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MEMORANDUM FOR INDUSTRY DIRECTORS  
DIRECTOR, FIELD SPECIALISTS  
DIRECTOR, INTERNATIONAL  
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE

FROM: Paul D. DeNard /s/ *Paul D. DeNard*  
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SUBJECT: Industry Directive on Examination of Forms 1042

The purpose of this LMSB Industry Directive is to provide audit recommendations to examiners with regard to the U.S. withholding agents required to file Forms 1042. Examining agents should adapt these and other audit procedures to the unique circumstances of each particular case. This LMSB Directive is not an official pronouncement of the law or the position of the Service, and cannot be used, cited or relied upon as such.

If you have any questions, please call Thomas Chillemi, Qualified Intermediary Team Manager at (212) 298-2101.

Attachments (2)

## Introduction

On October 14, 1997, Final Income Tax Regulations substantially revising and replacing existing regulations regarding withholding of tax under chapter 3 (Sections 1441-1464) of the Internal Revenue Code were published in the Federal Register as T.D. 8734. Under sections 1441 and 1442 of the Internal Revenue Code, a person that makes a payment of U.S. source interest, dividends, royalties, and certain other types of income to a foreign person must generally deduct and withhold 30 percent from the payment. A lower rate of withholding may apply under the Code (e.g. section 1443), the regulations, or an income tax treaty. Generally, a payor of these types of income must also report the payments on Form 1042-S. See Section 1.1461-1(c). Examiners must be familiar with these and other updated rules and regulations on withholding and the extent of transitional relief. See also T.D. 8881 and Notice 2001-4.

U.S. withholding agents are generally required to file an annual Federal income tax return on a Form 1042 to report amounts, which are actually withheld or would have been required to be withheld but for an exemption under the regulations or under an income tax treaty. U.S. withholding agents must attach Forms 1042-S to the Form 1042 reporting the name and address of, amounts paid to, and, if any, amounts withheld from each recipient of U.S. source income. IRS audits of Forms 1042 are meant to ensure that U.S. withholding agents properly withheld income taxes on payments of U.S. source income to foreign persons, and properly reported such payments on Forms 1042 and 1042-S. The audits should also ensure that only foreign persons and entities are included on Forms 1042-S. To the extent that any such parties are not documented or properly presumed to be foreign, the examiner should apply the rules of chapter 61 and Section 3406 to determine the withholding and reporting requirements.

Other changes to the regulations provide for Qualified Intermediaries to withhold tax, but not to report information regarding account holders. These changes will affect the scope and extent of audits performed by the Service. Similarly, new rules cover non-qualified intermediaries and both withholding and non-withholding partnerships and trusts. Documentation and reporting requirements differ based on the classification of the entities to which the U.S. withholding agent makes payments. Thus, the examiner must ensure that the withholding agent properly relied on the classification of the intermediary as part of determining whether the amount of withholding is correct.

The following guidelines serve mainly as recommendations to examiners for the audit of U.S. withholding agents. The individual examiner may deviate from the guidelines in order to adapt the audit to the particular circumstances of each case.

## **Audit Plan**

Examiners are advised to use the following ten steps to audit U.S. withholding agents.

### **STEP 1: Analyze the Withholding Agent's Withholding Tax System**

The examiner should analyze the withholding tax system and internal controls relating to the withholding process. The general ledger may not be the appropriate beginning point as many U.S. withholding agents have a separate custodial account system that records receipts and payments on a daily basis.

The examiner should review the methods used by the U.S. withholding agents to process new accounts, including identification of the payee. The examiner should consider the following forms in his or her review of the methods used to identify payees:

- 1) W-9
- 2) W-8ECI
- 3) W-8BEN
- 4) W-8EXP
- 5) W-8IMY

The examiner should also review the U.S. withholding agent's systems to determine whether he or she considers the following:

- a) Beneficial Owner Processing
- b) Exempt Entity Processing
- c) "No Documentation" Requirements Processing
- d) Processing for Intermediary
- e) Interest Withholding and Exemptions
- f) Securitized Transactions
- g) REIT processing
- h) OID
- i) Eligible Securities
- j) U.S. Branch processing
- k) Affiliate Transactions
- l) International Organizations
- m) Exempt Recipients
- n) Backup Withholding

The above list is not exclusive and the examiner may consider other aspects of the withholding agent's systems based on the circumstances of each particular case.

In order to reduce the time required to perform the audit, the examiner may request that the withholding agent provide the following:

- a) A summary of the withholding tax system process,
- b) System flowcharts,
- c) An explanation of how each or all of the systems described in (a) - (n) above is addressed within the taxpayer system,
- d) Recommended breakdown into strata before the arrival of the team for this process, or other strata selection considerations,
- e) Internal Control Reports or other information from an internal control review function,
- f) A manual that describes the overall system.

