Tax reform includes important information reporting and withholding changes

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In brief

The 2017 tax reform and reconciliation act (the Act), enacted on December 22, 2017, makes important changes to information reporting and withholding tax rules, including:

- A new federal tax withholding requirement relating to certain transfers of partnership interests;
- New reporting requirements relating to:
    - the sale of certain life insurance contracts, and
    - the receipt of fines, penalties, and other amounts from certain taxpayers; and
- Changes to various non-payroll withholding tax rates that are tied to individual and corporate income tax rates.

Observations: *Taxpayers may need to implement changes immediately to their policies and procedures to conform to the new rules. Also, taxpayers reorganizing or restructuring in light of US tax reform should consider the impact the tax reform changes have on their tax withholding and reporting profile. Restructuring could cause changes in the source of income being paid or the status of a taxpayer (e.g., from non-US payor to US payor, or vice versa). Taxpayers should determine whether they are subject to new or additional tax withholding or information reporting obligations as a result of restructuring efforts due to US tax reform.*

In detail

New withholding requirements on certain transfers of partnership interests

The Act requires transferees to withhold 10 percent of a non-US transferor's amount realized from the disposition of an interest in a partnership where the gain or loss on the sale is treated as effectively connected income (ECI) under new Section 864(c)(8) of the Internal Revenue Code (Code). The withholding provision under new Code Section 1446(f)(2) provides that withholding generally is not required if the transferor furnishes an affidavit to the transferee stating, among other things, that the transferor is not a foreign person.

New Section 864(c)(8) provides that a nonresident alien individual's or foreign corporation's gain or loss from the sale, exchange, or other disposition of a partnership interest occurring on or after November 27, 2017 generally is treated as effectively connected with the conduct of a trade or business in the United States to the extent that the person would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value on the date of the sale or exchange.

If the transferee fails to withhold, the partnership must withhold from distributions to the transferee partner the amount the transferee failed to withhold.

Observation: *Given the complexity of determining when withholding is applied in the public market where the partnership is not a party to a transfer, the IRS on December 29, 2017 issued Notice 2018-08, suspending application of the new Section 1446(f) withholding requirement in the case of a disposition of an interest in a publicly traded partnership. The suspension is intended to allow the IRS time to provide appropriate guidance on implementation of the new requirement. The Notice does not suspend the Code Section 1446(f) withholding requirement with respect to dispositions of interests in non-public partnerships, nor does the suspension affect the underlying tax liability associated with ECI.*

The Notice indicates that the forthcoming guidance will be prospective and will include transition rules that are intended 'to allow sufficient time' to prepare for implementation of the rules. The IRS asks for comments on the need for a similar suspension with regard to partnerships other than publicly traded partnerships.

New reporting requirements relating to certain life insurance contract transactions

The Act imposes reporting requirements on the purchase of a life insurance contract in a reportable policy sale — i.e., an acquisition of an interest in a life insurance contract where the purchaser has no family, business, or financial relationship with the seller (other than the acquisition of the contract). The Act also imposes reporting requirements when reportable death benefits are paid.

Under the rules for reportable policy sales, the buyer and the issuer of the insurance contract are subject to the following requirements:

- Buyer's obligation to report policy sales: The buyer of a life insurance contract in a reportable policy sale must report information to the IRS, the insurance company that issued the contract, and the seller, including:
  - the buyer's name, address, and taxpayer identification number (TIN);
  - the name, address, and TIN of each recipient of payment in the sale;
  - the date of the sale;
  - the name of the issuer; and
  - the amount of each payment.

The statement the buyer provides to the issuer of a life insurance contract is not required to include the amount paid for the purchase of the contract.

- Issuer's obligation to report policy sales: Upon receipt from the buyer of the information described above, or receipt of any notice of the transfer of a life insurance contract to a foreign person, the issuer of the policy must report the information to the IRS and the seller regarding the seller's investment in the contract. Information required to be reported includes:
  - the name, address, and TIN of the seller or transferor to a foreign person;
  - the basis of the contact, and
  - the policy number of the contract.

