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#4**CHAPTER 3 AND CHAPTER 4 CREDITS AND REFUNDS: Protect Taxpayer Rights by Aligning the Rules Governing Credits and Refunds for Domestic and International Withholding****TAXPAYER RIGHTS IMPACTED¹**

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

PROBLEM

Under Internal Revenue Code (IRC) §§ 1441-1443 (Chapter 3), the IRS imposes withholding on payments made to non-resident aliens and foreign corporations and allows credits and refunds of the amounts to which these taxpayers are entitled.² For many years, the operation of this regime closely paralleled the approach taken by the IRS with respect to domestic withholding under IRC § 31 in that there were no restrictions limiting credits or refunds to the amount of withheld tax actually paid over to the IRS.³ With the advent of the additional reporting and withholding requirements established by the Foreign Account Tax Compliance Act (FATCA), which passed IRC §§ 1471-1474 (Chapter 4), the IRS has become increasingly concerned about fraudulent activity on the part of taxpayers and withholding agents.⁴ Such is the case, even though approximately 85 percent of Chapter 3 and Chapter 4 withholding agents are domestic and therefore can be reached by the IRS for tax enforcement purposes.⁵

While IRS fears may have some foundation, the nature and extent of the potential fraudulent activities have not been established by the IRS through any comprehensive, statistically valid evidence.⁶ Nevertheless, the IRS has taken the drastic step of freezing Chapter 3 and Chapter 4 refunds for up to one year or longer, while attempting to match the documentation provided by taxpayers with the documentation provided by withholding agents. This action is not only costly for taxpayers, but for the IRS which estimates that an extension of the freezes through early 2016 will result in an interest expense of approximately \$4.4 million.⁷ As of August 31, 2015, over 50,000 refund claims aggregating to well in

1 See Taxpayer Bill of Rights available at www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

2 See Treas. Reg. §§ 1.1462-1 and §1.1464-1.

3 For a discussion of prior IRS practice in the processing of Chapter 3 refund claims, see Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-40-121, *Improvements Are Needed to Verify Refunds to Non-resident Aliens Before the Refunds Are Sent Out of the United States*, 6 (Sept. 2010).

4 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat 71 (2010); Notice 2015-10, 2015-20 I.R.B. 965.

5 Large Business and International before (LB&I) response to TAS information request (Sept. 9, 2015). This percentage is developed from data provided by the IRS with respect to fiscal year ending (FYE) 2012 and FYE 2013, which are the only years for which it furnished this information.

6 LB&I response to TAS information request (Sept. 9, 2015). After analyzing the issue with respect to the 2008 tax year (TY), TIGTA found no statistically significant indicia of fraud relating to IRS processing of refund claims by non-resident aliens. A judgmental sample of TY 2007 and TY 2008 returns, however, revealed significant control weaknesses in the processing of refunds claimed on Forms 1040NR that could be exploited and therefore should be remedied. TIGTA, Ref. No. 2010-40-121, *Improvements Are Needed to Verify Refunds to Non-resident Aliens Before the Refunds Are Sent Out of the United States* 2 (Sept. 2010).

7 IRS presentation: *Foreign Account Tax Compliance Act, Large Business & International (LB&I) Withholding & Refunds (W&R) Discussion*, slide 4 (Oct. 2015).

excess of \$100,000,000 have been frozen by the IRS.⁸ The vast majority of these taxpayers filing refund claims actually appear to be substantially more compliant than a comparable portion of the overall U.S. taxpayer population.⁹ However, the IRS has indefinitely retained amounts owing to this substantial group of taxpayers while it proves the compliant majority innocent in order to protect the tax system from potential exploitation by the noncompliant few.¹⁰ Moreover, the IRS has proposed issuing Chapter 3 and Chapter 4 regulations providing that, in general, even taxpayers who were subjected to proper withholding and who possess complete documentation of that withholding will nevertheless be fully or partially denied a refund of the withheld amounts unless the withholding agent has correctly remitted to the IRS the full amount of withholding for all taxpayers.¹¹ With that step, the IRS would largely complete the transformation of its prior administrative practice of treating domestic and international credit and refund claims similarly, to a new international enforcement regime under which the burdens and risks are disproportionately shifted to largely compliant taxpayers.

