



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[REG-132240-15]

RIN 1545-BN52

Withholding on Certain Distributions under Section 3405(a) and (b)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains a proposed regulation regarding withholding on certain periodic and nonperiodic distributions under section 3405, other than eligible rollover distributions. This regulation would affect payors and payees of these distributions.

DATES: Written or electronic comments and must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-132240-15), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-132240-15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov> (indicate IRS REG-132240-15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulation, Jeremy D. Lamb at (202) 317-6799; concerning submissions of comments, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

## **Background**

Section 3405(a)(1) requires the payor of any periodic payment to withhold income tax from the payment. Under section 3405(a)(2), an individual generally may elect not to have section 3405(a)(1) apply with respect to periodic payments made to the individual. Section 3405(b)(1) requires the payor of any nonperiodic distribution to withhold income tax from the distribution. Under section 3405(b)(2), an individual generally may elect not to have section 3405(b)(1) apply with respect to any nonperiodic distribution.

Section 3405(e)(2) defines a periodic payment as a designated distribution that is an annuity or similar periodic payment. Section 3405(e)(3) defines a nonperiodic distribution as any designated distribution that is not a periodic payment. A designated distribution generally is defined in section 3405(e)(1) as any distribution or payment from or under an employer deferred compensation plan, an individual retirement plan (as defined in section 7701(a)(37)), or a commercial annuity. For this purpose, an employer deferred compensation plan is defined in section 3405(e)(5) as any pension, annuity, profit sharing, or stock bonus plan or other plan deferring the receipt of compensation, and a commercial annuity is defined in section 3405(e)(6) as an annuity, endowment, or life

insurance contract issued by an insurance company licensed to do business under the laws of any State.

Section 3405(e)(1)(B) identifies certain amounts or payments that are not a “designated distribution” for purposes of section 3405 withholding. Under section 3405(e)(1)(B)(iii), any amount that is subject to withholding under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount or which would be so subject but for a tax treaty is not a designated distribution.

Section 3405(e)(13)(A) provides generally that, in the case of any periodic payment or nonperiodic distribution that is “to be delivered outside of the United States and any possession of the United States,” no election may be made under section 3405(a)(2) or (b)(2) with respect to such payment, with the result that withholding may not be waived. Section 3405(e)(13)(B) provides that section 3405(e)(13)(A) does not apply if the recipient certifies to the payor, in such manner as the Secretary of the Treasury may prescribe, that the recipient is not (i) a United States citizen or a resident alien of the United States, or (ii) an individual to whom section 877 applies. Section 877(h) provides that section 877 applies to certain nonresident alien individuals whose expatriation date, as defined in section 877A(g)(3), is before June 17, 2008.

Notice 87-7 (1987-1 C.B. 420), see §601.601(d)(2)(ii)(b), provides guidance under section 3405(e)(13)(A) to payors of designated distributions with respect to their duty to withhold income tax from such distributions. The notice addresses designated distributions to the following categories of payees: (1)

payees who have provided the payors with a residence address outside of the United States;<sup>1</sup> (2) payees who have provided the payors with a residence address within the United States; and (3) payees who have not provided the payors with a residence address.

Notice 87-7 specifies that, if a payee has provided the payor with a residence address outside of the United States, the payor is required to withhold income tax from designated distributions to the payee. If a payee has provided the payor with a residence address within the United States, the payor is required to withhold income tax from these distributions to the payee unless the payee has elected no withholding in accordance with the applicable provisions of section 3405. If a payee has not provided the payor with a residence address, the payor is required to withhold income tax from designated distributions; included within this category is 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.

