

Part 4. Examining Process
Chapter 10. Examination of Returns
Section 21. U.S. Withholding Agent Examinations - Form 1042

4.10.21 U.S. Withholding Agent Examinations - Form 1042

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4.10.21.1 (07-29-2008)

Introduction

1. This IRM section provides the basic concepts of U.S. source income which is subject to reporting and withholding when paid to foreign persons.
2. This IRM will cover two types of U.S. withholding agent audits. The first part of this IRM will provide 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. The second part of this IRM will provide 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.
3. This IRM will not be discussing the Qualified Intermediary (“ QI” , see definition below) external audits required under the QI Agreement between the QI and the IRS. See Rev. Proc. 2000-12.
4. It is recommended that the examiner should also view, as an additional reference, the Industry Directive on Examinations of Forms 1042, dated October 31, 2003, for certain guidance with regard to U.S. withholding agent audits.

5. For further assistance, contact the U.S. Withholding Agent Program Technical Advisors.

4.10.21.1.1 (07-29-2008)

NRA Withholding Tax

1. Certain income received by foreign persons is subject to United States gross basis taxation. The income must be fixed, determinable, annual or periodic (FDAP); it must be U.S. sourced; and it must not be included in the foreign person's gross income as effectively connected with any U.S. trade or business of that person (ECI). If these conditions are met, the income will generally be subject to the withholding rate under IRC Sections 1441 or 1442 (generally 30%). The withholding rate can be reduced or eliminated based on an applicable treaty or Code section, such as the portfolio interest exception. Treas. Reg. 1.1441-2 prescribes certain other exceptions to when withholding is required with respect to U.S. source FDAP income. IRC Sections 1441-1443 and 1461 set forth when and how the tax is withheld and reported.
2. Withholding and reporting might instead be required under IRC Section 1445 with respect to dispositions of U.S. real property interests and under IRC Section 1446 with respect to foreign partners' allocations of ECI from partnerships. Withholding under these sections is not addressed in this section and is not included in the definition of NRA withholding in this IRM section.

4.10.21.2 (07-29-2008)

Basic Terms Defined

1. **Amounts subject to NRA withholding** - In general, certain reportable amounts (see definition of Reportable Amounts below) paid to foreign persons from sources within the U.S. that are fixed or determinable annual or periodical (FDAP) income and that are not reported as effectively connected with a U.S. trade or business are subject to NRA withholding. Withholding applies to limited types of gain income not related to real estate interests, including gains from dispositions of natural resources under IRC Section 631, and gains from contingent payments received from the sale or exchange of certain intangible property. See also FDAP income definition below.
An amount is considered paid when it is includable in income under the cash-basis method of accounting. A payment is subject to withholding whether it is made directly to the beneficial owner or made for the benefit of the beneficial owner, including a payment to that person's creditors. A payment for withholding purposes may also arise based on an allocation of income under IRC Section 482. See Treas. Reg. 1.1441-2(e).
2. **Backup withholding** - The withholding required under Section 3406 of the Code with respect to payments made to certain U.S. persons.
3. **Beneficial owner** - The person who, under U.S. tax principles, is required to include the item in gross income on a tax return. See Treas. Reg. 1.1441-1(c)(6)(i). Excluded from this definition are agents of such persons and intermediaries (see definition for Intermediary), as well as certain persons who receive income in connection with conduit transactions. See Treas. Reg. 1.1441-7(f).
4. **Change in circumstances** - Any change that makes any information on a Form W-8 incorrect (see Withholding Certificate below). The account holder is required to notify the withholding agent within 30 days of such change. The Form W-8 becomes invalid when the withholding agent knows or has reason to know of a change in circumstances affecting the correctness of the form. See Treas. Reg. section 1.1441-1(e)(4)(ii)(D).
5. **Disregarded entity** - A business entity that has a single owner and is not treated as a corporation under Treas. Reg. 301.7701-2(b). If an entity is disregarded, its owner is treated as the owner of the income for

NRA withholding purposes, though different rules may apply for determining a preferential withholding rate under an income tax treaty.

- 6. Documentary evidence; other appropriate documentation** - The terms documentary evidence and other appropriate documentation refer to documentation other than a withholding certificate (Form W-8, see Withholding Certificate definition) that may only be provided for documenting the status of payees for payments made outside the United States to offshore accounts (see definition of Offshore Accounts below), or any other evidence that under the IRC Code or regulations certifies or establishes the status of a payee or beneficial owner as a U.S. or a foreign person. See Treas. Reg. 1.1441-1(c)(17) and 1.1441-1(b)(7).
- 7. Documentation** - The term documentation refers to both withholding certificates and documentary evidence or other appropriate documentation. See Treas. Reg. 1.1441-1(c)(18).
- 8. Effectively Connected Income (ECI)** - Generally, when a foreign person engages in a trade or business within the United States, certain U.S. and foreign source income associated with such trade or business may qualify as ECI, which is taxed on a net basis rather than by withholding at source. To establish a withholding exemption for ECI, the withholding agent must generally receive a beneficial owner's withholding certificate (Form W-8ECI) showing a U.S. TIN and representing under penalties of perjury that the income is effectively connected with the conduct of a trade or business within the United States and that it is includable in the beneficial owner's gross income for the tax year. See Treas. Reg. 1.1441-4(a)(2)(i). But see the presumption rules applicable to certain U.S. branches. FDAP income (defined below) may or may not be effectively connected with a U.S. trade or business. A withholding certificate is effective only for the item or items of income specified therein.
- 9. Exempt recipient** - Generally, any payee that is not required to be provided a Form 1099 and is exempt from backup withholding under IRC Section 3406. Such persons are not necessarily exempt from the NRA withholding requirements.
- 10. Fiscally transparent entity** - In connection with obtaining a treaty prescribed reduced rate of withholding, an entity is treated as fiscally transparent with respect to an item of income to the extent that interest holders in the entity must, on a current basis under relevant foreign law, take into account separately their share of an item of income paid to the entity, whether or not distributed, and must determine the character of the items of income as if they were realized directly from the sources that paid it to the entity. For example, partnerships, common trust funds, and certain trusts may be generally considered to be fiscally transparent with respect to items of income received by them. Such entities are not considered to have derived income for purposes of IRC Section 894(c), and they maybe ineligible for treaty benefits under this code section, though their interest holders may be so eligible.
- 11. Fixed or Determinable Annual or Periodic (FDAP)** - In general, income that is includible in gross income under IRC Section 61. Income is fixed when it is paid in amounts known ahead of the time paid. Income is determinable whenever there is a basis for calculating the amount to be paid. Examples of FDAP income include interest, dividends, rents, royalties, and compensation. See Treas. Reg. 1.1441-2. Certain U.S. source FDAP income is excluded from withholding, such as interest qualifying under IRC Sections 871 or 881 as portfolio interest (see definition below) and income excludible under a U.S. income tax treaty with a country with respect to which the foreign recipient meets the residency and other requirements for obtaining the treaty exemption. See also IRC Section 894(c). Gains from asset sales are generally not FDAP income. But see the withholding requirement applicable to sales of U.S. real estate or stock in a U.S. real property holding company. See Treas. Reg. 1.1445-1(b).
- 12. Flow-through entity** - A flow-through entity is a foreign partnership, a foreign simple trust or foreign grantor trust, or, for payments for which a reduced rate of withholding is claimed under an income tax

treaty, any entity to the extent it is considered fiscally transparent (as defined above). In such cases, withholding is determined based on the status of the entity's owners. See definition of Beneficial Owner. When an entity executes an applicable withholding agreement with the IRS to act as either a Withholding Foreign Partnership or Trust, it is then itself generally authorized to act as a withholding agent with respect to certain of its owners. See Rev. Proc. 2003-64 and subsequent amendments to the pro-forma withholding agreements. Foreign estates and foreign complex trusts are not generally considered flow-through entities for withholding purposes. Whether an entity is a partnership is determined under the entity classification regulations. See Treas. Reg. 1.1441-1(c)(27).

- 13. Foreign corporation** - Any corporation that is not a domestic corporation. See IRC Section 7701(a)(5). A domestic corporation is one that was created or organized in the U.S. or under laws of the U.S. or any of its states, or the District of Columbia. See Treas. Reg. 1.1441-1(c)(4).
- 14. Foreign central bank of issue** - A bank that is by law or government sanction the principal authority, other than the government itself, to issue instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose law it is organized. For purposes of IRC Section 895, the Bank of International Settlements is treated as though it were a foreign central bank of issue. IRC Section 895 generally exempts from U.S. taxation income that a foreign central bank of issue receives from obligations of the United States (or of any agency or instrumentality thereof) or from interest on deposits with persons carrying on the banking business unless such obligations or deposits are associated with commercial banking functions or other commercial activities of the foreign central bank of issue. An exemption might also apply under IRC Section 892 for foreign central banks not engaged in commercial activities within the U.S. A foreign central bank of issue should generally provide a Form W-8EXP to a withholding agent to establish eligibility for an applicable withholding exemption under those sections.
- 15. Foreign government exemption** - In connection with the withholding exemption under Treas. Reg. 1.1441-8, a foreign government includes only its integral parts or controlled entities as defined in Treas. Reg. 1.892-2T. Only a foreign government or an international organization (defined below) qualifies for exemption from taxation under IRC Section 892. This section generally excludes from gross income and exempts from U.S. taxation income which a foreign government receives from investments in the United States in stocks, bonds or other domestic securities; financial instruments held in the execution of governmental financial or monetary policy; and interest on deposits in banks in the United States of monies belonging to the foreign government. Income of a foreign government from any of these other sources listed below are not exempt from taxation: (a) that derived from the conduct of commercial activity, (b) that received directly or indirectly from a controlled commercial entity, and (c) that derived from the disposition of any interest in a commercial entity.
- 16. Foreign partnership withholding** - Treas. Reg. 1.1441-1(c)(12) defines "payee" as the person to whom payment is made. The partners of a foreign partnership are generally considered the payees of income paid to the partnership. See Treas. Reg. 1.1441-5(c)(1)(i). A foreign partnership may be treated as the payee by a withholding agent if it is a withholding foreign partnership (see definitions for Withholding Certificate and Flow-through entity), or it certifies that the payment is ECI associated with the partnership's U.S. trade or business (see definition for Documentation above). The same rules apply to tiered partnerships. Therefore, for a payment to a foreign partnership that has another foreign partnership as a partner (lower-tier partnership), withholding would generally be determined based on the status of the partners of the lower-tier partnership. These rules do not apply to domestic partnerships. See Treas. Reg. 1.1441-5.
- 17. Foreign person** - Any person who is a nonresident alien individual (defined below), a foreign corporation, a foreign trust, a foreign estate, and any other non-U.S. person. See Treas. Reg. 1.1441-

1(c)(3)(ii). NRA withholding tax applies only to foreign persons.

