

**Memo**

To: / Location: LiFTS Partners and Managers

From: / Location: Stanley Kolodziejczak / New York

Date: December 1, 2005

Subject: Internal Revenue Service audits for Internal Revenue Code Section 1441 compliance may affect law firms.

**EXECUTIVE SUMMARY**

*In recent years the Internal Revenue Service (IRS) has targeted banks and other financial institutions seeking to gain greater compliance with regards to withholding under Internal Revenue Code Section (IRC Sec) 1441. Lately, however, examinations have been expanded to audit withholding agents including law firms with moderate amounts of reportable payments. The IRS wants to achieve 100 percent audit coverage of all withholding agents.*

**Discussion**

IRC Sec 1441 requires any person who pays to a foreign person amounts of US-sourced dividends, interest, rents, royalties, and other fixed or determinable income to deduct and withhold thirty percent (30%) from the gross amount paid. Other fixed and determinable income includes compensation for personal services.

Over the past few years, the IRS has targeted banks, broker dealers, life insurance companies and other companies in the financial services industry seeking higher compliance in withholding and reporting on payments made to foreign persons. At many of these institutions, the examinations have shown there were insufficient controls in place to accurately withhold and report on these payments. The IRS is now in the process of expanding IRC Sec 1441 audits with a stated goal of obtaining 100 percent audit coverage of all withholding agents.

Very often law firms have business practices that become subject to these withholding requirements. For example, the use of nonresident experts in connection with litigation or the

use of nonresident business consultants gives rise to withholding. Moreover, the withholding requirements would apply to nonresident contract attorneys. It is quite often the case, that the finance functions within a law firm are not aware of payments to nonresidents. Further, in the past, it is unlikely that this issue would come up in the course of a financial statement audit or in the preparation of a tax return.

Generally, assuming the work is done in the US, the law firm must withhold 30% from the gross amount paid to a foreign payee, unless the law firm can reliably associate the payment with valid documentation that establishes either the payee is a US person or the payee is a foreign person that is the beneficial owner of the income and is entitled to a reduced rate of withholding. Normally, the law firm must get the documentation before making the payment. Form W-8 is requested from a foreign person. In the event the foreign person is claiming an exemption or reduced rate of withholding under an income tax treaty the foreign person must provide Form 8283.

The amount of taxes the law firm is required to withhold determines the frequency of deposits. The rules are very similar to the payroll deposits procedures. Accordingly, if at the end of any quarter-monthly period the total amount of un-deposited taxes is \$2,000 or more, the law firm must deposit the taxes within three-banking days after the end of the quarter-monthly period. The law firm must use the Electronic Federal Tax Payment System to make electronic deposits of all depository tax liabilities if they deposited more than \$200,000 on an annual basis.

At the end of every calendar year the withholding agent must also file Form 1042 and Form 1042-S to report payments subject to withholding. Generally, Form 1042 and 1042-S must be filed by March 15 of the year following the calendar year in which the income subject to reporting was paid. The withholding agent must furnish a Form 1042-S for each recipient even if the income payment was exempt from tax under a US income treaty.

There are a number of penalties that are applicable for failing to comply with these withholding requirements. Penalties ranging from 2% to 15% can be assessed for failing to deposit amounts withheld. Moreover, additional penalties can be assessed for failing to file the required annual reporting Form 1042 and Form 1042-S. The penalty for not filing Form 1042 on time is usually 5% of the unpaid tax for each month or part of the month up to a maximum of 25%. A penalty for each 1042-S not filed, ranges from \$15 to \$50 with overall caps that run from \$75,000 to \$250,000.

In recent years, the IRS has had a very active program targeting banks and other financial institutions designed to increase IRC Sec 1441 compliance. The program currently is being expanded to target even moderate withholding agents including law firms. We are aware of one law firm that is currently under examination concerning their Form 1042 and Form 1042-S filings. We anticipate that additional firms will be contacted in the near future.

**Conclusion**

Our professionals at PwC have been dealing with IRC Sec 1441 examinations and have been able to successfully help clients mitigate penalties and improve their overall systems and process that lead to higher levels of compliance. Often voluntary disclosure of past reporting oversights can mitigate penalties. We suggest that you discuss the recent activity by the IRS in pursuing IRC Section 1441 audits and advise our law firm clients that voluntary disclosure / filing is an excellent way to reduce possible exposure. If we can assist your firm with any aspect of Form 1042 and Form 1042-S please contact Stanley Kolodziejczak at (646) 471-3160.