### **Explanation of Provisions**

The Department of the Treasury and the IRS have concluded that Notice 87-7 generally provides an administrable standard with respect to withholding under section 3405 that is consistent with the purposes of the statute. Thus, the proposed regulation is based on the guidance provided in Notice 87-7. However,

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<sup>1</sup> For purposes of this preamble, references to the "United States" include any possession of the United States.

stakeholders have requested clarification regarding the application of Notice 87-7 and section 3405(e)(13)(A) in the following situations:

- The payee provides the payor with an Army Post Office (APO), Fleet Post Office (FPO), or Diplomatic Post Office (DPO) address.<sup>2</sup>
- The payee provides the payor with a residence address located within the United States but provides payment instructions that request delivery of the designated distribution to a financial institution or other person located outside of the United States.

The proposed regulation includes rules that would address these situations, and the regulation when finalized would supersede the guidance in Notice 87-7 for payors of designated distributions with respect to their duty to withhold under sections 3405(a)(1) or (b)(1).

#### A. Payees with a Military or Diplomatic Post Office Address

For purposes of section 3405(e)(13)(A), the proposed regulation treats an APO, FPO, or DPO address as an address located within the United States. In 1986, section 3405(e) was amended to add section 3405(e)(13) as one of several provisions intended to increase compliance with the internal revenue laws by United States persons resident abroad and green card holders. The legislative

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<sup>2</sup> Army Post Office (APO) is associated with Army or Air Force installations. Fleet Post Office (FPO) is associated with Navy installations and ships. APO/FPO addresses are utilized by Department of Defense personnel, their family members, and other authorized users. Diplomatic Post Office (DPO) provides global mail service to authorized personnel assigned to designated posts abroad.

history indicates that Congress was concerned, based on data gathered by the General Accounting Office (GAO),<sup>3</sup> that the percentage of taxpayers who fail to file returns is substantially higher among Americans living abroad than it is among those resident in the United States and that it is often difficult for the IRS to enforce compliance by these taxpayers. S. Rep. No. 99-313, pt. 4, at 390 (1986).

The GAO data referred to in the legislative history does not include United States military personnel and their families as taxpayers who are living abroad. Johnny C. Finch, United States Citizens Living in Foreign Countries and Not Filing Federal Income Tax Returns, United States General Accounting Office, May 8, 1985. In addition, enforcement of compliance by individuals receiving mail at an APO, FPO, or DPO address generally does not involve the same challenges as enforcing compliance by other taxpayers living abroad. Because APO, FPO, and DPO delivery destinations are generally United States military or diplomatic facilities, taxpayers with an APO, FPO, or DPO address commonly maintain a current or former employment or contractor relationship with the United States federal government. Moreover, these addresses are generally treated as “domestic” by the United States Postal Service. United States Domestic Mail Manual, 608.2.2. Accordingly, the Department of the Treasury and the IRS have concluded that designated distributions to United States military and diplomatic personnel or their families should not be treated as delivered outside of the United

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<sup>3</sup> Effective July 7, 2004, the GAO's legal name was changed from the General Accounting Office to the Government Accountability Office.

States solely because those payments or distributions are to be delivered to a United States military or diplomatic post office address. For these reasons, the Department of the Treasury and the IRS have determined that treating an APO, FPO, or DPO address as located within the United States for purposes of section 3405(e)(13)(A) is consistent with the tax avoidance concerns underlying the enactment of section 3405(e)(13).

#### B. Payees with a Residence Address Located Within the United States

The proposed regulation would impose new withholding requirements on payors regarding certain payees who have provided the payor with a residence address located within the United States. Under Notice 87-7, payors are not required to withhold if a payee provides a residence address located within the United States and the payee elects no withholding. Notice 87-7 does not specifically address whether payors are required to withhold when a payee provides a residence address located within the United States but also provides payment instructions indicating that the funds are to be delivered outside of the United States. As explained above, section 3405(e)(13)(A) was enacted because Congress was concerned about noncompliance. Section 3405(e)(13)(A) refers to “any periodic payment or nonperiodic distribution which is to be delivered outside of the United States.” Consistent with the text of section 3405(e)(13)(A) and its purpose, the proposed regulation requires payors to withhold in certain circumstances when a payee provides a residence address located within the United States but also provides payment instructions indicating that the funds are to be delivered outside of the United States.

