



Form 1042 Audits and FATCA Updates

2023 Financial Services Tax Conference

July 12, 2023
1:30 p.m. and 3:00 p.m.

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Agenda

01

1042 Audit Updates

02

Audit Best Practices

03

Resolving Unagreed Issues

04

Other Hot Topics

Crypto/Mergers & Acquisition and 1099K

01

1042 Audits Updates

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Hot Topics/Recent Audit Issues

Recent IDRs are extremely broad

- Requests appear to come from Form 1120 and 1065 examinations
- Transfer pricing related questions included
- Questions related to nonwithholdable payments made under intercompany agreements
- Requests for invoices and proof of payment
- Requests for internal audits of IRW practices
- Requests for information appearing on other returns (Forms 1065 and 1120) and/or the returns themselves

IRS is requesting all responsive documents to be provided electronically

- Internal taxpayer policies may limit electronic delivery of PII data
- Short IDR response deadlines, max 30-day turnaround given



Hot Topics/Recent Audit Issues

Issues raised on audit

- Audit of Financial Institutions, Multi-Nationals and Non-Financial Institutions which have never been audited
- Questions related to payments between related entities including with non-financial MNCs
- Issues raised related to treaty interpretation of under Business Profits provisions
- Review of all Accounts Payable payments
- Reconciliation of amounts reported on Form 1042 and aggregate of the Form 1042-S payment amounts
- Rejection of 0% w/h on Forms 1042-S to “Unknown Recipient”

Cases being handled by Revenue Agents irrespective of geographic location of taxpayer/RA

- Revenue Agent may have less experience in the industry of the taxpayer
- Revenue Agents unable to travel to taxpayer offices to review PII data

Internal Revenue Manual (IRM) Identified Issues of Note

4.10.21.9.10

“Transactions and Other Items Requiring Special Treatment by Withholding Agents”

- Qualified Investment Entities
- OID
- Securities Lending
- Sweep Accounts
- REPOs
- NPCs
- Equity-Linked Instruments
- Syndicated Loans
- Payments to Foreign Intermediaries and Foreign Flow-Through Entities

Special Considerations for Identified Issues of Note

Securities Lending

- Withholding and reporting may result from both the substitute payments as well as the fees
- Different parties may have responsibility for the substitute payment vs the fees (e.g., custodian may have knowledge and responsibility for the substitute payments made on the borrowed security but contracting parties may be only parties with knowledge regarding fee payments) so it is important to determine who is responsible for withholding and reporting on each payment
- Character and sourcing rules for fees will depend on which party is paying the fee and the type of collateral used (e.g., cash vs non-cash collateral)
- Securities lender can pay either interest or other type of payment (e.g., rent) depending on type of collateral pledged
- Securities borrower likely paying rent (e.g., compensation for use of property). Note issue of how to determine where property is used

Repos

- For a Repo (where withholding agent is the seller of the security), withholding agent will be making interest payment at time of repurchase
- For a Reverse Repo (where withholding agent is the buyer of the security), withholding agent may be making payments of substitute interest or substitute dividends, depending on the security purchased

Special Considerations for Identified Issues of Note (cont.)

Syndicated Loans

- Reporting and Withholding obligations under syndicated loans typically will belong to admin agent
- Distinguished from loan participations where lenders may have their own withholding and reporting obligations with respect to participants
- Contracts should always be reviewed to confirm responsibilities
- If any confusion arises over whether borrower, agent, or other party has the withholding and reporting obligations, this should be spelled out in agreement

Payments to Foreign Intermediaries and Foreign Flow-Thru Entities

- Note that there is a difference between an entity acting as an intermediary and a flow-through entity and withholding consequences can vary (esp with respect to hybrid/rev hybrid relationships and Sec 1446(f))
- For foreign flow-through entities, multiple forms of documentation may be required to handle hybrid & reverse hybrids depending on the payments made and treaty claim eligibility
- E.g., for hybrid treaty claims, a Form W-8IMY + W/h Stmt + Underlying Docs will be required for withholdable payments, even when the Form W-8BEN-E with treaty claim is provided for the same payment
- E.g., for reverse hybrid treaty claims, Form W-8IMY + W/h Stmt + Underlying Docs required only for portion of payment allocable to underlying owners eligible for treaty relief while Form W-8BEN-E generally provided for remainder (no looking through reverse hybrids when using statutory exceptions)

