



Part 4. Examining Process

Chapter 10. Examination of Returns

Section 21. U.S. Withholding Agent Examinations - Form 1042 (Cont. 1)

4.10.21 U.S. Withholding Agent Examinations - Form 1042 (Cont. 1)

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4.10.21.8

U.S. Financial Institution Withholding Agent Audit

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-xxxxxx;
 - 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:

A. 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
To: (Name of Taxpayer and Company, Division or Branch)		Subject: NRA Withholding Taxes
IDR OF FINANCIAL INSTITUTION – NRA WITHHOLDING AGENT		Submitted to: Dates of Previous Requests:
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.	

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