- 18. Grantor trust** - A foreign trust all or a portion of which is treated as owned by the grantor or other person under Sections 671 through 679 of the Code.
- 19. Hybrid entity** - Any entity (other than an individual) that is treated as fiscally transparent under U.S. tax law (see definitions for Flow-through Entity and Foreign Partnership Withholding), but is not treated as fiscally transparent by a country with which the U.S. has an income tax treaty (see definition for Fiscally Transparent Entity). Hybrid entity status is relevant in connection with both treaty benefits and for determining the beneficial owner of income under U.S. tax principles.
- 20. Intermediary** - Any person that acts as a custodian, broker, nominee, or agent for another person, regardless of whether or not that other person is the beneficial owner of the amount paid.
- 21. International organization** - An international organization is any public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288-288(f)). In general, to qualify as an international organization, the U.S. must participate in the organization pursuant to a treaty or under the authority of an Act of Congress authorizing such participation. See Treas. Reg. 1.1441-9 concerning the related exemption from NRA withholding.
- 22. Nonqualified intermediary** - Any intermediary that is not a U.S. person and that is not a qualified intermediary. See definitions for Intermediary and Qualified Intermediary.
- 23. Nonresident alien individual** - Any individual who is not a U.S. citizen or resident of the U.S. See IRC Section 7701(b).
- 24. Offshore accounts** - Determining the existence of an offshore account is potentially relevant in connection with the presumption rules (as defined below) for determining the status of certain undocumented payees and in connection with the use of documentary evidence in lieu of a withholding certificate (both as defined herein). These are in general accounts which are located outside the U.S. See Treas. Reg. 1.6049-5(c)(1) for more on the rules applicable to offshore accounts.
- 25. Overwithholding adjustments** - If the withholding agent discovers that it overwithheld NRA withholding tax in a tax year by March 15 of the following calendar year, it can use either the reimbursement or the set-off procedure to adjust the overwithholding.
 - A. Reimbursement procedure - Under this procedure, the withholding agent repays the payee with its own funds by March 15 of the following calendar year and reports for the year of the overpayment (1) the repaid amount on a timely filed Form 1042-S to the payee and (2) a claim for credit on Form 1042. The withholding agent is then reimbursed by reducing any subsequent deposits it makes before the end of the following year with respect to payments subject to withholding.
 - B. Set-off procedure - Under this procedure, the withholding agent repays the payee by reducing the amount it would have been required to withhold on later payments it makes to the same person by the earlier of the due date or actual filing date of Form 1042-S. See Treas. Reg. 1.1461-2.
- 26. Portfolio interest** - Portfolio interest is generally excluded as an amount subject to NRA withholding, though it may be subject to Form 1042-S reporting. To qualify as portfolio interest, the interest must be paid on obligations issued after July 18, 1984 and meet certain other requirements under IRC Section 871, such as that:
 - A. The obligation is issued in registered form or is a foreign-targeted bearer obligation as defined in

Section 871 regulations;

- B. The payee certifies its status as a foreign person and as the beneficial owner of the income;
- C. The recipient is not a shareholder having 10% or more ownership of the payer;
- D. The interest is not contingent interest.

Reference IRC Sections 871 and 881 for further details about this withholding exemption.

- 27. Presumption rules** - Rules for determining an undocumented account holder's / payee's (as defined below) relevant characterizations for withholding purposes, such as whether an entity is a U.S. or foreign person. See Treas. Reg. 1.1441-1(b)(3). These rules may sometimes be superseded by a withholding agent's knowledge concerning the payee. See definitions for Reason to Know and Standard of Knowledge below.
- 28. Qualified intermediary** - A person that is a party to a withholding agreement with the IRS and is:
- A. A foreign financial institution or a foreign clearing organization (other than a U.S. branch or U.S. office of the institution or organization);
 - B. A foreign branch or office of a U.S. financial institution or a foreign branch or office of a U.S. clearing organization; or
 - C. Any other person the IRS accepts as a qualified intermediary. See Rev. Proc. 2000-12 and any amendments thereto.
- 29. Reason to know** - A standard of knowledge that might result in a requirement for a withholding agent to withhold at a rate in excess of that which would result from reliance on a payee's withholding certificate or from applying the presumption rules (defined above). See Treas. Reg. 1.1441-7(b)(2-3) and 1.1441-1(b)(3)(ix)(B). See also Standard of Knowledge definition.
- 30. Reportable amounts** - In general, an amount subject to reporting on Form 1042-S for amounts paid to foreign persons subject to withholding. Such amounts include certain amounts subject to Form 1042-S reporting but for which withholding is not applied, including certain payments exempted on account of a treaty or applicable code section. See Treas. Reg. 1.1461-1(c)(2) and Treas. Reg. 1.1441-1(e)(3)(vi).
- 31. Reportable payments** - Payments made to certain U.S. recipients that are required to be shown on a return required under IRC Sections 6041 - 6050 and for which withholding may be required under the conditions prescribed by IRC Section 3406.
- 32. Resident Alien (RA)** - Any individual who is not a U.S. citizen or national of the U.S. who meets the green card test or the substantial presence test for the calendar year. See IRC Section 7701(b).
- 33. Reverse hybrid entity** - Any entity (other than an individual) that is not fiscally transparent under U.S. tax law principles (i.e., is treated as a corporation), but that is fiscally transparent under the laws of a jurisdiction with which the U.S. has an income tax treaty (such as an entity akin to a partnership).
- 34. Standard of knowledge** - Treas. Reg. 1.1441-7(b)(1) defines the standards the withholding agent must apply to determine the correct reporting under IRC Sections 1441 - 1443.
- 35. Tax liability** - The withholding agent will be liable for a tax amount resulting from failing to withhold or deposit amounts subject to NRA withholding. See IRC Section 1461. Both the withholding agent and the foreign recipient may be held liable for such tax, applicable interest and any penalties resulting from a withholding failure.

- 36. U.S. sourced income** - In general, the source of income is the place where income-generating activity occurs or where the asset giving rise to the relevant income is located. IRC Sections 861, 863 and 865 prescribe rules for determining when certain types of income are U.S. or foreign sourced, which is relevant for NRA withholding. See definition of Amounts Subject to NRA Withholding and Figure 4.10.21-3.
- 37. U.S. withholding agent** - A U.S. person who has control, receipt, custody, disposal or payment of income to a foreign person.
- 38. Undocumented account holder** - An account holder for whom the U.S. Withholding Agent does not hold valid documentation in connection with a payment.
- 39. Withholding certificate** - The term withholding certificate, per Treas. Reg. 1.1441-1(c)(16), means various versions of Form W-8, Form 8233, Form W-9 (Form W-9 indicates U.S. status), or any other certificates that under the IRC code or regulations certifies or establishes the status of a payee for withholding or reporting purposes. This term is referred to alternatively in this section as either a withholding certificate or as a Form W-8. See Figure 4.10.21-1 for the different types of Forms W-8 and other forms.

Figure 4.10.21-1

Withholding Certificate

<u>Form</u>	<u>Description</u>
Form W-8BEN	Certificate of Foreign Status of Beneficial owners for United States Tax Withholding (including claims of treaty benefits by foreign persons)
Form W-8ECI	Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States
Form W-8EXP	Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding
Form W-8IMY	Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding
Form 8233	Exemption From Withholding on Compensation For Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual
Form W-9	Request for Taxpayer Identification Number and Certification

40.

Withholding foreign partnership or withholding foreign trust - A foreign partnership or a foreign simple or grantor trust that has entered into a withholding agreement with the IRS in which it agrees to assume primary withholding responsibilities with respect to certain of its partners, beneficiaries or owners.

41. Withholding agent - Any person, U.S. or foreign, that has control, receipt or custody of an amount subject to withholding or who can disburse or make payments of an amount subject to withholding is a withholding agent. The withholding agent may be an individual, corporation, partnership, trust, association or any other entity, including (but not limited to) any foreign intermediary, foreign partnership and U.S. branches of certain foreign banks and insurance companies. Generally, the person who pays (or causes to be paid) the amount subject to withholding to the foreign person (or to its agent) must withhold.

42. Withholding statement - The written statement provided to a withholding agent by an intermediary or by a nonwithholding partnership or trust for allocating payments and for applying withholding to each underlying account holder or owner. The statement must contain sufficient information for a withholding agent to apply the correct rate of withholding on payments for the accounts identified on the statement and to properly report such payments on Forms 1042-S and Forms 1099, as applicable.

4.10.21.3 (07-29-2008)

Impact of NRA Withholding Tax Law Changes Effective 2001

1. Final Income Tax Regulations, Treas. Reg. 1.1441 - 1.1443 and Treas. Reg. 1.1461, effective January 1, 2001 substantially changed the prior regulations. These regulations prescribe in detail the reporting and withholding responsibilities of withholding agents.
2. Two of the concerns addressed in these regulations:
 - A. Foreign persons incorrectly being provided treaty benefits or being incorrectly treated as beneficial owners of income; and
 - B. U.S. Persons being unidentified for IRC Section 3406 withholding purposes and for Form 1099 reporting.
3. Some of the regulatory changes included:
 - A. Prescribing various withholding and reporting related requirements for payments to foreign intermediaries, flow-through entities and other foreign payees, including the Qualified Intermediary regime for foreign financial institutions;
 - B. Prescribing withholding requirements in certain cases with respect to Original Issue Discount (OID);
 - C. Prescribing general due diligence requirements for withholding agents in determining withholding rates and specific due diligence requirements for certain payments by financial institutions;
 - D. Prescribing detailed “presumption rules” generally applicable for determining the withholding applicable to undocumented payees; and
 - E. Effectively eliminating the so-called “address rule” for granting treaty- based withholding rates in favor of a documentation-based system that includes various withholding certificates (i.e., Forms W-8BEN, W-8IMY, W-8ECI, and W-8EXP).

4.10.21.4 (07-29-2008)

Summary of Relevant Code Sections

1. IRC Section 1441 - generally sets forth such things as:
 - A. The persons subject to having NRA withholding applied against their income;
 - B. The income subject to withholding;
 - C. The entities qualifying as Withholding Agents; and
 - D. The statutory withholding rates.
2. IRC Section 1442 - requires the withholding of tax in certain cases with respect to payments made to foreign corporations.
3. IRC Section 1443 - requires the withholding of tax in certain cases with respect to foreign tax- exempt organizations and prescribes the 4% withholding rate applicable to foreign private foundations.
4. IRC Section 1444 - provides for the withholding rate on Virgin Island source income paid to U.S. persons, resident aliens and U.S. corporations.
5. IRC Section 1445 - provides for withholding of tax on dispositions of U.S. real property interests.
6. IRC Section 1446 - requires domestic and foreign partnerships to withhold on ECI (as determined under section 1446(c)) allocable to foreign partners.
7. IRC Section 1461 - sets forth a withholding agent's liability for underwithheld tax.
8. IRC Section 1463 - allows for the application of interest and penalties to cases in which the payee paid the underlying tax that was required to have been withheld.
9. IRC Sections 871 & 879 - provides for the imposition of tax on certain U.S. source income paid to nonresident alien and foreign corporations who are not engaged in a U.S. trade or business.

