Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Process Unit
Knowledge Base – International

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Shelf		Business Inbound
Book	8	Withholding Business
Chapter	1	FDAP Payments
Section		

Unit Name	FDAP Payments - Statistical Sampling and Projection Procedures	
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Process Overview

FDAP Payments - Statistical Sampling and Projection Procedures

The purpose of this unit is to describe the use of statistical sampling in the audit of a U.S. withholding agent (USWA) and associated projection procedures. Statistical sampling techniques are useful when an examiner is attempting to review a population of transactions too voluminous to review in full. This is especially useful for audits of large entities with a large number of Forms 1042-S transactions or payments of Fixed Determinable Annual Periodic (FDAP) income subject to withholding (that may or may not have been reported). There may also be instances in which the complexity of transactions necessitates statistical sampling, even if the total number of transactions is not that large.

An audit of a USWA usually involves a review and analysis of withholding certificates, account holder Information, and other associated documentation. This may require a lot of time and resources. In such instances the examiner should consider the use of sampling as an audit tool. IRM 4.10.21.9.1.3, *Review of Form 1042-S*, recommends sampling as a means of verifying Form 1042 year end account balances and IRM 4.10.21.9.8, *Use of Statistical Sampling*, further recommends use of statistical sampling in the review of USWA reporting and withholding obligations. Statistical sampling can also be used as part of the risk focused audit process as it allows the examiner to target certain segments of the population. In the case of the Form 1042 exam, these could be certain income types or exemption codes.

There are two common types of sampling: Judgmental and Statistical.

- In Judgmental sampling, items selected for exam based on examiner's professional knowledge and judgement, meaning the selection of items is biased. Any adjustments made are limited to the items selected and cannot be projected to the population.
- In Statistical sampling, items to be examined are selected randomly, meaning every item in the population (simple random sampling) or within a strata has an equal chance of being selected. The selection therefore is unbiased. Adjustments made to the sample items can be projected to the population.

Statistical sampling should be considered whenever examination of large volume of data is considered necessary based on adjustment potential, but examination of 100% of items is prohibitive in terms of time and resources. Efficiently designed samples (e.g. use of stratification, elimination of strata with lower risk levels, use of certainty stratum etc.) will ensure effective utilization of IRS exam resources.

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FDAP Payments - Statistical Sampling and Projection Procedures

A Computer Audit Specialist (CAS) must be involved in order to project audit adjustments from a sample to a population. The CAS can also assist with statistical sampling decisions and therefore a referral for CAS assistance should be made very early in the audit process. While CAS involvement is necessary for both designing and projecting a statistical sample, the Foreign Payments Practice (FPP) examiner can perform much of the work and make many of the decisions concerning population development and refinement.

The starting point for any audit of a USWA should be an analysis of the it's systems to ensure, among other things, that all applicable payments and payees are incorporated into the withholding and reporting system. The process of designing a statistical sample includes defining the population, selecting the appropriate sample unit, refining the population, and determining the stratum boundaries and sample size. While CAS expertise should be specifically relied on for sample decisions such as stratification strategies (including the creation of certainty strata) and determining lower dollar (exposure) limits for sample inclusion; many population development and refinement decisions (e.g., which income and exemption codes to include in the population of audited transactions) are decided by the examiner.

Currently the recommended sample unit are Forms 1042-S filed with the Service. Other candidates to consider using as the sample unit include individual or total payments made to an account holder. Regardless of the sampling unit chosen, withholding certificates, account file information, and all other relevant information necessary to determine the correct reporting and withholding rate, should be reviewed for every sample unit selected for review in the sample.

To leverage and effectively utilize resources in both statistical sampling and non-statistical sampling situations, a comprehensive risk analysis should be conducted by the exam team (see IRM 4.46.3.3, *Risk Analysis Process).* The risk analysis should include input from the taxpayer. An issue-based approach should be used in an attempt to identify issues that are material, have significant compliance risk, and may pose compliance challenges for the withholding agent under audit. Overall tax impact should be considered. The assessment of what is material is a matter of professional judgment. In setting materiality thresholds, the examiner should consider both quantitative and qualitative factors. These factors include but are not limited to dollar value and permanency.

