Non-U.S. Horse Owner Withholding Tax Compliance Issues & Considerations

The University of Arizona
Race Track Industry Program
44th Annual Global Symposium on Racing

December 6, 2017
Notice

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Agenda

• Chapter 3 Withholding Overview
• Racing Industry Challenges
• Payee Documentation
• Reporting
Chapter 3
Withholding
Overview
General Construct

When payments that economically arise in the United States are made to foreign persons, the IRS needs help collecting tax on the payment.

- **Withholding Agent**: Responsible for collecting the required information or the 30% tax and has secondary liability for mistakes.
- **Foreign Payee**: Has primary liability for tax on the payment unless valid documentation is provided.

Qualifying payment triggers application.

Foreign

Foreign Payee
The Rules

**Tax Speak**

U.S. source “fixed or determinable, annual or periodic” income paid to foreign beneficial owners is subject to U.S. withholding tax

**Plain English**

Foreign persons who make money in the U.S. pay tax in the U.S.

FDAP income triggers withholding tax

Purse winnings on races conducted in the U.S. are considered U.S. Source FDAP (See Rev. Rul. 85-4 and IRS Publication 515)
The Rules

Tax Speak

The applicable withholding tax rate is 30%, unless the foreign person is eligible for treaty or statutory relief.

Plain English

The default is 30% tax off the top of the payment.

Treasury negotiates tax breaks under treaties with other countries.

- For horse owners, treaty claim is generally “no permanent establishment”

ECI not subject to 30% withholding, but net winnings may be subject to tax at regular US corporate rates.
The Rules

Tax Speak

Withholding must be performed by any person(s) having custody, control, receipt, or payment of the tax

Plain English

Withholdable payments are also subject to annual information reporting (Forms 1042 and 1042-S)

The IRS doesn’t have time to chase foreign payees, so you get to do it

If your are making a withholdable payment, or directing someone else to make the payment, you (and that someone else) are responsible for turning the right amount of tax over to the IRS

And you have to tell the IRS what’s going on, so they can chase the payees if they really want to
The Rules

**Tax Speak**

Tax relief may be available under a treaty between the US and the payee’s country of residence

**Plain English**

Treaty relief on withholdable payments may mean reduction of, to complete exemption from, withholding tax

Treaty relief on ECI means the income is exempt
The Rules

Tax Speak

Withholding relief must be supported by documentation (Forms W-8)

Plain English

Payees must tell you whether they are eligible for treaty relief

They swear to treaty eligibility on an IRS form before you make the payment

If they do not give you the right form, or a form that looks right, withhold at 30%
# The Rules

## Tax Speak

| Withholding non-compliance results in secondary liability for the withholding agent |
| Pyramiding (gross-up) applies |
| Plus interest and penalties |

## Plain English

| If you mess it up, you have to pay the tax yourself – AND IT’S NOT EVEN YOUR INCOME |
| The payee benefits if you pay the tax, and the IRS treats that as more income to the payee. Which triggers more tax. That you will be expected to pay. Which is even more income. And so on … |
| And it will hurt. A lot. |
What is the worst that could happen if we mess this up?

ACo pays a foreign entity ("FC") $1 million of U.S. purse winnings. ACo obtains no W-8BEN-E, withholds nothing, and files no 1042 or 1042-S.

ACo is liable for withholding and penalties as follows. In addition, interest will run on the $428,571 withholding payment and any accuracy-related or failure to file penalties due, starting on the due date for ACo’s Form 1042.

