Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:NEW:1:POSTF-155932-01
AAmmirato

date: November 6, 2001

to: Ihor G. Kihiczak, International Examiner, LMSB, [redacted]

from: Area Counsel
(Heavy Manufacturing and Transportation: [redacted])

subject: [redacted] **Section 881(a) Tax**

This memorandum responds to your request for legal advice. This memorandum should not be cited as precedent.

ISSUES

1) Whether taxpayer may claim a refund by filing Form 1120X for taxes paid pursuant to section 881(a)(1) on Form 1042?
Conclusion: No.

2) Whether the claim for refund of the section 881(a)(1) taxes on Form 1120X constitutes a valid informal claim for refund?
Conclusion: Yes. However, only the informal claim for the section 881(a) taxes paid for the [redacted] taxable year is timely.
3) Whether taxpayer is entitled to deduct on Form 1120 the taxes paid pursuant to section 881(a)(1)? Conclusion: Further factual development is needed.

FACTS

[redacted] ("taxpayer") entered into a consultant agreement dated [redacted] with [redacted], a related [redacted] corporation (brother/sister corporations). The consultant agreement provided that [redacted] would perform consulting services on behalf of taxpayer for a fee equal to [redacted]% of the operating revenue of taxpayer ("[redacted]% payments"). The original agreement further provided that the amount shall be net of any taxes and/or any deductions accrued in the United States. The agreement was amended by an addendum effective beginning on [redacted] which provides that the fee shall exclude any taxes accrued in the U.S. (i.e. that any withholding tax, if applicable, would not be withheld but instead would be paid by the taxpayer from its own funds).

The operating revenue of taxpayer was $[redacted], $[redacted] and $[redacted] for the taxable years [redacted], [redacted] and [redacted], respectively. Taxpayer made payments equal to [redacted]% of its operating revenue to [redacted] in the amounts of $[redacted],

$[redacted] and $[redacted] during the taxable years [redacted], [redacted] and [redacted], respectively. Taxes pursuant to section 881(a) were paid by taxpayer in the amounts of $[redacted], $[redacted] and $[redacted] for the [redacted], [redacted] and [redacted] taxable years on Form 1042 for each year ("section 881(a) taxes").

The section 881(a) taxes were not withheld from the [redacted]% payments made to [redacted]. In calculating the section 881 taxes, taxpayer took into account the "additional income" to [redacted] resulting from taxpayer's payment of such taxes.[1] Taxpayer deducted the [redacted]% service fees and the section 881(a) taxes on Form 1120 for each of the taxable years.

In [redacted], taxpayer filed claims for refund on Forms 1120X for the section 881(a) taxes paid during the taxable years [redacted], [redacted] and [redacted]. Taxpayer argues that the services were performed by [redacted] outside the U.S., and, therefore the compensation was not subject to a tax pursuant to section 881(a).[2] Although the taxes were paid on a Form 1042, taxpayer argues that it may claim a refund for the taxes on Form 1120X because the taxes were not withheld from the [redacted]% payments to [redacted].

LEGAL AUTHORITY

A 30% income tax is imposed on the recipient for compensation paid to a foreign corporation where the payment for services is sourced within the U.S. Section 881(a)(1). A payment for services is sourced within the U.S. where the services are performed within the U.S. Section 861(a)(3). A person which makes a payment to a foreign corporation for services within the U.S. is required to withhold the required U.S. tax ("withholding agent"). Section 1441.

---

[1]It is well established that payment of taxes for a third party is further income to that third party which is subject to further taxes. See Safe Harbor Water Power Corp. v. U.S., 303 F.2d 928 (Ct. Cl. 1962). It appears that taxpayer used the following formula in calculating the section 881(a) tax due:

S (total amount of withholding tax due) = a(amount of income initially paid)/ 1 - r(withholding rate) - a. See Dale, "Withholding Tax on Payments to Foreign Persons" 36 Tax L.Rev. 49, 90 - 91 (1980).

[2]Only for purposes of this discussion, we assume taxpayer's position is correct. The sourcing issue is being addressed by the audit team.

A withholding agent must file an annual return of the tax withheld on Form 1042. An original copy of Form 1042 must be filed on or before March 15 of the year following the calendar year in which the tax was required to be withheld. Treas. Reg. 1.1461-2(b)(1). An information return, Form 1042S, must also be filed which shows certain items paid to a foreign corporation. Treas. Reg. 1.1461-2(c)(1).