FDAP Payments - Statistical Sampling and Projection Procedures

When determining which sample units to include in the sample population, similarly to determining which transactions to review when not utilizing statistical sampling, sample units should be evaluated in terms of risk. Sample units determined to have the least amount of risk of being underwithheld on, or possibly generating the least amount of tax on an actual or projected basis may be eliminated from the sample. The most common sample unit employed in foreign payment audits is the form 1042-S. The most common sample unit characteristic used to measure risk of underwithholding is a measure of maximum potential underwithholding, calculated as ((gross payment amount multiplied by 30%) minus actual withheld tax).
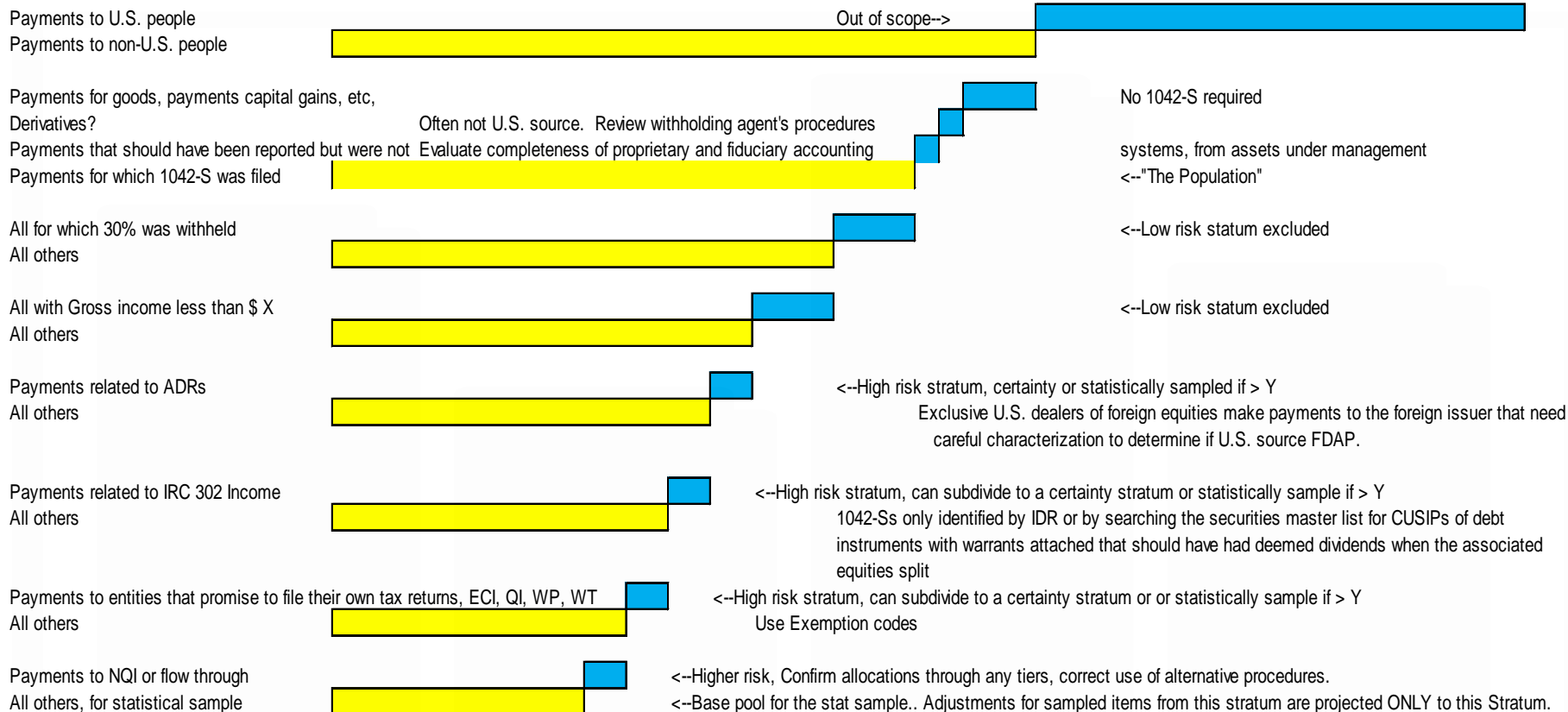
Using this measure, an examiner may decide to eliminate all transactions from the population that have already been withheld at 30%. This elimination would not affect the validity of the sample because the sample would only be projected over the population of transactions from which the sample was selected; and per IRS procedure, every sample unit within the same stratum will have an equal chance of being selected. Additionally, a certainty stratum of high dollar maximum potential underwithholding may be created due to the increased risk associated with large dollar transactions. Every transaction in a certainty stratum is reviewed, and as previously mentioned, is not projected further.

