IRS begins denying withholding credit reported on Forms 1042-S

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In brief

The Internal Revenue Service (IRS) recently began denying refunds of withholding tax credits claimed on Form 1040NR, U.S. Nonresident Alien Income Tax Return, as substantiated on Forms 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding. This development appears to be in connection with the April 28, 2015 issuance of Notice 2015-10 (Notice) by the U.S. Department of the Treasury (Treasury) and the IRS. The Notice states that Treasury and the IRS intend to promulgate regulations and establish Internal Revenue Manual (IRM) procedures to limit claims for refunds or credit from withholding taxes reported on Form 1042-S to amounts verified by the IRS as actually deposited.

IRM Section 21.8.1 was updated on January 19, 2016 to describe the IRS procedures to implement the Notice’s limited refund and credit process. The government indicated in the Notice that the planned regulations and presumably the IRM procedures would apply to refund or credit amounts withheld in calendar year 2015. These procedures appear to have been implemented on amounts withheld in years prior to 2015. Recent IRS correspondence indicates that individual refunds or credits claimed on 2014 Forms 1040NR for taxes withheld and reported on 2014 Forms 1042-S are being denied. The correspondence also indicates that the IRS was unable to verify the deposits of the reported amounts or that the individual’s Form 1042-S information did not match the information reported by their withholding agent.

In detail

Background

Internal Revenue Code (IRC or Code) Sections 1441 and 1442 impose an obligation on withholding agents to withhold tax from US source fixed, determinable, annual or periodic (FDAP) income paid to a foreign person. This is commonly referred to as ‘Chapter 3 withholding’ or ‘nonresident alien (NRA) withholding.’ FDAP payments include interest, dividends, rents, scholarships, grants, royalties, and other income types. A withholding agent is any person that has control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. The withholding agent is required to report aggregate US source FDAP payments made and any associated tax withheld in a calendar year on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons. Additionally, payments to a particular payee are reported to the IRS on Form 1042-S and a copy is provided to the payee.

Notice 2015-10

The IRS released Notice 2015-10 on April 28, 2015, to address instances where individuals filed claims for refund or credit of amounts withheld under Chapter 3 and other withholding regimes, but where the withholding agent failed to deposit the tax reported on Forms 1042 and 1042-S.
The concern articulated in the Notice is that the IRS may be unable to recover any excess refund or credit if later it is determined that no tax was actually paid and the relevant taxpayer or withholding agent is outside the United States. The Notice announced the intention of Treasury and the IRS to promulgate regulations and develop IRM procedures to address this issue. The regulations will grant only a full or partial claim for refund or credit to the extent that the withholding agent deposited or otherwise paid the amount withheld.

The planned regulations will create three levels of refunds:

- no refund where the amount cannot be traced,
- a partial refund where the refund is partially substantiated, and
- a full refund where amounts are substantiated by the IRS.

**Observation:** The IRS historically has not matched the withholding deposited by a withholding agent and tax liability reported on Form 1042 with the amount reported on Form 1042-S and reported on an individual tax return to determine whether an individual is eligible for a refund or credit of the amount withheld. The Notice indicates that, absent an exception, the IRS could still deny a refund or credit even if the NRA payee could demonstrate that the taxes were withheld or provide a copy of Form 1042-S. The payee will typically not have visibility as to whether the amounts withheld were actually deposited in part or in full until they receive a denial of a refund or credit claimed on his or her individual income tax return. See our **Insight:** IRS guidance to modify claims for refund or credit of excess withholding tax under Chapter 3 or 4.

**Updated IRM Section 21.8.1**

IRM Section 21.8.1 was updated in January 2016 to implement new Form 1042-S validation procedures. Two subjects addressed in the updated IRM procedures are a systematic freeze on certain Form 1040NR accounts and the IRS' matching program for Forms 1042-S. IRM Section 21.8.1.11.14.2 now states that “beginning January 1, 2015, all Forms 1040NR claiming Form 1042-S (CRN 330) credits will be reviewed for validity. Forms 1040NR with a credit balance will have that portion of the refund systematically frozen for up to 168 days...Form 1040NR accounts with a zero balance or balance due will not have a systematic freeze.” Further, the freeze will systematically release at the end of the 168 period unless IRS deems the credit invalid.

IRM Section 21.8.1.11.14.3 notes the IRS “implemented a systematic matching program to verify that the Form 1042-S submitted by a recipient is valid for refund.” The matching program “compares the information...from the withholding agent’s Tax Year 2014 Form 1042-S (Copy A) submitted to the IRS against the recipient’s Form 1042-S (Copy B) filed with their income tax return. The comparison will determine if a credit matches and if a credit was previously allowed.”

