

Notice of Proposed Rulemaking and Notice of Public Hearing

Withholding on Interest in the Case of Sales of Obligations Between Interest Payment Dates

REG-114000-97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This notice of proposed rulemaking provides guidance regarding the obligation to withhold on interest paid with respect to obligations in the case of the sale of obligations between interest payment dates. These regulations would affect United States and foreign withholding agents and recipients. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of oral comments to be presented at the public hearing scheduled for January 26, 1998, at 10 a.m. must be received by January 5, 1998.

ADDRESSES: Send submission to: CC:DOM:CORP:R (REG-114000-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Reg-114000-97), Courier desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.us-treas.gov/prod/tax_regs/comments.html. The hearing scheduled for January 26, 1998, will be held in the Commissioner's Conference Room, room 3313, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lilo Hester at (202) 622-3840 (not a toll-free number); concerning submissions and the hearing, Evangelista Lee, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

In T.D. 8734, 1997-44 I.R.B. 5, the IRS and Treasury published final withholding and reporting regulations under chapter 3 of the Internal Revenue Code (Code) and other sections of the Code. Section 1.1441-3(b)(2) of the final regulations provides that no withholding is required upon interest accrued on the date of a sale of debt obligations when the sale occurs between two interest payment dates, even though the amount is treated as interest under §1.61-7(c) or (d) and is subject to tax under section 871 or 881. In contrast, §1.1441-2(b)(3) of the final regulations provides that withholding is required on amounts of original issue discount in the event of a sale of an original issue discount obligation or a payment on such an obligation, subject to certain exceptions. The IRS and Treasury believe that, in view of these provisions, the exemption from withholding on non-OID amounts is no longer justified. A withholding agent that pays amounts to a foreign person in connection with the sale of an obligation between interest payments dates is in the same position as a withholding agent that pays amounts to a foreign person in connection with the sale of an original issue discount obligation. The withholding exemption for sale of debt obligations between interest payment dates provides an easy avenue for the avoidance of the documentation requirements imposed under sections 871(h) and 881(c) for purposes of qualifying interest on registered debt obligations as portfolio interest. For this reason, and in order to create parity with the tax treatment of original issue discount obligations under chapter 3 of the Code, it is no longer appropriate to continue this exemption.

Under §1.1441-2(b)(3), a withholding agent must withhold on an amount of original issue discount to the extent that it has actual knowledge of the proportion of the amount of the payment that is taxable to the beneficial owner under section 871(a)(1)(C) or 881(a)(3)(A). A withholding agent has actual knowledge if it knows how long the beneficial owner has held the obligation, the terms of the obligation, and the extent to which the benefi-

cial owner purchased the obligation at a premium. A withholding agent is treated as having knowledge if the information is reasonably available. Special rules are provided for withholding agents with which the beneficial owner does not maintain a direct account relationship. Further, the regulations under §1.1441-2(b)(3) dealing with original issue discount provide that, in the case of an obligation that would qualify as portfolio interest if documentation were provided to the withholding agent, withholding is required on the entire amount of stated interest, if any, and original issue discount, if no such documentation is provided, irrespective of whether the withholding agent has knowledge of the portion of the payment representing taxable original issue discount. For this purpose, the withholding agent may rely upon the IRS "List of Original Issue Discount Instruments" contained in IRS Publication 1212 (available from the IRS Distribution Centers).

In response to comments, the provisions in §1.1441-3(b)(1) are proposed to be modified to reduce the amount upon which withholding is required. No obligation to withhold is imposed under current law on the payment of stated interest on an obligation that was purchased between interest payment dates. Under §1.61-7(c), interest received on the interest payment date is treated as a return of basis to the extent it represents accrued unpaid interest as of the date of purchase as reflected in the new holder's basis for the obligation. Therefore, when the new holder receives a payment of the stated interest, the holder's tax liability is limited to the amount of interest accrued after the date of purchase (subject to additional adjustments reflecting possible acquisition premiums or market discounts). Because of the difficulty for a withholding agent to determine the amount accrued to the holder and other adjustments affecting the actual amount taxable to the holder, withholding on the entire amount of stated interest is required under the current withholding regulations under §1.1441-3(b)(1).

Commentators have asked that the withholding agent be permitted to withhold on the amount that it knows is taxable. The final withholding regulations did not modify the proposed regulations on this point because the Treasury and IRS consider that withholding on the en-

tire amount is justified if withholding on sales of obligations between interest payment dates is not required. However, because these proposed regulations require withholding, the regulations permit a withholding agent to adjust the amount of withholding at the time of payment of stated interest to account for earlier withholding.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 26, 1998, at 10 a.m. in the Commissioner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitution Ave, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit comments and an outline of the topics to be discussed and the time to be devoted to each topic by January 5, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has

passed. Copies of the agenda will be available free of charge at the hearing.

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Proposed Amendments to the Regulations

Accordingly, CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.1441-3, paragraph (b) is revised to read as follows:

§1.1441-3 Determination of amount to be withheld

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(b) *Withholding on payments on certain obligations*—(1) *Withholding at time of payment of interest.* When making a payment on an interest-bearing obligation, a withholding agent must withhold under §1.1441-1 upon the gross amount of stated interest payable on the interest payment date, regardless of whether the payment constitutes a return of capital or the payment of income within the meaning of section 61, unless the withholding agent has knowledge of the actual amount of interest paid. For this purpose, the withholding agent may rely on information provided by the issuer (or its paying agent), on a representation from the beneficial owner, or on information that the withholding agent has in its records. To the extent an amount was withheld on an amount of capital rather than interest, see rules for adjustments, refunds, or credits under §1.1441-1(b)(8).

(2) *No withholding between interest payment dates*—(i) *General rule.* A withholding agent is not required to withhold under §1.1441-1 upon interest accrued on the date of a sale of debt obligations when that sale occurs between two interest payment dates (even though the amount is treated as interest under §1.61-7(c) or (d) and is subject to tax under section 871(a) or 881(a)), unless the withholding agent has knowledge of the amount paid as interest. For purposes of this paragraph (b)(2)(i), a withholding agent is treated as having knowledge in the same manner as a withholding agent has knowledge for

purposes of §1.1441-2(b)(3)(ii), dealing with withholding on original issue discount. In addition, notwithstanding lack of knowledge (within the meaning of §1.1441-2(b)(3)(ii)), withholding is required on the entire amount of stated interest paid with respect to the obligation as determined as of the date of original issue if the withholding agent, pursuant to the provisions in §1.1441-1(b)(3), treats the payment as made to a foreign payee because it cannot associate the payment with required documentation and the amount would qualify as portfolio interest. See §1.1441-1(b)(8) for adjustments to any amount that has been overwithheld as a result of this provision.

(ii) *Applicable rules.* Any exemption from withholding pursuant to paragraph (b)(2)(i) of this section applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6049 and backup withholding under section 3406. See §1.6045-1(c) for reporting requirements by brokers with respect to sale proceeds. Any exemption from withholding under paragraph (b)(2)(i) of this section is not a determination that the accrued interest is not fixed or determinable annual or periodical income. See §1.61-7(c) regarding the character of payments received by the acquirer of an obligation subsequent to such acquisition (that is, as a return of capital or interest accrued after the acquisition).

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Michael P. Dolan,
*Acting Commissioner of
Internal Revenue.*

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