OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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October 28, 1998

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NORTH FLORIDA
CC:SER:NFL:JAX
ATTN: MICHAEL ZIMA

FROM: PHYLLIS E. MARCUS
BRANCH CHIEF CC:INTL:BR.2

SUBJECT:

This Field Service Advice responds to your memorandum dated January 17, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer

Parent

Individual A

Individual B

$c

$d

ISSUE:

Whether Taxpayer's failure to file Forms 1042 and 1042S and failure to make deposits of withholding tax was due to reasonable cause and not to willful neglect.

CONCLUSION:

There is insufficient information to determine whether Taxpayer's failure to file returns and make deposits was due to reasonable cause and not to willful neglect.

FACTS:

The facts may be summarized as follows. Taxpayer is a United States corporation, the wholly owned subsidiary of Parent, a Swiss corporation. Taxpayer was engaged in the business of locating real property, procuring European investors to purchase it, and then managing the property on behalf of the investors, guaranteeing the purchasers a return on their investment, and charging a management fee for itself. The investors were nonresident alien individuals.

Individual A, Taxpayer's president and a director of Taxpayer, was the corporate officer who primarily dealt with Taxpayer's investors. Individual B, a CPA and former tax manager for an insurance company, was the employee in charge of its tax return preparation function. Taxpayer's practice was to prepare Forms 1040NR for the investors and send them the returns for their signatures. In preparing the investors' returns, Taxpayer made elections under section 871(d) of the Internal Revenue Code for the investors, causing the investors' rental income to be treated as effectively connected with a United States trade or business. During its relationship with the investors, Taxpayer made guaranteed payments to the investors.

Payments to nonresident aliens were made in 1991 and 1992 in the respective amounts of $c and $d. Accordingly, payments subject to 30 percent withholding for tax years 1991 and 1992 were $c and $d.

Because of business disputes and resulting litigation with the investors, Taxpayer did not prepare any returns for the investors in 1991 and 1992. The investors, however, filed their own returns for those years and did not revoke their section 871(d) elections. The statute of limitations has run on the investors' returns. None of the investors filed Forms 4224 with Taxpayer for those years (or any years). Nevertheless, Taxpayer did not withhold any tax on the payments it paid over to the investors. Taxpayer did not file Forms 1042 and 1042S for 1991 and 1992. Individual A has stated that it was his understanding that Taxpayer had no

withholding obligation because the foreign investors had elected to treat their rental income as effectively connected with a United States trade or business, and that he relied on the tax professional employed by Taxpayer to ensure compliance with tax requirements.

It is proposed to issue a notice of deficiency to Taxpayer abating the withholding tax under section 1463 of the Code, but charging the taxpayer with additions to tax under section 6651(a) for failure to file and section 6656 for failure to make timely deposit of tax.

In Taxpayer's view, penalties and interest should not apply because Taxpayer as payor did not violate the provisions of the withholding requirements, since Taxpayer had made section 871(d) elections on behalf of the investors on prior year returns, the rental payments made to the investors were deemed effectively connected with a U.S. trade or business and had been reported on their returns for 1991 and 1992 as such type of income. Thus, the rental payments were not subject to withholding under section 1441(c)(1) of the Code. Taxpayer asserts that section 1.1441-4(a) of the Income Tax Regulations, under which the investors were required to file Forms 4224 with Taxpayer in order to receive the rental payments free of withholding, is invalid because it adds an additional, nonstatutory requirement, in that it requires the filing of Form 4224 with the withholding agent. Taxpayer also asserts that it had good cause for its failure to file and make deposit of tax because it relied on the advice of tax professionals.

LAW AND ANALYSIS

Law

1. Duty to withhold

Section 1441(a) of the Code generally requires all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any items of income specified in section 1441(b) (to the extent that any of such items constitutes gross income from sources within the United States) of any nonresident alien individual to deduct and withhold a tax equal to 30 percent thereof.

Section 1441(b) of the Code specifies that rent is an item of income referred to in section 1441(a).

Section 1441(c)(1) of the Code provides an exception to the general rule of section 1441(a) as follows:

> No deduction or withholding under subsection (a) shall be required in the case of any item of income (other than compensation

> for personal services) which is effectively connected with the conduct of a trade or business within the United States and which is included in the gross income of the recipient under section 871(b)(2) for the taxable year.

