

FORM 1042 INFORMATION REPORTING REQUIREMENTS

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Taxpayers have an obligation to file information reporting forms to report certain payments to non-resident individuals, foreign corporations, foreign partnerships, and certain foreign fiduciaries, estates, and trusts.¹ In general, every U.S. person that makes a fixed or determinable payment of annual or periodic income (FDAP payment) from U.S. sources must withhold the correct amount of U.S. withholding tax and remit that tax to the IRS.² The withholding tax rate is 30% as imposed by Secs. 871(a)(1) and 881(a) unless the rate is reduced by a tax treaty (discussed below) in force between the United States and the country in which the recipient of the income resides.³

Secs. 1441 and 1442 require tax withholding on nonresident aliens and foreign corporations, respectively. The obligation for U.S. federal income tax withholding is discussed in great detail in the regulations, which were originally promulgated in 1997 and generally apply to all payments made after 2000 (TD 8734, 8804). The regulations on withholding tax from foreign persons are designed to be integrated with certain information reporting and backup withholding rules applied to similar payments to U.S. persons.

Information Reporting

U.S. persons⁴ who make FDAP payments to those foreign persons noted

above are required to file Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons. Form 1042 is due by March 15 and is prepared on a calendar-year basis (regardless of the taxpayer's year end). If additional time is required to file the form, an extension may be filed to extend the filing date but not the payment of the tax. Taxpayers are also responsible for filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, and Form 1042-T, Annual Summary and Transmittal of Forms 1042-S. Forms 1042-S and 1042-T are also due by March 15. It is important to note that Form 1042-S must be filed when a U.S. person makes FDAP-type payments (discussed below) to a foreign person who is subject to U.S. withholding, even if no tax was withheld because of an existing income tax treaty or specific statutory exemption from withholding as provided by the Code.⁵

Types of Payments and Timing of Withholding

FDAP-type income payments include interest, dividends, rent, salaries, wages, premiums, annuities, compensation, remunerations, emoluments, or certain other fixed or determinable annual or periodic gains and income.⁶ The regulations provide guidance on the amount of tax to be withheld.

The amount of withholding must generally be based on the gross amount of payments subject to withholding, with no allowance for deductions,⁷ and it is required at the time a payment is made to a foreign person for an amount that is subject to withholding as described above.⁸ Although similar requirements apply to dividend distributions, a more complex set of rules must be reviewed to ascertain if the corporate distribution represents a taxable dividend, a nontaxable return of capital, or a capital gain.⁹

OID Rules

If a foreign beneficial owner of an obligation carrying original issue discount (OID) sells or exchanges the obligation, the amount of OID¹⁰ is subject to tax.¹¹ The OID is also taxable when a payment is made on such obligation. The amount taxable is the amount of OID that accrued while the foreign person held the obligation, up to the time that the obligation is sold or exchanged or that a payment is made on the obligation, reduced by any amount of OID that was taken into account prior to that time (due to a payment made on the obligation). In the case of a payment made on the obligation, the tax due on the amount of OID may not exceed the payment amount reduced by the tax imposed on any

¹ Secs. 1441 and 1442; Regs. Secs. 1.1441-1 through -9.

² Secs. 1441(a) and 1442(a).

³ Id.; Regs. Sec. 1.1441-6.

⁴ "U.S. person" includes U.S. citizens and residents, domestic partnerships and corporations, and certain trusts and estates. See Sec. 7701(a)(30).

⁵ TD 8881, Section B.2.

⁶ Sec. 1441(b).

⁷ Regs. Sec. 1.1441-3(a).

⁸ Regs. Sec. 1.1441-1(b).

⁹ Regs. Sec. 1.1441-3(c). A distribution is taxable as a dividend to the extent of a corporation's current and accumulated earnings and profits (E&P). All distributions are first deemed to come out of current E&P. See also Secs. 301, 316, and 317.

¹⁰ Sec. 871(g)(1)(b)(i) excludes from the definition of OID any obligations outstanding for 183 days or less.