4.10.21.5 (07-29-2008)

Form 1099 Backup Withholding Tax vs. NRA Withholding Tax

1. The Form 1099 / Backup Withholding and NRA Withholding Tax regimes share some basic similarities. Both systems require the reporting of certain types of income and the withholding of taxes in certain cases. Both have an annual income tax return requirement, which is Form 945 with respect to backup withholding and Form 1042 with respect to reporting certain U.S. source payments made to foreign persons and amounts withheld. In addition, both have informational reporting requirements with respect to income recipients (Forms 1099 and Forms 1042-S for U.S. and foreign recipients, respectively). Apart from these separate reporting requirements, withholding and reporting occurs under these regimes based on different criteria. As a result, despite some general similarities, a major determination for a withholding agent is in properly documenting or otherwise classifying a recipient as either a U.S. or a foreign person. When a recipient is a U. S. person, NRA withholding is inapplicable, and Form 1099 reporting and backup withholding is sometimes required. When a recipient is foreign person, NRA withholding and reporting is required with respect to certain income payments, and no Form 1099 / Backup withholding requirements are triggered. For further guidance on Backup Withholding, see IRC Section 3406 and Pub. 1281.
2. Although this IRM section deals principally with NRA Withholding, Form 1099 reporting and backup

withholding also needs to be considered as part of an integrated audit. Auditing Form 1042 information can result in collateral adjustments to Forms 1099 and 945 when, for example, persons classified as foreign by a withholding agent need to be reclassified as U.S. persons subject to backup withholding and Form 1099 reporting. Additionally, deficiencies in a withholding agent's Form 1042 related systems may indicate a generic problem in its tax reporting systems.

4.10.21.6 (07-29-2008)

Important Forms to Know

1. Form 1042 - This is the income tax return for reporting the liability for NRA withholding tax, the amounts withheld, the reportable amounts paid to foreign persons and any credit claimed for amounts withheld by other withholding agents. This return is due on March 15th (or the next business day if the 15th falls out on a nonbusiness day) of the following year. All Forms 1042 are required to be filed on a calendar year basis, and consolidation of separate legal entities for Form 1042 filing purposes is NOT permitted. For Forms 1042 filed on or before April 15 following the end of the calendar year covered by the Form, the Form 1042 is considered filed on April 15 for purposes of determining the statute of limitations on assessment. See IRC Section 6501(b)(2).
2. Form 1042-S - This is an information reporting form that a withholding agent files with the IRS and issues to each foreign recipient (NRA) of a reportable amount. It shows, among other things, the amount and type of income paid to the recipient, the tax withheld, and any applicable withholding exemption. The Form(s) 1042-S should have the same due date as the Form 1042.
3. Form W-8BEN - This form is provided by a foreign recipient to a withholding agent to certify the recipient's non-U.S. status and status as beneficial owner of the income being paid. It may also be used to claim withholding related treaty benefits when properly completed. If no TIN is provided, it generally will remain in effect for a period starting on a date the form is signed and ending on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect. If a TIN is provided, the 3 year rule does not apply and it remains in effect until a change in circumstances. See Form W-8BEN Instructions.
4. Form W-8IMY - This form is provided to a withholding agent by a foreign recipient that is an intermediary or flow-through entity, rather than itself a beneficial owner of the income being paid to it. This form is commonly used by foreign financial institutions such as broker-dealers that are receiving payments in an intermediary capacity on behalf of their account holders. It is generally valid indefinitely unless a change in circumstances renders the form incorrect. See Form W-8IMY Instructions.
5. Form W-8ECI - This form is provided to a withholding agent by a foreign recipient who is the beneficial owner of a reportable amount, when the income is ECI that the recipient is to report on a U.S. tax return (i.e., Form 1120F or Form 1040NR). Although no tax need be withheld in such cases, there is a Form 1042-S reporting requirement imposed on the withholding agent. It generally will remain in effect for a period starting on a date the form is signed and ending on the last day of the third succeeding calendar year unless a change in circumstances makes any information on the form incorrect. See Treas. Reg. 1.1441-4(ii)(C) and Form W-8ECI Instructions.
6. Form W-8EXP - This form is provided to a withholding agent by a foreign recipient who is the beneficial owner of the reportable income claiming certain withholding exemptions applicable to tax-exempt entities. A common use of this form is when the recipient is a foreign government. Although there will be no withholding tax, there will be Form 1042-S reporting of the reportable amounts. It generally will remain in effect for a period starting on a date the form is signed and ending on the last day of the third succeeding calendar year, See Treas. Reg. 1.1441-4(ii)(B).

7. Form W-9 - This form is used for certifying a recipient's status as a U.S. person. No NRA withholding and reporting is required in such cases (see above concerning Form 1099 / Backup Withholding). It is generally valid indefinitely unless a change in circumstances makes any information on the form incorrect.
8. Form 8233 - This form is completed by a nonresident alien individual to obtain a tax treaty withholding exemption with respect to amounts paid for the individual's performance of certain personal services within the U.S. For each tax year, this form should be completed and submitted to the withholding agent.
9. Form 5471 - IRC Section 6038 requires filing of Form 5471, Information Return of U.S. Person with Respect to Certain Foreign Corporations. Form 5471 is an extensive reporting by certain U.S. shareholders of information that pertains to their interests in foreign corporations.
10. Form 5472 - IRC Section 6038A requires filing of Form 5472, Information Return of a 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. This form is filed by a U.S. corporation, 25% of which is owned by a foreign corporation or a foreign corporation engaged in a trade or business within the U.S. Form 5472 captures entity data and summary financial information on intercompany transactions. It is required to be filed by any reporting corporation that had a reportable transaction with a foreign related party.
11. Form 945 - This form, the Annual Return of Withheld Federal Income Tax, is used to report withheld federal income tax from certain nonpayroll payments, including gambling, IRAs and pensions. Another type of nonpayroll payment is backup withholding. Backup withholding is required when a Form 1099 is missing a Tax I.D. number or contains an incorrect Tax I.D. number with respect to a reportable payment. See Pub. 15 and Pub. 1281 for more information on Form 945.

4.10.21.7 (07-29-2008)

Important Items to Consider for Pre-audit Planning

1. An audit of Form 1042 may result in an adjustment to both Form 1042 and Form 945. Therefore, when auditing Form 1042, the examiner must always determine the statute of limitations on the audit years for both Form 1042 and Form 945. If applicable, the examiner is required to obtain and have executed Form 872 and Form SS-10 to protect the statute of Form 1042 and Form 945, respectively. See IRM 25.6.22 and Pub. 1035 for more details.
2. It is highly recommended that the examiner determine whether the taxpayer has entered into any agreements with the IRS in regard to their withholding systems, policies, procedures or other requirements, such as a:
 - A. Submission under Rev. Proc. 2004-59, Voluntary Compliance Program (the "Section 1441 VCP"), including any applicable remediation agreement;
 - B. Closing Agreement
 - C. Pre-Filing Agreement for the audit year; and/or
 - D. Memorandum of Understandings (including one covering an on-line Form W-8 system).
If so, examiner should obtain a copy of the memorandum, agreement or submission for background and to ensure that the taxpayer has satisfied any of its conditions applicable to the audit year.

4.10.21.8 (07-29-2008)

U.S. Financial Institution Withholding Agent Audit

1. Commercial banks and brokerage firms are examples of financial institutions that act as U.S. withholding agents. Certain of these institutions act as intermediaries with respect to their clients' investments in securities and deposits. As a result, these institutions may make investments and receive payments in a fiduciary or custodial relationship with their clients. For example, when a foreign person's account is credited by a broker-dealer with U.S. source FDAP income that the broker-dealer has received on the foreign person's behalf, the financial institution may have NRA reporting and withholding responsibilities with respect to the income. This type of audit will focus on determining if such 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 been instead been subjected to backup withholding under IRC Section 3406.

4.10.21.8.1 (07-29-2008)

Functional Review of NRA Operational Procedures

1. The examiner should perform a functional review of the U.S. withholding agent's NRA withholding tax related operating procedures.

4.10.21.8.1.1 (07-29-2008)

Review of Written Procedure and Training Manuals

1. The first step is a review of written procedure and training manuals such as:
 - A. Summaries of withholding tax systems
 - B. System flow charts covering payments made to account holders
 - C. Internal control, audit reports or other information which relate to the withholding tax function; and
 - D. Manuals related to functions that may have withholding tax implications, including:
 - Payment system design;
 - Account opening procedures;
 - Validation procedures for Form W-8;
 - Procedures for determining or classifying undocumented accounts;
 - Application of presumption rules.
 - E. Training manuals for personnel for departments that control the following functions:
 - NRA Withholding tax determinations or implementation;
 - Opening new accounts;
 - Preparing Forms 1042 & 1042-S.

Evaluation of the above written procedures (or lack thereof) may provide the examiner with an indicator of the overall reliability of the taxpayer's withholding tax functions. This assessment may assist in determining the extent of additional audit procedures, such as the review of account files statements and withholding certificates.

4.10.21.8.1.2 (07-29-2008)

Review of Form 1042 and 1042-S

1. Form 1042

A. Reconciliation - The gross income and net tax liability reported on Form 1042 should agree to the gross income and taxes withheld as determined by combining these amounts from all Forms 1042-S filed. To verify this, the examiner should obtain the taxpayer's reconciliation workpapers and Forms 1042-S. The examiner can also request for a computer audit specialist (CAS) to perform a reconciliation in certain cases of payments contained in computer sensitive files.

Note: Examiner should account for line 66 of Form 1042, Credit for amounts withheld by other withholding agents, during the reconciliation process.

B. Deposit Requirements - The tax liability for each applicable period of the year (normally quarter-monthly which is the 7th, 15th, 22nd and last day of the month) is required to be shown in the Record of Federal Tax Liability section on Form 1042. The examiner should ensure that the withholding agent did not instead complete this section, in some situations, based on deposit dates, as this error may prevent identification of late deposits. The examiner should otherwise insure that deposits were made timely by reviewing the taxpayer's payments and deposits records. Due dates for deposits and associated penalties are discussed below:

- If the total withholding tax for a calendar year is less than \$200, the tax can be paid when the tax return (Form 1042) is timely filed.
- If at the end of any calendar month the total amount of withholding tax is more than \$200 but less than \$2,000, the Withholding Agent must deposit the taxes within fifteen days after the end of the month.
- If at the end of any quarter-month period the withholding tax is \$2,000 or more, the Withholding Agent must deposit taxes within three banking days after the end of the quarter-monthly period. A quarter-monthly period ends on the 7th, 15th, 22nd, and last day of the month.

2. Form 1042-S: With the assistance of the CAS, year end account statements (or the information included on them) should be obtained on a sample basis. The Forms 1042-S for these accounts should be compared to verify the correctness of such items as:

- Gross income (Box 2)
- Tax Withheld (Box 7)
- Income code (Box 1)
- Tax rate (Box 5)
- Exempt code (Box 6)
- Recipient code (Box 12)

3. See Form 1042-S instructions for Income, Exemption and Recipient codes and other application form requirements. See Pub. 515 for tax rates.

4.10.21.8.2 (07-29-2008)

Account Opening / Updating Procedures

1. Normally the status of an account holder, the withholding rates and other information are entered into

the withholding agent's systems. Generally, this can be expected to occur when an account is opened. These procedures are critical in determining:

- A. The status of the account holder as a foreign or U.S. person;
- B. The type of account holder (i.e. as an individual or entity);
- C. For foreign persons, the basis of any treaty claims; and
- D. Ultimately, the withholding rate, if any.

