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Form 1042 Compliance and Audit Strategies

Navigating Rules on Withholding on U.S.-Source Income for Foreign Persons

WEDNESDAY, JULY 20, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Form 1042 Compliance and Audit Strategies Seminar

July 20, 2011

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Today's Program

Approaches To Chap. 4 Withholding And Form 1042 Compliance
[Laurie Hatten-Boyd]

Slide 7 - Slide 27

When Withholding And Forms 1042, 1042-S, 1042-T Required
[Adam Konrad]

Slide 28 - Slide 42

Evolution Of IRS Enforcement In 1042 Area
[Cynthia Hoffman]

Slide 43 - Slide 50

Laurie Hatten-Boyd, KPMG

**APPROACHES TO CHAP. 4
WITHHOLDING AND FORM
1042 COMPLIANCE**

Agenda For This Section



- ◆ **Foreign Account Tax Compliance Act (FATCA)**
 - New Chap. 4 withholding regime

- ◆ **Evolution of IRS enforcement initiative under current Chap. 3 withholding regime (Form 1042)**



Foreign Account Tax Compliance Act (FATCA)

Withholding - Current Rules



- ◆ **The current 1441 withholding rules were designed to ensure that the correct withholding and reporting occurs on U.S.-source FDAP, based on the tax status of the beneficial owner of the income.**

- ◆ **Under these rules, a U.S. person can avoid disclosure by:**
 - Investing in U.S.-source income through offshore corporation (0% on portfolio interest and broker proceeds; 30% on dividends)
 - Investing in U.S.-source income through foreign partnership as undisclosed owner (30% on interest and dividends; 0% on broker proceeds)
 - Investing directing in non-U.S. assets (no reporting for payments of non-U.S.-source income by non-U.S. payor outside the U.S.)

FATCA Withholding



- ◆ **New withholding regime aimed at expanding reporting of U.S. persons investing offshore**
- ◆ **Disclosure of U.S.-owned foreign entities**

Overview Of Requirements



- **30% withholding on any withholdable payment made to a foreign financial institution (FFI), unless FFI enters into a disclosure agreement with the IRS**
- **The agreement will require FFI to identify U.S. accounts and to report these to the IRS on an annual basis**
- **Previously, only required to look through flow-through entities such as partnerships and certain trusts**
- **Will be required to look through all entity types, with limited exceptions**

Definitions: Withholdable Payment



- **Any payment of U.S.-source FDAP income (e.g. dividends, interest, OID, rents), and**

- **Any gross proceeds from the sale or other disposition of a security that can give rise to the payment of U.S.-source dividends or interest**

- **Exclusion: Income that is effectively connected to the conduct of a trade or business within the U.S.**
 - Unknown at this time: Vendor payments

Definitions: Foreign Financial Institution



- **A financial institution is defined as any entity that:**
 - **Accepts deposits in the ordinary course of business**
 - **Is in the business of holding financial assets for others, or**
 - ***Is primarily engaged in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such instruments***
 - Given this broad definition, an FFI includes hedge funds, private equity funds and other collective investment vehicles.

Definition – U.S. Account



◆ U.S. account

- Depository or custodial account maintained by the financial institution, as well as any debt or equity interest in the financial institution, held by a specified U.S. person or U.S.-owned foreign entity

- **Specified U.S. person** is generally a U.S. non-exempt recipient (individual, trust, partnership or estate) and privately held U.S. corporation
- **U.S.-owned foreign entity** is one with substantial U.S. owners
 - Corporation or partnership in which specified U.S. person owns 10%, directly or indirectly.
 - Investment vehicles – 10% is reduced to 0%, so any U.S. ownership

The Disclosure Agreement



- **The foreign financial institution must undertake to:**
 - Obtain information from “account holders,” to determine which are U.S. accounts

 - Comply with due diligence procedures (to be specified)
 - Report annually for U.S. accounts
 - Provide further information upon request

- **Banking secrecy jurisdiction considerations**

- **Model agreement?**

Reporting



- ◆ **The foreign financial institution will be required to report the following:**
 - Name, address and TIN of each account holder who is a specified U.S. person
 - Name, address and TIN of each substantial U.S. owner of a U.S.-owned foreign entity
 - The account number
 - The account balance or value (timing, calculation method to be determined)
 - Gross receipts to and withdrawals/payments from the account (also to be determined)