EXAMPLE

Taxpayer is a retired non-resident alien individual whose only U.S. source income during the year is dividend income from U.S. stocks. The dividend income is subject to U.S. tax, but in an amount less than what was withheld by the withholding agent. The withheld amount is remitted by the withholding agent to the IRS and is properly reported on the Form 1042-S issued to Taxpayer. Although Taxpayer files an early Form 1040NR seeking a refund of the overwithholding, several months elapse with no response from the IRS. Taxpayer, who relies on the overwithheld dividends as retirement income, contacts the IRS regarding the status of the refund and is forced to incur toll charges while waiting on hold for a lengthy period. When the call is finally answered, the IRS customer service representative says only that the IRS will need additional time to process the return and that Taxpayer should allow up to one year from the date the Form 1040NR was due.¹² The IRS states, “We apologize for the inconvenience,” as Taxpayer wonders how to pay for short-term living expenses.¹³ Where the refund is concerned, Taxpayer’s only options are to hope that the review will occur more quickly than predicted, to contact the Taxpayer Advocate Service for assistance in expediting processing of the Form 1040NR, or, eventually, to file suit in a federal district court.

8 IRS, Compliance Data Warehouse, IRTF Entity and IMF Trans History tables (Oct. 28, 2015); IRS presentation: *Foreign Account Tax Compliance Act, Large Business & International (LB&I) Withholding & Refunds (W&R) Discussion*, slide 9 (Oct. 2015).

9 TAS makes this assertion because our analysis found that individual taxpayers filing Form 1040NR refund claims have a lower percentage of high-scoring Discriminant Index Function (DIF) returns in comparison to filers overall. Data drawn Nov. 10, 2015 for TY 2014 from IRS Compliance Data Warehouse, IRTF Entity table, and IMF Transaction History tables. See particularly Total Positive Income (TPI) Class 72, which encompassed most taxpayers in this group. High-scoring DIF returns were defined as those with a DIF value that exceeded 80 percent of DIF scores in the general population for a particular TPI class. We calculated a cutoff point for DIF scores at the 80th percentile for each TPI class for TY 2014, and calculated the percentage of Form 1040NR refund filers in each TPI class that exceeded the DIF cutoff point. Overall, only approximately two percent of Form 1040NR refund filers exceeded their respective DIF cutoff points, compared to 20 percent for individual filers in the general population (especially TPI Class 72). Accordingly, Form 1040NR refund filers showed a lower percentage of “high-scoring” DIF returns, and thus more compliant behavior, than the overall population. We did, however, identify certain small groups of taxpayers within the overall group who appear to have considerable compliance issues (see TPI Classes 80 and 81). LB&I notes that the above-discussed “[s]coring methodologies and the filters used are not conclusive in determining if 1040NR filers are more compliant than the overall taxpayer population.” LB&I response to TAS informal fact check (Dec. 11, 2015). This methodology, however, is the approach TAS typically employs to evaluate the relative reporting accuracy of two distinct groups.

10 See IRC § 6611(e)(4), under which the IRS may hold a claim without paying interest for up to 180 days from the later of the due date of the return or when the return is filed. The IRS may issue regulations providing some exceptions that could narrow the scope and impact of these freezes. Notice 2015-10, 2015-20 I.R.B. 965.

11 Notice 2015-10, 2015-20 I.R.B. 965.

12 IRS, SERP Alert 15A0416, *Form 1040NR Frozen Refund Extension* (Sept. 11, 2015).

13 *Id.*

Although Taxpayer's situation is unfortunate and unjustifiable, it actually could be worse. If the requisite Form 1042-S was not properly issued by the withholding agent, Taxpayer's right to receive the refund could be lost.¹⁴ Likewise, even though amounts were correctly withheld from payments made to Taxpayer, if the withholding agent did not remit any deposits to the IRS with respect to those amounts, Taxpayer, although not at fault, would not be entitled to a refund.¹⁵

RECOMMENDATION

To protect taxpayer rights, the National Taxpayer Advocate recommends that Congress amend IRC §§ 33 and 6401(b)(2) to provide that unless the IRS identifies some affirmative indicia of fraud, taxpayers will be entitled to a full credit or refund if they can demonstrate that withholding occurred at source.

PRESENT LAW

Chapter 3 generally requires withholding agents to collect the substantive tax liability of non-resident aliens imposed under IRC §§ 871(a), 881(a), and 4948 by withholding on certain payments of U.S. source fixed or determinable annual or periodical income.¹⁶ Likewise, Chapter 4 directs withholding agents to withhold tax on certain payments to foreign financial institutions (FFIs) that are covered nonparticipating FFIs and nonfinancial foreign entities that do not provide information regarding their substantial U.S. owners.¹⁷ Chapter 4 also generally requires participating FFIs to withhold tax on certain payments to accounts of recalcitrant account holders and payees that are nonparticipating FFIs.¹⁸