4.10.21.8.2.1 (07-29-2008)

New Account Examination Procedures

1. The examiner should review the procedures for new accounts using the following criteria:
 - A. Any information, other than withholding certificates (i.e., Forms W-9 and W-8), used to determine if the account is held by a U.S. person or a foreign person, such as:
 - Residence and mailing addresses shown on account opening applications;
 - Documentation submitted by the account holder for identification purposes (i.e. passports, driver's license, articles of incorporation, etc.); and
 - Account-file information or correspondence.
 - D. Procedures used to determine an account holder's status for withholding purposes, including when the account is not documented with a withholding certificate or when information provided during account opening is inconsistent with the information showing on the certificate. The examiner should further determine if the information noted in part (a) above is used for withholding purposes in lieu of the presumption rules for undocumented account holders.

Note: The information noted in parts (a) and (b) cannot be used in lieu of presumption rules for undocumented account holders. The U.S. withholding agent can rely on a valid withholding certificate (i.e. Form W-8), documentary evidence only in the case of off-shore accounts, or the regulations' presumption rules to determine the status of a payee. This information is relevant, however, because if for a specific account holder the information contradicts claims on a withholding certificate or documentary evidence, such documents may be unreliable or invalid based on the applicable standard of knowledge imputed to the withholding agent (see Standard of Knowledge definition above). See also "Requirement to Rely on Presumption Rules" and "Validation Process" sections.

- E. Procedures which require the separation of functions, if applicable. For example, the individual who solicits Forms W-8 should be different from the individual who validates the Forms. In addition, the individual that validates should be from a different department than the individual who solicits.
- F. Procedures for recording and updating information into the withholding and account systems (i.e., master files) to reflect information received via Forms W-8 and opening procedures. The following minimum information should be captured by the NRA Withholding and Accounting systems from Form W-8:
 - Foreign person status;
 - Type of Form W-8 (BEN, EXP, IMY, or ECI) used to document the account

holder;

- Type of Entity (corporation, trust, etc.);
- Treaty claim (Part II of Form W-8BEN) and limitations or conditions set forth on this form;
- Expiration date of Form W-8 (if applicable).

4.10.21.8.3 (07-29-2008)

Due Diligence - Standard of Knowledge

1. The examiner should insure that the withholding agent has applied the due diligence standards set forth in Treas. Reg. 1.1441-7(b)(1) in its determination of the correct reporting and withholding to be applied. Under this regulation, if a withholding agent knows or has reason to know that a withholding certificate (e.g. Form W-8BEN) or documentary evidence provided by the payee is unreliable or incorrect, the withholding agent must withhold and report at a full rate of 30%. If a withholding agent relies on another agent to obtain documentation, the withholding agent is generally considered to know, or have reason to know, facts within the knowledge of its agent. Note: the account file information is relevant information for an examiner to make any such determinations.

4.10.21.8.3.1 (07-29-2008)

Reason to Know

1. Generally, a withholding agent will be considered to have known a claim of foreign status or for a treaty-based withholding rate to be incorrect or unreliable if the statements contained in the withholding certificate or in other information which the withholding agent has, would cause a reasonable person to question the claims made. A more specific reason to know standard applies with respect to payments by financial institutions. See Treas. Reg. 1.1441-7(b).

4.10.21.8.3.2 (07-29-2008)

Actual Knowledge

1. Despite representations made on an otherwise valid withholding certificate, a withholding agent must withhold and report based on its actual knowledge of facts concerning the recipient when that knowledge results in a higher rate of withholding than would have been applied by sole reliance on the certificate. For example, if a withholding agent makes a payment to a U.S. person and the withholding agent has actual knowledge that the U.S. person is acting as an agent for a foreign person, the withholding agent must treat the payment as made to a foreign payee. (This does not apply when the U.S. person is a Financial Institution.)

4.10.21.8.3.3 (07-29-2008)

Application of Presumption Rules

1. If a withholding agent cannot reliably associate a payment with a valid withholding certificate (or documentary evidence for offshore accounts), the withholding agent must follow the presumption rules contained in Treas. Reg. 1.1441-1(b)(3) to determine the status of the payee for withholding and reporting purposes, subject to the above knowledge standards. If the withholding agent fails to comply with the presumption rules, it may be liable for the correct withholding tax, interest and penalties. See Treas. Reg. 1.1441-1(b)(3) and IRC Section 1461 for further details. The IRC Section 1441 presumption rules are summarized below.

4.10.21.8.3.3.1 (07-29-2008)

Classification (Type of Entity)

1. The withholding agent must generally presume that a payee is an individual, a trust, an estate, a corporation or one of the persons enumerated under Treas. Reg. 1.6049-4(c)(1)(ii)(A)(i) through Treas. Reg. 1.6049-4(c)(1)(ii)(Q), or a partnership by following the rules under Treas. Reg. 1.1441-1(b)(3).

4.10.21.8.3.3.2 (07-29-2008)

U.S. versus Foreign Status

1. Generally, a payment that a withholding agent cannot reliably associate with valid documentation is presumed made to a U.S. person. Treas. Reg. 1.1441-1(b)(3)(iii). However, the payee will be presumed to be a foreign person if the payee is an exempt recipient and there are certain indicia of foreign status. See Treas. Reg. 1.1441-1(b)(3)(iii)(A). Indicia of foreign status is also relevant for determining the status of a partnership as U.S. or foreign. See Treas. Reg. 1.1441-5(d) for more details on partnerships' presumption rules. Note: If the partnership is presumed to be foreign, it is not the beneficial owner of the income paid to it. If the partnership is presumed to be domestic, it is a U.S. nonexempt recipient for backup withholding / Form 1099 reporting purposes.

Also, a payment is generally presumed made to a foreign payee if the payment is made outside the U.S. to an off-shore account and the withholding agent does not have actual knowledge that the payee is a U.S. person. See Treas. Reg. 1.1441-1(b)(3)(iii)(D) and 1.6049(d)(2) & (3).

4.10.21.8.3.3.3 (07-29-2008)

Foreign versus U.S. Status of Partnership

1. If it is presumed or know that a payee is a partnership, the withholding agent must determine the classification of the partnership as foreign or domestic. A partnership is presumed to be foreign when its EIN begins with “ 98” , where the payer’s communications with the partnership are mailed to an address in a foreign country, or where the payment is made outside the United States. In all other circumstances, the payer may presume that the partnership is domestic (in which event no NRA withholding tax is applicable, however, backup withholding may be triggered). See Treas. Reg. 1.1441-5(d)(3) for more details.

4.10.21.8.3.4 (07-29-2008)

Requirement to Rely on Presumption Rules

1. A withholding agent that withholds at a rate less than that applicable under the presumption rules or based on its actual knowledge will be liable for the tax required to be withheld (or backup withheld) without the benefit of a reduced rate, unless the withholding agent is able to demonstrate that the proper amount of tax was paid. See Treas. Reg. 1.1441-1(b)(7)(i). Note: Even if the withholding agent establishes that the proper amount of tax was paid by the recipient, the withholding agent may be subject to penalties. See IRC Section 1463.
2. However, a withholding agent may not rely on a payee’s presumed status if it has actual knowledge or reason to know that the status or characteristics of the payee or beneficial owner differ from its presumed status and a greater amount of withholding tax would apply based on such knowledge.

4.10.21.8.4 (07-29-2008)

Validation of the Certification of Foreign status and/or Treaty Claim (Form W-8)

1. This section provides general guidance for the review of Forms W-8. It also provides guidance to determine the corrected withholding tax and/or reporting requirements if the forms are found to be

invalid or unreliable.

4.10.21.8.4.1 (07-29-2008)

Reliance on Withholding Certificate (Form W-8)

1. A U.S. withholding agent may generally rely on a properly completed withholding certificate (i.e., Forms W-8), as defined in Treas. Reg. 1.1441-1(c)(16), to establish a recipient's foreign status or a claim of treaty benefit. Documentary evidence can instead be used with respect to offshore accounts. The withholding certificate must be completed with respect to any item on the form that is relevant to the claim made by the direct account holder and must not contain claims which are inconsistent with claims made in any part of the form. The certificate might also be invalid if it contradicts or is inconsistent with other information known to the withholding agent. In this connection, a withholding agent must rely on its actual knowledge or the reason to know standard in the regulations when such knowledge results in a higher withholding tax rate than would have occurred through reliance on the withholding certificate. See Treas. Reg. 1.1441-7(b)(4).

4.10.21.8.4.2 (07-29-2008)

Account Review

1. The following should generally be requested for each account reviewed:
 - A. Withholding certificates, or documentary evidence (for offshore accounts)
 - B. Account file information for information needed to administer and open the account such as:
 - Mailing instructions and addresses;
 - Information supporting the account holder's status as an individual, corporation, or other entity;
 - Authorization for certain transactions (i.e. buy or sell stock);
 - Other account instructions and correspondence;
 - Account application forms and updates.

4.10.21.8.4.3 (07-29-2008)

Validation Process

1. As stated previously (See "Reliance on Withholding Certificate (Form W-8)"), the U.S. withholding agent can generally rely on a valid Form W-8 to determine the correct taxes to be withheld and the correct reporting of income. If the withholding agent does not have a valid Form W-8, the withholding agent must generally use the applicable presumption rules to determine the attributes of the account holder relevant for prescribing the rate of withholding. If the withholding agent does not rely on the presumption rules when required to do so, the withholding agent may be liable for taxes underwithheld as well as interest and penalties.
2. It is recommended that the validation of Form W-8 be performed in three steps:
 - A. Line by line review to ensure that the form is complete and consistent on its face. Note that a failure on any one line item does not necessarily invalidate the certificate and all claims made therein. However, the examiner should consider such failures carefully and shall take special caution in the case of systemic failures.

- B. Comparison of information on the Form W-8 with the information in the account file and/or account application form. A material contradiction may invalidate the Form W-8. In this connection, the examiner should review account file information and new account application forms and updates for indication of U.S. status (i.e. U.S. mailing address, or a copy of a U.S. driver's license used as identification to open the account) or information that would indicate residence in country other than that claimed on the Form W-8 for an account holder making a treaty based claim.
- C. Check of expiration of Form W-8 to ensure valid with respect to the applicable payment. See Exhibits 4.10.21-3.

Note: It should also be noted that, in general, an invalid W-8 cannot be perfected by other supporting documentation, except for curing address. The examiner should exercise sound judgment in applying these guidelines.

4.10.21.8.4.4 (07-29-2008)

Permanent and Mailing Address Considerations

- 1. The examiner should pay special attention to the address lines on the withholding certificates and the addresses otherwise reported by the account holder or shown in the account files and customer master files. See Treas. Reg. 1.1441-7(b)(5).

