

IRS Focuses on Form 1042 Examinations

By: Philip T. Pasmanik, CPA, MST

U.S. taxpayers have an obligation to file information reporting forms to report certain payments to foreign corporations, foreign individuals, foreign partnerships, and certain foreign fiduciaries, trusts, and estates.¹ Generally, every U.S. person that makes a fixed or determinable payment of annual or periodic income (FDAP) from U.S. sources must withhold the proper amount of U.S. tax and remit it to the IRS.² The rate of tax withheld on such payments is 30%.³ U.S. persons⁴ who make FDAP payments are required to file Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons. Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, is filed with the IRS, and a copy is sent to the income recipient to report such FDAP payments⁵ and any associated withholding.

The 30% withholding rate can be reduced by various exceptions provided in the statute or by a reduced tax rate under a tax treaty between the United States and the country in which the foreign recipient of the U.S. source income resides.⁶ For certain types of payments, treaty-reduced withholding rates are available only if the

beneficial owner of the payment provides the withholding agent with a withholding certificate that includes a taxpayer identification number.⁷ This requirement should be carefully complied with by the withholding agent because that agent is liable to the IRS for the amount of tax required to be withheld⁸ as well as for interest and penalties.⁹

New IRM Provision

In July 2008, the IRS issued a new Internal Revenue Manual (IRM) section,¹⁰ U.S. Withholding Agent Examinations—Form 1042, that provides for an increased level of focus by IRS examiners to examine and enforce the statutory requirements for withholding and the related compliance reporting of FDAP-type payments to foreign persons.

The IRM is intended to cover two types of U.S. withholding agent audits. First, it provides general guidance for audits of U.S. financial institutions, which may have nonresident alien (NRA) withholding tax and reporting requirements in connection with their custodial or brokerage activities.¹¹ Second, it provides general guidance for audits of U.S. nonfinancial

entities that may have NRA withholding and reporting responsibilities with respect to their payments to foreign persons for obtaining services or other entitlements.¹²

Instructions to Withholding Agent Examiners

The guidance provided in the IRM includes instructing withholding examiners to consider Form 1099 reporting and backup withholding as part of an integrated audit.¹³ In addition, the IRM provides guidance for the examiner to ascertain the statute of limitation on the audit years for Forms 1042 and 945, Annual Return of Withheld Federal Income Tax.

If applicable, the IRM instructs the examiner to obtain and have executed Forms 872, Consent to Extend the Time to Assess Tax, and SS-10, Consent to Extend the Time to Assess Employment Taxes, to protect the statute of limitation on such forms.¹⁴ The IRM also recommends that the examiner ascertain whether the taxpayer under exam has entered into any agreements with the IRS in regard to withholding systems, policies, procedures, or certain other requirements.¹⁵

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1 Secs. 1441 and 1442; Reg. Secs. 1.1441-1 through -9.

2 Regs. Sec. 1.1441-2(a).

3 Secs. 1441(a) and 1442(a).

4 "U.S. person" includes U.S. citizens and residents, domestic partnerships and corporations, and certain estates and trusts (Sec. 7701(a)(30)).

5 FDAP payments include interest, dividends, rent, salaries, wages, premiums, annuities, compensation, remunerations, emoluments, or certain other fixed or determinable annual or periodic gains and income (see Sec. 1441(b)). Form

1042-T is filed to summarize all Forms 1042-S issued in a tax year.

6 Regs. Sec. 1.1441-6.

7 Regs. Sec. 1.1441-1(e)(4)(vii).

8 Sec. 1461.

9 Sec. 1463.

10 IRM Section 4.10.21 (7/29/08).

11 IRM Section 4.10.21.1.

12 Id.

13 IRM Section 4.10.21.5.

14 IRM Section 4.10.21.7.

15 Id.

Reliance on Withholding Certificate

The IRM provides guidance to withholding examiners with respect to reliance on a withholding certificate that is part of the review process of Form 1042-S.¹⁶ A U.S. withholding agent can generally rely on a properly completed withholding certificate (Form W-8) to establish foreign status or claim treaty benefits.¹⁷ The withholding certificate must be completed for any item on the form that is relevant to the claim for treaty benefits by the direct account holder and must not include claims that are inconsistent with other claims in any part of the form.¹⁸

Various Provisions

The IRM instructs examiners to request, for each account under review, withholding certificates, other evidence of offshore accounts, and account information needed to administer and open the

account (e.g., addresses, account holder status, and other account instructions).¹⁹ In addition, the IRM instructs examiners to ask for an explanation of the withholding and reporting procedures for real estate investment trust distributions, original issue discount transactions, and securities lending transactions.²⁰

U.S. financial institution withholding agent audits are intended to focus on determining whether amounts paid to account holders have been properly subjected to NRA withholding and reporting, including whether any payments treated as paid to foreign persons should have instead been subjected to backup withholding under Sec. 3406.²¹

Conclusion

With the release of new IRM Section 4.10.21, the IRS has given notice to its examiners—and to taxpayers—that it expects increased examination of Form 1042

information reporting. But it has also provided a roadmap for compliance. Taxpayers should consider reviewing their withholding and reporting compliance procedures to ensure adherence to the requirements of Secs. 1441 and 1442 and should discuss their obligations with their tax advisers.

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EditorNotes

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¹⁶ IRM Section 4.10.21.8.1.2.

¹⁷ IRM Section 4.10.21.8.4.1.

¹⁸ Id.

¹⁹ IRM Section 4.10.21.8.4.2.

²⁰ IRM Section 4.10.21.8.7.

²¹ IRM Section 4.10.21.8.