its payment. Just as there can be payment of income without a deduction for a required withholding, there can be withholding of tax from a payment without the required deposit or payment of the withheld tax, in each case triggering liability to the withholding agent for the failure. The Notice could be viewed as conflating withholding with payment by indicating the intention to issue regulations that would deny a credit to the extent of nonpayment, even when there has been withholding. Treasury has a legitimate interest in ensuring that credits and refunds are not issued for taxes that have not been withheld. But that interest does not appear to extend to denying tax credits and refunds under the applicable code provisions for taxes that were in fact withheld simply because of nonpayment.

When a tax is actually withheld from a payment, it is deemed to be paid by the beneficial recipient of the income for determining the timeliness of a refund claim. The income inclusion for the tax withheld assumes the tax credit will be granted. If the rules were to be changed as the Notice suggests so that there would be a reduction in the credit for non-payment, it would seem that the amount of the loss of credit, to be consistent, would reduce the amount of the required income inclusion, which in turn would reduce the amount of the required withholding — a “gross down.” For example, when the required withholding rate is 30 percent and 30 percent of the gross required payment is deducted as a tax, the recipient is charged with income equal to 100 percent of the required payment. Under the Notice, however, it would appear to follow that the extent to which the tax withheld was not deposited or paid over, the amount of the inclusion would be less and so too would the liability of the withholding agent. Nothing in the Notice addresses this.

A construction that would deny a credit for taxes withheld but not paid over suggests that there is an inability to collect that amount from the withholding agent, even in light of the various statutory tools allowing the IRS to proceed against the withholding agent and its responsible officers. The notice suggests a possible limit to applying the rules it would introduce by focusing on withholding agents not within the jurisdiction of the United States. Whether that withholding agent would have any obligation to withhold a tax, however, may be questionable. Despite the suggestion that the concern is with non-U.S. persons who are technical withholding agents, the notice doesn’t suggest that it would limit the rules it would introduce to purported tax withholdings by only those persons.

Has a Tax Been Withheld?

The various withholding tax provisions deal with an amount withheld or to be withheld as a tax from either an actual or deemed payment. With few exceptions, tax isn’t required to be withheld absent an actual or a deemed payment. Of course, the payment could be actual or constructive, but there must be an amount that would constitute income. The foregoing may seem obvious: At least for non-effectively connected income, the withholding obligation generally tracks income inclusion on a cash basis. This discussion assumes there is such an actual or a deemed payment. That, however, does not necessarily mean we must assume a tax was actually withheld from that payment.

Consider a case in which a payee is owed $100 but receives only $70. When does the difference between the amount due and the amount received represent a tax withholding? If no tax was required to be deducted from the payment, it would seem one should not presume that a tax was withheld, but rather that there was a short payment. On the other hand, if in the example a 30 percent tax is required to be deducted and the payee receives only 70 percent of the gross payment due, may the payee presume a tax of 30 percent of the gross payment due was withheld? Does it make a difference in that case if the payer had no intention of depositing or paying it as a tax? Finally, does it make a difference if the payer, regardless of its intentions, had only 70 percent of the amount due, all of which he paid? In all of the above cases, how does the filing or nonfiling of Form 1042-S affect the conclusions?

46Cf. reg. section 301.6402-3T(e).
47See sections 6511, 6513(b)(1) and (3).
48See Notice 2015-10, section I.
50Cf. section 1446.
51Cf. section 1.1441-2(d) and (e); cf. Tate & Lyle Inc. v. Commissioner, 87 F.3d 99 (3d Cir. 1996).
Those questions are of no moment under the Notice: If one reads the Notice literally, and assuming amended regulations are consistent with the Notice, in all of the above circumstances no credit would be available to the payee if the 30 percent not paid to the recipient was not deposited. Yet if one reads the governing statutory provisions as outlined above, one must reach a contrary conclusion, at least when the payer is required to deduct a tax and has sufficient funds in addition to the payment made to deposit the required tax.