4.10.21.8.4.4.1 (07-29-2008)

Permanent Address Form W- 8 Line 4

- 1. A person's permanent residence address is an address in the country where the person claims to be a resident for purposes of that country's income tax. In the case of a certificate furnished in order to claim a reduced rate of withholding under an income tax treaty, the residence must be determined in the manner prescribed under the applicable treaty. See Treas. Reg. 1.1441-6(b).
The permanent address on Form W-8 cannot be a U.S. address. For NRA withholding purposes, the permanent address cannot be a financial institution (unless that financial institution is the beneficial owner), in care of address, or any other similar type which does not indicate a physical location. See Treas. Reg. 1.1441-1(e)(2)(ii).
- 2. The examiner should check addresses indicated on records such as the customer master files, which may include changes in circumstance (i.e., new U.S. addresses or addresses outside treaty country) that have not been considered by the withholding agent for updating its certification forms.

4.10.21.8.4.4.2 (07-29-2008)

Mailing Address Form W- 8 Line 5

- 1. The withholding agent has reason to know that a Form W-8 is unreliable or incorrect to establish a direct account holder's status as a foreign person if a U.S. mailing address is listed on this line, subject to the below cure provision. See Pub. 515.

4.10.21.8.4.4.3 (07-29-2008)

Address Cures using Additional Documentation (Only for Line 4 or Line 5)

- 1. The U.S. withholding agent can rely on a Form W-8 with a defective address line to establish foreign status or treaty claims if it has obtained additional documentation from the account holder as prescribed in Treas. Reg. 1.1441-7(b)(5)(i). Examples of such additional documentation would be:

2. For Individuals

- A. A government issued document with documentary evidence such as a non-U.S. photo ID (e.g. passport, driver license). The document must be valid when submitted to the withholding agent and must be submitted to the withholding agent within three years of the date of the payment; and
- B. A reasonable written explanation from the account holder supporting foreign status.

3. For Entities:

- A. Documentation that proves entity status or, for an account maintained outside the U.S., a tax information statement filed with a country with which the U.S. has an income tax treaty in effect.
- B. The figure below shows examples of documentation which can be accepted:

Figure 4.10.21-2

Entity	Documentation
Corporation:	Articles of Incorporation
Partnership:	Partnership Agreement
Trust:	Trust Agreement

4.10.21.8.4.5 (07-29-2008)

Forms W - 8 Provided After Date of Payment

- 1. The examiner may consider, among other factors, the following factors in determining whether a withholding certificate received after the date of payment (or other documentation or evidence if it is an offshore account) should be accepted for purposes of allowing a reduced withholding rate with respect to payments to foreign persons:
 - A. Whether information and representations on a later secured withholding certificate (or on other documentation if it is an offshore account) provided are consistent with information in the account file or in other records maintained by the withholding agent, the examiner should request and review all account files as a result.
 - B. Whether the withholding certificate (or other documentation if it is an offshore account) establishes facts in existence at the time the relevant payments were made.
Example: The Form W-8 was signed June of 2006 to support foreign status and treaty benefits for a payment received in January of 2005. The examiner should ask the taxpayer how they confirmed that residency of the beneficial owner was the same in January 2005.
 - C. In general, the examining agent should consider all the underlying facts and circumstances when validating a Form W-8 provided after the date of payment, and should accept any such documentation only when entirely satisfied with its reliability and veracity.

Note: If the proof consists of showing that the tax was paid by the account holder, the withholding agent may still be subjected to interest and penalties under IRC Section 1463.

4.10.21.8.5 (07-29-2008)

Use of Statistical Sampling

- 1. Validating Forms W-8 will normally require statistical sampling of accounts because of the number of

accounts and volume of payments made. A referral for CAS assistance should normally be submitted early in the audit process. The starting point for sampling of a financial institution's NRA payments should be, as noted above, a thorough analysis of the withholding agent's systems to ensure, among other things, that all applicable payments and payees are incorporated into the withholding and reporting system. Potential sampling units to consider in developing a sampling plan include total payments made to an account holder, total payments made to an account, reportable amounts per Forms 1042-S issued by the withholding agent, and individual payments. Regardless of the sampling unit chosen, withholding certificates and account file information should be reviewed for every account holder receiving a payment selected for review. In order to reduce audit time, the CAS may request that the withholding agent review the sampling plan to provide input to improve its efficiency or raise other issues. Input may include, but is not limited to determining the sampling unit, sample size and stratum criteria, along with appropriate statistical and auditing justifications. It must be noted that the use of statistical sampling as an audit tool by the service does not require the approval of the taxpayer. For a more thorough treatment of Statistical Sampling Audit Techniques, please refer to IRM 4.47.3.

2. Stratification by factors other than just reportable amounts should be considered including:
 - A. Lines of Business;
 - B. Type of W-8 (BEN, EXP, ECI or IMY);
 - C. Type of income (Dividends, interest, other);
 - D. Type of Recipient per Form 1042-S recipient code;
 - E. Withholding tax rates;
 - F. Type of transaction (see 4.10.21.8.7 below);
 - G. Recipient's Country of Residence for Tax Purposes per Form 1042-S.

4.10.21.8.6 (07-29-2008)

Withholding and Reporting Verification

1. In determining the correct rate of NRA Withholding and Backup Withholding for a single payment or group of similar payments, account documentation, applicable presumption rules, type of payment being made, and any applicable tax treaties should first be taken into account. Once the correct rate of tax is determined based on these factors, steps should be taken to ensure the correct rate was applied for withholding purposes, and that amounts withheld were accurately reported via Forms 1042-S or Forms 1099, as applicable. In instances where additional NRA Withholding, additional Backup Withholding, or assessment of penalties results from the use of a statistical sample, the results should be extrapolated to the sample population where appropriate.
2. To this end, account statements and similar records that show the type of income earned and tax withholding should be obtained for each applicable payment and the associated payees. Account records that show how the withholding agent has classified payments along with records that show how those same payments were classified by the payee of the income to the withholding agent may also be requested.
3. Copies of all Forms 1042-S and Forms 1099 filed by the withholding agent to report all payments under review should be obtained to ensure proper reporting, including cases in which the examiner is not proposing any change to the withholding rate. All information appearing on Forms 1042-S that might affect withholding tax (e.g. income codes and amounts, exemption codes, recipient code, recipient

country for tax purposes, amounts repaid to account holders, etc.) should also be reviewed for accuracy and completeness, and should be compared to the documentation reviewed by the examiner.

4.10.21.8.7 (07-29-2008)

Transactions and Other Items Requiring Special Treatment by Withholding Agents

1. NRA withholding and reporting for the transactions listed below require application of special rules. In order for the withholding agent to comply with these requirements, the withholding agent should establish procedures to identify and to insure the correct withholding and reporting for each type of transaction. After identifying their existence, the examiner should ask the taxpayer for a detailed explanation of the withholding and reporting procedures for each of these types of transactions. If the procedures are deficient or incomplete, the examiner should expand the examination to insure that the transactions were properly reported and that taxes were properly withheld.

4.10.21.8.7.1 (07-29-2008)

Real Estate Investment Trust (REIT) Distributions

1. REIT distributions to foreign shareholders are subject to NRA withholding, except when the distribution is designated as a capital gain dividend, a return of basis, or a distribution in excess of the shareholder's basis in the REIT stock. Treas. Reg. 1.1441-3(c)(4)(i)(C). For capital gain dividends, a 35% withholding tax applies under IRC Section 1445. See IRC Section 1445(e)(6) and Treas. Reg. 1.1445-8. As enacted under the American Jobs Creation Act of 2004, however, capital gain distributions are not taxed under IRC Section 1445 for foreign shareholders owning REIT stock regularly traded on a U. S. exchange that have not held over 5% of such class of the REIT's stock at any time during the year of the distribution. Such distributions are instead subject to NRA withholding. The examiner should question how the withholding agent determines the correct rate and should spot check several REIT distributions.

4.10.21.8.7.2 (07-29-2008)

Original Issue Discount (OID)

1. Generally, no NRA Withholding applies to the sale of debt obligations, even though accrued interest or OID is included in the amount paid by the purchaser to a foreign seller. The major exception is for sales where the principal purpose is to avoid tax and the withholding agent has actual knowledge or has reasons to know of such purpose. The sale is not reportable on a Form 1042-S unless NRA withholding was required under this principal purpose test. Redemptions of obligations that carry OID are subject to NRA withholding tax. The amount subject to withholding tax is the amount accrued to the holder from the date of purchase, as determined by the withholding agent. If the withholding agent has not been provided with reliable date of purchase information or cannot otherwise calculate the amount of OID to the holder, then the withholding agent must withhold on the entire amount of OID accrued since the obligation's issuance. In determining the taxable amount of OID, a withholding agent may rely on information provided in IRS Publication 1212, "List of Original Issue Discount Instruments." The amount of taxable OID (or treated as taxable) is reportable on Form 1042-S. Short-term OID obligations (i.e., with a maturity of 183 days or less from the date of original issue) are not subject to NRA withholding tax or reporting on Form 1042-S.

4.10.21.8.7.3 (07-29-2008)

Securities Lending

1. When a loan of securities is outstanding during the record date for a dividend or interest payment, the lender of the securities is, among other things, typically entitled to a payment from the borrower to account for the foregone dividend or interest (i.e., since the lender is not the holder of record on

the record date). The payment made by the borrower of securities is called a “substitute dividend” or “substitute interest”, which may be subject to NRA withholding tax if paid to foreign persons.

2. For NRA withholding purposes, a “look-through” rule applies to define the character and source of the substitute amount paid in connection with the loan of any securities. Based on the “look-through” rule, a substitute interest amount is treated as portfolio interest if the underlying security generates portfolio interest in connection with the payment. These rules further apply to security lending transactions between foreign counterparties, subject to provisions to mitigate overwithholding that could result from repeated lending of the same underlying security.

4.10.21.8.7

Transactions and Other Items Requiring Special Treatment by Withholding Agents

4.10.21.8.7.4 (07-29-2008)

Over Night Deposits (Sweep Accounts)

1. Commercial banks sometimes offer their larger accounts preferred treatment. One of these benefits is earning interest on the balance at the close of the business day. Typically the balances are combined and used to purchase interest bearing securities. The next business day the interest earned is credited to the customers account.

4.10.21.8.7.5 (07-29-2008)

Repurchase Agreements (REPO's)

1. Under U.S. tax principles, a REPO is typically characterized as a collateralized loan where the purchaser of the underlying security is deemed to be a lender of funds to the seller in the amount of the purchase price. The seller of the security is treated as the borrower. The loan is for the period until the REPO matures, when the securities are sold back to the original seller (i.e. the cash borrower). Typically, the repurchase price exceeds the original sales price, giving rise to a charge consisting of financing interest.
2. If the financing interest is U.S. sourced and paid to a foreign person, it may be subject to NRA withholding. However, see the exception for certain short term obligations referenced in Treas. Reg. 1.1441-2(a). In addition, an examiner may find substitute payments (dividend or interest) made by the cash lender to the borrower as part of the REPO. These substitute payments are similar to those typically seen in securities lending transactions, whose sourcing is determined with respect to the underlying security for withholding and reporting purposes. See the Securities Lending section and IRC Section 1058 for more information.