Pursuant to the new matching program, the IRS also will issue a Letter 5532C, Notification of Preliminary Action Regarding Chapter 3 or Chapter 4 Withholdings Shown as Payments on Your Tax Return, to the individual taxpayer. The Letter 5532C advises the taxpayer that the IRS reduced or eliminated the amount shown on Form 1040NR, line 62d, because the Form 1042-S information does not match the information reported by their withholding agent and advises the individual to contact their withholding agent. The letters will not specify the reason for the mismatch. Rather, the IRM instructs that the taxpayer and withholding agent must determine the reason for the Form 1042-S mismatch, and the withholding agent must submit an amended Form 1042-S and provide a corrected Form 1042-S to the taxpayer, if necessary.

**Observation:** The Notice indicates that the new refund procedures would apply to credits or refunds claimed on withholding reported for calendar year 2015. The IRM indicates that the procedures begin applying on January 1, 2015. IRS correspondence relates to withholding that occurred in calendar year 2014. Clearly, the IRS is applying the new refund or credit process earlier than indicated in the Notice.

The IRM also provides IRS representatives with guidance on how to respond to taxpayers who reply in writing or by telephone to Notice CP21A, CP22C, or Letter 5532C. For example, the IRM provides that individual taxpayers who call or write to the IRS to generically inquire as to why their credit was denied should be advised to contact the withholding agent to determine the reason that Form 1042-S did not match the information reported by the withholding agent without providing any further information. Individual taxpayers who contact the IRS in writing or by telephone, to explain that the withholding agent confirmed that the taxpayer’s Form 1042-S matches the copy submitted by the withholding agent, will be required to fax their Form 1042-S (Copy B) to the IRS for verification.

Once the IRS verifies that Copy A (submitted by the withholding agent) and Copy B (filed by taxpayer with Form 1040NR) match, the IRS will make a notation on the individual’s Form 1040NR account. This will not
automatically release the 168-day freeze. If the Form 1042-S information matches and a credit was not previously allowed by the IRS, the IRS will either manually release the freeze or let the freeze expire on its own after the 168-day period. If the matching program indicates that a Form 1042-S did not match, the IRS will first reverse the claimed credit. The IRS will not grant the claimed credit without further information.

**Change in enforcement**

The IRS recently began sending correspondence to individual taxpayers, including CP21C, CP22A, and Letter 5532C, denying credit for the taxes withheld and reported on 2014 Forms 1042-S. NRA payees filing US income tax returns and claiming credits or refunds based on withholding taxes reported on Form 1042-S have had a limited time period to respond to these notices from the IRS. The IRS and Treasury have not yet promulgated regulations as described in the Notice, but this development confirms that the IRS is taking proactive steps consistent with the revised IRM procedures. The correspondence addresses instances in which the IRS believes it has facts to support the position that a withholding agent did not deposit or otherwise pay some or all of the withheld taxes reported on Forms 1042 and 1042-S or that the information reported to the IRS on the individual’s Copy B of Form 1042-S does not match the information provided to the IRS by the withholding agent.

There are several scenarios that could arise which would result in the denial of a refund or claim on an individual’s return for withheld taxes reported on Form 1042-S. For example, any inconsistencies or inaccuracies in the amounts reported in Box 7a, federal tax withheld, Box 7b, check if tax not deposited with IRS pursuant to escrow procedure, or Box 10, total withholding credit, on Form 1042-S, with the amounts deposited and liability reported on Form 1042, could result in IRS correspondence to the beneficial owner of the income.

It is imperative that individual taxpayers who receive IRS correspondence related to a refund or claim for withheld taxes reported on Form 1042-S take proactive steps. Individuals should immediately contact the withholding agent about the notice. It is also critical for individuals to contact the IRS by telephone or in writing to respond to the notice by the due date noted on the correspondence.

**The takeaway**

This development comes at a time when observers have noted increased enforcement activity by the IRS in the US information reporting arena despite budget constraints. The IRS has now followed through to increase its scrutiny of, and tighten its standards for, documentation required for refund and credit claims for over withholding on payments to non-US recipients. Together, these developments have made it more difficult for withholding agents and non-US persons to claim refunds of withheld tax. It is essential that individual taxpayers proactively work with withholding agents to address the cause of the IRS denial of a refund or credit claim.

**Let’s talk**

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