When designing a sample to be used in determining a deficiency in a tax audit, the amounts to be used as the reported amount must be determined. In an expense audit the reported amount for each sampling unit will usually be the amount of each individual expense. The adjustment amount is usually the amount of that expense disallowed upon audit. For example, while reviewing a sample of legal expenses a reported amount might be $2,000 paid for consultation with an attorney. Upon audit, an examiner might determine the $2,000 was actually paid as a bribe. Since a bribe is not an allowable expense, the adjustment amount would be $2,000 of disallowed expense.

FDAP Payments - Statistical Sampling and Projection Procedures

Diagram below illustrates how payments can be categorized in Form 1042 Audit

Payments to U.S. people   Out of scope-->
Payments to non-U.S. people

Payments for goods, payments capital gains, etc,   No 1042-S required
Derivatives?   Often not U.S. source. Review withholding agent's procedures
Payments that should have been reported but were not   Evaluate completeness of proprietary and fiduciary accounting   systems, from assets under management
Payments for which 1042-S was filed   <--"The Population"

All for which 30% was withheld   <--Low risk statum excluded
All others

All with Gross income less than $ X   <--Low risk statum excluded
All others

Payments related to ADRs   <--High risk stratum, certainty or statistically sampled if > Y
All others   Exclusive U.S. dealers of foreign equities make payments to the foreign issuer that need careful characterization to determine if U.S. source FDAP.

Payments related to IRC 302 Income   <--High risk stratum, can subdivide to a certainty stratum or statistically sample if > Y
All others   1042-Ss only identified by IDR or by searching the securities master list for CUSIPs of debt instruments with warrants attached that should have had deemed dividends when the associated equities split

Payments to entities that promise to file their own tax returns, ECI, QI, WP, WT   <--High risk stratum, can subdivide to a certainty stratum or or statistically sample if > Y
All others   Use Exemption codes

Payments to NQI or flow through   <--Higher risk, Confirm allocations through any tiers, correct use of alternative procedures.
All others, for statistical sample   <--Base pool for the stat sample.. Adjustments for sampled items from this stratum are projected ONLY to this Stratum.

For acronyms, see the "Glossary of Terms and Acronyms" slides.

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FDAP Payments - Statistical Sampling and Projection Procedures

The table below illustrates how Forms 1042-S (a common sampling unit for audits of foreign payments) can be categorized, and also illustrates the use of a combination of both statistical and judgmental or manual sampling within the same audit.

Order of Categorization	Description of Categories	Sample Method
(A)	ADR (identified by the word "ADR" in the name of account)	Manual Selection, Judgment Sample
(B)	302 Issue (selected based on inquiry with Taxpayer to identify forms that were affected by the 302 Issue)	Manual Selection, Judgment Sample
(C)	All Forms with the Type of Recipient Chapter 3 Status Code 05 - U.S. Branch treated as U.S. Person	Manual Selection, Judgment Sample
(D)	All Forms with Type of Recipient Chapter 3 Status Codes: - 09 Withholding Foreign Partnership - 11 Withholding Foreign Trust - 12 Qualified Intermediary Forms with blank Status Code and blank "NQI_EIN" Forms with "Recipient US TIN" filled in	Manual Selection, Judgment Sample
(E)	NQI	"NQI EIN" was not blank, Statistical Sample
(F)	Beneficial Owner	Beneficial Owner - Everything else before Recipient Code 08, Statistical Sample
(G)	RC 08 - All Forms with the Recipient Code 08 (Partnership other than withholding foreign partnership)	Manual Selection, Judgment Sample

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FDAP Payments - Statistical Sampling and Projection Procedures

In statistical samples of foreign payments by USWA, the reported amount used might be the amount of tax withheld on a payment, and the adjustment amount, which is the difference between what was withheld and the amount of tax that should have been withheld as determined upon audit. However, in some instances this design has resulted in significant sampling error (an amount that represents uncertainty introduced through the use of statistical sampling vs a 100% review). Projected results of IRS samples are calculated by a CAS using the approved CAS statistical sampling software. Sampling error may reduce the projected deficiency determined by a sample designed and executed by the IRS.

