Prepare For More Audits Of Tax Info And Withholding Filings

By **Jared Goldberger, Jenny Austin and Amit Neuman** (August 12, 2021)

Jared Goldberger

Jenny Austin

Amit Neuman

The Biden administration has set forth an array of big-ticket proposals since taking office and at least one thing seems to be clear: Increased enforcement by the Internal Revenue Service is on the horizon.

Since taking office, the administration has proposed a variety of tax compliance initiatives that seek to (1) collect additional revenue and (2) close the so-called tax gap — i.e., the difference between taxes owed to the government and taxes actually paid.

Although many of these initiatives are still being considered and negotiated in Congress, tax professionals are anticipating an increase in tax compliance enforcement through increased IRS audits — particularly in the realm of tax information reporting and withholding.

Increased IRS Enforcement

To provide context, the U.S. Department of the Treasury's "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," also known as the Green Book, released in May, proposed providing the IRS with additional funding over the course of the next decade.

In fact, additional IRS funding was one of the major revenue raising provisions originally in the Infrastructure Investment and Jobs Act, which is currently being considered by Congress.

Despite the current draft of the infrastructure bill being stripped of additional IRS funding, the congressional appropriations process is still being used as a path to increase IRS funding. The majority of any additional IRS funding would likely be allocated to (1) upgrading information technology capabilities and (2) supporting the expansion of enforcement activity — e.g., by hiring and training IRS agents.

Although the Biden administration's precise plans for the IRS outlined in the Green Book are not currently included in the Senate's infrastructure bill, these plans, together with a few more recent developments, discussed below, have provided taxpayers and, in particular, financial institutions valuable insight as to how the IRS may focus its energies in the future.

First, one of the many noteworthy proposals introduced in the Green Book was a new "comprehensive financial account information reporting regime."

The administration's brief overview of this proposal suggested that it would leverage the tax information reporting regimes already in place — e.g., reporting on IRS Forms 1099 to report nonemployment income — by requiring financial institutions to report additional data points on financial accounts to the IRS in information returns — e.g., gross inflow and outflow of cash, transactions with foreign accounts, and transfers to and from another account with the same owner.

This expansion of information reporting may achieve a few IRS objectives, including increased visibility of business income, increased effectiveness of enforcement and encouraging voluntary taxpayer compliance.

Second, in July, the Treasury and the IRS published proposed treasury regulations relating to the obligation to electronically file certain tax returns and information returns.[1]

The proposed regulations provide in great detail the circumstances in which certain tax returns and/or information returns would be required to be filed electronically and, in general, attempt to further induce the use of electronic filings. If finalized, these regulations would help the IRS more efficiently collect digitized taxpayer information.

Lastly, the Senate's infrastructure bill currently includes a provision relating to the information reporting of certain cryptocurrency transactions. A fact sheet on the infrastructure bill published by the Biden administration in July stated that there is a heightened interest in "strengthening tax enforcement when it comes to cryptocurrencies."

Although many of the administration's plans are currently just proposals, increased IRS enforcement appears to be a priority. Taxpayers, especially financial institutions, should consider whether now is an appropriate time to ensure that existing tax compliance processes and procedures, such as those related to on-boarding, withholding, and information reporting, are up to date and functioning in accordance with current law.

Taking these steps now will assist in a more seamless transition to take into account future information reporting guidance, as well as addressing IRS audit issues in the future.

Internal Compliance Considerations

One area that taxpayers may see an increase in IRS enforcement is the auditing of IRS Forms 1099, 1042 — that annual withholding tax return for U.S. source income of foreign persons — and Form 1042-S — for reporting a foreign person's U.S. source income subject to withholding.

In addition to dedicating greater resources, the IRS has already increased its focus on these reports and information returns over the past few years. This is, in part, due to the information that the IRS has been receiving from the Foreign Account Tax Compliance Act reporting regime since 2014.

An IRS audit of a taxpayer's Form 1042, 1042-S or 1099 will largely focus on the institution's customer on-boarding, withholding and reporting procedures, processes and implementation.