4.10.21.8.7.6 (07-29-2008)

Notional Principal Contracts (NPC)

1. There is no NRA withholding obligation on payments made under NPCs to foreign persons. See Treas. Reg. 1.1441-4(a)(3). If, however, these payments are ECI as to the foreign person, or are presumed so under the regulations, income reporting is required on Form 1042-S. See Treas. Reg. 1.1441-4(a). The ECI presumption may be rebutted by a withholding certificate representing that the payments are not effectively connected with the conduct of a U.S. trade or business. Instead of a withholding tax certificate, a payee may represent in a master agreement governing the transactions in NPCs between the parties that the counterparty is a U.S. person or a non-U.S. branch of a foreign person. Income on NPC's that are regarded as embedded interest or recharacterized as certain other payments under U.S. tax principles might be subject to NRA withholding and reporting.

4.10.21.8.7.7 (07-29-2008)

Syndicated Loans

1. A syndicated loan results when financial institutions collectively participate in funding a single loan. Generally, one of the participants will act as an administrator and distribute the interest income to the other participants. The administrator will be the withholding agent. The following issues should be considered related to syndicated loans:
 - A. **“bank loan exception”** IRC Sections 871(h) and 881(c) generally provide that a non-U.S. person is exempt from the 30 percent withholding tax on portfolio interest. There are several limitations on this exemption. One is the “bank loan exception”. The portfolio exemption does not apply to any interest received by a bank on the extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. See IRC Section 881(c)(3)(A). Accordingly, foreign banks, who are participants in the syndicated loan, should not benefit from the portfolio exemption.
 - B. **“change in circumstances” events** Often the participants will change. For example, when the original participants sell all or a portion of their interests in the loan to another bank, withholding related documentation is required from each of the new participants.
 - C. **required NRA withholding agent’s responsibilities** An audit concern is to determine if required Forms 1042 and 1042-S were not filed and/or Forms W-8 were not secured.

4.10.21.8.7.8 (07-29-2008)

Payments to Foreign Intermediaries and Foreign Flow-through Entities

1. Reportable amounts that withholding agents pay to foreign intermediaries or foreign flow-through entities require specific treatment because intermediaries and flow-through entities are not beneficial owners of income. Examples of flow-through entities are foreign partnerships, simple and grantor trusts, and disregarded entities.
2. Foreign intermediaries and flow-through entities must provide the U.S. withholding agent a Form W-8IMY. This form indicates that account holder is not the beneficial owner of the reportable income. The form also indicates if the account holder has entered into an agreement with the Service to act as a withholding agent.
3. Foreign financial institutions can enter into an agreement with the Service to act as a Qualified Intermediary (QI). All foreign intermediaries, who do not have an agreement with the IRS to act as QIs are, by default, Non-Qualified Intermediaries (NQIs). See Rev. Proc. 2000-12.
4. Foreign partnerships, simple or grantor trusts, can elect to enter into an agreement with the Service become a Withholding Partnership (WP) or a Withholding Trust (WT). A foreign flow-through entity that has not become a Withholding Partnership or a Withholding Trust is, by default, a Non-Withholding Partnership (NWP) or a Non-Withholding Trust (NWT). See Rev. Proc 2003-64.

4.10.21.8.7.8.1 (07-29-2008)

Withholding & Reporting on Payments to Qualified Intermediary (QI)

1. The QI can elect whether or not to assume primary withholding responsibilities. The U.S. withholding agent will be notified about this decision with a valid Form W-8IMY that the QI furnishes to the withholding agent.
2. If the QI has assumed primary withholding responsibilities, the U.S. withholding agent is not required to

withhold NRA taxes with respect to those payments associated with QI-designated accounts. However, it is still subject to reporting on these payments. The U.S. withholding agent will report payment amounts paid to the QI with respect to such accounts on Form 1042-S with 0% taxes withheld. These Form(s) 1042-S will be issued to the QI by the U.S. withholding agent.

3. If the QI has not assumed primary withholding responsibilities, the withholding agent will withhold based on withholding statements provided by the QI with respect to QI-designated accounts. The QI is not required to provide specific client names and client details to the withholding agent. Instead the QI will provide Form(s) 1042-S that indicate the total dollar amount and amounts withheld on a “pooled basis”, i.e. amounts subject to withholding at the 15% withholding rate would be one pool, amounts subject to withholding at the 30% withholding rate would be another pool, etc. There will be a separate Form 1042-S for each pool. Assuming the QI assumed primary withholding responsibility, the Forms 1042-S will show taxes withheld.
4. Under the QI contract with the IRS, the QI is required to designate the accounts that are covered under the QI contract. For accounts that the QI did not designate as covered by the QI contract, or for indirect account holders of the QI the below described NQI procedures shall be followed.

4.10.21.8.7.8.2 (07-29-2008)

Withholding & Payments to Non Qualified Intermediary (NQI)

1. An NQI should provide to the withholding agent a Form W-8IMY and the appropriate documentation for each of the beneficial owners that are to receive the income paid by the withholding agent to the NQI. The NQI must also provide a withholding statement to the withholding agent for allocating payments of income to the beneficial owners and for determining the applicable withholding rates. If the NQI has provided all the above information, the U.S. withholding agent may generally withhold and report based on the information provided by the NQI. Information reporting is made by the withholding agent to each beneficial owner on a separate Form 1042-S rather than under the pooling approach generally applicable to payments made by U.S. withholding agents to QIs.
2. If the NQI does not provide the above information to the U.S. withholding agent, the U.S. withholding agent must withhold the maximum NRA withholding rate (30%) on all U.S. sourced FDAP income. Unallocated payments (i.e. the remaining amounts after allocation based on the withholding statement took place) are reported on a separate Form 1042-S as paid to an unknown account holder, with withholding generally determined under the applicable presumption rule.

4.10.21.8.7.8.3 (07-29-2008)

Withholding & Reporting for Payments to Withholding Partnership / Withholding Trust (WP / WT)

1. U.S. withholding agents generally do not withhold NRA taxes on a foreign partnership or trust that have provided a valid Form W-8IMY indicating their status as a Withholding Partnership or a Withholding Trust. Withholding Partnerships and Trusts must assume primary withholding responsibilities. The income paid to the WP or the WT will be reported on Form 1042-S with 0% taxes withheld.

4.10.21.8.7.8.4 (07-29-2008)

Withholding & Reporting for Non-Withholding Partnership / Non-Withholding Trust (NWP / NWT)

1. The treatment of a Non-Withholding Partnership (NWP) or a Non-Withholding Trust (NWT) is generally similar to the treatment of a NQI. The NWP or the NWT should provide the withholding agent with names of all partners / beneficiaries, together with applicable documentation of their status and a

withholding statement containing an allocation schedule for each payment of income.

If the NWP or the NWT does not provide the above information to the U.S. withholding agent, the U.S. withholding agent must generally withhold in accordance with the applicable presumption rule.

4.10.21.8.8 (07-29-2008)

Portfolio Interest

1. IRC Sections 871(h)(1) and 881(c)(3) generally exempt from NRA withholding interest payments (including OID) on foreign targeted bearer obligations and registered obligations.

4.10.21.8.8.1 (07-29-2008)

Foreign Targeted Bearer Obligations

1. A bearer obligation is one that is not in registered form. The bearer obligation is foreign targeted when it meets the following three requirements:
 - A. There are arrangements to ensure that the obligations are not sold to U.S. persons
 - B. Payment of interest is made outside the U.S. and its possessions
 - C. The face of the obligation states that any U.S. person who owns the obligation will be subject to U.S. taxation. See IRC section 163(f)(2).

4.10.21.8.8.2 (07-29-2008)

Registered Obligations

1. An obligation is registered when it meets the requirements specified in Treas. Reg. 1.871-14(c). Among these requirements is that the withholding agent obtain a withholding certificate or documentary evidence that the beneficial owner of the payment is not a U.S. person. Such documentation must be provided before expiration of the beneficial owner's limitation period for claiming a refund with respect to such interest. See Treas. Reg. 1.871-14(c)(3). This documentation requirement does not apply in cases of foreign targeted registered obligations, which have separate requirements. See Treas. Reg. 1.871-14(e).

4.10.21.8.8.3 (07-29-2008)

Exceptions

1. The following are interest income payments that do not qualify for the portfolio interest exemption even when the interest is paid with respect to a registered or foreign targeted bearer obligation:
 - A. Interest which is paid to a foreign person who owns 10 percent or more of the entity paying the interest.
 - B. Interest which is paid to a foreign bank on the extension of credit made pursuant to a loan agreement entered into in the ordinary course of the bank's trade or business.
 - C. Interest which is paid to a foreign controlled corporation from a person related to that foreign controlled corporation; or
 - D. Contingent interest paid to a foreign person.

4.10.21.8.9 (07-29-2008)

U.S. Financial Institution - Consideration of Payments to Foreign Vendors

1. Many U.S. Financial Institutions are multinational corporations that make payments to foreign persons in a proprietary capacity. Therefore the examiner should review their payments to foreign vendors and other related and unrelated foreign persons for possible withholding tax and reporting requirements. See Nonfinancial Institution Withholding Agent Audit Section.

4.10.21.8.10 (07-29-2008)

Suggested Initial Information Document Requests (IDR)

1. These information document requests are provided as a general guide to the examiner. It is recommended that they be adapted by the examiner to fit the needs of the audit. An example of how some of these requests may be addressed in an IDR is illustrated in Exhibit 4.10.21-1, Model IDR For Financial Institution Audits.
 - Request # 1 - The examiner should request copies of Forms 1042 and Forms 1042-S, along with supporting documentation.
 - Request # 2 - The examiner should request information relating to policies and procedures of fiduciary (custodial) accounts. Areas covered should include account opening, documentation validation, renewal of Forms W-8, sourcing and characterization of income. The examiner should consider requesting operating manuals, and interviewing relevant personal.
 - Request # 3 - The CAS, with the assistance of the examiner, should attempt to identify all systems involved in any aspect of processing and tracking transactions that are potentially subject to NRA withholding and reporting. Some withholding agents may use many different systems, so consideration should be given to requesting data flow diagrams at a system's level.
 - Request # 4 - The CAS, with the assistance of the examiner, should attempt to identify the systems along with the specific files or tables to be used as sources of information needed to identify all payments potentially subject to NRA reporting and or withholding. Special consideration should be given to ensuring all payments requiring special treatment by the withholding agent are accounted for through the custodial systems.

4.10.21.9 (07-29-2008)

Nonfinancial Institutions Withholding Agent Audit (Payments of FDAP U.S. Sourced Income to Foreign Persons)

1. The audit will focus on companies or other 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. When payments made to a foreign vendor consist of U.S. sourced income, there will generally be reporting and withholding tax requirements. There is an additional reporting requirement with respect to certain U.S. taxpayer's transactions with related foreign persons. These transactions will be reported on Forms 5471 and 5472 (described above in IRM Section 4.10.21.6).