Amounts withheld by withholding agents under Chapter 3 and Chapter 4 must be deposited with the IRS.¹⁹ If, for any calendar year, the withholding agent fails to remit the proper amount of withheld taxes, it must pay the shortfall out of its own funds and is also subject to the payment of penalties and interest.²⁰ For each calendar year, withholding agents must file a Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, with the IRS showing the aggregate amount of income they withheld under Chapter 3 and Chapter 4 and the aggregate withholdings they remitted to the government.²¹ Additionally, withholding agents issue Forms 1042-S to each taxpayer from which amounts have been withheld and file the Forms 1042-S with the IRS.²² In order to claim a credit or refund of the amounts withheld, taxpayers must attach the Form 1042-S to their annual tax return.²³

IRC § 33 allows non-resident aliens to claim a credit or refund of taxes withheld at source under Chapter 3. In turn, Chapter 4 provides that FATCA-related credits or refunds will be made available under the rules governing Chapter 3.²⁴ Specifically, the beneficial owner of the income may claim a credit of

14 Treas. Reg. § 301.6402-3T(e); IRM 21.8.1.11.14.1, *Claims for Tax Withheld at Source* (Oct. 1, 2015).

15 IRM 21.8.1.11.14.1, *Claims for Tax Withheld at Source* (Oct. 1, 2015).

16 IRC § 1441.

17 IRC §§ 1471(a), 1473(1). IRC § 1471(d)(1)(B) excepts from the reporting and withholding requirements those accounts that are held by individuals at the same FFI and have an aggregate value of \$50,000 or less.

18 IRC § 1471(b)(1)(D).

19 IRC § 6302; Treas. Regs. §§ 1.1461-1(a), 1.1474-1(b), and 1.6302-2.

20 Treas. Reg. § 1.1461-1. See also IRC §§ 6601, 6651(a)(2), and 6656.

21 Treas. Reg. § 1.1461-1T(b)(1).

22 Treas. Reg. § 1.1461-1T(c).

23 Treas. Reg. § 301.6402-3T(e).

24 IRC § 1474(b)(1).

the amount of tax actually withheld under Chapter 3 or Chapter 4 against the total income tax computed on the beneficial owner's return.²⁵

For cases of overwithholding, the Chapter 3 and Chapter 4 regulations can be read as generally providing a credit or refund of an overpayment of tax that has actually been withheld at source.²⁶ According to the IRS, however, "Under a special rule in section 6401(b)(2), the credit under section 33 is treated as a refundable credit only in the case of a beneficial owner who is a non-resident alien and who has made an election to be treated as a U.S. resident under section 6013(g) or (h)."²⁷ Barring such an election, the IRS's position now is that, even if withholding at source actually takes place, the overpayment required to support a refund only occurs if the withheld amounts are remitted by the withholding agent to the IRS.²⁸

Based on this analysis, the IRS has initiated the practice of matching taxpayer requests for Chapter 3 or Chapter 4 credits or refunds with the information filed by withholding agents before allowing the requested claims.²⁹ To the extent that the claim for refund, which must be evidenced by a Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, cannot be matched with at least some deposit from the withholding agent, no credit or refund will be allowed.³⁰ Nevertheless, the IRS has not yet developed the technology necessary for automatic matching, a shortcoming warned against by the National Taxpayer Advocate in the 2013 Annual Report to Congress.³¹

As a result of this technological deficiency, the IRS originally imposed an across the board 168-day freeze on most Chapter 3 and Chapter 4 refund claims to allow for manual review.³² The freeze has now been extended for up to one year from the date that any unreviewed and unverified returns were due or filed, whichever is later.³³ This one-year freeze period could be further expanded by the IRS as it attempts to implement automated matching systems for 2014, 2015, and beyond.

By contrast, the IRS has adopted the opposite approach with respect to credits and refunds of withheld employment taxes under IRC § 31, which is worded similarly to IRC § 33.³⁴ In the case of this domestic withholding, the IRS allows a credit or refund to taxpayers, even if the employer fails to make the actual deposit with the IRS. The regulations under IRC § 31 expressly provide, "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."³⁵

Where Chapter 3 and Chapter 4 are concerned, however, the IRS has announced its intention to propose regulations that would allow full credits or refunds only after a taxpayer files the requisite Form 1042-S

25 IRC §§ 1462 and 1474(b)(1); Treas. Reg. §§ 1.1462-1(a) and 1.1474-3(a).

26 Treas. Reg. §§ 1.1464-1(a) and 1.1474-5(a)(1).

27 Notice 2015-10, 3, 2015-20 I.R.B. 965.

28 *Id.*

29 IRM 21.8.1.11.14.1, *Claims for Tax Withheld at Source* (Oct. 1, 2015).

30 *Id.*

31 National Taxpayer Advocate 2013 Annual Report to Congress 244.

32 IRM 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR* (TC 810-3 -E Freeze) (May 1, 2015); IRS, SERP Alert 15A0188, *FATCA-Programming Beginning in January 2015 Affecting Certain Forms 1040NR* (TC 810-3 -E Freeze) (Mar. 23, 2015).

