

Time for a Withholding Tax Check-Up

By Megan L. Brackney

If it is not already on the schedule, CPAs should remember to talk to business clients about withholding on payments to nonresident aliens. A withholding agent who fails to withhold when required may be on the hook for the withholding tax liability, as well as potential penalties for failure to file Forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. The IRS has been increasing enforcement in this area after forming a special group, the Foreign Payments Practice (FPP), in 2013 to focus on the administration and enforcement of the withholding rules.

Failure to fulfill the obligations of a U.S. withholding agent can have serious consequences for employers.

Withholding Rules

The rules surrounding withholding on U.S.-sourced income are complex. This article describes some of the basic general rules, but tax professionals should review the applicable statutes, regulations, and guidance before advising a client about whether a specific payment is subject to withholding and what the client must do to be compliant. IRS Publication 515, the IRS's Withholding Agent Frequently Asked Questions page (<http://bit.ly/2oIA2Fw>), the IRS's audit guide "U.S. Withholding Agent Examinations," and Internal Revenue Manual 4.10.21 are helpful resources.

A payor of U.S.-sourced income to a nonresident alien is generally required to deduct and withhold 30% of the amount of the payment, unless a lower treaty rate applies. The with-

holding obligation is imposed under Internal Revenue Code (IRC) sections 1441 (for individuals) and 1442 (for corporations), which require, with certain exceptions, withholding agents to withhold on U.S.-sourced income, including interest, dividends, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, and other fixed or determinable annual or periodic (FDAP) gains, profits, and income. Certain gains and payments of original issue discounts (OID) are also subject to withholding under sections 1441 and 1442. There are many exceptions to these rules. For example, withholding does not apply to payments of income effectively connected with a U.S. trade or business [Treasury Regulations section 1.1441-4(a)(1)], payments for services performed outside the United States [Treasury Regulations section 31.3401(a)(6)-1(b)], or for payment of portfolio interest under IRC sections 871(h) and 1441(c)(9). Also, tax treaties may reduce or eliminate withholding on interest, dividends, and other specified categories of FDAP (Treasury Regulations section 1441-6).

The concept of a withholding agent is very broad, and it includes any person, U.S. or foreign, that has control, receipt, or custody of an amount subject to withholding who can disburse or make payments on an amount subject to withholding or who makes a withholdable payment [IRC section 1441(a); Treasury Regulations section 1.1441-7(a)(1)]. Withholding agents can be individuals, corporations, partnerships, trusts, or any other entity. In Private Letter Ruling (PLR) 200244017, the IRS determined that a law firm that had consulted with a foreign lawyer was a withholding agent and required to withhold on the payment to the foreign lawyer for his work in the United States.

A withholding agent must withhold on payments to foreign persons unless the withholding agent can "associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is a U.S. person" or to an otherwise exempt payee [Treasury Regulations section 1.1441-(b)(3)]. Generally, the payee provides the with-

holding agent with a Form W-9 or W-8 to determine a payee's status as a nonresident alien or U.S. person. If the withholding agent cannot reliably associate the payment with documentation, there are certain presumptions contained in Treasury Regulations section 1.1441-1(b)(3) to determine the payee's status.

Liability for Taxes and Penalties for Failure to Withhold

Withholding agents must annually file Forms 1042 and 1042-S to report the income paid and the amount of withholding [Treasury Regulations section 1.441-7(a)(1)]. Form 1042 is filed solely with the IRS and reports the withholding agent's total amount of withholding and payments made to the IRS. Form 1042-S is filed with the IRS, but also provided to each payee, and reports the income and amount of withholding specific to that payee. A withholding agent usually must withhold at the time of payment [Treasury Regulations section 1441.2(e)(1)]. Taxes withheld must be deposited weekly, monthly, or annually (with the filing of Form 1042), depending on the amount of withheld taxes.

A withholding agent who does not withhold when required can be liable for the tax that should have been withheld (IRC section 1461). An assessment against the withholding agent under section 1461 is not a penalty, but rather the actual payment of the tax that should have been paid on the U.S.-sourced income by the nonresident alien. In addition to the tax itself, withholding agents can be subject to delinquency penalties under IRC section 6651 for failure to file or pay, or accuracy penalties under section 6662 and fraud penalties under section 6663. Late filing of Forms 1042-S also can result in a penalty of \$250 per form, up to a maximum of \$3,000,000 per year, or \$50 per form if the form is not correctly filed within 30 days after the required filing date, up to a maximum of \$536,000 (\$187,500 for small businesses) per year [IRC sections 6721(a) and (b); Form 1042-S Instructions]. A withholding agent can cure its noncompliance after the fact by obtaining a Form W-8 or other documentation from the payee, but the withholding agent may still be subject to penalties and interest ("U.S. Withholding Agents Frequently Asked Questions," Questions 31 and 32).

Forms 1042 and 1042-S fall under the general statute of limitations rules of IRC section 6501 [N. Indiana Pub. Serv. Co. v. Comm'r, 101 T.C. 294, 299 (1993)], and thus, if no return is filed, the statute of limitations for assessment of withholding tax liability against the withholding agent never begins to run [IRC section 6501(c)(3)]. Accordingly, a business that has made payments to nonresident aliens during the year, but for which the business has determined that withholding was not required (e.g., payments were for ser-

vices rendered abroad), may want to file a protective "zero" Form 1042 for the year so that the statute of limitations begins to run.

Recent Guidance on Form 1042-S

In February 2017, the IRS issued Fact Sheet FS-2017-3 to clarify certain Form 1042-S requirements and to outline common errors. FS-2017-3 reminds withholding agents that they must complete five identical copies of the Form 1042-S: one for the IRS, three for the recipient of the payment, and one for the withholding agent's records. FS-2017-3 also identifies problems with reporting joint owners as a common error and clarifies that Form 1042-S must never report more than one person as the recipient. Where there are joint owners, a withholding agent must issue a single Form 1042-S to the owner whose status the withholding agent relied upon to determine the withholding tax rate (i.e., the owner subject to the highest rate of withholding). If another owner requests a separate form 1042-S, the withholding agent must allocate the payment and tax withheld among the joint owners and issue a separate Form 1042-S to each owner.

FS-2017-3 also clarifies the rules regarding extensions, stating that to request a 30-day extension to file Form 1042-S, the withholding agent must file Form 8809 (Application for Extension of Time to File Information Returns) before the March 15 due date of the Form 1042-S. An automatic 30-day extension will then be granted. A further extension will be granted, at the IRS's discretion, only if the filer can demonstrate extenuating circumstances requiring an additional extension. The second extension must be filed on a Form 8809 before the end of the initial extension period.

FS-2017-3 also alerts withholding agents to an upcoming change in the form for the 2017 tax year that will require the withholding agent to assign a Unique Form Identifier (UFI) to each Form 1042-S that it files. The IRS has added this requirement so that when an amended Form 1042-S is filed, it can more easily identify which Form 1042-S has been amended when a withholding agent files multiple forms for the same recipient.

An Ounce of Prevention

Failure to fulfill the obligations of a U.S. withholding agent can have serious consequences for employers. With the IRS focusing more on this area, now is a good time for CPAs to talk to their business clients about whether they are withholding agents, and, if so, to put procedures in place to ensure compliance with the law. □

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