4.10.21.9.1 (07-29-2008)

Introduction

1. U.S. entities that make payments in a proprietary capacity to foreign persons for services or other entitlements may have NRA withholding and reporting requirements. For example, this may occur when a U.S. entity makes a payment to a foreign vendor in exchange for U.S. sourced services. Another fact pattern illustrating these responsibilities is as follows. A large multinational pharmaceutical company

pays royalties to a foreign company for drugs it sold within the United States. The royalty payments would typically constitute U.S. source FDAP income to a foreign company. Therefore, the income would be subject to NRA reporting (Form 1042 and Form 1042-S), and a NRA withholding tax of 30% absent a valid treaty or ECI related claim. In addition to payments to foreign vendors of U.S. source FDAP income, there are other payments that may generate NRA withholding and reporting (i.e. dividend payments). The examiner should examine all material payments to foreign persons as possible U.S. sourced FDAP income payments. The below sections provide a three-step audit procedure to determine payments that may generate NRA withholding and reporting responsibilities.

4.10.21.9.2 (07-29-2008)

Industries Likely to Have NRA Withholding and Reporting

1. The below listing is not all inclusive. It is provided so that examiners dealing with one or more of these industries will be aware of the possibility of NRA requirements:
 - A. Professional Services Providers: Law, Accounting, Architecture;
 - B. High Tech Industries: Computer Software and Hardware Providers, Medical Equipment;
 - C. Intellectual Products Providers: Entertainment Industry, Publishing Industry;
 - D. Pharmaceutical Industry;
 - E. Real Estate Industry.

4.10.21.9.3 (07-29-2008)

Payment to Foreign Vendors -Three-Step Audit Procedure

1. 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. The majority of these payments will be made to foreign vendors by the accounts payable department. Therefore, the examiner should obtain from the taxpayer the following:
 - A. The account payable file and similar files that contains all vendor payments;
 - B. The vendor record (file containing all vendor names and vendor information).
2. In order to determine those payments that are subject to NRA reporting and withholding tax, steps one and two require analysis of the taxpayer's accounts payable file and vendor file. It is recommended that a Computer Audit Specialist (CAS) be requested to assist in each of these three steps:
 - A. Determining all foreign vendors;
 - B. Determining all payments of FDAP Income to them;
 - C. Determine any such FDAP Income (from step two) that is U.S. sourced and the applicable withholding rate, if any.

Note: Line by line review of a withholding certificate (i.e. Form W-8) is necessary to ensure that the form is complete and consistent on its face. Note that a failure on any one line item does not necessarily invalidate the certificate and all claims made therein. However, the examiner should consider such failures carefully and shall take special caution in the case of systemic failures. It should also be noted that, in general, an invalid Form W-8 cannot be perfected by other supporting documentation. The examiner should exercise sound judgment in applying these

guidelines.

4.10.21.9.3.1 (07-29-2008)

Determine All Foreign Vendors (Step 1)

1. This first step requires the analysis of the vendor file to identify vendors that may be foreign persons. The vendor file is a listing of all vendors, including names and other pertinent information relating to the vendor. All vendors who meet one or more of the following criteria should be considered to be a possible foreign vendor:
 - A. Vendor's EIN starting with 98-xxxxxxx;
 - B. Vendor's ITIN starting with 9xx-7/8x-xxxx;
 - C. Address fields:
 - Country: not U.S. or blank;
 - Zip Code: not U.S. format;
 - State: not a U.S. state or blank;
 - City: foreign city.
 - D. Vendor #, if coded for foreign vendors;
 - E. Any other factors which indicate possible foreign status.
2. The above are recommended indicators to determine that the vendor may be foreign. The examiner should review the vendor file to set any other criteria that may be used for the particular taxpayer.
3. Some of the vendors selected may be U.S. vendors. Therefore, it is recommended that this list of possible foreign vendors should be presented to the taxpayer for their review. If the taxpayer can establish that the vendor is not foreign, the name should be removed from further review.

4.10.21.9.3.2 (07-29-2008)

Determine All Payments of FDAP Income to Foreign Vendors (Step 2)

1. In step two payments to foreign vendors are ascertained. Not all payments to the foreign vendors selected in step one would be FDAP income. The examiner should decide which payment would most likely result in FDAP income to the vendor. Some of the most common expenses paid by the taxpayer that may result in FDAP income payments to the vendors are:
 - A. Interest;
 - B. Royalties, Patents, Copyrights (Intellectual Assets);
 - C. Royalties – Natural Resources (Timber, Oil, Coal);
 - D. Personal Service Fees, Wages;
 - E. Annuities & Pensions;
 - F. Rents.

The above is not an all inclusive list of possible expenses, which may result in FDAP income payments to the foreign person. The examiner should consider the facts and circumstances of

each taxpayer in determining all possible payments which may result in FDAP income to the foreign person.

2. It is recommended that the examiner should first test the accuracy of how expenses are categorized by the taxpayer before step two is performed. Often expenses are not accurately categorized by the taxpayer. For example, some portion of a large contract for computer hardware might pertain to training and maintenance functions. That portion would be personal service fees, which would be FDAP income if performed within the U.S. but the entire payment may have been incorrectly treated as computer hardware expense by the taxpayer.
3. Once the examiner has determined the validity of the categorization, the step two's analysis can be performed. The examiner should at least review material payments that may be FDAP even though the taxpayer did not correctly categorize them as such. The examiner should compile all payments of the selected expenses paid to the foreign vendors.

4.10.21.9.3.3 (07-29-2008)

Determine Foreign Vendors FDAP Income Which Was U.S. Sourced (Step 3)

1. At this point the examiner has determined payments to foreign vendors which are FDAP income. The source of the income (U.S. sourced vs. Foreign sourced) should now be determined. See the summary of general sourcing rules from IRC Sections 861, 863, and 865 in Figure 4.10.21-3 below.
2. The regulations under Treas. Reg. 1.1441-2(a) require that the income payments be presumed U.S. source when the source is not known to the payer. Therefore, any FDAP income determined in step 2 that the source is unknown to the payer is presumed to be U.S. sourced and subject to a 30% withholding tax. The taxpayer has the burden of proof to overcome the presumption.

Figure 4.10.21-3

Sourcing Rules Type of Income	Determinative Factors (as may be modified or excluded by an applicable treaty)
Personal Services	Generally where services are performed, subject to potential allocation under Treas. Reg. 1.861-4 and to a limited exclusion based on temporary U.S. presence. Even for U.S. source income, withholding under IRC Section 1441 is not required to the extent the compensation is subject to withholding as wages.
Dividends	Generally depends on whether Paying Corporation is domestic or foreign.
Interest	Generally depends on whether payor is domestic or foreign (Where Incorporated). Interest paid by a U.S. branch of a foreign corporation is U.S. source income. IRC Section 884(f)(1)(A). For original issue discount, see IRC Section 871(g)(3).

Rent	Where the property is located
Royalties, Patents & Copyrights	Where the property is used (benefits derived)
Royalties-Natural Resources	Where the property is located
Pensions	Generally depends on where the related services were performed, though earnings on a U.S. plan are U.S. source income. For allocating between employer contributions and earnings for defined-benefit pension plans, See Rev. Proc. 2004-37. Also reference the income exclusion provided under IRC Section 871(h) for certain payments from qualified annuity plans under IRC Section 403(a)(1).

4.10.21.9.4 (07-29-2008)

Treatment of Personal Services Paid to Foreign Persons

1. Personal services are 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. See Treas. Reg. 1.1441-2(a). The following are factors the examiner can consider in determining where the personal services were performed:
 - A. Contemporaneous Records:** The existence of contemporaneous records may support the contention that the taxpayer knew where the services were performed at the time of payment. The nonexistence of contemporaneous records might indicate that the taxpayer may have not known where the services were performed and therefore should have presumed the services to be U.S. sourced;
 - B. Travel Expenses:** Payment of a vendor's travel expenses to the U.S. would suggest that services were performed in the U.S.;
 - C. Vendor Contracts:** The contract might indicate where and when the services would be performed;
 - D. Interviews:** The examiner can interview the person who approved the expense payment or the contract.
2. The foreign vendor's statements should be reviewed during this process; however, keep in mind that they may not be the most reliable source to determine the source of the expense. It is usually in the vendor's best interest to source all income as foreign to minimize the tax withholding.
3. Upon the completion of this step, the examiner should have determined all payments to foreign vendors

of U.S. source FDAP income. These payments will generally be subject to NRA reporting and a 30 percent withholding (may be reduced by treaty, if the account is properly documented).

4.10.21.9.4.1 (07-29-2008)

Payments to Foreign Persons Not Made by Accounts Payable Department

1. It is recommended that a modified three step audit be performed for payments made by departments other than the accounts payable department. The examiner should identify material payments made to foreign persons.
2. Some common examples of other payments which may be subject to withholding tax are:
 - A. Treasury Department – Dividend payments to foreign shareholders;
 - B. Pension Department - Payments to former employees who were resident aliens and have relocated and now are nonresident aliens;
 - C. Human Resources – Payments to senior officers (i.e. payments to foreign board of directors).
3. Payments to related foreign entities may also not be made by the accounts payable department. Such payments may be identified based on, among other things, Forms 5471 and 5472 as described below.

4.10.21.9.5 (07-29-2008)

Suggested Initial Information Document Requests (IDR)

1. These information document requests are provided as a guide to the examiner. It is recommended that they be adapted by the examiner to fit the needs of the audit. An example of how some of these requests may be addressed in an IDR is illustrated in Exhibit 4.10.21-2, Model IDR For Nonfinancial Institution Audits. In general, the topics for this IDR are as follows:
 - Request # 1 - The examiner should request copies of Forms 1042, 1042-S, 5471 and 5472, along with supporting documentation.
 - Request # 2 - The examiner, with the assistance of the CAS, should inquire about existing systems, policies and procedures used to identify payments subject to NRA withholding for withholding and reporting purposes.
 - Request # 3 - The examiner should inquire about existing systems, policies and procedures used to ensure acquisition of appropriate withholding certificates acquire withholding certificate.
 - Request # 4 - The CAS, with the assistance of the examiner, will attempt to identify the systems along with the specific files or tables to be used as sources of information needed to identify all payments potentially subject to NRA reporting and or withholding.

4.10.21.9.6 (07-29-2008)

Use of Forms 5471 and Forms 5472

1. Forms 5471 and 5472 are for reporting transactions between U.S. persons and certain related foreign entities. The examiner should review the transactions which reflect payments by U.S. person to foreign entities to identify payments possibly subject to withholding tax.

4.10.21.9.6.1 (07-29-2008)

Form 5471

1. Generally, the Form 5471 is required to be filed by a U.S. person having certain ownership interests in a foreign corporation. A separate Form 5471 is required to be filed with respect to each foreign corporation meeting these ownership rules. This IRM will focus on the Schedule M attached to the Form 5471. Schedule M is completed by a U.S. person who has controlling interest in a foreign corporation that is a Controlled Foreign Corporation (CFC). See IRC Section 957. Schedule M reports transactions between the taxpayer and its CFC and reports the following payments made by the taxpayer to the CFC, some of which may be U.S. sourced FDAP income to the CFC:

- A. Compensation;
- B. Commissions;
- C. Rents;
- D. Royalties;
- E. License fees;
- F. Interest;
- G. Dividends.

The examiner should determine if these amounts were subjected to NRA withholding and reported on Forms 1042 and 1042-S. If not, an explanation should be provided by the taxpayer.

