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# IRS Proposes to Clarify Retirement and Annuity Elective Withholding Rules for Payees with Foreign Addresses

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**Authors**

Fred Farkash, CEBS, Fellow-ISCEBS

Marjorie Martin, FSPA, EA, MAAA

IRS proposes to update their elective withholding requirements for retirement plan distributions (other than eligible rollover distributions) sent to payees with foreign addresses. The proposal clarifies that payees can provide U.S. military or diplomatic post office addresses to opt out of withholding, but that a payee who fails to provide a U.S. address cannot opt out of withholding even if the funds are directed to a financial institution in the U.S.

## Background

As IRS explained in Notice 87-7, the payor of periodic or nonperiodic distributions made from an employer deferred compensation plan, individual retirement plan, or commercial annuity must withhold an amount from the distribution for payment of the payee's income taxes. For this purpose, an employer deferred compensation plan is a pension, annuity, profit sharing, stock bonus plan, or other retirement plan that provides for deferral of compensation. The payee may opt out of withholding under these section 3405 rules unless the distribution is delivered outside of the U.S. (for this purpose, “U.S.” includes possessions). The notice went on to provide these three instructions:

1. **Payees who provide the payor a residence address outside of the U.S.** The payor must withhold, and the payee cannot elect out of such withholding.
2. **Payees who provide the payor with a residence address within the U.S.** The payor is required to withhold from distributions made to the payee unless the payee has elected out of such withholding.
3. **Payees who have not provided a residence address to the payor.** The payor must withhold, and the payee cannot elect out of such withholding. This includes a payee who has provided the payor with an address for the payee's nominee, trustee, or agent without also providing the payee's residence address.

However, the payor need not withhold under these rules if the payee certifies under penalties of perjury that he or she is not a citizen or resident alien of the U.S. or a person who is considered to have expatriated for the principal purpose of avoiding U.S. tax. Individuals who so certify may be exempt from tax withholding under these rules; however, they may also be nonresident aliens of the U.S. who are subject to 30 percent nonresident alien tax withholding on their U.S. source income (unless they validly claim exemption from tax, or that a lower treaty rate applies to their payment under a U.S. tax treaty with their country of residence).

**Buck comment.** Several types of distributions are not subject to these elective withholding rules — such as eligible rollover distributions paid from a retirement plan (subject to 20 percent mandatory federal income tax withholding unless the payee elects to directly roll over the distribution to an eligible retirement plan), payments from nonqualified plans (that are considered wages subject to the regular wage withholding rules), the non-taxable portion of a distribution (such as the after-tax contributions recovered tax-free from a retirement plan distribution), and ESOP pass-through dividend distributions.

## IRS proposes regulations

Proposed regulations would memorialize the 1987 guidance and add refinements for payees with a military or diplomatic post office address and for payments directed to an address outside the U.S.

**U.S. Military or diplomatic address.** These addresses are treated as domestic addresses rather than foreign. Payors do not need to force withholding as is the case with foreign addresses in general.

**Domestic residence address with foreign payment instruction.** The proposed regulations would require withholding when any periodic or nonperiodic distribution is to be delivered to a financial institution or other person located outside the U.S. This would include payments wired to a U.S. financial institution with “further credit to” instructions directing the financial institution to forward the payment to a financial institution or other person outside the U.S. It would also include distributions that reference an International Automated Clearing House Transaction (IAT), International Bank Account Number (IBAN), or Society for Worldwide Interbank Financial Telecommunication (SWIFT) Code that is linked to a foreign financial institution or another person outside the U.S.

**Foreign address or no address.** For both situations, the lack of a domestic address triggers mandatory income tax withholding — an election out of withholding cannot be honored. This is true even if the delivery instructions direct that funds be deposited with a financial institution located within the U.S.

**Different rules for nonresident aliens.** The proposed regulation would also clarify that these elective withholding rules do not apply to nonresident aliens (or individuals who are presumed to be nonresident aliens) even if treaty benefits apply. For such participants, withholding is controlled by IRC 1441, which generally requires 30 percent withholding on the U.S. source income portion of the distribution unless a proper claim for treaty benefits is made (typically using IRS Form W8-BEN and furnishing an International Tax Identification Number, or ITIN).

> **Buck comment.** The IRS presumption rules under the section 1441 regulations generally provide that if a payee does not provide IRS Form W-9 (to tell the payer they are a U.S. citizen or resident alien, also known as a "U.S. person") or if a payee does not provide the payor with a U.S. Social Security number and a mailing address that is either in the U.S. or in a country that has a tax treaty with the U.S. that would exclude the payment from tax if the payee was a resident of that country, then the payee would be presumed to be a nonresident alien (and subject to nonresident alien withholding). Notably the 1441 presumption rules only require a *mailing address* in a foreign country that exempts pension and annuity income under a tax treaty with the U.S., not necessarily a *residence address* in that country to be treated as a U.S. person.
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> Since the proposed regulations incorporate the section 1441 regulations by reference, the section 1441 regulations are first applied to determine whether a payee is presumed to be a U.S. person or nonresident alien. Then, if the section 1441 presumption rules allow you to treat a person with a foreign mailing address as a U.S. person (based on providing a Social Security number and a mailing address being in a country that exempts U.S. source pension or annuity income under a tax treaty), such an individual apparently would, under the proposed regulation, not be allowed to elect out of federal income tax withholding under the elective withholding rules (unless the payee is a nonresident alien who submits IRS form W8-BEN to claim treaty benefits to avoid U.S. income tax withholding). If the presumption rules require the payor to treat a payee as a nonresident alien, the payee would be exempt from tax withholding under the elective withholding rules but would be required to have income tax withheld on U.S. source income at 30 percent or at whatever lower treaty rate applies under a tax treaty (if the claim of a lower treaty rate on Form W8-BEN is valid).

## Effective date and reliance

Payors may continue to follow Notice 87-7 until this proposed regulation is finalized. Alternatively, they may rely on the modified guidance described in the proposed rule. The IRS asks that any comments on the proposal be submitted no later than August 29, 2019.

## In closing

Plan administrators may wish to review their current procedures for handling payments of distributions other than rollovers when a foreign address, or no address, is provided.

In addition, confirm that appropriate withholding procedures are in place for nonresident aliens who may or may not be able to claim treaty benefits. Such payments are not only subject to special withholding rules, they are also reportable on IRS Form 1042-S instead of IRS Form 1099-R. Also, if there are foreign payees in your plan who live in a foreign country that totally excludes U.S. source pension and annuity income under a tax treaty, such payees may need to file form W8-BEN with the payor to avoid U.S. elective income tax withholding being taken from their distributions once these regulations are implemented by the payor.

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