For purposes of Step 1 above, and Step 2 below, the examiner should issue an Information Document Request (IDR) in order to make a preliminary evaluation of the adequacy of the U.S. withholding agent's systems. See the attached Exhibit 1 for recommended language to use in this IDR.

**STEP 2: Review the Account Opening Procedures/Identify Payee**

In general, payee status is determined upon entry into the bank/brokerage/insurance/custodial account system. The status of the payee must be determined in order to analyze the withholding tax treatment of a payment. The determination of payee status is the most fundamental of all analyses, and the most critical step that is performed at the opening of an account. The examiners must exercise their professional judgment to determine whether sufficient controls are in place to ensure the proper classification of the account holder as U.S. or foreign. The examiner should consider the following:

- a) Whether the U.S. withholding agent properly identifies appropriate account withholding treatment.
- b) Whether the U.S. withholding agent ensures that proper separation of duties with respect to opening and processing of accounts is part of the internal control description. For example, employees whose duties include opening accounts are not part of the retention, custody or accounting for records. Exceptions are immediately noted, and internal controls descriptions include written procedures on how to handle such exceptions.

In order to reduce the time required to perform the audit, the examiner may request that the U.S. withholding agent document the processes and procedures utilized in determining proper opening account procedures and payee status. These processes and procedures may be described in a manual, internal audit report, training manual for account openings, or checklists for opening account procedures. The examiner may request that the withholding agent provide specific recommendations for audit reviews or review of internal control.

STEP 3: **Reconcile to Ensure That All Income Paid to Nonresident Alien and Foreign Corporations Subject to Withholding Has Been Considered.**

Obtain the U.S. withholding agent's reconciliation of Forms 1042-S to Form 1042.

STEP 4: **Determine the Appropriate Strata (also called "stratification" or "segregation")**

After reviewing the system, and before selecting a sample, the examiner should group the transactions into strata. In developing the strata, the examiner should ensure that all types of anticipated documentation would have some audit coverage. Each of the transactions should be grouped into strata according to dollar value or other areas of interest or concern. Such interest may include, but is not limited, to the following:

- 1) Accounts grouped by withholding rate.
- 2) Accounts grouped by amount.
- 3) Accounts grouped by the recipient's country from Form 1042-S.
- 4) Accounts grouped by the recipient's code from Form 1042-S
- 5) Accounts grouped by the expected documentation to be reviewed such as W-8IMY, W-8BEN, and W-8EXP.
- 6) Accounts grouped by business unit.
- 7) Accounts grouped by cost center.
- 8) Accounts grouped by Margin Account, certain interest accounts etc.

In order to reduce the time required to perform the audit, the examiner may request that the U.S. withholding agent provide a recommended segregation or stratification at the beginning of the

audit, and work with the audit team to develop the strata. The withholding agent may have concerns that may be accommodated in the sample design. The ultimate decision resides with the audit team.

**STEP 5: Determine Appropriate Sample Size**

The appropriate sample size for a given strata is determined by the Computer Audit Specialist ("CAS") with the assistance of the Statistical Sampling Coordinator, or appropriate team member. Sample size will be determined after each strata has been identified and population counts are known. The sample size should be sufficient to ensure that the sample is representative of the population.

In most cases, the sample size will be at least 100 accounts, excluding all the strata tested on a 100% basis to support the use of the ratio and regression estimators. Other factors that could affect sample size include, but are not limited to, the number of items in the population, the variability of the dollar amounts associated with the population and the number of strata utilized.

In order to reduce time required to perform the audit the examiner may request that the U.S. withholding agent provide recommended sample size, with appropriate statistical justifications for the sample size.

**STEP 6: Request Documentation of the Sample**

The examiner will determine the sample and request the documentation information from the U.S. withholding agent. For each account selected as part of the sample, the examiner should request the current account file for review of the documentation and calculation of the withholding.

**STEP 7: Verify Appropriate Identification/Classification of Payee**

- 1) Review information provided in Step 6 to see that the payee provided appropriate documentation.
- 2) Verify that documentation of payee status has been reviewed by the withholding agent for accuracy.
- 3) Verify that the U.S. withholding agent has properly classified payees having foreign status.

**STEP 8: Review Documentation Requirements for Various Types of Income.**

Using the information obtained in Steps 5 and 6 verify that the process results in the correct amount of withholding recorded in each sample.

