Tax Update

Pepper Hamilton LLP
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Extension of Time to Clean Up Withholding Taxes

On November 3, 2005, the IRS announced that the voluntary compliance program (VCP) for cleaning up errors in withholding taxes on payments to foreign persons would be extended to March 31, 2006.[1] At the same time, the IRS announced its intention to audit 100 percent of Form 1042/1042S filers. The articulated position is that the terms of clean up under the VCP will be kinder and gentler than audit resolutions.

Originally designed for financial institutions, the VCP was created pursuant to Rev. Proc. 2004-59, and has been used by non-financial institutions to resolve historical non-compliance with the rules. The withholding rules are found in Section 1441 and 1442, and apply to taxes imposed on non-U.S. persons earning U.S. source fixed, determinable, annual or periodic income (FDAP) that is not connected to a U.S. business.[2] Many non-financial institutions are, or should be, Form 1042/1042S filers. Private equity and venture funds should also be specifically concerned about the application of the rules.

Are you a Form 1042/1042S filer? You have the exposure if you pay U.S. source FDAP to non-U.S. persons. That type of income includes:

- payments for services rendered by an independent contractor or other non-employee while in the U.S.
- payments of licensing fees or royalties to non-U.S. persons
- payments of dividends from U.S. sources to non-U.S. persons
- payments of interest to non-U.S. persons.

With respect to the withholding on services, it is the place where services are rendered that controls, not the place of contract, the residence of the payee, or the place of payment. If you have relied on a contractor claiming treaty benefits to avoid the withholding tax, you should have received a Form 8233 from the contractor. That form has only a one-year validity. Be sure the forms you rely on are up-to-date and have the required TIN. Also, determine whether your company pays non-U.S. Board members for attending meetings in the U.S. If so, your company should be withholding the appropriate tax (after application of any treaty).

Royalties are frequently a problem if the license is for global usage - you should be withholding on the portion that is attributable to the right to use in the U.S. and contracts are frequently not written to support that action.

For private equity funds, given the recent rise in leveraged dividends, the withholding on dividends is a considerable issue. The withholding needs to occur at 30 percent, unless the payor can reasonably associate the payment with the right of a partner to utilize a tax treaty or other exemption. Recently, we reviewed a group

Speakers Corner

Todd Reinstein will be speaking at the ABA Tax Section's Midyear Meeting on February 4, 2006 in San Diego, CA on "Part II - Proposed 199 Regulations and How They Affect the Structure of Real Estate Transactions."

Annette Ahlers led a panel discussion at the Association for Corporate Growth's education seminar on "Tax Issues to Consider in Common Acquisition Scenarios" on Tuesday, December 13, 2005. Her presentation is online at http://www.pepperlaw.com/pepper/pdfs/ACG121305.ppt.

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of forms collected for this purpose by an investment fund, and we found that more than 90 percent were not correctly completed and could not be relied upon to reduce the withholding tax. Failure to timely withhold the tax and pay it to the IRS leaves the withholding agent liable for the amount of the tax, interest and penalties. The penalty for failure to timely deposit can be quite high.

Under the VCP, the taxpayer essentially self-audits its withholding obligations, and discloses pursuant to the terms of the revenue procedure. While the taxpayer must pay the under-withheld tax and interest the IRS is taking a liberalized approach to penalty relief and is also allowing remediation - getting the right forms, having the taxpayer ID number provided to make the form complete, etc. Thus, under audit the IRS will not be as accepting of bad forms and lack of compliance.

Pepper Perspective

Consider whether your company or client makes payments of the types described above, and if so, review your procedures for complying with the withholding tax rules. If you find errors, the VCP may be the right approach for you.

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ENDNOTES

1 Rev. Proc. 2005-71.

2 The taxes are imposed under Section 871 and Section 881.

IRS Issues New Proposed Regulations Regarding Corporate Estimated Tax Payments

On December 7, 2005, the IRS issued new proposed regulations on calculating corporate estimated tax liabilities.[1] The new proposed regulations apply to tax years beginning after the date that is 30 days after the date they are published in the *Federal Register*. For calendar year companies, the earliest taxable year the regulations would be effective is 2007. Taxpayers, however, may rely on these proposed rules for taxable years beginning on or after the date the notice of proposed rulemaking is published in the *Federal Register*, provided that the taxpayer applies all of these proposed rules in determining its required installments.

Background

Corporations generally must remit their annual tax liability during the tax year in quarterly installments. The installments can be based on a pro rata portion of the corporation's estimated annual tax liability. Alternatively, the quarterly installments can be based on the corporation's annualized taxable income (taxable income for a specific period of months that is extrapolated into an annual amount) or the corporation's adjusted seasonal taxable income. The new proposed regulations address concerns that taxpayers are employing techniques that reduce or eliminate corporate estimated tax payments for one or more installments.

The new proposed regulations thus provide specific rules for determining taxable income for any annualization period, including how economic performance is to be applied. That is, taxpayers generally will have to take into account an item of income in computing annualized taxable income for a particular period only to the extent the item is incurred under Code 451 of the Code. Section 451 provides the general rules for including an item in income, on or before the last day of the annualization period.

With regard to deductions, the proposed regulations generally provide that taxpayers are required to take into account deduction for a particular annualization period only to the extent that the item is deductible under Treas. Reg. Section 1.461-1 that provides the general rules for deducting an item by an accrual method taxpayer, on or before the last day of the annualization period. These proposed regulations also provide special rules for depreciation, certain deductions and Section 481 adjustments.

Net Operating Loss Carryovers

One major change is the treatment of Net Operating Loss (NOL) carryovers. As noted in the preamble to the proposed regulations, Revenue Ruling 67-93[2] allowed taxpayers to deduct NOL carryovers from income for a seasonal install-

ment payment before annualizing the income for that period, as though the period was a short taxable year. The IRS and Treasury disagreed with this treatment. The proposed regulations require taxpayers to annualize taxable income before taking into account a NOL carryover and then reduce the annualized amount by the NOL carryover in calculating the installment payment due for the period. As a result, Rev. Rul. 67-93 will become obsolete when the proposed regulations become effective.

Pepper Perspective

Taxpayers should begin planning implementation strategies for the new proposed regulations in 2006, including working with treasury functions to inform them of the new cash requirements that might be placed on their respective company as a result of the proposed regulations. Also, the Treasury and IRS are soliciting comments before February 22, 2006 on these proposed regulations.

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ENDNOTES

[1] *See* Prop Regs § 1.6655-2.

[2] 1967-1 C.B. 366.

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