

Automotive Tax Insights

September 30, 2011

Global Information Reporting - International Tax Reporting and Withholding

Automotive companies enter into thousands of transactions each year. Many of these transactions involve making payments of interest, dividends, rents, royalties, or compensation for services. Where a U.S. taxpayer makes a payment of U.S. source income of the type outlined above to a foreign person or entity, withholding may be required. Failure to withhold can result in the U.S. taxpayer, not a foreign recipient, being liable for the tax that should have been withheld, plus substantial penalties and interest.

General Rules of Withholding

Non-resident alien (NRA) withholding is required when a person, also known in this situation as a withholding agent, makes a payment of U.S. source fixed, determinable, annual, or periodic (FDAP) income to a NRA beneficial owner (NRA beneficial owners include individuals, corporations, and other entities). The standard withholding tax rate in such a scenario is 30-percent, but that rate may be reduced by a tax treaty or by a provision of the Internal Revenue Code. Examples of FDAP income include interest, dividends, rents, royalties, and compensation for services.

FDAP payments, and any tax withheld on those payments, are reported to NRA beneficial owners on Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*. The withholding agent reports its aggregate payments and related withholding on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*. Failure to properly report and withhold may expose the withholding agent to liability for the tax that should have been withheld, plus



substantial penalties and interest. When combined, these amounts can quickly grow into significant liabilities.

Three-Step Audits of Withholding Agents

In 2008, the IRS announced that it was designating withholding tax issues as a Tier I issue. A Tier I issue generally has high strategic importance to the IRS and a significant impact on one or more industries. A Tier I issue may also involve numerous taxpayers, significant monetary risk, substantial compliance risk, or high visibility. Tier I issues are subject to significant oversight and control by an issue owner executive who is responsible for developing the issue and resolving examinations consistently. The elevation of withholding tax issues to Tier I status requires all IRS examiners to focus on withholding tax matters during their audits and to coordinate their audits and their findings with the designated issue owner executive and issue management team. For each department of a withholding agent that is audited, examiners are instructed to approach the audit in three main steps.

First, examiners use certain information, such as employer identification numbers, address fields, vendor numbers, and other information, to identify foreign vendors or payees.

Second, examiners test the controls used by withholding agents to identify FDAP payments being made to foreign vendors or payees. A withholding agent's failure to have written policies, procedures, system flowcharts, controls, etc. does not mean that it is not in compliance with the information reporting and withholding rules. It does mean, however, that the IRS may perform a more extensive and intrusive audit to ensure compliance. Therefore, companies should have a rigorous invoice approval process and adequate system controls in place to help ensure the integrity and accuracy of critical data elements required to properly differentiate between FDAP and non-FDAP payments.

Third, examiners identify foreign vendor or payee FDAP payments made by the company that are U.S. source. If the withholding agent does not have contemporaneous documentation that identifies the source of the payment, examiners will presume the payment is U.S. source. Contemporaneous documentation can be correspondence, contract invoice notations, etc. Accounts payable departments should have procedures in place that require invoice notations that identify the percentage of services provided in the United States. If these procedures fail, the accounts payable department should contact the department requesting the service or approving the invoice to obtain information relating to where services were performed.

Appropriate preparations should be made if an examiner requests to interview individuals in charge of approving or processing payments, since these individuals often do not have experience dealing with the IRS. When possible, a taxpayer representative should be present for the interview. Alternatively, the taxpayer might

consider proposing acceptable alternatives in place of an interview (e.g., suggest to the IRS that the company provide written responses to specific questions).

Examiners may also request copies of Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, and Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation*, to identify payments made to related foreign entities. Examiners will attempt to match these payments to those reported on Forms 1042 and 1042-S. Companies that receive this request need to approach it with caution since Forms 5471 and 5472 generally are filed on an accrual basis, while FDAP payments are reported on a cash disbursement basis. Accordingly, amounts reported on Forms 5471 and 5472 may not directly reconcile with amounts reported on Forms 1042 and 1042-S.

What This Means to Automotive Companies

Automotive companies must be prepared for an IRS examination in connection with international information reporting and withholding. Once the IRS notifies the taxpayer of its intent to perform an audit it may be too late to remedy any noncompliance, since the remediation process can take up to a year or more to complete. Therefore, companies should consider assessing their level of compliance with the NRA reporting and withholding rules as soon as possible. If deficiencies are found, proactively remediating those deficiencies will drastically reduce exposures to withholding taxes, penalties, and related interest.

To help ensure compliance on a prospective basis, automotive companies may consider (1) improving their internal systems, (2) developing and implementing new policies and procedures, and (3) better training personnel responsible for implementing the international information reporting and withholding rules.

How PwC Can Help

Many automotive companies are not aware of their noncompliance with the NRA information reporting and withholding rules because they have not identified the departments within their organizations where U.S. source FDAP payments are made. One of the primary challenges to compliance is that the corporate departments most susceptible to noncompliance are frequently those outside of the direct control and jurisdiction of the tax department, like accounts payable, human resources, legal, marketing, payroll, pension, and treasury.

Withholding agents must evaluate their compliance issues in anticipation of both financial statement audits and IRS examinations. Any issues should also be evaluated when engaging in merger and acquisition transactions.

Recognizing that one size does not fit all, PwC's Global Information Reporting (GIR) team has designed two levels of service to conducting an information reporting and

withholding review. Based on your company's facts and circumstances, you may choose to work with PwC to:

Execute a PwC "health check": Our team may work with your tax and other internal departments to review areas where instances of noncompliance commonly occur. Led by PwC, this process, which is similar to mock audit, follows the guidance in the IRS Revenue Manual to provide a comprehensive overview of your company's current level of compliance and potential deficiencies associated with the information reporting rules. Subsequently, PwC may assist you with remediating compliance failures of the past, while also helping to establish processes and procedures that promote go-forward compliance.

Take the self-guided approach: Understanding that some organizations may choose to assess compliance themselves, PwC has developed a program to help your internal staff identify the basics of compliance and assess your state of readiness. To get your team started, PwC will conduct an educational session to provide your internal team with the guidance on information reporting and withholding rules and procedures to ensure compliance from the first payment to year-end reporting. We will also arm your team with knowledge of the common compliance errors and challenges so your company can avoid them. At the end of this session, we will work with your staff to address issues specific to your organization.

Once your self-assessment is complete, PwC can work with your team to assist in remediating any errors and develop a plan to support compliance activities in the future, or we may perform a review to verify your results.

For more information regarding automotive tax services, please visit us at www.pwc.com/auto

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Upcoming Automotive and Tax Events

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The Greenbrier, West Virginia

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