33 IRS, SERP Alert 15A0416, *Form 1040NR Frozen Refund Extension* (Sept. 11, 2015); IRS, SERP Alert 15A0417, *Form 1120-F Frozen Refund Extension* (Sept. 11, 2015).

34 See IRC § 31.

35 Treas. Reg. §1.31-1(a).

if the IRS can confirm that the withholding agent remitted the full amount of the aggregate liabilities for which the withholding agent is responsible.³⁶ In the event that a withholding agent has only partially satisfied its deposit requirements with the IRS, the regulations will also provide for a *pro rata* allocation of the amount deposited among taxpayers seeking to claim credits or refunds for the withholding in question.³⁷ Some exceptions may be developed for certain scenarios, such as in cases where the under deposit of tax is *de minimis*, or in cases where the withholding agent in question has a demonstrated history of compliance with its deposit requirements.³⁸ None of these proposed exceptions, however, addresses circumstances where proper amounts were actually withheld from a specific taxpayer's account.

REASONS FOR CHANGE

The IRS has transformed Chapter 3 and Chapter 4 tax administration into a system that assumes non-compliance and is dedicated disproportionately to denying unwarranted benefits to the malfeasant few at the cost of the compliant majority who deserve their credits and refunds. Although the IRS may be reacting to control weaknesses in its non-resident alien refund process identified by TIGTA, the IRS has neither demonstrated that this category of taxpayers is comparatively noncompliant, nor that widespread fraud is actually occurring.³⁹ Nevertheless, most taxpayers seeking refunds of amounts withheld under Chapter 3 or Chapter 4 will have their refunds frozen for up to one year, if not longer, while the IRS attempts to match applicable documentation and satisfy itself that fraud has not occurred.⁴⁰ Moreover, no guarantee exists that this one-year period will not be further extended by the IRS as it attempts to implement automated matching systems for 2014, 2015, and beyond. Thus thousands of compliant taxpayers will experience indeterminate delays in receiving their legitimately claimed refunds, while the IRS tries to marshal its internal resources and detect a relatively few bad actors.

At the same time, the IRS is considering regulations that would allow taxpayers full refunds only to the extent that their withholding agent has fully remitted to the IRS all withholding liabilities for all taxpayers. As a result, a taxpayer could conceivably end up waiting a year or more only to find out that even though the taxpayer's withholding was properly collected and remitted to the IRS by the withholding agent, such was not the case with all other funds collected by the withholding agent, and therefore the taxpayer is only entitled to a proportional amount of the long-delayed refund. By contrast, the IRS currently accepts creditor-risk in the case of domestic withholding, such as on employment taxes, and taxpayers need only show that the withholding actually occurred to be entitled to a credit or refund from the IRS.⁴¹

The IRS argues that the shift in enforcement burden now proposed with respect to international withholding is necessary as a means of preventing fraud. Nevertheless, it has not produced any systematic and rigorous analysis documenting the nature and scope of this risk. No comprehensive statistically valid

36 Notice 2015-10, III.A., 2015-20, I.R.B. 965.

37 *Id.*

38 *Id.*

39 TIGTA, Ref. No. 2010-40-121, *Improvements Are Needed to Verify Refunds to Non-resident Aliens Before the Refunds Are Sent Out of the United States*, 6 (Sept. 2010); LB&I response to TAS information request (Sept. 9, 2015).

40 IRM 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR (TC 810-3 -E Freeze)* (May 1, 2015). See also IRS, SERP Alert 15A0416, *Form 1040NR Frozen Refund Extension* (Sept. 11, 2015); IRS, SERP Alert 15A0417, *Form 1120-F Frozen Refund Extension* (Sept. 11, 2015). The IRS informed taxpayers that those who requested a refund of tax withheld on a Form 1042-S by filing a Form 1040NR will have to wait up to six months from the original due date of the 1040NR return or the date the 1040NR is filed, whichever is later, to receive any refund due. IRS, *What to Expect for Refunds in 2015*, available at <http://www.irs.gov/Refunds/What-to-Expect-for-Refunds-This-Year> (last visited on Apr. 1, 2015).

