B e r g q u i s t & R o s s i

Trusted Corporate Tax and Transfer Pricing Advisors

Increased IRS enforcement activity: Withholding and reporting requirements for payments to a foreign person

Key Points

- **If your company makes cross-border payments to non-U.S. persons or entities then you may have tax withholding collection, deposit and compliance reporting requirements.**

- **If you have never filed any withholding tax returns (Form 1042/1042-S) and make cross-border payments you potentially have liability for the uncollected withholding tax, failure to file withholding tax returns, in addition to interest and penalties for each year delinquent.**

- **The IRS understands that many companies are not collecting withholding tax and has initiated a new campaign to target non-compliant withholding agents and is now in the process of increasing its enforcement activity surrounding payments to non-U.S. persons.**

- **Any companies with gaps in their process for complying with reporting and withholding requirements needs to determine their exposure and consider remediation steps.**

New IRS Compliance Campaign

Last year the IRS announced a new campaign to target “Withholding and International Individual Compliance” regarding Forms 1042 and 1042-S. Those who make payments of certain U.S.-source income to foreign persons must comply with withholding, deposit, and reporting requirements. In 2019 **the IRS released Memo LB&I-04-0219-002, describing procedures for withholding agents to submit delinquent withholding tax returns in addition to the requirements for those who can participate.**

For those with tax withholding on Forms 1042 / 1042-S and related information forms reporting requirements, now is the time to evaluate non-compliance, quantify their tax exposure and consider the IRS’s voluntarily disclosure procedures for previous non-compliance to try to avoid penalties. If a taxpayer has received a notification from the IRS of an impending examination or referral to examination, it will not be permitted to use these procedures.

Background

In general a foreign person (individuals, corporations and partnerships) is subject to U.S. tax on its U.S-. source income for certain types of income. Most types of U.S.- source income received by a foreign person is subject to U.S. tax of 30%; however a reduced tax rate, including exemption, may apply if there is a tax treaty between the foreign person's country of residence and the United States.

The tax is withheld from the payment made to the foreign person by the US payor (withholding agent).

For example, U.S. Corporation licenses software from a foreign vendor used in the U.S. this royalty payment is considered U.S. source income. The U.S. Corporation is a withholding agent and is responsible for the withholding tax liability. If the U.S. withholding agent fails to withhold from the payment, the agent is liable for the tax, as well as interest and any applicable penalties. A withholding agent can exclude the payment from withholding with certain documentation, or the withholding agent may apply a reduced rate of withholding if it has received certain U.S. tax forms (W-8BEN-E) from a foreign person entitled to a reduced rate of withholding.

U.S. withholding and reporting obligations arise in a number of scenarios,

- **Nonresident Alien ("NRA") Withholding;** Withholding agents who pay income to foreign persons may be required to withhold tax from those payments for fixed, determinable, annual or periodical ("FDAP") income such as royalties, rents, interest, dividends, and services.
- **Backup Withholding;** If a person fails to provide a U.S. Taxpayer Identification Number ("TIN") in the manner required or if instructed by the IRS. Usually withholding agents collect Form W-9 (Request for Taxpayer Identification Number and Certification) from payees in order to document the TIN. The backup withholding tax rate is 24% beginning in 2018.
- **Effectively Connected Income ("ECI") Withholding;** A partnership (foreign or domestic) that has income effectively connected with a U.S. trade or business must pay a withholding tax on the effectively connected income that is allocable to its foreign partners.

The following items are some common examples of non-US sourced FDAP income, which is taxed on a gross basis:

- Compensation for personal services (salaries and wages)
- Dividends or Interest (as well as OID)
- Real property income, such as rents, other than gains from the sale of real property
- Royalties, such as royalties for software licensed and used in the U.S.
- Scholarships and fellowship grants
- A sales commission paid or credited monthly
- Prizes awarded to foreign artists for pictures exhibited in the U.S.

Determination of amount to withhold.

- Amounts subject to reporting on Form(s) 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding,* include all amounts paid to foreign persons that are subject to withholding, even if no amount is deducted and withheld because there is a specific treaty exemption that reduces the withholding tax or a valid Form W-8BEN-E on file.

- A withholding requirement relates to an amount required to be deducted and withheld from the payment of income paid to a foreign person. Similar to amounts subject to reporting you must include and file Form 1042-S and Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.*

Reporting income subject to reporting and taxes withheld on payments made to foreign corporate vendors can be a challenging for any organization. There are complicated rules applicable to the withholding and reporting of cross-border payments under Chapter 3 of the Internal Revenue Code and Chapter 4 of the Code, known as the Foreign Account Tax Compliance Act (FATCA), which requires reporting on Forms 1042, 1042-S, and 8966 and evaluating Forms W-8BEN, W-8BEN-E, and W-8IMY among others. However, what makes this even more of a challenge is the limited focus that many organizations place on oversight, due diligence and standardized processes on the compliance requirements but also the interaction among A/P departments and Corporate Tax Groups on the underlying transactional information. The result usually means there is potential tax exposure risk under an IRS examination that will result in additional tax, penalties and interest that can total close to 50% of the original amount paid to a vendor.

How we can help:

Our services are focused to meet your company's specific needs, which include:

- Identifying and tracking payments subject to withholding by conducting a thorough review of your payment processes and any exemptions.
- Preparation of any withholding tax returns including any delinquent tax returns.
- Working with your company and with key personnel to implement documentation and reporting process.
- Education of your employees to ensure they understand the criteria, and requirements.
- Where required, assist in the IRS' Foreign Payments Practice (FPP) Voluntary Disclosure program.

If you have not looked at your foreign withholding and reporting requirements before, now is the time to reconsider it.

Bergquist & Rossi is the value alternative, providing quality service at a reasonable price. For more information, please contact us at pbergquist@brtaxlaw.com or gkyroudis@brtaxlaw.com at:

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