In general, tax on-boarding procedures involve the collection of tax certifications from account holders — e.g., clients, customers, partners, investors. These tax certifications are typically provided by U.S. account holders on Form W-9 and non-U.S. account holders on the Form W-8 series.

The accurate completion and continuing validity of such tax certifications are critical to financial institutions for determining (1) the appropriate amount of U.S. federal withholding tax, if any, that may apply to payments made to an account holder and (2) the corresponding information reporting to the extent required under the Internal Revenue Code.

To the extent a Form W-9 or Form W-8 is incomplete or insufficient in any regard, the IRS may consider such account holder as undocumented, even if the omission is immaterial to some. Failure to appropriately on-board and document an institution's account holders may result in underwithholding exposure and associated penalties and interest.

In anticipation of a future IRS audit, taxpayers may also consider revisiting measures that have been established to ensure appropriate and valid on-boarding of account holders. For example, an institution may review a Form W-8 or Form W-9 validation procedure to ensure that the procedure has been updated to take into account the latest forms and IRS guidance.

Another example is a review to ensure that appropriate remediation measures are in place to the extent that a Form W-8, or the account holder's file, contains certain U.S. indicia — e.g., a U.S. address or a U.S. telephone number.

To the extent such U.S. indicia is not appropriately cured or remediated, the ability of a financial institution to rely on the Form W-8 may be called into question. Failure to have sufficient systems in place to identify incomplete or inconsistent tax certifications may give rise to material risks for a financial institution, including both monetary and reputational risks.

On-boarding failures will likely have spillover effects on a taxpayer's withholding and reporting efficiency. For example, invalid documentation may result in the incorrect withholding rate being applied to impacted payments.

In addition, efficient withholding tax processes may also identify whether a previously delivered tax certification has expired — e.g., an IRS Form W-8BEN-E, certificate of status of beneficial owner, which is generally only valid for a period of three years — or become inaccurate, at which point the financial institution may be required to withhold on payments made to such account holder at the highest applicable rate until the account holder provides the financial institution with an updated tax certification.

Failure to have sufficient processes that identify appropriate levels of U.S. federal withholding tax also poses material risks and liability for financial institutions.

Once it is determined that efficient tax on-boarding and withholding processes are established, financial institutions should also ensure that they have efficient information reporting processes that are compliant with the Code.

Such processes should be able to sufficiently identify whether an account holder would be subject to information reporting on, for example, IRS Form 1099 or IRS Form 1042-S and whether any exceptions to such reporting apply.

IRS Form 1099 or Form 1042-S will also have an impact on the financial institution's own Form 945, reporting withheld federal income tax from nonpayroll payments, and Form 1042. While onboarding and withholding failures may be identified during the course of an audit, reporting inconsistencies will likely be noticed by the IRS during the course of its internal review of such forms.

Further, any improved technological efforts made by the IRS that focus on Forms 1099, 1042-S, and 1042, etc., may be able to further identify unreconciled variances, which may result in a notice or other form of correspondence being sent to the institution by the IRS asking for an explanation of such variances.

The Focus on Financial Institutions

The IRS has been increasing its use of data analytics to better select tax returns and specific issues to examine for several years now. By (1) further investing in upgrading information technology capabilities and (2) increasing the amount of information that financial institutions would be required to report annually, the IRS will be better equipped to identify trends and potential tax issues of financial institutions' account holders.

By examining financial institutions' compliance with information returns, such as Forms 1099, 1042 and 1042-S, the IRS may be able to identify systemic compliance issues in an area where the penalties for noncompliance can be considerable.

In an era where IRS enforcement is expected to increase significantly for high-net-worth individuals and pass-through entities, the IRS may expect that it will be better served by having access to detailed information from all the financial institutions these taxpayers do business with rather than having to go through the third-party summons process.

Audits in the information reporting and withholding space are already on the rise, and the Biden administration has made its intentions to expand the effort clear. Now is the time to ensure you're ready for the IRS.

Jared B. Goldberger and Jenny A. Austin are partners, and Amit S. Neuman is an associate, at Mayer Brown LLP.

Mayer Brown senior adviser Warren Payne and partner Mark Leeds contributed to this article.

[1] Treas. Reg. 102951-16.