The notice assumes a tax was withheld from a payment but would nevertheless tie the applicability of the credit otherwise granted under the applicable code provisions for withheld taxes to proof of the deposit or payment of the tax withheld. The effect of that rule would be the same as if the failure to deposit or pay over a withheld tax would require the conclusion that the tax had not been withheld in the first place, which as will be seen, is contrary not only to the structure of the code but also to the holding in Begier v. IRS.\(^{52}\)

In Begier, the Court had occasion to determine whether a statutory trust had been created under section 7501 for taxes deducted from wages but not timely paid over. The Court stated:

> Withholding thus occurs at the time of payment to the employee of his net wages. S. Rep. No. 95-1106, p. 33 (1978) (“Assume that a debtor owes an employee $100 for salary on which there is required withholding of $20. If the debtor paid the employee $80, there has been $20 withheld. If, instead, the debtor paid the employee $85, there has been withholding of $15 (which is not property of the debtor’s estate in bankruptcy).”). See Slodov, 436 U.S., at 243 (stating that “there is no general requirement that the withheld sums be segregated from the employer’s general funds,”) and thereby necessarily implying that the sums are “withheld” whether or not segregated.\(^{53}\)

Under Begier, the absence of payment of a withheld tax does not negate the creation of a statutory trust, and the creation of a statutory trust appears to coincide with the tax withholding regardless of payment. The Notice doesn’t suggest otherwise. Rather, it may be that the Notice is suggesting that the terms “withheld” or “withhold” in regulations may be construed to require that for an amount to be treated as a tax withholding, the amount must have been deducted for the purpose of making the required deposit or payment of the tax. And in determining whether that purpose has been met, only proof of an actual deposit or payment will be sufficient. Thus, for example, if a payee is owed $100 but is only paid $70, the shortfall in payment does not necessarily mean the shortfall was deducted as a tax. The payor may only have had $70 and paid all he had; or, the payor had no intention of withholding any amount for the purpose of making a tax deposit or payment, but was attempting to pocket the difference.\(^{54}\)

Proof of deposit of an amount of tax that was deducted from a payment would be a strong implication that a tax had been withheld from the payment as would a later payment of that tax, which clearly indicated it was the payment of the withholding amount.

But neither of those observations necessarily answers the threshold question whether an amount was withheld as a tax if the withholding agent’s deposit or payment cannot be proven in the manner prescribed by the regulations. The usual method of proof is the receipt of Form 1042-S for chapter 3 or 4 withholding, indicating a tax was withheld and allocated to the beneficial recipient; but the issue raised by the Notice is whether that proof may be conclusively rebutted by the IRS by a statement that a shortfall exists, and worse still one not necessarily traced to the amount deducted from the beneficial recipient. In other words, it would seem that under the Notice it is insufficient to show, for the purpose of obtaining a full credit, that the amount deducted from a payment was deducted for the purpose of depositing or paying the withholding tax if the IRS were to advise there had been an aggregate shortfall.

Among the problems with that approach, apart from its going beyond the statute, the Notice appears to ignore the possibility that an amount required to be deducted from a payment for the purpose of paying a tax is statutorily presumed to create a trust for the benefit of the United States whether or not deposited or paid, at least for purposes of section 7501, if the payor had sufficient funds to pay the tax when making the payment that is less than the amount due under the contract.

Section 7501, a provision not mentioned in the Notice, provides that whenever any person is required to collect or withhold a tax from any other person and to pay over the tax, “the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States.” Any such trust fund that is created has been held not to constitute part of the assets of the withholding agent, at least

\(^{52}\)496 U.S. 53 (1990).

\(^{53}\)Begier, 496 U.S. at 60-61.

\(^{54}\)See id. at 71 (Scalia, J., concurring).
under the bankruptcy provisions. If a tax is actually withheld, the withholding agent, in addition to being liable for the tax, must deposit the tax withheld in accordance with the regulations under section 6302 or make payment of any balance due with the filing of its withholding tax return and can be liable for an addition to tax for the failure to deposit the tax.