Where a withholding agent **over-withholds and deposits** the tax with the Service, the foreign payee and not the withholding agent is entitled to a refund or credit. Section 1464; Treas. Reg. 1.1464-1(a). Where a withholding agent **overpays the tax to the Service but does not over-withhold** from the foreign payee, the Service will credit or refund the overpaid tax to the withholding agent not the foreign payee. Treas. Reg. 1.1464-1. The withholding agent has two options to recover the overpayment (which was not withheld):

1) File a claim for credit or refund of the overpayment in the manner as provided in the regulations under section 6402. Treas. Reg. 1.6414-1(a)(flush language). Treas. Reg. 301.6402-3(a)(4) provides that "[i]n the case of an overpayment of income taxes for a taxable year for which a form other than Form 1040, 1040A or 1120 was filed....a claim for credit or refund shall be made on the appropriate amended income tax return"; or

2)The withholding agent may claim a credit of an overpayment for any calendar year by showing the amount of the overpayment on the return on Form 1042 for such calendar year, which shall constitute a claim for credit. Treas. Reg. 1.6414-1(b).

DISCUSSION

1) Whether taxpayer may claim on a Form 1120X a refund of the section 881(a) taxes paid on Form 1042? <u>Conclusion</u>: No.

Since the section 881(a) taxes were not withheld from the [redacted]% payment to [redacted], taxpayer is entitled to any credit or refund of such paid taxes. <u>See</u> Treas. Reg. 1.1464-1(a). Of course, a timely claim for credit or refund must be made within the statutory period. Two options for claiming a credit or refund of the taxes were available to taxpayer: 1) showing such amount as an overpayment on Form 1042 filed for such year; or 2) file a claim for credit or refund in a manner provided in section 6402. Treas. Reg. 1.6414-1.

Since the 1042 for the respective years has already been filed, option 1 above is not available to taxpayer. Therefore, taxpayer was required to file a claim for refund within three years from

the date of filing the Form 1042 pursuant to section 6511. The fact that the tax was not withheld from the [redacted]% payment to [redacted] does not permit a refund claim for the section 881(a) taxes on a Form 1120X. Taxes imposed pursuant to section 881(a) are taxes on the foreign corporation and are not reportable on a withholding agent's Form 1120.

Taxpayer extended, pursuant to section 6501(c)(4), the period of time for assessment of taxes reportable on Form 1120. An agreement to extend the period of assessment pursuant to section 6501(c)(4) extends the period for filing a claim for refund or credit to six months after the expiration of the period within which an assessment may be made pursuant to the agreement under section 6501(c)(4). Section 6511(c). The extension of the period for filing a claim for refund or credit relates to taxes reportable on taxpayer's Form 1120. The extension does not extend the period for filing a claim for refund or credit of taxes paid on Form 1042.

2) Whether the claim for refund of the section 881(a)(1) taxes on Form 1120 constitutes a valid informal claim for refund? Conclusion: Yes. However, only the informal claim for the section 881(a) taxes paid for the [redacted] taxable year is timely.

The validity of informal claims for refund have long been recognized. See United States v. Kales, 314 U.S. 186 (1941). In order to be valid, an informal claim must be clear in alerting the Commissioner that a refund of taxes is sought for certain years. Missouri Pacific R.R. v. United States, 214 Ct. Cl. 623, 627 (1977). A claim is valid where "the Commissioner knew, or should have known, that a claim was being made." Newton v. United States, 143 Ct. Cl. 293, 300 (1958).

In our facts, taxpayer claimed a refund for section 881(a) taxes paid for the taxable years [redacted], [redacted] and [redacted] on Forms 1120X filed in [redacted] of [redacted]. The claim was clear and unambiguous, therefore, it constitutes an informal claim for refund. However, an informal claim for refund must be made within the three year statutory period pursuant to section 6511. As discussed above, the extension of the period of assessment of taxes reportable on Form 1120 did not extend the period for filing a claim for refund of taxes reportable on Form 1042. Taxpayer did not extend the period for assessment of taxes reportable on Form 1042. Therefore, only the informal claim for refund of the section 881(a) taxes paid during [redacted] (due on [redacted]) would be timely.

3) Whether taxpayer is entitled to deduct on Form 1120 the taxes paid pursuant to section 881(a)(1)? Conclusion: Further factual

development is needed.

Section 881(a) imposes a tax on the foreign payee not on the payor (the taxpayer here). It is well established that expenses incurred for the benefit of another taxpayer are not deductible under section 162 unless the taxpayer pays the expense for its own direct benefit in connection with its own trade or business. See Austin Co. v. Commissioner, 71 T.C. 955, 967 (1979). Since the payments for services in our case are between "controlled parties", the payments must also be "arm's length" pursuant to section 482. Therefore, in order to be deductible under section 162(a), taxpayer would need to establish that the [redacted]% payment plus the payment of the section 881(a) taxes constitute an "arm's length" payment for the consulting services pursuant to section 482 and the regulations thereunder. If the proper "arm's length" amount is only the [redacted]% payments, then the additional amounts (the withholding tax paid with the taxpayer's own funds) do not constitute deductible consultant fees.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions please contact attorney Anthony Ammirato at (973)645-2539.

JOSEPH F. MASELLI
Area Counsel
(Heavy Manufacturing and
Transportation:[redacted]

By:_____
WILLIAM F. HALLEY
Associate Area Counsel
(Large and Mid-Size Business)