### C. Payees with a Residence Address Located Outside of the United States and Payees Who Have not Provided a Residence Address

Unless section 3405(e)(13)(B) applies, if the payee's residence address that is provided to the payor is located outside of the United States, the payor is required to withhold income tax under section 3405 from any designated distribution, without regard to the delivery instructions and without regard to any attempt to elect no withholding. Thus, for example, withholding under section 3405 would be required even if a payee with a foreign residence address has requested that the distribution be deposited with a financial institution located within the United States. Given the ease with which the funds deposited with a financial institution in the United States can be withdrawn by a person located outside the United States, the Department of the Treasury and the IRS have concluded that the payee's residence address is more likely to be indicative of the place the distribution is ultimately to be delivered than the location of the financial institution. As proposed, the same requirement to withhold income tax under section 3405 would apply if a payor has not provided a residence address to the payee. Furthermore, 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 has not provided a residence address for purposes of this regulation.

These rules are consistent with the approach in Notice 87-7, which uses the residence address of the payee in order to determine whether a taxpayer is permitted to make an election not to have withholding apply under section 3405(a)(2) or (b)(2). The Department of the Treasury and the IRS have

determined that this interpretation articulated in Notice 87-7 should be retained because it provides an administrable standard that has been relied upon for many years, is consistent with the legislative history, and appropriately addresses tax avoidance concerns underlying section 3405(e)(13)(A).<sup>4</sup>

#### D. Payments Subject to Withholding under Subchapter A of Chapter 3

In accordance with section 3405(e)(1)(B)(iii), the proposed regulation clarifies that a designated distribution does not include a distribution that is subject to withholding under subchapter A of chapter 3 or that would be so subject but for a tax treaty and, therefore, the withholding rules under section 3405(a) and (b) do not apply to such distributions. For example, section 3405(a) or (b) withholding would not apply to a United States-source distribution to a nonresident alien individual from a trust described in section 401(a). In such a case, the withholding rules of section 1441 (within subchapter A of chapter 3) would apply to such distributions. See §1.1441-1(b)(1).

#### **Proposed Applicability Date**

This regulation is proposed to apply with respect to distributions on or after the applicability date of the final regulation. Taxpayers may continue to rely upon Notice 87-7 until this regulation is finalized. Upon publication of a final regulation, Notice 87-7 will be superseded. Notwithstanding the previous sentence,

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<sup>4</sup> The committee report states that "it will be appropriate to require withholding with respect to pension payments to persons with foreign addresses absent a showing that withholding is not required." S. Rep. No. 99-313, pt. 4, at 391 (1986).

taxpayers may rely upon §31.3405(e)-1(b)(1) and (2) of the proposed regulation until the applicability date of the final regulation.

### **Special Analyses**

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations. Because this 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 regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Requests for Public Hearing**

Before this proposed regulation is adopted as a final regulation, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The Department of the Treasury and the IRS request comments on all aspects of the proposed rules, including any administrative concerns and how they should be addressed. All comments will be available at [www.regulations.gov](http://www.regulations.gov) or upon request. A public hearing will be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the **Federal Register**.

### **Statement of Availability of IRS Documents**

IRS revenue procedures, revenue rulings, notices and other guidance cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

### **Drafting Information**

The principal author of this proposed regulation is Jeremy D. Lamb, IRS Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Department of the Treasury and the IRS participated in the development of the proposed regulation.

### **List of Subjects in 26 CFR Part 31**

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

#### **PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME AT THE SOURCE**

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

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Par. 2. Section 31.3405(e)-1 is added to read as follows:

§31.3405(e)-1 Questions and answers relating to withholding on pensions, annuities, and certain other deferred income.