02

Audit Best Practices

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Best Practices: Prior to Examination



Prior to Examination

Create, maintain and follow accurate IRW Practices and Procedures manuals.
The IRS will ask for the documents

Ensure proper validation of all withholding certificates

Maintain proper organization of all Certificates/Forms/Validation Documents

Perform internal audit/health checks

Become familiar with relevant provisions of the Internal Revenue Manual

Best Practices: During an Examination

During an Examination

Be prepared for opening meeting

Ask for Draft IDRs

Provide samples of documents

Schedule a regular status meeting

Ask for draft NOPAs

Relevant Internal Revenue Manual (IRM)

 4.10.21

“U.S. Withholding Agent Examinations - Form 1042”

- Provides Revenue Agents with the rules/procedures for conducting a Form 1042 examination.
- Revenue Agents will adhere to this document when conducting an examination.
- Familiarity with this document is critical.
- If the actions of a Revenue Agent are in conflict with the rules outlined in this document, work with the Revenue Agent to explain the issue using the IRM as evidence of the position.

 4.46.4.7

“Information Document Request Process”

- IDR Process, “is intended to encourage collaboration between the taxpayer and the IRS to discuss and determine the necessary information for proper issue development.”
- Draft IDRs are to be provided to the taxpayer with finalization of the IDR generally occurring within 10 days.
- Once finalized the IRS and taxpayer should agree to a “reasonable” time period for the IDR response.
- If the taxpayer fails to respond or the responses are incomplete, the IRS may grant a single 15-day extension before commencement of enforcement.
- Enforcement generally consists of Delinquency Notice (general 10-day response time) followed by a Pre-Summons Letter (general 10-day response time) and finally a Summons

03

Resolving Unagreed Issues

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Resolving Unagreed Issues

01 Examination resolution

- Work to resolve the issue with the Revenue Agent
- Results in a Closing Agreement
- Less expensive, faster and fewer formalities

02 Fast track

- Appeals Officer acts as mediator to help bring about a resolution
- Neutral third party hears the issue
- Non-binding
- Case must be accepted to Fast Track, not automatic
- Faster and less expensive than traditional Appeals
- Resolution is not guaranteed

03 Traditional appeals

- Long and costly process
- Many formalities
- Resolution guaranteed but may not be in taxpayer's favor
- Can potentially settle an issue affecting both open and unopen tax years

Voluntary Disclosure

IRS Voluntary Disclosure Program

- Disclose, to the IRS, compliance issues identified by taxpayers
- Initial contact can be on a “no name” basis
- Will need to be accepted by the IRS Voluntary Disclosure Program
- Results in a Closing Agreement that can cover multiple years
- Goal is for waiver of related penalties and/or reduced liability
- IRS will request evidence of compliance with terms of Closing Agreement in any later examination

04

Hot Topics - Crypto

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U.S. Regulatory Updates

The Infrastructure Investment and Jobs Act enacted in November 2021 expanded information reporting to cryptocurrencies

- Expanded the rules for information reporting of digital assets by brokers under sections 6045 and 6045A
- Scope of the provision is unclear
- Clarifying amendments to this Act failed to pass, but there has been post-passage proposed legislation to clarify the provision
- Transfer reporting to broker and non-broker wallets
- Expansion of section 6050I reporting to digital assets
- Information reporting changes generally apply to returns required to be filed and statements required to be furnished after December 31, 2023

Announcement 2023-2

- Transitional guidance under sections 6045 and 6045A allows brokers to report gross proceeds and basis as required under existing law and regulations as of December 23, 2022, until the Treasury Department and the IRS issue new final regulations.