By contrast, if a tax is not actually withheld as required, the withholding agent may be liable for that tax, but the withholding agent is not liable for a penalty for failing to deposit the tax. Moreover, on the face of the statute, a statutory trust fund is created under section 7501 if a tax is required to be deducted and only regarding “the amount of tax so collected or withheld.” Thus, amounts that are neither required to be deducted nor actually deducted or withheld as a tax from a payment are not required to be deposited nor treated as having been deposited into a statutory trust for the United States. Taxes that are in fact deducted from a payment, however, fall within the statutory trust provisions of section 7501.

To be sure, whether an amount is treated as constituting part of a statutory trust in favor of the United States depends on several factors, including whether an amount was deducted as a tax from a payment. As noted by the Court in Begier, if an income payment of $100 is due and only $80 is paid in circumstances when $20 is required to be withheld as a tax, the $20 held back is treated as a withheld tax for purposes of section 7501 if the withholding agent in fact was in possession of the $20 at the time the payment was made. If the withholding agent had the $20 when the payment of $80 was made, the $20 will be treated as the corpus of the statutory trust. Moreover, this will be true even if the $20 is not segregated.

The creation of the statutory trust gives the IRS specific rights that are greater than the rights of a mere unsecured creditor. The IRS may seek to enforce those rights by assessment and collection in the same manner as if the amount impressed with a trust were a tax. But while the creation of the statutory trust gives the IRS additional tools to collect the tax that was withheld, the mere creation of the statutory trust does not appear to mean that the amount impressed with the trust has been either deposited or paid over. Indeed, in Begier as well as cases that preceded and followed it, it seems clear that the creation of the statutory trust was not considered the payment of the tax; rather, the issue was whether a later payment of the tax impressed with the trust could be treated as a voidable preference. Thus, even when a statutory trust is created, payment will not be achieved if the trust fund is later dissipated. But to the extent the funds impressed with the trust continue to exist, they should be available to the IRS and, if available, will give rise to a later payment of the tax withheld.

What is significant for this discussion is not the extent to which the statutory trust created by section 7501 may give the IRS the ability to be preferred in a bankruptcy of the withholding agent debtor with its attendant tracing issues, but rather that the deduction of tax from the payment required by statute creates the statutory trust because of the required tax withholding, to the extent there were sufficient funds in excess of the payment. Based on Begier, it appears that a later nonpayment or deposit of the tax in the statutory trust doesn’t negate the conclusion the tax was withheld when the payment was made, and as a result, due credit must be given.

Additional Practical Concerns

While there would be a serious issue of the validity of a regulation reducing or eliminating a tax credit for a tax considered to be withheld from a payment solely because the withheld tax was not deposited or paid over absent a change in the code, that doesn’t mean the IRS lacks a legitimate concern regarding the granting of a tax credit to a beneficial recipient absent proof the tax was withheld. Apart from the issue of a shortfall, the IRS ordinarily accepts as proof a Form 1042-S issued in accordance with the regulations under section 1461. If the IRS is not able to verify that the tax reflected as withheld on the Form 1042-S is in accordance with the deposits indicated, it would seem possible for the IRS to question whether a tax was withheld from the claimant.

The Notice suggests that the regulations to be issued would treat the absence of a record of a deposit or payment as the equivalent of nonpayment and nonpayment as conclusive of non-withholding. Based on the statutory scheme, such a rule appears to paint with too broad a brush. However, it might be possible to fashion a rule that would create a rebuttable presumption for non-withholding in at least some circumstances. Under that rule, the presumption of non-withholding could be rebutted by proof that the elements for a

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55 See Begier, 496 U.S. at 62.
56 Reg. section 1.1461-1(a).
57 Id.
58 Section 6656.
59 Section 1461. Its responsible officers may be liable for a penalty equal to 100 percent of the tax. Section 6672.
60 See Begier, 496 U.S. at 60-61. Moreover, this would appear to be true even to the extent the tax deducted exceeds the amount that was required to be deducted.
statutory trust under section 7501 have been met — that is, (a) a payment was due on which a tax was required to be deducted; (b) a net payment was made, with the difference being equal to the required tax withholding; and (c) at the time of payment, the withholding agent had funds in addition to the payment equal to the tax required to be deposited. If all three requirements could be established by the beneficial recipient, there could be no question that a tax withholding occurred for which a credit must be granted.