Under section 871(d) of the Code, a nonresident alien individual who during the taxable year derives any income from real property held for the production of income and located within the United States may elect to treat all such income as income which is effectively connected with a trade or business in the United States. In that case, the income shall be taxable as provided in subsection (b)(1) whether or not the individual is engaged in trade or business within the United States. The election remains in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary. Under section 1.871-10(c)(1) of the regulations, if an election is in effect, the income to which the election applies shall be treated, for purposes of section 1.1441-4(a), as income which is effectively connected with the conduct of a trade or business in the United States by the taxpayer.

Section 1.1441-4(a)(1) of the Code provides in part:

> No withholding is required under section 1.1441-1 in the case of any item of income if such income is effectively connected with the conduct of a trade or business within the United States by the person entitled to such income and is includible in the person's gross income under section 871(b)(2)...for the taxable year and if the person has filed the statement prescribed by paragraph (a)(2) of this section...In determining whether an item of income from sources within the United States is, or is deemed to be, effectively connected with the conduct of a trade or business within the United States by the person entitled to the income, see...section 871(d)....

Under section 1.1441-4(a)(2) of the regulations, in order for the exemption to apply for any taxable year, the person entitled to the income must file with the withholding agent a statement in duplicate that the income described in the statement is, or is expected to be, effectively connected with the conduct of a trade or business within the United States and that such income is includible in his gross income for the taxable year. This statement must be filed with the withholding agent for each taxable year of the person entitled to the income and before payment of the income in respect of which it applies. The statement may be made on a properly executed Form 4224. The withholding agent is required to attach the statement to Form 1042S filed for the calendar year in which payment is made.

In Casa de la Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990), the Tax Court held that because the petitioner failed to meet the requirements of section 1.1441-4(a)(2) of the regulations, in that no Form 4224 was filed, the petitioner was not excepted from its duty to withhold tax on interest paid to a nonresident alien. The Court did not reach the merits of whether the nonresident alien's income was effectively connected with a United States trade or business for purposes of section 1441(c)(1). The petitioner in La Jolla did not challenge the validity of the regulation. See also Housden v. Commissioner, T.C. Memo 1992-91.

2. Validity of Regulation

Courts defer to regulations promulgated by the Secretary. The degree of such judicial deference depends upon whether the regulation is a legislative or interpretative regulation. There is no specific directive to the Secretary to promulgate regulations which execute section 1441 of the Code. Therefore, section 1.1441-4(a) is an interpretative regulation. Rowan Cos v. United States, 452 U.S. 237, 253 (1981).

An interpretative regulation must be upheld if it "implements the Congressional mandate in some reasonable manner." National Muffler Dealers Association, Inc. v. United States, 440 U.S. 472, 476 (1979) (quoting United States v. Cartwright, 411 U.S. 546, 550 (1973)). In determining whether an interpretative regulation implements the Congressional mandate in some reasonable manner, the Court must examine whether it "harmonizes with the plain language of the statute, its origin, and its purpose." National Muffler Dealers Association, supra at 477. Such a regulation cannot be declared invalid unless it is "unreasonable and plainly inconsistent with the revenue statutes." Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948).

Recently, the Supreme Court has further clarified the test for determining the validity of an interpretative regulation. First, the Court inquires whether the intent of Congress is clear as to the precise question at issue. Nations Bank v. Variable Annuity Life Insurance Co., 513 U.S. 810, 813 (1995), citing Chevron U.S.A. v. Natural Resources Defense Counsel, Inc., 467 U.S. 837, 842 (1984). If so, that is the end of the matter. Id. But if the statute is silent or ambiguous with respect to the specific issue, the question for the Court is whether the agency's answer is based on a permissible construction of the statute. Id. At 843. If the administrator's reading fills a gap or defines a term in a way that is reasonable in light of the legislature's revealed design, the Court would give the administrator's judgment controlling weight. Id. At 844. The Supreme Court has acknowledged that "the choice among reasonable interpretations is for the Commissioner, not the Courts." National Muffler Dealers Association, supra at 488.