As of this date, the Office of Information and Regulatory Affairs indicate that these regulations remain in the Proposed Rule Stage

U.S. Reporting Considerations

Industry Approaches to Form 1099 Reporting While Waiting for Regulations

- Form 1099-K reporting used by some exchanges to report crypto
- Form 1099-MISC reporting used by some to report other income events, such as bonus rewards or income from staking.
- Some combination of Form 1099-B, K, MISC, and NEC reporting
- Form 1099 reporting only upon payee request

Form 1042-S Reporting

- Consideration as to the source of digital asset income from a U.S. tax perspective
- U.S. source payments to a non-U.S. person may result in a default 30% withholding tax, without reduction under an applicable tax treaty or statutory exemption
- Among income types to be reviewed: staking income, bonuses and awards, income from crypto lending
- U.S. source payments paid to non-U.S. payees may result in Form 1042-S reporting
- Impacts to tax due diligence at onboarding

Potential Foreign Account Tax Compliance Act (FATCA) implications

- Operations outside of the United States

Global Reporting Considerations

For digital asset activity outside of the United States, there are developments toward a standardized framework for intergovernmental exchange of information

- The OECD released a document that provides a new Crypto-Asset Reporting Framework (CARF) and amendments to CRS to cover crypto assets
- CARF defines the relevant crypto-assets in scope and those subject to reporting
- Once implemented by participating jurisdictions, CARF would require Crypto-Asset Service Providers to report on sales, exchanges, and transfers of digital assets
- OECD intends for the CARF to function in the same way as the Common Reporting Standard (CRS) by exchanging information on a global level
- Set to become effective on January 1, 2026

The European Commission proposed new tax transparency rules for all service providers facilitating transaction in crypto-assets for customer residents in the European Union

- Intended to compliment the Markets in Crypto-Assets (MiCA) Regulations and anti-money laundering rules
- Expected to be in the form of an amendment to the Directive for Administration Cooperation (DAC)
- Consistent with the CARF and amendments to the CRS

Operational Considerations

For digital asset activity outside of the United States, there are developments toward a standardized framework for intergovernmental exchange of information

- Broker discussions with customers
- Customers should review tax implications with a tax advisor
- Implications of providing late data and efforts required due to time constraints
- Determine ability to provide Form 1099 and 1042-S
- Systems and processes in place or need to be developed/enhanced
- Managing cost of implementation and whether to charge for increased efforts and systems
- Determining whether to buy or build a solution
- Outsourcing
- Prepare to request extensions



05

Hot Topics - Merger & Acquisition Considerations

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Acquisitions / Mergers – Due Diligence Considerations

Type of Acquisition is Significant:

- If acquiring a line of business (in contrast to a stock acquisition), there is a new payor/withholding agent for the acquired accounts. “Clean slate” for withholding liabilities, but Acquirer may be relying on Target’s client documentation and systems for compliance starting Day 1 after acquisition.
- If a stock purchase, the payor/withholding agent stays the same. No clean slate here.

Significant of Due Diligence in Stock Acquisition

When acquiring another business, checking the Target company’s compliance with NRA withholding and reporting rules should be part of any due diligence plan.

- Past compliance “sins” of the Target could become YOUR problem if they are not adequately identified.
- Management needs to know what (if any) tax problems it may be inheriting.
- The extent of Target’s problems, if any, could determine the amount of resources needed after the acquisition.
- You will need to act quickly – due diligence period is often very short!

Acquisitions / Mergers – Due Diligence Considerations

Pre-Acquisition Considerations:

- Evaluate current procedures (e.g., account opening)
- Test effectiveness of those procedures (for example, testing sample of documentation)
- Evaluate relevant systems and determine if necessary tax functionality is present and working.
- Review any IRS correspondence, such as penalty notices, voluntary disclosures, audit notices, etc.