Other Foreign Entities



- **30% withholding also applies to withholdable payments made to foreign non-financial entities (FEs). An FE is any entity that is not an FFI. To avoid this withholding, the FE must:**
 - Provide a certification to the withholding agent that it does not have any U.S. substantial owners, or
 - Provide the name, address and TIN of any U.S. substantial owners to the withholding agent

- **The withholding agent will then report to the IRS.**

Exempt Beneficial Owners



➤ Payments to the following will not be subject to withholding or reporting:

- Foreign governments
- International organizations
- Foreign central banks, and
- Any other beneficial owners identified as posing a low risk of tax evasion

Effective Date



- **Payments made after Dec. 31, 2012**

- **Grandfather provision:**
 - Withholding exclusion on any payment under any obligation outstanding on March 18, 2012; OR
 - Gross proceeds from any disposition of such an obligation



IRS Sect. 1441

Compliance Initiative

IRS Now Has Significant Interest In Sect. 1441 Compliance



- ◆ **For the first time in more than 15 years, the IRS is aggressively pursuing withholding agents' compliance with the Sect. 1441 withholding rules.**
-
- The IRS has been preparing for Form 1042 audits for several years. As part of this preparation, it has:
 - Drafted new sections for auditing US withholding agents in the Internal Revenue Manual
 - Trained more than 2000 examiners, and
 - Created a national team in New York to assist auditors around the country with the routine implementation of these audits

Sect. 1441 Background Information



◆ Under the old regulations:

- Form W-8 for Code exceptions
- “Address rule” for dividends

◆ **IRS was aware the rules were inadequate and that there was mass non-compliance. Specifically, the IRS was aware that:**

- Foreign Intermediaries provided Form W-8 for Code exceptions, and
- Dividend rate was based on the address of the foreign intermediary

◆ **The IRS decided to halt enforcement action until it could promulgate new rules to address these problems.**

“New” 1441 Regulations



- ◆ **New regulations released in 1997 (effective for payments after 1/1/2001)**
 - Key to new regulations is documentation
 - Family of Forms W-8 (W-8BEN, W-8IMY, W-8ECI and W-8EXP)
 - Due diligence requirements (no conflicting information with claims made)
 - Mandatory presumption rules in which documentation is missing or invalid
- ◆ **2001 was “transition year”; IRS agreed not to audit.**
 - During this time, the IRS discussed strict auditing standards at various conferences.
 - U.S. withholding agents performed “health checks” using the stated standards and realized compliance levels were still inadequate; sought IRS help.

Voluntary Compliance Program (VCP)



- ◆ **Withholding agents came forward voluntarily**
 - Explained compliance problems in detail
 - Negotiated lower standards for acceptance of forms
 - Eliminated interest for failure to withhold, if no tax
 - Resulted in retroactive withdrawal of Sect. 1.1441-1(b)(7)(iii)

- ◆ **IRS learned a great deal through this process**
 - Types of income commonly missed by withholding agents
 - Types of industries in which non-compliance was common
 - Significant questions to ask on audit
 - How to train auditors

Updated Internal Revenue Manual (July 2008)



◆ In response to VCP, IRS updated its IRM to include sections on auditing US withholding agents

- Added Sect. 4.10.21

- IRM provides solid background information on withholding requirements and types of income that may be subject to withholding.

- IRM broken into two categories:

- Financial institutions
- Non-financial institutions

Withholding – Tier 1 Designation



- ◆ Tier 1 designation for withholding
 - What does this generally mean?
 - IRS believes it is issue of “high strategic importance”
 - Designation of owner executive/issue management team

 - LMSB technical advisor
 - Significant counsel role in cases
 - Examiners must consider

 - What has this specifically meant for withholding?
 - Increase in the number of compliance audits
 - Tremendous increase in the number of IDRs
 - Also large increase in the number of informal requests

Adam Konrad, Reinhart Boerner Van Deuren

**WHEN WITHHOLDING AND
FORMS 1042, 1042-S AND 1042-T
REQUIRED**



Overview

- Withholding generally
- Exemptions from withholding
- Withholding agent responsibilities and documentation
- Presumptions
- Use of intermediaries



No Withholding Unless Tax Due

- Bridgerock is a large Japanese tire maker with a U.S. subsidiary, Windrock, that has gross revenue of \$10 billion. When Bridgerock sells all of its Windrock shares, the sale should not be subject to any tax in the U.S. Accordingly, no withholding is required.