(a) The following questions and answers apply for purposes of determining whether a payor of a distribution described in section 3405(a) or (b) must withhold income tax under this section. For purposes of this section, references to the United States include possessions of the United States.

(b)(1) Q-1: Is an Army Post Office (APO), Fleet Post Office (FPO), or Diplomatic Post Office (DPO) address an address located within the United States for purposes of section 3405(e)(13)(A)?

(2) A-1: For purposes of section 3405(e)(13)(A), an APO, FPO, or DPO address is an address located within the United States.

(c)(1) Q-2: Is the payor required to withhold income tax from any distribution described in section 3405(a) or (b) if the payee's residence address that is provided to the payor is located within the United States?

(2) A-2: If the payee's residence address that is provided to the payor is located within the United States, the payor is required to withhold income tax from any distribution described in section 3405(a) or (b) unless the payee has made a valid election of no withholding in accordance with section 3405(a)(2) or (b)(2). Any election of no withholding with respect to a distribution under section 3405(a)(2) or (b)(2) is not valid if the payee instructs the payor to do one or more of the following in connection with the distribution:

(i) Send the distribution to a financial institution or other person located outside of the United States;

(ii) Send the distribution to a financial institution or other person located within the United States with further instructions (such as “for further credit to” instructions) directing that the funds be forwarded to a financial institution or other person located outside of the United States; or

(iii) Send the distribution to a financial institution or other person pursuant to payment instructions (including addenda information) that reference an International Automated Clearing House Transaction (IAT), International Bank Account Number (IBAN), or Society for Worldwide Interbank Financial Telecommunication (SWIFT) Business Identifier Code (BIC) linked to a financial institution or other person located outside of the United States.

(d)(1) Q-3: Is the payor required to withhold income tax from a distribution described in section 3405(a) or (b) if the payee’s residence address that is provided to the payor is located outside of the United States?

(2) A-3: Unless section 3405(e)(13)(B) (which provides an exception for certain nonresident aliens) applies, if the payee’s residence address that is provided to the payor is located outside of the United States, the payor is required to withhold income tax from a distribution described in section 3405(a) or (b), without regard to the delivery instructions and without regard to any request by the payee to elect no withholding. Withholding would be required, in this case, even if the payee has requested that the distribution be delivered to a financial institution or other person located within the United States.

(e)(1) Q-4: Is the payor required to withhold income tax from a distribution described in section 3405(a) or (b) if the payee has not provided the payor with the payee's residence address?

(2) A-4: If a payee has not provided the payor with the payee's residence address, the payor is required to withhold income tax from a distribution described in section 3405(a) or (b). A payee may not elect no withholding under section 3405(a)(2) or (b)(2) and any purported election of no withholding by such payee is not valid. For purposes of this section, 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 has not provided a residence address.

(f)(1) Q-5: Do the withholding rules under section 3405(a) and (b) apply to a payee who is to receive a distribution that is subject to withholding under subchapter A of chapter 3 (or that would be so subject but for a tax treaty)?

(2) A-5: In accordance with section 3405(e)(1)(B)(iii), a designated distribution does not include a distribution of a United States-source payment that is subject to withholding under the rules of section 1441 and §1.1441-1(b)(1) of this chapter (or that would be so subject but for a tax treaty), such as a pension or other deferred compensation plan distribution to be made to a payee who is a nonresident alien (or other individual payee who is presumed to be a foreign person under the presumption rules of §1.1441-1(b)(3) of this chapter). Withholding under the rules of section 1441 and §1.1441-1(b)(1) of this chapter, rather than under the rules of section 3405(a) or (b), would apply to such a distribution.

(g)(1) Q-6: What is the effective date and applicability date of this section?

(2) A-6: This section is effective on the date of publication of the Treasury decision adopting these rules as a final regulation in the Federal Register. The regulation in this section applies with respect to distributions on or after the applicability date of the final regulation.

Kirsten Wielobob

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Deputy Commissioner for Services and Enforcement

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