Indemnifications:

- Acquirer may want indemnification for any losses stemming from Target's noncompliance.
- Don't place too much reliance on an indemnification. It should not be viewed as a substitute for due diligence.
- The content of the indemnity could depend on the pre-acquisition due diligence

Acquisitions / Mergers – Due Diligence Considerations

Post Acquisition Considerations:

- Reporting arising from acquisition (1099-B? 1099-INT?)
- Normal Payment Reporting (Form 1099, 1042-S, etc)
 - Standard Procedure – Acquirer and Target is each responsible for the information reporting on payments made in the year
 - Alternative Procedure (Rev Proc 99-50) – Parties agree that Acquirer handles all information reporting for the year. Must be an acquisition of substantially all the assets or a business unit of predecessor
- Consider FATCA and CRS classifications of entities post-merger/acquisition
 - GIINs will need to be changed for FIs if a new entity is formed or an entity is moving into a new group
 - New entity will need to open accounts so status should be determined quickly
- Documentation & Classification of Accounts
 - Plan to have copies of account holder documentation transferred from predecessor to acquirer
 - Acquirer will need to validate documentation received but in certain circumstances acquirer has the option to rely upon status assigned by predecessor for up to 6 months (presuming no knowledge status is inaccurate)
 - Merger or acquisition must be from unrelated USWA (or QI if acquirer is also a QI) for ch 3 purposes and a USWA or PFFI/M1FFI for ch 4 purposes
 - Additional option for PFFIs to rely upon status of predecessor (USFI/PFFI/DCFFI) until change of circumstances occurs if certain conditions are met, including a sampling of statuses assigned by predecessor

06

Hot Topics - 1099K

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U.S. Regulatory Update

American Rescue Plan Act of 2021, enacted in March 2021

- Beginning January 1, 2022, a Third Party Settlement Organization (TPSO) is required to report payments in settlement of third party network transactions with respect to any participating payee that exceed a minimum threshold of \$600 in aggregate payments regardless of the aggregate number of transactions

IRS Notice 2023-10

Delayed implementation of the requirement for TPSO reporting more than \$600 for the 2022 calendar year

For returns for calendar years beginning before January 1, 2023, a TPSO may apply the prior threshold and report where the gross payments to a participating payee for goods and services during the calendar year exceed \$20,000 and there are more than 200 transactions

IRS will not assert penalties for failing to file or failing to furnish Forms 1099-K unless the gross amount of aggregate payments to be reported exceeds \$20,000 and the number of transactions exceeds 200

Beginning January 1, 2023, a TPSO is required to report payments in settlement of third party network transactions with any participating payee that exceeds a minimum threshold of \$600 in aggregate payments regardless of the number of such transactions

The transition period does not apply to payers that have performed backup withholding under section 3406(a) during calendar year 2022

Operational Considerations

Ongoing Legislation Challenges	Managing different Form 1099-K reporting thresholds	Increased reporting	Due diligence requirements
<ul style="list-style-type: none">• May nullify the ARPA changes• Establish a middle ground threshold (proposals of \$5,000 and \$10,000 as a compromise)• Managing different Form 1099-K reporting thresholds	<ul style="list-style-type: none">• No de minimis threshold for payment card transactions• Transition from 200 transactions and \$20,000 threshold for TPSO to 'exceeds \$600' threshold requires system updates and may impact backup withholding processes	<ul style="list-style-type: none">• Volume of Forms 1099-K reported• Payers previously exempt from Form 1099-K reporting may be required to report under new threshold	<ul style="list-style-type: none">• Taxpayer identification number (TIN) collection and validation• Forms W-8 to document non-U.S. persons

Operational Considerations

Increased backup withholding obligations

- Lower threshold applies to a larger volume of payees that may be subject to backup withholding

Determining what items are included in the transaction subject to Form 1099-K reporting

- Gross amount that reflects all positive sales transactions on the date of the transaction
- No adjustments for fees, refunds chargebacks, or other costs and refunded amounts

Understanding State Form 1099-K reporting rules

- Volume of Forms 1099-K reported
- Payers previously exempt from Form 1099-K reporting may be required to report under new threshold

Prepare for reporting 2023 information in 2024

- Review applications, processes, and procedures, and determine what needs to be updated for the new reporting requirements
- Research updates to IRS FAQs, publications, and other guidance

Q&A

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Thank you!

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