U.S. Source Income

- Interest paid by U.S. persons
- Dividends paid by U.S. corporations
- Services performed in the U.S.
- Rents where the property is used in the U.S.
- Royalties where the IP is used in the U.S.
- Sales of U.S. real property interests



Withholding On FDAP

- USCo pays a royalty to Hong Kong Company for intellectual property used in the United States. USCo must withhold 30% of the royalty. If USCo does not withhold on the royalty, then USCo will be liable for the tax on that payment to the IRS.



Exemptions From Withholding

- Effectively connected income
- Portfolio interest
- Bank deposit interest
- Treaty-based reductions



Additional Considerations

- Withholding on foreign partners
- Passive investments in U.S. real property



Proof Of Residency

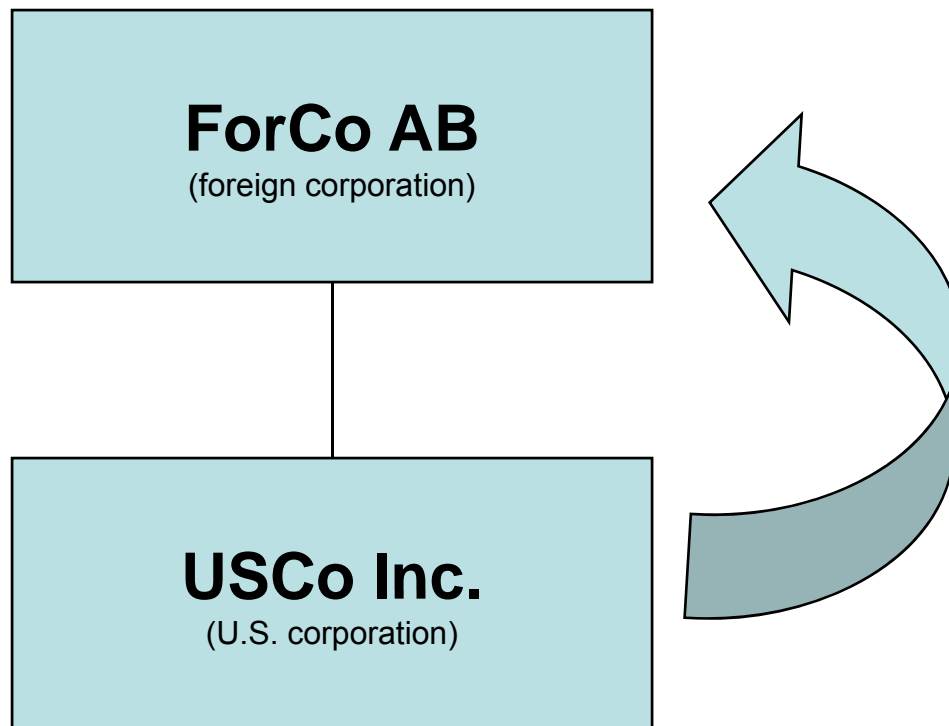
- U.S. payees provide a W-9.
- Non-U.S. payees provide:
 - W-8BEN
 - W-8ECI
 - W-8IMY
 - W-8EXP
 - 8233



Presumptions


- Classification
- Individual/trust/estate
- Corporation/"exempt recipient"
- Partnership
- U.S. or foreign (generally, presume U.S.)

Intermediaries: Direct Payment



On June 24, USCo Inc., a U.S. corporation, pays a \$1 million dividend to its sole shareholder, ForCo AB, a foreign corporation organized under the laws of Foronia.