4.10.21.9.6.2 (07-29-2008)

Form 5472

1. A separate Form 5472 is filed with respect to each foreign shareholder owning 25% or more of a U.S. taxpayer. Part IV of the Form reports the following payments by the taxpayer to the foreign corporation, which may be U.S. sourced FDAP income to the foreign corporation:

- A. Compensation;
- B. Commissions;
- C. Rents;
- D. Royalties;
- E. Interest.

The examiner should determine if these amounts were subject to NRA withholding and reported on Forms 1042 and 1042-S. If not, an explanation should be provided by the taxpayer.

4.10.21.9.7 (07-29-2008)

Reconciliation of Audit Findings to Forms 1042 and 1042-S

1. The examiner should obtain copies of Forms 1042 and Forms 1042-S and compare the audit finding to the gross income reported on the forms. If less than 30 percent was withheld and reported on the filed forms, the examiner should request and examine the Forms W-8 and Forms 8233.

2. If Forms 1042 and 1042-S were not filed, substitute or delinquent return procedures should be followed.

4.10.21.10 (07-29-2008)

Colleges and Universities: Treatment of Scholarships and Grants

1. IRC Section 1441(b) indicates the applicable rate for scholarship and fellowship grants is 14%. It applies to amounts includible in the gross income of nonresidents who are temporarily present in the U.S. under nonimmigrant visas under Sections 101(a)(15)(F), (J), (M), or (Q) of the Immigration and Nationality Act (issued to students, researchers, visiting teachers, and cultural exchange program participants).
2. Since amounts treated as a “qualified scholarship” are excluded from gross income under IRC Section 117(a), the 14% withholding applies to the taxable amounts incident to a qualified scholarship. A qualified scholarship includes the student’s tuition, fees, books, and related expenses, but not living expenses (i.e., room, board or travel).
3. In addition, the 14% withholding applies to grants from a tax-exempt educational or charitable organization, an international organization, the government of a foreign country (or including the states), and an agency of the Federal or a state or local government received by a nonresident alien present in the U.S. on an F, J, M, or Q visa even though the individual is not a candidate for a degree at an educational institution.
4. Withholding at less than the 14% rate may be permitted under certain circumstances to approximate the actual U.S. tax liability of recipients. A student or teacher may submit Form W-4, Employee’s Withholding Allowance Certificate, to the withholding agent to claim personal exemptions and deductions in case of certain taxable payments (e.g., amounts from certain training or exchange programs).
5. In addition, treaties may exempt scholarship or fellowship income from U.S. tax. Students, teachers, or researchers claiming an exemption under a treaty are required to file a Form 8233, Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual, with the withholding agent.

4.10.21.11 (07-29-2008)

Penalties

1. The examiner should consider all applicable penalties, including those listed below.
2. The Service’s approach to penalty administration must ensure consistency, accuracy, impartiality, and representation as stated in IRM 20.1.1.2.2(1). Taxpayers must be given the opportunity to have their interest heard and considered. Examiners need to take an active and objective role in case resolution so that all factors are considered.

4.10.21.11.1 (07-29-2008)

Penalties applicable to Form 1042 and related withholding tax deficiencies

1. Failure to File – IRC Section 6651(a)(1)
2. Failure to Pay - IRC Section 6651(a)(2)
3. Failure to Deposit- IRC Section 6656
4. Accuracy-Related - IRC Section 6662
5. Fraud – IRC Section 6663

4.10.21.11.2 (07-29-2008)

Penalties applicable to Form 1042-S

1. Failure to File Correct Information Return - IRC Section 6721
2. Failure to Furnish Correct Information Return - IRC Section 6722

4.10.21.11.3 (07-29-2008)

Factors to Consider in the Assessment of Penalties

1. The examiner must evaluate facts and circumstances in determining when penalties should be assessed. The examiner should consider whether the taxpayer is entitled to any penalty relief. Generally, relief from penalties falls into four separate categories:
 - Reasonable cause
 - Statutory exception
 - Administrative waiver
 - Correction of Service error

IRM 20.1.1.3 should be carefully reviewed and considered before a penalty determination is made. Generally, the taxpayer will have the burden of proof to support their position for nonapplication of the penalties. Additional factors which the examiner may consider are as follows:

E. Reasonable cause

The taxpayer must show why reasonable cause applies. The taxpayer must show why a reasonable person would have failed to properly file, withhold, report or deposit NRA withholding taxes. Ignorance of the law is generally not accepted as reasonable cause.

- **Ordinary course of business** - If the withholding, reporting, and depositing of NRA taxes is part of the ordinary course of business of the withholding agent, it may be more difficult for the taxpayer to support a position for nonapplication of a penalty based on reasonable cause.
- **Repetitive audit issue** - If the taxpayer was audited on this issue previously and an adjustment was made it will be more difficult for the taxpayer to support their position for nonapplication of a penalty based upon reasonable cause.
- **"Section 1441 VCP" submission and other types of agreements with the IRS** -The examiner may consider whether the taxpayer has made a VCP submission, or other types of agreement, with the IRS and complied with its remediation plan it submitted to the IRS.

Exhibit 4.10.21-1 (07-29-2008)

Model IDR for Financial Institution Audits

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number EXHIBIT 4.10.21-1
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To: (Name of Taxpayer and Company, Division or Branch)	Subject: NRA Withholding Taxes
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IDR OF FINANCIAL INSTITUTION – NRA WITHHOLDING AGENT	Submitted to: Dates of Previous Requests:
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Description of Documents Requested:

Please provide copies of the following:

1a) Forms 1042 and Forms 1042-S for calendar years _____
____, _____, & _____

1b) Work papers and other supporting documentation used
in the preparation of the Forms 1042 & 1042-S requested
above

1c) Listing of names and departments of those persons who
had primary responsibility for the preparation of Forms
1042 & 1042-S

2a) Any and all internal audit reports, for the years shown in
1a above, that pertain to each company's fiduciary activities,
including but not limited to:

- i) customer account openings
- ii) documentation validation (U.S. vs. Foreign
status, Entity type etc.)
- iii) renewal of expiring or invalid Forms W-8
- iv) recording of transactions of the fiduciary
accounts
- v) determination of source (U.S. vs. Foreign)
- vi) type of income (dividend vs. interest)
- vii) application of withholding and reporting

2b) Any and all operating manuals and written procedures
for the years shown in 1a above, that pertain to each entity's
fiduciary activities, including but not limited to:

	i) customer account openings
	ii) documentation validation (U.S. vs. Foreign status, Entity type etc.)
	iii) renewal of expiring or invalid Forms W-8
	iv) recording of transactions of the fiduciary accounts
	v) determination of source (U.S. vs. Foreign)
	vi) type of income (dividend vs. interest)
	vii) application of withholding and reporting

2c) Names, Titles and Departments of those persons who had primary responsibility for functions indicated in 2a & 2b.

Exhibit 4.10.21-2 (07-29-2008)

Model IDR for Nonfinancial Institution Audits

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number EXHIBIT 4.10.21-2
To: (Name of Taxpayer and Company, Division or Branch)		Subject: NRA Withholding Taxes
IDR OF NONFINANCIAL INSTITUTION – NRA WITHHOLDING AGENT		Submitted to: Dates of Previous Requests:

Description of Documents Requested:

Please provide copies of the following:

1a) Forms 1042, Forms 1042-S, Forms 5471 and Forms 5472 for each entity of the consolidated group for the calendar years ____, ____, & ____.

1b) Work papers and other supporting documentation used in the preparation of the above requested forms.

1c) Any internal audit reports for the years identified in item 1 above that pertain to each company's withholding and reporting obligations, including but not limited to identification of relevant payments, validation procedures and procedures for reporting.

1d) Operation manuals and written procedures in effect for the years identified in item 1a above pertaining to each company's withholding and reporting obligations, including but not limited to identification of relevant payments, validation procedures and procedures for reporting.

1e) Names, titles and departments of those persons who had primary responsibility for the preparation of Forms 1042, 1042-S, 5471, and 5472.

1f) Names, titles and departments of those persons who are familiar with the documents mentioned in items 1c and 1d and persons that had primary responsibility for the functions mentioned in items 1c and 1d.

To the extent your operations manuals or written procedures in effect for the years identified in 1a do not answer, please provide the following information:

2a) Please identify the systems, and provide operating manuals and written procedures that insure that all payments made to non-U.S. persons (individuals or entities) that are subject to NRA withholding (Treas. Reg. 1.1441 – 1.1446) have been identified.

2b) Please indicate your procedures to determine whether a payment is:

- i) made to a foreign person
- ii) fixed or determinable annual or periodical (FDAP)
- iii) U.S. sourced

2c) Please provide a list of all departments that make payments to all foreign individuals and/or entities. Please note the term payments includes, but is not be limited to:

- i) Payments to foreign vendors
- ii) Payments of Investment Income to foreign persons

iii) Payments to foreign related parties

iv) Payments of pension benefits to foreign persons

2d) Please indicate names and titles of persons who have primary responsibility for any department identified in your response to question 2c.

3) Please identify the systems, and provide operating manuals and written procedures that insure withholding certificates (Forms W-8 or Forms 8233) are requested from foreign individuals and / or entities receiving income subject to NRA withholding.

Exhibit 4.10.21-3 (07-29-2008)

Validity Period of Form W-8

Exhibit 4.10.21-3

Validity Period (When Form Expires)

Form Type Expires

W-8BEN A W-8BEN, with a valid U.S. Taxpayer Identification Number (TIN) generally will remain in effect, provided the withholding agent reports on Form 1042-S at least one payment annually to the beneficial owner, until a change in circumstances makes any information on the form incorrect.

A W-8BEN, without a U.S. Taxpayer Identification Number (TIN), generally will remain in effect for the period starting the date the form was signed and ending December of the third succeeding year. (i.e. Signed September 2005, will expire 12/31/2008)

W-8ECI A W-8ECI generally will remain in effect for the period starting the date the form was signed and ending December of the third succeeding year. (i.e. Signed September 2005, will expire 12/31/2008)

W-8EXP A W-8EXP, with a valid U.S. Taxpayer Identification Number (TIN) generally will remain in effect, provided the withholding agent reports on Form 1042-S at least one payment annually to the beneficial owner, until a change in circumstances makes any information on the form incorrect.

Generally, a W-8EXP without a valid U.S. Taxpayer Identification Number (TIN), will remain in effect for the period starting the date the form was signed and ending December of the third succeeding year. (i.e. Signed September 2005, will expire 12/31/2008)

However, W-8EXP submitted by a foreign government, or foreign central bank (1.892-2T(a)(2)) without a U.S. Taxpayer Identification Number (TIN) will remain in effect until a change in circumstances makes any information on the form incorrect.

W-8IMY Generally, a W-8IMY will remain in effect until the status of the person whose name is on the certificate is changed in a way relevant to the certificate or circumstances change that make the information on the certificate no longer correct. The indefinite validity period, however, does not extend to any withholding certificate, documentary evidence, or withholding statements associated with the certificate

Change in circumstances - If a change in circumstances makes any information on the Form W-8 which was previously submitted incorrect, the account holder must notify the withholding agent within 30 days of the change in circumstances and a new Form W-8 will be required. Failure to do so will invalidate the previously submitted Form W-8.