

IRM 4.10.21
***U.S. Withholding Agent
Examinations – Form 1042***

IRS - LMSB Financial Services Industry

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Purpose

- Provides the basic concepts of NRA Withholding and Reporting
- Provides general guidance on examining U.S. Withholding Agent's Return, Form 1042

Basic Concepts

- Brief discussion of NRA Withholding Tax
- Basic terms definitions
- Impact of NRA Withholding Tax law changes effective 2001
- Provides relevant Code Sections

Basic Concepts ***(Continued)***

- Compare to Backup Withholding
- Summary of important NRA Withholding Tax related forms
- Pre-audit planning

Guidance on Examinations

- The IRM covers two types of U.S. withholding agent audits:
 1. Audits of U.S. financial institutions
 2. Audits of U.S. non-financial institutions

Audits of U.S. Financial Institutions

- Financial institutions are generally subject to NRA Withholding and Reporting requirements in connection with their custodial or brokerage activities.
- This type of audit will focus on determining if certain payments paid to foreign account holders or intermediaries have been appropriately subjected to NRA Withholding and Reporting.

Audits of U.S. Financial Institutions (Continued)

- 1. Functional Review of NRA Operational Procedures:**
 - Review of Written Procedures and Training Manuals
 - Review of Form 1042 and 1042-S
- 2. Account Opening / Updating Procedures:**
 - New Account Examination Procedures

Audits of U.S. Financial Institutions (Continued)

3. Due Diligence - Standard of Knowledge:

- Reason to Know
- Actual Knowledge
- Application of Presumption Rules
- Requirement to Rely on Presumption Rules

Audits of U.S. Financial Institutions (Continued)

- 4. Validation of the Certification of Foreign status and/or Treaty Claim (Form W-8):**
- Reliance on Withholding Certificate (Form W-8)
 - Account Review
 - Validation Process
 - Permanent and Mailing Address Considerations
 - Forms W-8 Provided After Date of Payment

Audits of U.S. Financial Institutions (Continued)

5. Use of Statistical Sampling

- The starting point should be a thorough analysis of the withholding agent's system
- A Computer Audit Specialist (CAS) will determine:
 - Sampling unit
 - Sample size
 - Stratum criteria
- The Withholding Agent should be consulted during the sample construction process

Audits of U.S. Financial Institutions (Continued)

6. Withholding and Reporting Verification:

- Ensure the correct rate of NRA Withholding and/or Backup Withholding was determined and applied for a single payment or group of similar payments by taking all relevant factors into consideration;
- Verify proper reporting on Forms 1042-S and/or Form 1099.

Audits of U.S. Financial Institutions (Continued)

- 7. U.S. Financial Institution - Consideration of Payments to Foreign Vendors**
- 8. Suggested Initial Information Document Requests (IDR)**

Non-financial Institutions Withholding Agent Audit

1. Introduction:

- The audit will focus on entities that make payments to foreign persons in their business activities in connection with obtaining services or the use of property or financing.
- Commonly, the relationship is one of a payer for services rendered by foreign persons (vendor payments). Many of these payments can be expected to have been affected or recorded by an account payable or similar department.

Non-financial Institutions Withholding Agent Audit (Continued)

2. Industries Likely to Have NRA Withholding and Reporting:

- Professional Services Providers;
- High Tech Industries;
- Intellectual Products Providers;
- Pharmaceutical Industry;
- Real Estate Industry.

Non-financial Institutions Withholding Agent Audit (Continued)

3. Payment to Foreign Vendors - Three-Step Audit Procedure:

- The examiner can use these procedures to test if payments made by the accounts payable department and other departments making payments to foreign persons require NRA reporting and withholding.
- It is recommended that a Computer Audit Specialist (CAS) be requested to assist in each of these three steps:

Non-financial Institutions Withholding Agent Audit (Continued)

Step 1: Identify all payments that are paid to a non-U.S. person

Analyze accounts payable using some combination of the following filters to identify all payments made to non-U.S. persons:

- Address fields
 - Country ≠ U.S.
 - State ≠ a U.S. state
 - Zip code ≠ U.S. format or U.S. zip code number
- TIN fields
 - EIN = 98-nnnnnnn
 - ITIN = 9nn-7/8n-nnnn
 - TIN = blank
- Vendor numbers – if foreign indicator is present
- Any other identifying fields

Non-financial Institutions Withholding Agent Audit (Continued)

**Step 2: Identify all payments that are FDAP income
(Fixed or Determinable, Annual or Periodic income).**

Typical FDAP payments made from accounts payable:
(Examiner would first test methods used to classify expenses)

- Royalties, Patents, Copyrights (Intellectual Assets)
- Royalties – Natural resources (Timber, Oil, Coal)
- Rents
- Interest
- Compensation for personal services
- Pensions and annuities
- Scholarships, grants
- Prizes, awards

Non-financial Institutions Withholding Agent Audit (Continued)

Step 3: Identify all payments that were U.S. sourced
(Determination made on a transactional basis)

Interest	If the debtor is U.S., the interest will be U.S. sourced
Royalties	If the intangible assets is located or used in U.S., the royalty is U.S sourced
Personal Service Fees	If the services are performed in the U.S., the Personal Service Fee income is U.S. sourced
Rent	If the property is located in the U.S., the rental income is U.S. sourced
Dividends	If the payer is U.S., the dividend is U.S. sourced

Non-financial Institutions Withholding Agent Audit (Continued)

4. Treatment of Personal Services Paid to Foreign Persons:

- Personal services are generally sourced at the location where the services were performed. Therefore, the taxpayer should establish the country where the services were performed.
- If the taxpayer cannot prove the location where the services were performed, it is presumed to be U.S. sourced. Treas. Reg. 1.1441-2(a)

Non-financial Institutions Withholding Agent Audit (Continued)

5. Payments to Foreign Persons by Departments other than Account Payable Department:
 - a. Treasury Department - Dividend payments
 - b. Pension Department - Pension payments
 - c. Human Resources - Payments to senior officers

Non-financial Institutions Withholding Agent Audit (Continued)

6. Use of Forms 5471 and Forms 5472:

- Form 5471, Schedule M reports certain U.S. sourced FDAP payments made by the taxpayer to a Controlled Foreign Corporation (CFC).
- Form 5472, Part IV reports certain U.S. sourced FDAP payments made by the taxpayer to its foreign affiliates.

Non-financial Institutions Withholding Agent Audit (Continued)

- 7. Reconciliation of Audit Findings to Forms 1042 and 1042-S**
- 8. Suggested Initial Information Document Requests**

Penalties

- 1. Penalties applicable to Form 1042 and related withholding tax deficiencies**
- 2. Penalties applicable to Form 1042-S**
- 3. Factors to Consider in the Assessment of Penalties**

Sources of Information

- IRM 4.10.21 - U.S. Withholding Agent Examinations – Form 1042 (coming soon)
- Forms and Instructions
 - Forms 1042 and 1042-S
 - Forms W-8 (series) and instructions
- IRS Publication 515 (<http://www.irs.gov/pub/irs-pdf/p515.pdf>)
- IRS website
<http://www.irs.gov/businesses/corporations/article/0,,id=96739,00.html>
- Treasury website (for proposed treaties)
<http://www.ustreas.gov/offices/tax-policy/treaties.html>
- State Department website
<http://www.state.gov/s/l/c8455.htm>
- Commercial Services
 - Tax Analysts (<http://www.tax.org/>)
 - RIA (with IBFD treaties) (<http://www.riahome.com/>)

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Questions?