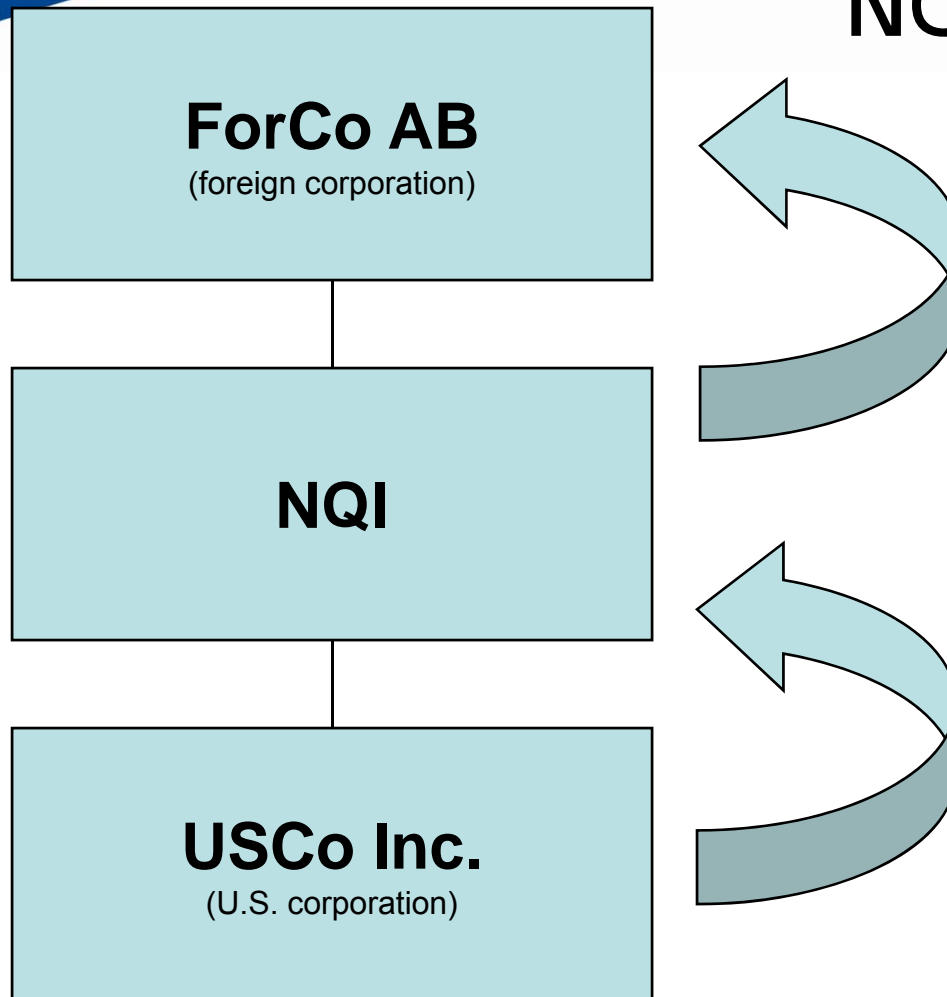
The applicable withholding rate is 5%, as provided in Article 10 of the tax treaty between the U.S. and Foronia.



Intermediaries: Direct Payment (Cont.)

1. ForCo provides a Form W-8BEN to USCo, certifying its status as a foreign corporation and eligibility for the 5% treaty withholding rate.
2. USCo withholds \$50,000 (5% of the \$1,000,000) and pays \$950,000 to ForCo.
3. USCo files a Form 1042-S with the IRS and provides a copy to ForCo.
4. USCo files a Form 1042 with the IRS.