¹¹ Sec. 871(a) generally duplicates the withholding requirement.

¹² Regs. Sec. 1.1441-2(b)(3)(i).

portion of the payment that is qualified stated interest.¹²

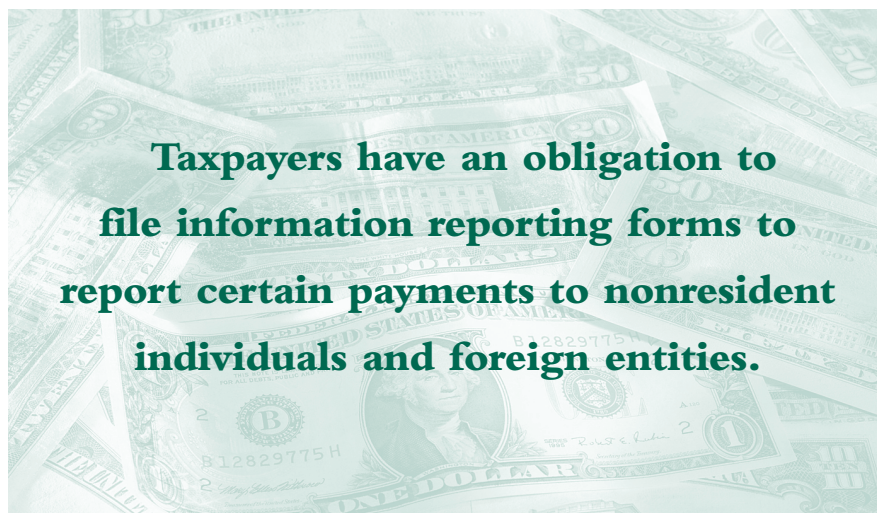
If a withholding agent cannot determine the taxable amount of OID on the redemption of an OID obligation (or on the sale or exchange of such an obligation if the principal purpose of the sale is to avoid tax), then it must withhold on the entire amount of OID accrued from the date of issue until the date of redemption (or the date the obligation is sold or exchanged), determined on the basis of the most recently revised IRS list of OID instruments as if the beneficial owner of the obligation had held the obligation since its original issue.¹³

Exceptions from Withholding

The statute provides numerous provisions to exempt from withholding certain types of income payments made to foreign persons. These include most payments of income, other than compensation for personal services performed by an individual, that is effectively connected with a U.S. trade or business,¹⁴ or payments of portfolio interest paid to foreign persons, unless the person required to withhold knows or has reason to know that the interest is not portfolio interest. Bank deposit interest that is not effectively connected with a U.S. trade or business is also exempt from withholding.¹⁵

Withholding Agent

A withholding agent, in general, is responsible for determining if a payee is a U.S. or foreign person. The withholding agent will generally use a withholding certificate (the Form W-8 series, Form 8233, Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual, or Form W-9, Request for Taxpayer Identification Number and Certification) to ascertain the payee's status. In certain situations, depending on the type of entity or the



type of payment made, other forms may be required to be furnished to the withholding agent. These include Form W-8ECI, Certificate of Foreign Person's Claim That Income Is Effectively Connected with the Conduct of a Trade or Business in the United States, or Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding. If the withholding agent has actual knowledge that a U.S. person received the payment as an agent of a foreign person, the withholding agent must treat the payment as made to the foreign person.¹⁶

A withholding agent is a person who is required to withhold tax under Secs. 1441, 1442, 1443, or 1461.¹⁷ A U.S. or foreign person is a withholding agent if he or she has control, receipt, custody, disposal, or payment of an income item of a foreign person that is subject to withholding. A withholding agent can be a foreign intermediary, a foreign partnership, or certain U.S. branches of a foreign entity. Once a person satisfies the definition of a withholding agent, he or she is liable to deduct and withhold for the payment of tax and to cause the appropriate tax returns as described above to be filed.¹⁸

The Payee

In general, a payee is the person to whom payment is made, even if that person does not own the payment. A foreign payee is a payee who is a foreign person; a U.S. payee is a payee who is a U.S. person.¹⁹

Treaty-Based Withholding

Many tax treaties provide for a lower rate of withholding or zero withholding on certain types of FDAP income, such as interest and dividends. A claim for a benefit under a tax treaty for a nonresident individual or a foreign corporation can be made on Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, which includes the beneficial owner's tax or employer identification number (TIN or EIN).