Consider the type and source of income in determining if the withholding is correct. Different types and sources of income may include the following:

- 1) Securities Lending
- 2) Interest Paid by U.S. Obligors
- 3) Sale of Property and Assumption of Bonds
- 4) Margin accounts
- 5) Interest Coupons in Default
- 6) Domestic Corporations Paying to Foreign Affiliates
- 7) Original Issue Discount
- 8) Bank Deposit Interest
- 9) Portfolio Interest
- 10) Interest and Real Property Mortgages
- 11) Interest Paid to CFC's
- 12) Notional Principal Contract Income
- 13) Dividends
- 14) Eligible Securities
- 15) Effectively Connected Income
- 16) U.S. Branch
- 17) REIT Distribution
- 18) International Organization

**STEP 9: Review For Proper Coding On Form 1042S:**

Review the Explanation of Codes listed on the instructions to Form 1042S and determine whether the codes reflected by the U.S. withholding agent are correct. A partial list of such codes is reflected below:

**Box 1**

<b>Income Code</b>	<b>Code #</b>
Interest paid by U.S. Obligors – general	01
Interest paid on real property mortgages	02
Interest paid to controlling foreign corp.	03
Interest on foreign corporations	04
Interest on tax-free covenant bonds	05
Dividends paid by U.S. corporations general	06
Dividends qualifying for direct dividend rate	07
Dividends paid to foreign corporations	08
Deposit Interest	29
Original Issue Discount (OID)	30
Short Term OID	31

### **Box 6**

<b>Exemption Code</b>	<b>Code</b>
Income Effectively Connected with a U.S. Trade or Business	01
Exempt under Code other than portfolio	02
Income is not from U.S. sources	03
Exempt under a Treaty	04
Portfolio interest	05
QI that assumes primary W/H responsibility	06
W/H foreign partnership or trust	07
U.S. Branch treated as a U.S. Person	08

### **Box 12**

<b>Recipient Code</b>	<b>Code</b>
Individual	01
Corporation	02
Partnership other than W/H foreign	03
W/H foreign partnership or foreign trust	04
Trust	05
Government or International Organization	06
Tax exempt Organization	07
Private Foundation	08

## **STEP 10: Extrapolate and Calculate Penalties:**

Any proposed adjustment resulting from the use of statistical sampling, from withholding or penalty will be computed in accordance with IRM 4.47.3. Penalties are described as follows:

<b>Type of Penalty</b>	<b>Authority</b>
Failure to File or Pay Tax	IRC Section 6651
Determination of Rate of Interest	IRC Section 6621
Failure to Obtain Documentation timely or act in accordance with applicable presumptions	IRC Reg. Section 1.1441-1(b)(7)
Accuracy Related – Negligence	IRC Section 6662(b)(1)
Fraud Penalty	IRC Section 6663
Failure to File Correct Information	IRC Section 6721
Failure to Furnish Correct Payee Stmt	IRC Section 6722

## **EFFECT ON OTHER GUIDANCE:**

This Directive should be applied in the context of Chapter 3 of the Internal Revenue Code and related regulations and rulings. This Directive is not meant to supercede any such guidance or law and



must be so construed. As in the case with any examination, IRS personnel are encouraged to use their professional judgment in developing and resolving factual issues.

## **Exhibit 1**

### **Information Document Request Recommendation**

The following requests are recommended to examiners of Forms 1042 in order to provide a base of knowledge on which to determine the adequacy and reliability of the withholding agent's systems. Such determination should precede sampling of accounts to ascertain the accuracy of the amounts reflected on Forms 1042 and 1042-S. The examiner should include the following questions in the first Information Document Request (Form 4564) served on the U.S. withholding agent.

Please provide the following preliminary information:

- a. Copies of Forms 1042 and Forms 1042-S for each entity of the consolidated group for the year's           .
- b. Work papers and other supporting documents used in preparing these Forms 1042 and Forms 1042-S.
- c. Any internal audit reports for the years identified in a. above that pertain to each company's fiduciary operations, including but not limited to customer account opening and validation procedures and procedures for recording customer transactions.
- d. Operating manuals and written procedures pertaining to the fiduciary activities of each entity, including but not limited to customer account opening and validation procedures and procedures for recording customer transactions and payments.
- e. Flowcharts, diagrams and other material that describe how customer account information is incorporated into each company's EDP system for, among other things, withholding and tax reporting purposes.
- f. Names and titles of all individuals familiar with the fiduciary operations of each entity.
- g. Names and titles of all individuals familiar with the manuals and procedures and charts provided in response to items d. and e. above.
- h. Customer ledgers or other records pertaining to each entity's fiduciary activities that record, report, identify or show information about all customers who have been classified as foreign residents for purposes of federal tax withholding and/or reporting purposes. Such records may be limited to those applicable to or used in connection with the years identified in item a. above.