



TRANSCRIPT

COURSE 1 - MODULE 8 - LESSON 4

Steps in an Audit

Welcome back

In the last lesson we talked about the Form 4564 and we got to the position in the process where you have received one. You've gathered the information, I will presume you were well prepared, kind of no excuses for you if not having gone through all the other modules you have already here! And sent it across to the IRS agent requestor. They are ready to start, so what are the next steps? That's what this lesson is all about.

In the earlier lesson we talked about the Internal Revenue Manual, IRM 4.10.21, which lays out specific steps for audits of financial and nonfinancial institutions. While the specific steps for each may be described differently, the general steps and focus is the same, so similarly to the last lesson for ease of understanding I'll group them together as I go through:

Let's start by looking at the areas the agent might want to have a look at. This is going to depend quite a bit on the type of organization you are, but nevertheless I will run through a list of a few functional areas of an organization that I would expect the agent will ask to review:

As you'd expect, prior to any visit, the manuals and other materials provided by the organization in response to the IDR will have been reviewed by the agent. The agent will review all the written procedures and training manuals collected.

Where manuals are not available, the review may consist of meetings and some detailed discussions with the persons responsible.

The areas the agent will cover should mirror the information, process and procedure manuals requested and include similar areas to the ones I went through before, such as

- Account opening procedures.
- Procedures used to validate forms w-8 and classifying undocumented accounts and the use of presumption rules.
- Withholding tax systems.
- Design manuals for payment systems.
- System flow charts covering payments.
- Internal controls, audit reports or other such information related to withholding tax functions.
- Deposit procedures.
- Refund procedures.
- Any other procedure manual or process that may have a withholding tax implication.

The point of this review allows an agent to assess an organizations level of understanding of the requirements.

As you would expect, an organization that is well documented with the correct rules may be assumed to be complying, whereas an organization that is not well documented or has outdated or incorrect procedures may be assumed not to be in complete compliance. I know which camp I would like to be in!

It's fair to say that the amount of attention an agent spends on an area may be related to how compliant they believe the organization is.



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I know I keep saying it, but this step should further highlight the importance of developing and maintaining good processes and procedures coupled with ongoing internal training.

So what's going to be included next? Well that's going to be a focus on your forms, and I'll start with the review the Form 1042. Here I'd expect the agent to focusing in on:

- Reconciliation of the income, tax liability and withholding reported on the Form 1042 compared to the Forms 1042-S, using the workpapers used by the organization to prepare the returns.
- Confirm that the deposits were made timely by reviewing payment and deposit records.
- Application of the escrow procedures, if applicable, by a review of an organizations internal coding.
- A review of the Forms 1042-S themselves.
- The agent will also look to determine if adjustments for over-withholding using the set off or reimbursement procedure were applied correctly.

Now it's possible here that the review of Forms 1042-S could be in total or dependent on numbers. Generally, this is undertaken on a sample basis for large numbers of forms filed.

The Forms 1042-S would be compared to the account information to verify the following are correct:

- Gross income – the amount of income paid compared to the customer statements
- Source of income as U.S. or foreign.
- Amount of tax withheld. This will be based on a review of the underlying Forms W-8, treaty claims, income type, etc.
- Income codes. The codes we discussed previously used by the IRS to identify the type of income. For example, code 01 is for interest paid by U.S. entities and code 06 is for dividends paid by U.S. entities.
- Tax rates. That they are specific and are either 30%, 0%, or calculated correctly using a valid treaty rate.
- Related exemption codes. This is where they refer to a code used when withholding is not applied. The exemption code itself is the explanation when withholding is marked as exempt. For example, exemption code 04 is for income exempt under a treaty.
- Recipient status codes. The codes that align with the status on the Forms W-8. For example, recipient status code 23 refers to individual.

Then there is always the use of the “catch all” Any other required information!

These steps are the most detailed review of an organizations payment systems, customer information systems, documentation systems, withholding tax calculation systems, etc.



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The agent will generally request a sample of the Forms 1042-S filed and confirm the recipient information back to the withholding certificates (i.e., Forms W-8, presumption rules, etc.) the income amounts back to each payment system and the withholding amounts back to treaty claims.

As you can see audits are a detailed analysis across so many areas here.

So, after all this information has been reviewed, what's next? Well, there is one more important step and you may be relieved to hear that it's the last in this particular journey and coincidentally the last lesson in this course!

So, let's leave this one on a cliff hanger and move on to find out what happens next!