Observation: *According to the conference agreement explanation of the Act, notice of the transfer of a life insurance contract to a foreign person triggering the issuer's obligation to report could include any sort of notice, including information provided for non-tax purposes, such as change of address notices, or information relating to loans, premiums, or death benefits with respect to a contract.*

- Reportable death benefits: When a reportable death benefit is paid under a life insurance contract, the payor insurance company must report information about the payment to the IRS and to the payee. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale. Information required to be reported includes:
  - the name, address, and TIN of the person making the payment;
  - the name, address, and TIN of each recipient of a payment;
  - the date of each such payment;
  - the gross amount of the payment; and
  - the payor's estimate of the buyer's basis in the contract.

Observation: *The use of insurance policies, which have long been acknowledged as vehicles to build or accumulate wealth, also has been the focus of a number of cases dealing with tax evasion and financial disclosure laws. This provision* *continues the trend toward increased transparency by requiring additional information reporting in this area.*

These new reporting provisions are intended to provide information needed by taxpayers and the IRS to determine gain or loss on reportable policy sales and the amount of a death benefit payment that is taxable.

Under the Act, the new reporting requirements are effective for reportable policy sales after December 31, 2017 and for reportable death benefits paid after December 31, 2017. The Act provides that the required information is to be furnished 'at such time and in such manner' as the US Department of the Treasury (Treasury) provides; such guidance has not yet been issued.

New reporting requirements with respect to certain fines, penalties, and other amounts

The Act denies deductibility for amounts paid to or at the direction of a government (or specified nongovernmental entities) in relation to the violation of a law, or the investigations into potential violation of a law, exceptions. Exceptions apply for amounts paid for restitution or to come into compliance with a law that was violated, or involved in the investigation, and for amounts paid or incurred as taxes due.

In order to provide the IRS and taxpayers information regarding amounts paid (whether by suit, agreement, or otherwise) in relation to the violation of a law the Act imposes a new requirement on government agencies to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount that the government required or directed to be paid or incurred exceeds $600. The report also must separately identify amounts that are for restitution or remediation of property or correction of noncompliance, as these may be deductible, whereas fines and penalties generally would not be deductible.

Observation: *Although taxpayers will not be subject to this new reporting requirement (governmental agencies will be required to report), taxpayers could be impacted if they pay fines, penalties, amounts pursuant to settlement agreements or orders entered into with governmental agencies, etc. Under the new reporting requirement, upon the payment of fines, penalties, and other amounts, impacted taxpayers are to be provided a report from the recipient governmental agency.*

The Act provides that the deduction denial and the new governmental reporting provision generally are effective for amounts paid or incurred on or after December 22, 2017 (the date of enactment), with exceptions for amounts paid or incurred under binding orders or agreements entered into before December 22, 2017. The Act provides that the required information is to be furnished by the appropriate governmental or other official 'in such form as determined' by Treasury; such guidance not yet been issued.

Changes to various non-payroll withholding tax rates tied to individual and corporate tax rates

Since certain non-payroll withholding tax rates are linked to individual and corporate tax rates, the Act's reduction of individual and corporate tax rates resulted in a corresponding reduction in the following non-payroll withholding tax rates:

- The backup withholding rate under Code Section 3406 changed from 28 percent to 24 percent (rate tied to fourth lowest individual rate);
- The withholding rate on gains from certain dispositions of US real property interests (USRPIs) by domestic partnerships, estates and trusts, foreign corporations, regulated investment companies (RICS), and real estate investment trusts (REITs) changed from 35 percent to 21 percent (tied to highest corporate rate) under Code Section 1445(e) (commonly known as FIRPTA, the Foreign Investment in Real Property Tax Act);
- The withholding rate on a foreign partner's share of ECI changed from 35 percent to 21 percent (tied to highest corporate rate) for corporate partners and from 39.6 percent to 37 percent (tied to highest individual rate) for non-corporate partners under Code Section 1446.

The takeaway

Taxpayers should review the impact of tax reform on US withholding tax and information reporting requirements to determine whether existing processes and procedures should be modified. As noted above, Treasury has not yet issued guidance (e.g., regulations, Notices, or forms) as to how certain information reporting is to be furnished so taxpayers need to stay alert to issuance of such instructions.

Let's talk

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