<table>
<thead>
<tr>
<th>Consequence</th>
<th>Calculation</th>
<th>Maximum due</th>
</tr>
</thead>
<tbody>
<tr>
<td>Withholding Agent’s Liability</td>
<td>30% x $1,000,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Gross-up or “Pyramid Effect”</td>
<td>$1,000,000 / 0.7 = $1,428,571</td>
<td></td>
</tr>
<tr>
<td><strong>Total Liability with Gross Up</strong></td>
<td>30% x $1,428,571</td>
<td><strong>$428,571</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Penalty</th>
<th>Calculation</th>
<th>Maximum due</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failure to File</td>
<td>$428,571 x 5%/month</td>
<td>25% = $107,143</td>
</tr>
<tr>
<td>Failure to Pay</td>
<td>$428,571 x 5%/month</td>
<td>25% = $107,143</td>
</tr>
<tr>
<td>Failure to Deposit</td>
<td>$428,571 x 10%</td>
<td>$42,857</td>
</tr>
<tr>
<td>Failure to File Information Reporting Return</td>
<td>2 x $100</td>
<td>$200</td>
</tr>
<tr>
<td><strong>Total Penalty Calculation</strong></td>
<td></td>
<td><strong>$246,628</strong></td>
</tr>
<tr>
<td>Intentional Disregard Penalty</td>
<td>$1,428,571 x 10% x 2</td>
<td>$285,714</td>
</tr>
<tr>
<td><strong>Total Potential Liability</strong></td>
<td></td>
<td><strong>$960,713</strong>*</td>
</tr>
</tbody>
</table>

* This total takes into account the maximum withholding agent liability plus penalties (taking into account a limited offset permitted under the rules) but no withholding agent liability or interest.
Racing Industry Challenges
What About From W-8ECI?

A single race may cause non-U.S. owners to be treated as carrying on a U.S. trade or business and, thus, purse earnings may be treated as ECI (See Rev. Rul. 58-63)

- Depends on owner facts & circumstances
- Form W-8ECI can be acceptable documentation to reduce withholding to zero (because you are already paying US tax on the earnings and there is no need to tax you twice)
Validating Treaty Claims

Remember, taxation may be relieved by a valid treaty claim, generally made on a Form W-8

Examples of when a withholding agent should facially disregard the owner’s claim of treaty benefits

- Foreign owner resides in a non-treaty jurisdiction but claims a U.S. income tax treaty with another jurisdiction
- Foreign owner claims exemption under a non-existent treaty (e.g. Cayman Islands)
- Special jurisdictions not covered by tax treaties (e.g. Hong Kong, Macau, and Taiwan residents are not covered by U.S.-China treaty)
- “Definitive knowledge“ of significant racing-related activity in the U.S. that could invalidate a treaty claim
Validating Treaty Claims

Owners tax resident in a jurisdiction with a treaty with the U.S. may claim that they are entitled to 0% withholding because they do not have a “permanent establishment” in the U.S.

- Whether owner has a permanent establishment is determined based on all the facts and circumstances
  - Stabling, training, concluding racing contracts, breeding

- Owners are not covered by the sportsmen/artists/athletes provision of tax treaties (unlike jockeys)

- Withholding agents should generally withhold:
  - Absent definite information contained in a statement filed together with a Form W-8 that the owner has not raced, or does not intend to enter, a horse in another race in the United States during the tax year, or
  - In cases where the withholding agent knows or has reason to know such a statement is false
When To Withhold

Withholding required upon “payment”

- A payment is considered made when the amount would be includible in the income of the beneficial owner under the U.S. tax principles governing the cash basis method of accounting

- Racing Industry Considerations:
  - Purse winnings are generally considered paid and subject to withholding upon transfer to horsemen’s account, without regard to when the horsemen actually withdraw or otherwise use the money
  - What about drug testing and claw back provisions? – If access to the winnings is permitted for any purposes (including claiming a horse in a subsequent race) before the drug testing clearance occurs, the IRS would argue the income is considered paid at the time the owner has access to the winnings, regardless of whether there is a later claw back for a failed drug test
  - Potential Solution – No transfer of winnings/access to winnings (including for claiming a horse) before drug testing contingencies are satisfied or until a valid W-8 is provided
Unique challenges related to non-U.S. horse owners

- Withholding agent unlikely to recover any cash once released offshore
- Lack of communication / inability to contact owners
- Difficulty obtaining withholding exemption forms (timely or otherwise)
- Lack of knowledge on U.S. withholding rules and tax treaty positions (including inaccurate advice provided by non-U.S. tax advisors)
- Reluctance / refusal by foreign owners to file U.S. tax returns
- Relationship considerations:
  - Incentivizing owners to continue racing at your track
  - Providing immediate access to winnings
  - Ability to claim horses
What Documentation Do I Need From Payees?
What documentation are we talking about?