Treaty-Based Return Disclosures

When a foreign payee is entitled to a reduced or zero rate of U.S. income tax withholding, the regulations under Sec. 6114 require Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), to be attached to the appropriate tax return. A taxpayer takes a treaty return position if there is a difference between the tax liability to be reported on its return and the liability that

¹³ Regs. Sec. 1.1441-2(b)(3). The IRS list of OID instruments is available at www.irs.gov/formspubs/article/0,,id=109875,00.html. This list is no longer published in Pub. 1212, *Guide to Original Issue Discount (OID) Instruments*.

¹⁴ Sec. 1441(c)(1).

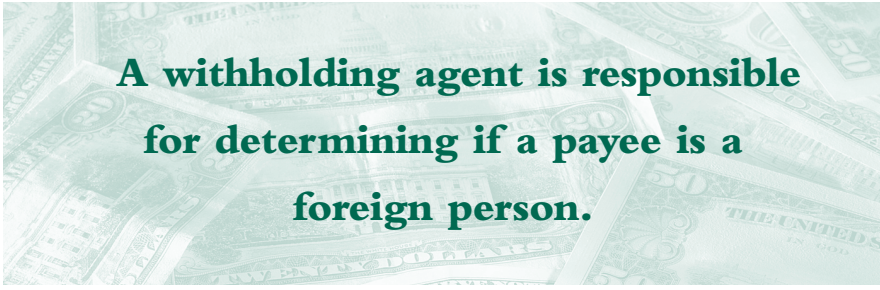
¹⁵ Secs. 1441(c)(9), (c)(10).

¹⁶ Regs. Sec. 1.1441-1(b)(2)(i).

¹⁷ Sec. 7701(a)(16).

¹⁸ Regs. Sec. 1.1441-7(a)(1).

¹⁹ Regs. Sec. 1.1441-1(b)(2)(i).



A withholding agent is responsible for determining if a payee is a foreign person.

would have been reported on that return had the relevant treaty position not existed.²⁰ In the case of a dividend payment from a U.S. corporation to a foreign corporation, the foreign corporation payee must file Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, and attach Form 8833, in order to claim treaty benefits.²¹ Reporting under Sec. 6114 is waived (unless required under the instructions to Form 8833) if:

- Amounts are properly reported on Form 1042-S for payments received

by a related party that is a Sec. 6038A reporting corporation;²²

- Amounts are properly reported on Form 1042-S and do not exceed \$500,000 in the aggregate (applies to taxpayers who are not individuals) for the tax year and are not received through an account with an intermediary or with respect to interest in a flowthrough entity;²³ and
- Payment was properly withheld and reported by a withholding agent that is a qualified intermediary, a

U.S. financial institution, or certain foreign partnerships and trusts (in which case, the beneficial owner of the income must be a direct account holder of a U.S. financial institution or qualified intermediary, a direct partner of a withholding foreign partnership, or a direct beneficiary or owner of a simple or grantor trust that is a withholding foreign trust).²⁴

Conclusion

The rules governing the withholding of income tax with respect to payments to nonresident persons are complex. In order to comply with these rules and avoid related penalties, each payment must be carefully examined under the withholding regulations to determine if withholding and related information reporting applies.

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²⁰ Regs. Sec. 301.6114-1(a)(2)(i).

²¹ In practice it may also be advisable to attach the disclosure to the income tax return (Form 1120, U.S. Corporation Income Tax Return) as well as Form 1042.

²² Regs. Sec. 301.6114-1(c)(6)(i).

²³ Regs. Sec. 301.6114-1(c)(8)(i).

²⁴ Regs. Sec. 301.6114-1(c)(7).