Intermediaries: NQI



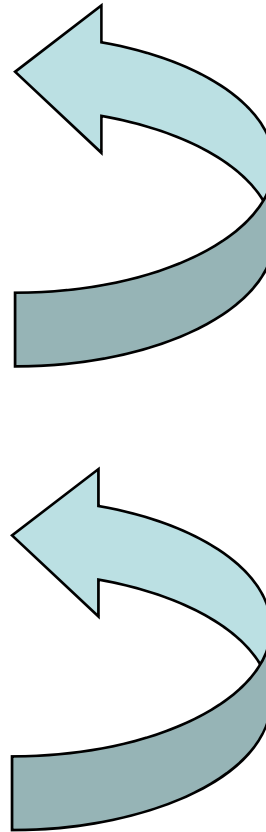
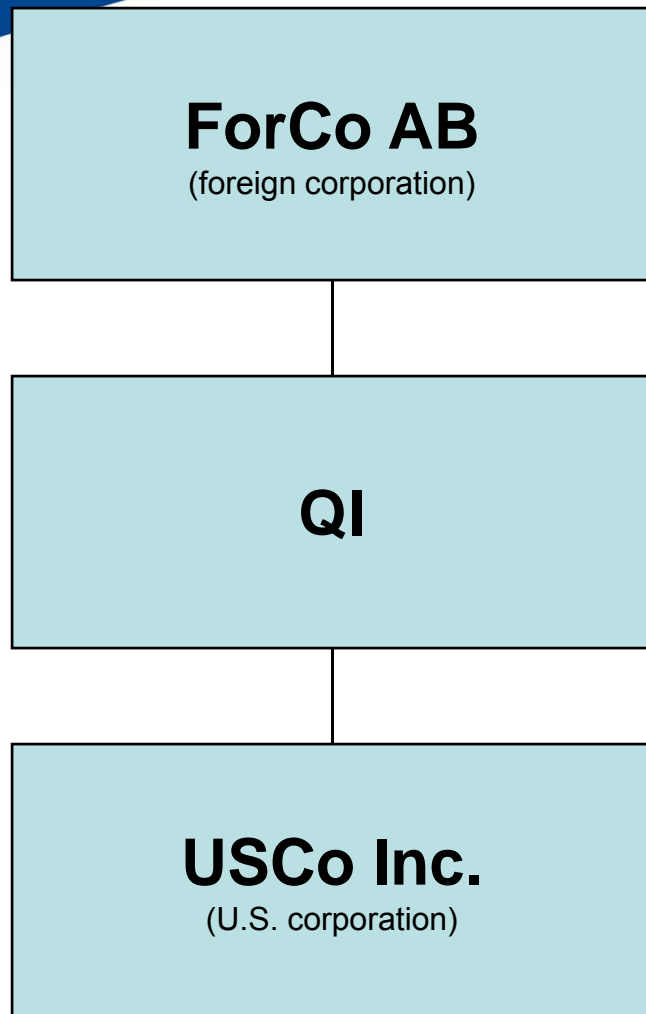
Same facts as Example I, except now USCo pays the dividend to an NQI, which remits the payment to ForCo AB.

Intermediaries: NQI (Cont.)

1. ForCo provides a Form W-8BEN to the NQI, certifying its status as a foreign corporation and eligibility for the 5% treaty withholding rate.
2. The NQI provides ForCo's Form W-8BEN, as well as a Form W-8IMY and a withholding statement, to USCo.
3. USCo withholds \$50,000 and pays \$950,000 to the NQI.
4. The NQI remits the \$950,000 to ForCo.
5. USCo files a Form 1042-S with the IRS and provides a copy to ForCo. The NQI, however, does not need to file a Form 1042-S, assuming it has provided USCo with all necessary information and has no reason to believe that USCo did not properly withhold (this is the "Multiple Withholding Agent Rule").
6. USCo files a Form 1042 with the IRS; the NQI does not file a Form 1042, as it did not file a Form 1042-S.

Intermediaries:

QI



Same facts as Example II, except the payment is made to a QI.

Intermediaries: QI (Cont.)

1. ForCo provides a Form W-8BEN to the QI, certifying its status as a foreign corporation and eligibility for the 5% treaty withholding rate.
2. The QI provides a Form W-8IMY and a withholding statement to USCo.
3. If the QI assumes primary responsibility for withholding, USCo pays \$1 million to the QI.
4. The QI withholds \$50,000 and remits \$950,000 to ForCo.
5. USCo files a Form 1042-S with the IRS naming the QI as the recipient, and provides a copy to the QI.
6. The QI files a Form 1042-S with the IRS naming ForCo as the recipient, and provides a copy to ForCo.
7. USCo and the QI each file a Form 1042 with the IRS.

Cynthia Hoffman, Schneider Downs

EVOLUTION OF IRS ENFORCEMENT IN 1042 AREA



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Overview: IRS Enforcement In Form 1042 Area

- Review: In December 2008, IRS designated withholding taxes as a Tier 1 audit issue.
- Audit approach for withholding, reporting, proper classification and documentation
 - Sources of information for IRS audits
 - IDRs and informal requests
 - Exam review process
 - Specific areas at issue
- Penalties



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IRS Audit Approach For Form 1042: Information Sources

- IRS searches forms 5471, 5472 and 1118 databases to find potential Form 1042 filing requirements.