FAQ #1: Do I get the same forms from every payee?

Answer: No. Depends on the payee:

- **Individual**: W-8BEN
- **For-profit entity (e.g., corporation or partnership taxed in its home country as if it were a corporation)**: W-8BEN-E or, if it is doing “real” business in the US, a W-8ECI
- **Flow-through (e.g., partnership) or intermediary**: W-8IMY, possible with an attached withholding statement identifying the “real” owners of the income and attaching their documentation
- **Entities already paying tax on their U.S. source income**: W-8ECI
When to Obtain & Update Forms

FAQ #2: Are W-8s infinitely valid? How long are W-8’s valid?

Answer: The forms become invalid if you know or have reason to know that facts have changed that makes the information on the forms incorrect. Absent a change in facts, the forms are valid until the end of the third year after you get them. So, if you get a form September 15, 2015, it is good until December 31, 2018.

- **Example:** A payee notifies you that they have moved from France to Spain. Their W-8BEN-E claiming French treaty benefits is invalid, and 30% withholding applies until they submit a new, valid form.

- Note – The three-year rule does not apply to W-9’s. A new W-9 should be obtained if there is a change in personal information (e.g. change in name, tax ID, or legal entity status).
Validating the Forms Received

**FAQ #3:**  *As long as the W-8 is complete, appears reasonable, and contains information that you don’t actually know or have reason to know is wrong, you can rely on it. What does this mean?*

**Answer:** *The fact-based representations on the form must be consistent with the other information you have about the payee (so you have to check)*

- Someone who understands the facts needs to be talking with someone who understands the tax issues
- Their collective knowledge (*including whatever is in the horsemen master files / bookkeeping records*) should be applied to inspect and approve the forms
- All required information must be provided by the payee
Validating the Forms Received (continued)

FAQ #4: If the W-8 is properly completed and validated by you, are you off the hook for any under withholding?

Answer: Generally, yes

• Even if you didn’t actually investigate every single statement on the form
• Even if the payee lied about its facts or got something wrong
• The “know or reason to know” standard means you should resist the temptation to be too helpful when vendors ask for help with the form (unless you specifically know the information provided to you is inaccurate).
Reporting
Form 1042/1042-S Reporting

Income Classification Codes (for 2017):

- Owners – Code 23 (Other FDAP Income)
- Trainers – Code 17 (independent contractor relationship) or Code 18 (employee or exclusive contractor relationship)
- Jockeys – Code 42 (no central withholding agreement) or Code 43 (central withholding agreement)
- Income codes are updated periodically and should be re-validated annually
Form 1042/1042-S Reporting (continued)

• **Annual Form 1042/1042-S Due Date**: March 15th (extension is available)

• **Withholding Tax Due Date** – Generally 3 business days after the quarterly monthly end date (7th / 15th / 22nd / last day of month), assuming more than $2,000 is owed at each quarterly monthly end date

• **Remember Late Payment, Penalties, Etc.**
Questions?

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Christopher Riccardi  
404-222-7187  
criccardi@kpmg.com
Appendix
Form W-8BEN-E: Part I, Line 5, FATCA classification

Withhold 30% unless FATCA withholding exception applies

May commonly see from financial payees. Will need to check GIIN on the IRS website.

May commonly see from nonfinancial vendors. If direct reporting NFFE, will need to check GIIN on the IRS website.