41 IRC § 31(a); Treas. Reg. § 1.31-1(a).

evidence has yet been produced to support IRS assertions that significant tax noncompliance is occurring, or may begin occurring, in the context of international withholding. The vast majority of taxpayers filing Forms 1040NR, *U.S. Non-resident Alien Income Tax Return*, seeking refund claims actually appear to be substantially more compliant than a comparable portion of the overall U.S. taxpayer population.⁴² Although concerns regarding potential fraud should be taken seriously, open-ended retention of taxpayer funds, reallocation of creditor burdens to taxpayers, and fundamental shifts in tax policy should not be based on unsubstantiated conjecture. Where evidence of fraud exists, the IRS should develop procedures that are narrowly tailored to address the risk of fraud, and not impose undue burden on taxpayers who are complying with the law.

The IRS has asserted that once improperly refunded amounts have left U.S. jurisdiction and gone abroad, they are virtually impossible for the IRS to recover. While this statement may be true, the IRS does not generally face this risk in the context of potential wrongdoing by Chapter 3 and Chapter 4 withholding agents. Indeed, according to the IRS, approximately 85 percent of these withholding agents are domestic and, therefore, can be reached by the IRS for tax enforcement purposes.⁴³

Thus, withholding agents, even those active in the international context, are primarily domestic and, to the extent they engage in noncompliant behavior, can be compelled by the IRS to remit the withholding payments they have collected, even where non-resident taxpayers are involved.⁴⁴ The IRS has far more effective tools and comprehensive resources at its disposal for this type of enforcement than the individual taxpayers to whom the IRS would now allocate this burden.

Further, according to the Information Reporting Program Advisory Committee (IRPAC), there are many non-fraudulent reasons for a deposit shortfall and most withholding agents have a proven track record in making accurate and timely deposits.⁴⁵ For example, the IRS might have unilaterally debited a withholding agent's Chapter 3 tax deposit account in order to settle a tax liability associated with another account of that agent.⁴⁶ Likewise, the withholding agent might have made a coding mistake when making its deposit with the IRS.⁴⁷ IRPAC concluded that the *pro rata* approach contemplated by the IRS confuses the legitimate problem of fraudulent refund claims with collection of shortfalls in withholding deposits.⁴⁸

IRS concerns regarding the possibility of fraud may well be legitimate. Nevertheless, the sweeping solutions implemented by the IRS do not properly balance the operations of the anti-fraud regime with the taxpayer's need for a process no more intrusive than necessary, part of a taxpayer's *right to privacy*. In so doing, the IRS unnecessarily burdens taxpayers and unintentionally may well be discouraging investment in the United States and harming global commerce.

Accordingly, taxpayers should retain the right to receive their Chapter 3 or Chapter 4 credits or refunds in a timely fashion, if they can demonstrate, to the satisfaction of the IRS, that the withholding actually occurred. These rights should parallel those existing with respect to domestic withholding. In order to be entitled to a Chapter 3 or Chapter 4 credit or refund, a taxpayer should be required to provide only

42 See discussion regarding DIF scores of Form 1040NR refund filers, *supra*.

43 LB&I response to TAS information request (Sept. 9, 2015). This percentage is developed from data provided by the IRS with respect to FYE 2012 and FYE 2013, which are the only years for which it furnished this information.

44 Treas. Reg. § 1.1461-1T(c). See also IRC §§ 6601, 6651(a)(2), and 6656.

45 IRPAC Public Report, International Reporting and Withholding Subgroup Report 65, 69 (Oct. 28, 2015).

46 *Id.*

47 *Id.*

48 *Id.*

a matching Form 1042-S from a withholding agent, or other persuasive evidence that withholding has taken place, unless the IRS has detected some affirmative indicia of fraudulent activity. Further, the burden of pursuing noncompliant withholding agents should not be borne by taxpayers with legitimate refund claims. Rather, as in the case of domestic withholding, the IRS should mobilize its widespread enforcement powers and seek to collect what is properly due and owing from these malfeasant withholding agents.

EXPLANATION OF RECOMMENDATION

The IRS has treated the implementation of FATCA as an opportunity to alter the assumptions and rules governing Chapter 3 and Chapter 4 withholding. With only minimal explanation and without any comprehensive statistically valid evidence to support its actions, the IRS has shifted from a compliance-based to an enforcement-based model of tax administration in the international withholding context. Taxpayers subject to Chapter 3 and Chapter 4 withholding are assumed to be either intentionally or unwittingly participating in fraudulent conduct and must wait up to one year or longer while the IRS proves the taxpayer's innocence before withheld amounts are released. Moreover, the IRS is considering shifting creditor risk with respect to withholding agents, over which taxpayers generally have no control whatsoever, away from the IRS and onto the shoulders of these same taxpayers.