Example: Wholly-owned subsidiary “Y” of foreign parent “X” files Form 5472, reporting \$200,000 paid to X for technical services performed by employees of X in tax year. Y did not file Form 1042 or Form 1042-S to report this payment. This results in a mismatch and may trigger an audit of Form 1042.

- Form 1042 reviews included as part of Form 1120, Form 1065, and Form 945 (back-up withholding) audits
- Matching deposits against 1042 reporting
 - Tips:
 - Assessments for other taxes may have caused IRS to reallocate 1042 deposits; make sure these are made separately.
 - Make sure you have correct entity name and EIN for each entity making deposits and filing reports.
 - Reconcile Form 1042 with Form 1042-S .
 - You have until March 15 each year to “fix” payee errors before you provide 1042-S to payee.



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IDRs And Informal Requests

- Requested information
 - Copies of Form 1042 and 1042-S for calendar year
 - Workpapers or supporting documentation used to prepare Form 1042 and Form 1042-S; reconciliation of Forms 1042 and 1042-S
 - Copies of Forms W-8 and Form 8233 from payees
 - Most likely a list of specific payees
 - Accounts payable registers or vendor file, to obtain names and addresses of vendors in order to identify non-U.S. vendors
 - Name of department and persons responsible for gathering documentation and preparation of Form 1042 and Form 1042-S
 - Operating manuals, written procedures and flowcharts for processes pertaining to fiduciary activities, including opening new customer accounts, validation, recording customer transactions and payments, determining or classifying undocumented accounts, renewal of expiring or invalid Forms W-8
 - Internal audit reports for years under exam that pertain to the fiduciary duty as withholding agent



IDRs And Informal Requests (Cont.)

- IRS exam teams more sophisticated and may include international examiner
- IRS may interview staff
- IRS concerned that proper documentation exists at time of payment, not after the fact
 - Note that acceptance of “late” W-8s may be allowed by examiner in certain circumstances under Treas. Reg. 1.1441-1(b)(7)(ii) and IRM 4.10.21.8.4.5

Example: Wholly-owned subsidiary “Y” of foreign parent “X” pays X \$200,000 for technical services performed by employees of X in tax year. Y also pays interest and dividends to X during the tax year. The dividends and interest were reported on Forms 1042/1042-S, and withholding was applied based on Form W-8BEN received from X for dividend and interest payments. The technical fees were not reported on Forms 1042/1042-S, nor was W-8BEN obtained for this type of payment. Withholding tax on this type of payment would have been nil under a treaty. IRS accepted the late W-8BEN, allowed Y to amend Form 1042/1042-S to report the payment, and waived penalties since under the facts and circumstances. The taxpayer had reason to apply the treaty rate of nil withholding, and the government’s interests had not been harmed.



IRS Audit Approach For Form 1042: Exam Review

- Proper classification of payments subject to withholding
 - ❖ What are you paying?
Note: Proper coding of payment on Form 1042-S
- Proper documentation of non-U.S. persons
 - ❖ Whom are you paying?
 - Payor may need to assist payee to understand which form is needed.
 - Reliance on documentation, unless payor has knowledge it is incorrect
 - Other documentary evidence may be relied upon in certain situations.
- Proper withholding and reporting
 - ❖ Have you determined amount of withholding based on the classification of payment, documentation of the payee, and income source on the proper forms?
- Has taxpayer applied due diligence standard of Treas. Reg. 1.1441-7(b)(1) in determining correct reporting and withholding?



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Specific Issues

- Hybrid instruments
 - Classification of payment at issue, which affects withholding amount and coding
- Gain recognition agreements
 - Deemed royalty payment or recognized gain may require reporting
- Transfer pricing
 - 1042 reporting reconciles with transfer pricing documentation for inter-company payments.



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Penalties

- IRC Sect. 6651: Failure to file or pay tax
- IRC Sect. 6621: Interest on underpayment
- IRC Sect. 6656: Failure to deposit
- IRC Sect. 6662: Accuracy related
- IRC Sect. 6663: Fraud
- IRC Sect. 6694: Reckless or intentional disregard
- IRC Sect. 6721: Failure to file information returns
- IRC Sect. 6722: Failure to furnish payee statements

Note that many penalty amounts apply *per occurrence!*