An alternative design that often results in a smaller sampling error, uses the a measure of maximum potential underwithholding ((gross payment amount multiplied by 30%) minus actual withheld tax) as the reported amount. The adjustment amount used is the amount of tax that should have been withheld less the amount of tax actually withheld.

Example 1
Determine the correct amount of withholding tax for payments appearing on a Form 1042-S.

Facts: Per Form 1042-S:
Gross payment = $100.
Actual withholding = $10.

Correct withholding determined upon audit = $30.

Reported Amount = ($100 multiplied by .30) minus $10 = $20
Adjustment Amount ($30 minus $10) = $20
Potential underwithheld tax was $20 and the actual understatement was $20.

FDAP Payments - Statistical Sampling and Projection Procedures

Auditor's Workbench Information Returns Master File (IRMF) (AW-I)

Examiners are encouraged to use Auditor's Workbench IRMF (AW-I) as a tool for determining the sample population. The sample unit used by AW-I is Form(s) 1042-S filed with the Service, obtained through the IRMF Query Tool. The examiner can filter the population and eliminate no risk or low risk pools, where risk is defined as Gross Income Paid multiplied by 30% minus the amount withheld. A file of the remaining population to be sampled is created and sent to a CAS, who imports the file into the CAS Statistical Sampling Program, used to randomly select the sample. Once the sample items are randomly selected by the CAS, the CAS will send a file of those randomly selected items back to the examiner. The examiner will import the file back into AW-I. Audit results for each selected item can then be recorded in AW-I. Once all Sample Items have been evaluated, the examiner will re-send the file that now includes any recorded adjustments. The CAS can now calculate projected adjustment on a pre-cure basis.

FDAP Payments - Statistical Sampling and Projection Procedures

Standards of Cured Documentation

An examiner should pay special attention to a withholding certificate that was provided after the date of payment. Such a withholding certificate is acceptable if it contains an affidavit that states that the information on the withholding certificate was accurate at the time of payment. The affidavit should be signed by the payee under penalties of perjury and dated. It can be added to the bottom of the form or on a separate page attached to the form.

If the withholding certificate is received more than a year after the date of payment, the examiner should review additional documentary evidence which USWA obtained to support a reduced rate of withholding. Examples of acceptable documentary evidence supporting a claim of foreign status in that year include an individual's contemporaneous government identification which contains a permanent residence address, or a certificate of incorporation from a foreign country that predates the audit year.

Documentary evidence establishing residence in a treaty county includes any government-issued identification stating the individual's name, address, and photograph that has been issued no more than three years prior to presentation to USWA. If older than three years, additional evidence of the person's residence in the treaty country is needed (i.e., a bank statement, utility bill, or medical bill). For entities, the documentary evidence is any official government document that includes the name of the entity and the address of its principal office in the treaty country.

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FDAP Payments - Statistical Sampling and Projection Procedures

Projection of Cured Documentation

In instances in which statistical sampling is used, projection of the sample is on a post-cure, rather than a pre-cure basis. Both are defined below and examples given of each.

Pre-Cure Error Projection

Pre-Cure Sample Projection is defined as projecting the sample after identifying deficiencies caused by inadequate account holder documentation, without taking into account any later cured documentation received by USWA as a result of actions taken after being notified of the sample items under review. Such curing could only reduce or eliminate the actual initial deficiency associated with that sample unit, but would not affect projection.

Post-Cure Error Projection

Post-Cure Sample Projection is defined as projecting the deficiency in the sample only after taking into account any curative documentation received by USWA as a result of actions taken after being notified of the sample items under review.

Example 2

Revenue Agent is examining a population consisting of 10,000 Forms 1042-S and selects a sample of 100 forms. Initial sample evaluation results in 50 errors, which means there are 50 errors Pre-Cure.