Section 1441(c)(1) of the Code was enacted by section 103(h)(5) of the Foreign Investors Tax Act of 1966, P.L. 89-809. The Senate Finance Committee Report contains the following:

> ...Under the new provision, withholding is not required on payments to nonresident alien individuals with respect to any item of income (other than compensation for services) which is effectively connected with the conduct of a trade or business within the United States. It is the understanding of your committee that the person required to withhold will be relieved of any liability for failure to withhold if the failure was in reliance upon information as to whether or not the income was effectively connected, furnished (in accordance with regulations to be issued) by the person entitled to the receipt of the income.

S. Rep. No.1707, 89th Cong., 2d Sess. (1966), at 30.

3. Penalties

Section 1463 of the Code provides that if a withholding agent fails to deduct and withhold tax as required and thereafter the tax against which such tax may be credited is paid, then the tax shall not be collected from the withholding agent, but in no case shall this section relieve such person from liability for interest or any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

Section 6651(a) of the Code imposes a penalty for failure to file an income tax return, unless it is shown that such failure is due to reasonable cause and not to willful neglect. Form 1042 is an income tax return. Northern Indiana Public Service Co. v. Commissioner, 101 T.C. 656 (1994). Section 6656(a) imposes a penalty for failure to make deposit of tax with the same exception for reasonable cause.

Section 301.6651-1(c)(1) of the regulations states that:

> [i]f the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.

The responsibility to file returns and pay tax rests upon the taxpayer and cannot be delegated. The taxpayer must bear the consequences of any negligent errors committed by its agent. Logan Lumber Co. v. Commissioner, 356 F.2d 846, 854 (5th Cir. 1966). There is an exception to this rule. When the taxpayer selects a competent tax advisor and supplies him with all relevant information, it is consistent with ordinary business care and prudence to rely upon his judgment. United States

v. Boyle, 469 U.S. 241 (1985). In Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner, T.C. Memo 1995-610, the Court held that:

> In order to qualify for this exception the taxpayer must demonstrate that: (1) Its tax advisor or return preparer had sufficient expertise to justify reliance... [citations omitted], (2) the taxpayer provided necessary and accurate information... [citations omitted], and (3) the taxpayer actually relied in good faith on the tax advisor's or return preparer's judgment... [citations omitted].

Reliance on an in-house tax advisor is treated as equivalent to reliance on an independent tax advisor. Burrus Land and Lumber Co., Inc. v. Commissioner, 349 F. Supp. 188 (W.D. Va. 1972). The Tax Court has held that a taxpayer that had not obtained Form 4224 with respect to effectively connected income and had not filed returns or withheld tax in reliance on the erroneous advice of his tax advisor had reasonable cause for his failure to file returns and make deposits. Housden, supra. See also Coldwater Seafood Corp. v. Commissioner, 69 T.C. 966 (1978).

Analysis

1. Application of section 1.1441-4(a)

During 1991 and 1992, Taxpayer collected and paid over rents to nonresident aliens. Since rent is an item of income specified in section 1441(b) of the Code, Taxpayer had a duty to deduct and withhold the 30 percent tax under section 1441(a), unless the exception under section 1441(c)(1) applied.

In order for the exception under section 1441(c)(1) of the Code to apply, the investors must have had income effectively connected with the conduct of a United States trade or business that was includible in their gross income, and to have filed Forms 4224 or equivalent statements to that effect with the withholding agent. Section 1.1441-4(a). Assuming valid elections under section 871(d) of the Code were made, section 1.871-10(c)(1) of the regulations provides that the rental income would be treated as effectively connected income for purposes of section 1.1441-4(a) (and thus, section 1441(c)(1)). Therefore, if the investors had filed Forms 4224 with Taxpayer for 1991 and 1992, it would be clear that Taxpayer would not have been required to withhold on the rental payments. Forms 4224 were never filed with Taxpayer for 1991 and 1992. The investors, however, had previously made elections under section 871(d). Because Taxpayer previously had prepared and filed the investors tax returns for years prior to 1991 and 1992, it knew the elections had been made. Since Taxpayer never received Forms 4224 from the nonresident aliens as required by section 1.1441-4(a) of the regulations, the exception under section 1441(c)(1) does not literally apply, and Taxpayer was

required to withhold the 30 percent tax. Under La Jolla and Housden, the analysis goes no further. The analysis does not reach the question of whether the income was in fact effectively connected, or the question of the withholding agent's knowledge or lack of knowledge of this fact, because Taxpayer was not in receipt of Forms 4224 from the investors making the claim that their rental income is effectively connected.[1]

2. Validity of regulation

Taxpayer asserts that section 1.1441-4(a) of the regulations, under which the investors were required to file Forms 4224 with Taxpayer in order to receive the rental payments free of withholding, is invalid because it adds an additional, nonstatutory requirement, in that it requires the filing of Form 4224 with the withholding agent.