U.S. or foreign income tax ID is necessary for treaty relief
Form W-8BEN-E (2016 going forward): Part III treaty claim

Necessary for treaty claims (along with U.S. or foreign income tax ID number noted on page 1)

May see completed to claim special rates

<table>
<thead>
<tr>
<th>Part II</th>
<th>Disregarded Entity or Branch Receiving Payment. (Complete only if a disregarded entity with a GIIN or a branch of an FFI in a country other than the FFI’s country of residence. See instructions.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>Chapter 4 Status (FATCA status) of disregarded entity or branch receiving payment:</td>
</tr>
<tr>
<td>12</td>
<td>Address of disregarded entity or branch (street, apt. or suite no., or rural route). Do not use a P.O. box or in-care-of address (other than a registered address).</td>
</tr>
<tr>
<td></td>
<td>City or town, state or province. Include postal code where appropriate.</td>
</tr>
<tr>
<td>13</td>
<td>GIIN (if any)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part III</th>
<th>Claim of Tax Treaty Benefits (if applicable). (For chapter 3 purposes only.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>14</td>
<td>I certify that (check all that apply):</td>
</tr>
<tr>
<td>a</td>
<td>The beneficial owner is a resident of the United States within the meaning of the income tax treaty between the United States and that country.</td>
</tr>
<tr>
<td>b</td>
<td>The beneficial owner derives the item (or items) of income for which the treaty benefits are claimed, and, if applicable, meets the requirements of the treaty provision dealing with limitations on benefits. The following are types of limitation on benefits provisions that may be included in an applicable tax treaty (check only one; see instructions):</td>
</tr>
<tr>
<td>c</td>
<td>The beneficial owner is claiming treaty benefits for U.S. source dividends received from a foreign corporation or interest from a U.S. trade or business of a foreign corporation and meets qualified resident status (see instructions).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part IV</th>
<th>Sponsored FFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>Name of sponsoring entity:</td>
</tr>
<tr>
<td></td>
<td>GIIN of sponsoring entity:</td>
</tr>
<tr>
<td>17</td>
<td>Check whichever box applies:</td>
</tr>
<tr>
<td></td>
<td>I certify that the entity identified in Part I:</td>
</tr>
<tr>
<td></td>
<td>• Is an investment entity;</td>
</tr>
<tr>
<td></td>
<td>• Is not a QI, W/Or, or WT, and</td>
</tr>
<tr>
<td></td>
<td>• Has agreed with the entity identified above (that is, not a nonparticipating FFI) to act as the sponsoring entity for this entity.</td>
</tr>
<tr>
<td></td>
<td>• Is a controlled foreign corporation as defined in section 957(a);</td>
</tr>
<tr>
<td></td>
<td>• Is not a QI, W/Or, or WT;</td>
</tr>
<tr>
<td></td>
<td>• Is wholly owned, directly or indirectly, by the U.S. financial institution identified above that agrees to act as the sponsoring entity for this entity; and</td>
</tr>
<tr>
<td></td>
<td>• Shares a common electronic account system with the sponsoring entity that enables the sponsoring entity to identify all account holders and paysies of the entity and to access all account and customer information maintained by the entity including, but not limited to, customer identification information, customer documentation, account balance, and all payments made to account holders or payees.</td>
</tr>
</tbody>
</table>
Form W-8BEN-E: Supporting FATCA representations

Common nonfinancial vendor classifications must also be supported by representations (referenced on line 5)

If this box is checked, the ownership disclosures on the last page should be completed.
Form W-8BEN-E: Required certifications

Must be completed; form generally expires in 3 years

Must be checked in all cases

If item 40(c) is checked (passive NFFE with substantial U.S. owners) this table must be completed, including TINs
W-8ECI

Also a one-pager that relieves 30% withholding (because the payee is already paying “normal” tax on the income)

U.S. Taxpayer Identification Number is required (and, in any case, would be for filing the U.S. tax return)

Explanation of ECI has to be done on an item-by-item basis.

Certification box needs to be checked
Form W-8IMY

A W-8IMY supports payments to persons who do not beneficially own the income, i.e., act as an intermediary.

If the payee has QI or withholding FP status, the payee will undertake ch 3 and FATCA documentation, withholding and reporting (so you don’t need to)

If nonwithholding FP, etc., status, means the payee will not take primary responsibility for documentation, etc., but will attach a withholding statement that includes all information and forms necessary for the payor to comply with its obligations
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