In most instances, the first two factors wouldn't pose a problem of proof for the beneficial recipient. The last factor, however, would require the beneficial recipient to establish the cash position of the withholding agent at the time of payment. That can be a somewhat daunting task at least in some cases. But perhaps it could be made less daunting if there were to be a presumption of sufficient funds that could be rebutted only by the IRS proving — through clear and convincing evidence — that the statutory trust fund did not have sufficient funds at the time of the payment, the effects of which would be to deny the statutory trust fund was ever created and to reduce the income inclusion to the beneficial recipient by the amount of the insufficiency. Thus, to the extent there were insufficient funds at the time of the payment for the creation of the statutory trust fund, there could be no withholding regarding the insufficiency and no credit for the amount of the insufficiency.

One of the reasons given for the rules the Notice would adopt is that there are foreign withholding agents whose assets are beyond the reach of the IRS, and therefore, the IRS does not have a practical remedy to enforce those agents’ obligations. Although it is unclear, one wonders whether this is a reference to the presumption against the extraterritorial application of section 7501 (if not the withholding provisions themselves). There may well be an issue concerning the validity of a section 7501 statutory trust in which the settlor is a non-U.S. person beyond the jurisdiction of the United States. This raises an issue of whether there could be an implied tax withholding when a statutory trust has no significance, the converse of the observations described above to the effect that to the extent a statutory trust is created, the withholding must have occurred. But while using the statutory trust authority to determine whether a tax withholding is deemed to have occurred appears justifiable, the potential unenforceability of the statutory trust provisions because of extraterritoriality does not appear to justify a conclusion that withholding did not actually occur, although it may justify a conclusion that at least in some cases, withholding may not have been required and therefore was presumed not to occur.

**Conclusion**

To the extent tax withholding is deemed to occur, a credit must be given for the tax withheld regardless of whether it was deposited or paid, and any regulation to the contrary would be of questionable validity.

To the extent a statutory trust is created by virtue of a hold-back from a payment for the purpose of deducting a tax, a withholding will be deemed to occur regardless of whether the tax withheld was deposited or paid over or what may later occur with the statutory trust’s assets.

A regulatory rule that presumes withholding doesn’t occur in a particular case and therefore that applicable credits are unavailable to the extent of non-deposit or nonpayment might be given effect if more narrowly drawn to apply only to “withholding” by a non-U.S. person to whom the presumption against the extraterritorial application of our statutes applies. However, there doesn’t seem to be a rational statutory basis for applying that rule to withholding by a U.S. person, and it would appear Treasury’s objective would be better served by limiting any final regulations accordingly.

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62See supra note 50.


