

Department of the Treasury
Internal Revenue Service
Chief Counsel Advice Memorandum

CCA 202134017 - Section 1442 - Withholding of Tax on Foreign Corporations

Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Proposed Withholding Tax Adjustment in Abusive Foreign Microcaptive Cases

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Background

In a typical abusive microcaptive arrangement involving a foreign entity, the following facts are generally present:

- A foreign entity ("**Captive**") makes a § 953(d) election to be treated as a domestic corporation;
- A domestic entity ("**Taxpayer**") makes payments directly to Captive that are claimed to be deductible insurance premiums;
- Taxpayer neither withholds any tax on the payments to Captive nor files a withholding tax return (Form 1042 , *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*); and
- Captive and Taxpayer are controlled, directly or indirectly, by the same person(s).

As a result of an examination, it may be determined that payments to Captive are not insurance premiums (because the arrangement does not involve insurance risk, there is no risk distribution, there is no risk shifting, and/or the arrangement is not insurance in its commonly accepted sense) and a revenue agent may deny Taxpayer's claimed deduction. If the payments to Captive are not for insurance, then Captive does not qualify as an insurance company under §§ 831(c) and 816(a) because more than half of the business of Captive was not insurance. In these cases, the payments made by Taxpayer to Captive may be properly asserted by a revenue agent to be amounts for which Taxpayer has a burden to prove that it does not have a withholding liability under § 1461 . The revenue agent may propose a withholding tax adjustment to Taxpayer in addition to denying Taxpayer's claimed deduction. We believe that such withholding tax adjustment should be successful. For purposes of completing *Form 886 A , Explanation of Items*, sample language for the withholding tax adjustment is provided below.

Sample Language

As a result of an examination, it has been determined that the amounts paid by Taxpayer to Captive were not insurance premiums for federal tax purposes because for **[INSERT TAX YEARS]**, the arrangements failed to meet **[LIST RELEVANT FACTORS: the risk shifting requirement, risk distribution requirement, insurable risk requirement, and/or the insurance in the commonly accepted sense requirement]** and Captive did not qualify as an insurance company for federal tax purposes for **[INSERT TAX YEARS]**. As such, Captive failed to meet the requirements of § 953(d) to be treated as a domestic corporation and, for federal income tax purposes, Captive was a foreign corporation for **[INSERT TAX YEARS]**.

Section 1442 generally imposes a withholding obligation with respect to payments of a type described therein made to a foreign corporation. Section 1461 considers any person that is required to deduct and withhold amounts to which § 1442 applies to be liable if it does not do so. A withholding agent that is related to a recipient within the meaning of § 482 is considered to have knowledge of the facts that give rise to a payment upon which withholding may be imposed, given that it is not able to rely on the exception to this requirement that is specified in Treas. Reg. § 1.1441 2(d) . Additionally, a withholding agent cannot rely upon a payee's claim of status as a U.S. or foreign person when it has actual knowledge or reason to know that the claim is unreliable or incorrect (or if no claim is made, may not rely on a presumption of a payee's status that would otherwise apply under § 1441 when it has actual knowledge or reason to know of facts contrary to the presumption). See Treas. Reg. §§ 1.1441 1(b)(2)(vii) (reliable association with documentation); 1.1441 1(b)(3)(ix) (requirement to withhold based on higher rate than applies under presumption); and 1.1441 1(d)(1)

(reliance on a payee's claim of U.S. status).

Because Taxpayer and Captive are owned or controlled, directly or indirectly, by the same interests, for purposes of assessing its withholding obligations, Taxpayer is considered under Treas. Reg. § 1.1441-2(d) to have knowledge of the fact that the purported premiums it paid to Captive were not made for actual insurance. Similarly, Taxpayer is considered to have knowledge that, because the arrangements were not insurance and therefore more than half the business of Captive was not insurance, Captive did not qualify as an insurance company under §§ 831(c) and 816(a) and thus Captive failed to meet the requirements of § 953(d) to be treated as a domestic corporation. Thus, Taxpayer should be treated as having knowledge of Captive's status as a foreign corporation for § 1442 withholding purposes under § 1.1441-2(d) or the other aforementioned Treas. Reg. § 1.1441-1 requirements that would cause Taxpayer to have "reason to know" or "actual knowledge" that it may not treat Captive as a U.S. person and that would not permit Taxpayer to rely on any claim made by Captive regarding its status as a U.S. person.

Additionally, Taxpayer has failed to establish that the payments it made to Captive in **[INSERT TAX YEARS]** were amounts not subject to withholding of tax under § 1442 . Because Taxpayer did not establish that fact and failed to withhold and deposit such amounts, Taxpayer is liable for withholding tax of **[INSERT 30% OF AGGREGATE PAYMENTS MADE TO CAPTIVE IN ALL TAX YEARS AT ISSUE]**. See § 1461 .

Because Taxpayer did not establish that fact, Taxpayer was also required to file Form 1042 to report the payments and report and pay the tax withheld. See Treas. Reg. 1.1461-1(b)(1) . As Taxpayer failed to file a Form 1042 for each of **[INSERT TAX YEARS]**, the IRS may assess Taxpayer for its failure to withhold and deposit tax at any time. See § 6501(c)(3) .¹

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¹ Consider the following additional citation as clarification that withholding tax and income tax are separate liabilities: "See also *InverWorld v. Commissioner*, 98 T.C. 70 (1992), and *S K Liquidating Co. v. Commissioner*, 64 T.C. 713 (1975)." Such citation may be appropriate if, for example, the statute of limitations has expired with respect to Taxpayer's income tax liability for a taxable year that is one of the taxable years for which a withholding tax adjustment is proposed.