It is District Counsel's position that section 1.1441-4(a) of the regulations is a valid exercise of the authority to issue interpretive regulations. We agree that the regulation is valid.

The procedures set forth in section 1.1441-4(a) of the regulations are not unauthorized simply because they are not also set forth in section 1441(c)(1) of the Code. The Senate Finance Committee report specifically authorizes regulations setting forth procedures for the furnishing of information by the nonresident alien to the withholding agent. As stated in the report, Congress intended that a withholding agent might pay over income to a nonresident alien without withholding in reliance on information furnished by the nonresident alien that the income is effectively connected. The procedures set forth in section 1.1441-4(a) are a simple and practical way to implement Congress' intention as to how the statute should work.

On Form 4224, a nonresident alien simply makes the claim that the identified income is or is expected to be effectively connected with the conduct of a trade or business within the United States. In requiring that Form 4224 be filed with the withholding agent so that the withholding agent may pay over and the nonresident alien may receive the identified income free of withholding, the regulation does not impose an unreasonable burden on either of them.

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[1]For prior years in which Taxpayer prepared the investors' tax returns including making the section 871(d) election, this analysis leads to an incongruous result. In these circumstances to require investors to file Forms 4224 would be superfluous since Taxpayer itself had made the section 871(d) elections treating the rental income as effectively connected on behalf of the investors in preparing the investors' tax returns.

In summary, the legislative history contemplates that regulations would be issued governing the manner in which information would be furnished to the withholding agent upon which the withholding agent could rely to release payment without withholding tax; section 1.1441-4(a) prescribes a reasonable method to accomplish this; thus, section 1.1441-4(a) is valid.

3. Imposition of penalties

Taxpayer remains liable for interest and penalties on the tax that Taxpayer failed to withhold. The penalties include the additions to tax under section 6651(a) for failure to file a return and under section 6656 for failure to make deposit of tax, unless the failures were due to reasonable cause and not to willful neglect.

The facts relevant to determining whether Taxpayer exercised ordinary business care and prudence in reliance on its tax advisor have not been fully developed. The relevant known facts are as follows. Individual B, who was in charge of tax preparation, was a CPA and had worked as a tax manager at an insurance company. It needs to be determined that Individual B had sufficient expertise to justify Taxpayer's reliance and that Individual B was aware of all relevant information. Therefore, additional information requested should include the tax information provided to the investors for 1991 and 1992, who provided the information, and when that information was provided. Also, you need to verify that Individual B had previously prepared all of the returns for the investors up until 1991, and that Individual B was aware that section 871(d) elections had been made by the investors. Individual A has stated his understanding that the section 1441(c)(1) exception was applicable and his reliance on the tax professionals employed by Taxpayer. Because Individuals A's statement suggests more than one tax professional was used as an advisor, you need to determine whether Individual A is claiming that he relied on more than Individual B. If so, you need to ascertain who those persons were and their relationship(s) to Taxpayer. This statement does suggest, however, that Taxpayer was aware of the tax issue and that he had relied in good faith on his tax advisor's judgment. The facts developed so far do not permit the inference that Taxpayer, in relying on his tax advisor's judgment, was negligent or that he willfully disregarded the law.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We disagree with your proposed approval of the issuance of the notice of deficiency. We agree that section 1.1441-4(a) of the regulations is a valid exercise of the Commissioner's authority and applicable to Taxpayer. Thus, absent the filing of the Forms 4224, Taxpayer was required to withhold tax on the rental payments made to investors. [redacted]

[redacted].

If you have any further questions, please call Carl Cooper at (202) 622-3840.

/s/ Phyllis E. Marcus
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