(Table appears on the following pages.)
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<th>Code Provision</th>
<th>Section 1441</th>
<th>Section 1462</th>
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<td>Original statutory language.</td>
<td>&quot;All persons...having the control, receipt, custody, disposal, or payment of interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual gains, profits, and income of another person, exceeding $3000 for any taxable year...are hereby authorized and required to deduct and withhold from such annual gains, profits, and income such sum as will be sufficient to pay the normal tax imposed hereon by this section, and shall pay to the officer of the United States Government authorized to receive the same; and they are each hereby made personally liable for such tax.&quot;</td>
<td>&quot;Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.&quot;</td>
<td>&quot;Where there has been an overpayment of tax under this section any refund or credit made under the provisions of section 322 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent.&quot;</td>
<td>&quot;The amount of tax withheld at the source under section 144 [provision dealing with withholding at the source for nonresident aliens] shall be allowed as a credit against the tax.&quot;</td>
<td>&quot;Whenever any person is required to collect or withhold any internal-revenue tax from any other person and to pay such tax over to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same, provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.&quot;</td>
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<td>Relevant legislative history.</td>
<td>&quot;Probably two-thirds of the income tax proposed as to individuals would be deducted and withheld at the source of the income and paid in full to the Government. This method of collection saves the taxpayer annoyance and at the same time practically doubles the amount of revenue the Government would otherwise receive. By this method the amount of tax due or to become due upon every fixed or determinable annual income is withheld and paid to the Government before it reaches the taxpayer.&quot; H.R. Rep. N. 5, 63rd Cong., 1st Sess., 1939-1 C.B. (part 2) 2.</td>
<td>[None.]</td>
<td>[None.]</td>
<td>[None.]</td>
<td>&quot;Existing law provides with respect to a number of taxes that the amount of the tax shall be collected or withheld from the person primarily liable by another person, who is required to return and pay to the Government the amount of the taxes so collected or withheld by him...Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he can not be treated as a trustee or proceeded against by distraint. Section [607] of the bill as reported impresses the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the Government’s claim the administrative provisions for assessment and collection of taxes.&quot; S. Rep. N. 558, 73rd Cong., 2d Sess., 1939-1 C.B. (part 2) 626.</td>
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<td>Miscellaneous comments.</td>
<td>The Revenue Act of 1917 eliminated withholding for virtually all income except for fixed and determinable annual or periodical gains, profits and income of nonresident aliens and income from tax-free covenant bonds. See Revenue Act of 1917, sections 1204(2), 1205(1), ch. 63, 40 Stat. 300, 332-333. Subsequent acts have extended withholding of income at source to foreign corporations and foreign partnerships. See Revenue Act of 1921, section 221(a) (extending withholding to partnerships composed in whole or in part of nonresident aliens); Revenue Act of 1928, section 145 (extending withholding to foreign corporations). When wage withholding from U.S. payees was finally reintroduced after it was eliminated in 1917, it was enacted through provisions separate and apart from the withholding regime associated with nonresident aliens, foreign partnerships and foreign corporations. See Social Security Act, sections 801, 802, 49 Stat. 620, 636-637 (enacting wage withholding of the Social Security tax); Revenue Act of 1942, P.L. 77-753, 56 Stat. 798, 884-894 (enacting wage withholding of the “Victory Tax”); Current Tax Payment Act of 1943, P.L. 78-88, ch. 120 sections 2(a), 1621-1622, 57 Stat. 126, 126-135 (enacting wage withholding of all income taxes).</td>
<td>[None.]</td>
<td>[None.]</td>
<td>In the Revenue Act of 1936, this section was amended so that taxes withheld at the source would be allowed as a credit for foreign corporations (it was already allowed as a credit for nonresident alien individuals). This is the legislative history for this amendment: “Section 32 of the existing law provides that the tax withheld at the source under section 143 [provision dealing with withholding at the source for nonresident aliens] from payments to an individual taxpayer shall be a credit against such taxpayer’s tax. A committee amendment expressly states that the same rule shall apply in the case of the tax withheld under section 144 [provision dealing with withholding at the source for foreign corporations]. By the terms of section 144 of existing law withholding in the case of payments to foreign corporations is subject to the same conditions as withholding from individuals under section 143. Under section 143(d) of existing law credit of the tax withheld from an individual is given against his tax. The committee amendment is therefore declaratory of existing law, and also makes it clear that the tax withheld in the case of a foreign corporation shall always be a credit against the tax, whether collected by return or not.” Senate Rep. No. 2156, 74th Cong., 2d Sess., 1939-1 C.B. (part 2) 688.</td>
<td>When this section was originally enacted in 1934, it was a section under the excise tax provisions. In 1939 this section was moved to the general administrative provisions.</td>
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