Subsequently taxpayer cures 30 out of the 50 errors, which means there are 20 errors remaining Post-Cure.

If projection is performed Pre-Cure the projection would be based on 50 sample units having an error.

If projection is performed Post-Cure the projection would be based in 20 sample units having an error.

FDAP Payments - Statistical Sampling and Projection Procedures

Several industry groups have raised concerns on the IRS policy regarding projection of cured documentation in both Qualified Intermediary (QI) and USWA audits, as well as the elimination of low or no risk pools from samples of USWA audits.

The main questions raised are whether examiners should eliminate pools which they determined have no or low risk and whether examiners should use pre-curing or post-curing results to extrapolate to the whole population.

Foreign Payments Practice (FPP) audit recommendations are as follows:

- Examiners will continue to eliminate no risk or low risk pools.
- Examiners will instruct the CAS to extrapolate post-cure.
- Information reporting penalties should not be projected.

FDAP Payments - Statistical Sampling and Projection Procedures

Post Initial Sample Evaluation Cure Period

Upon completion of evaluating the initial sample, the audit team will issue another Information Document Request (IDR) informing the USWA of any potential deficiency, including any projected deficiency. That IDR will inform the USWA of a 60 day period in which the Service will delay proposing a final projection of any deficiency. This 60 day period will begin on the date the IDR is issued and is intended to allow the USWA time to cure accounts identified as having inadequate account holder documentation resulting in a deficiency. The Service will project the sample results once the 60 day period has expired and the Service has evaluated all new documentation submitted by the USWA during the 60 day period.

Identification of Failed Systems, Processes and Procedures and Subsequent Action

If a statistical sample is used during an audit of a USWA or the review of a QI Certification or Periodic Review Report and it results in a significant deficiency, the examiner will encourage and work with the USWA or the QI, to the extent practical, in identifying the cause of any such deficiency. This effort should include identifying any failed systems, processes or procedures, as well as determining the steps to be taken to minimize similar failures in the future.

Process Applicability

FDAP Payments - Statistical Sampling and Projection Procedures

Sampling requires fewer resources from both the IRS and the taxpayer, and is an efficient way to determine correct tax. Statistical sampling techniques are valuable examination tools where it is uneconomical to audit voluminous accounting data. Proper use of statistical sampling substantially increases the quality of IRS examinations.

Criteria	Resources
▪ Large number of items	▪ IRM 4.47.3.3.(2) - *General Instructions*
▪ Sufficient adjustment potential to warrant examination	▪ IRM 4.47.3.3 - *General Instructions*
▪ Examination of 100% of items is prohibitive in terms of time and resources	▪ IRM 4.47.3.1 - *Background*

Summary of Process Steps

FDAP Payments - Statistical Sampling and Projection Procedures	
Process Steps	
Statistical sampling process includes various steps listed below and the next slide.	

Step 1	Make Referral to CAS
Step 2	Perform Systems Analysis
Step 3	Perform Data Analysis
Step 4	Design the Sample

Summary of Process Steps (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures	
Process Steps	
Statistical sampling process includes various steps listed on the previous slide and below.	

Step 5	Evaluate the Sample
Step 6	Project the Sample

Step 1: Make Referral to CAS

FDAP Payments - Statistical Sampling and Projection Procedures
Step 1
Make referral to CAS.

Considerations	Resources
Examiners should contact their CAS on the case or, if there is no CAS assigned, contact the Statistical Sampling Coordinator (SSC). Requests for CAS assistance should be made through the LB&I Specialist Referral System (SRS). Examiners and CASs can request assistance from the SSC by initiating an informal request using SRS.	▪ IRM 4.10.21.9.8 - *Use of Statistical Sampling* ▪ IRM 4.47.3.2.4 - *Requests for Assistance from CAS* ▪ IRM 4.47.3.2.5 - *Requests for Assistance from Statistical Sampling Coordinators*

Step 2: Perform Systems Analysis

FDAP Payments - Statistical Sampling and Projection Procedures

Step 2

Main objectives of system analysis are often 1) to determine appropriate level of system reliance, 2) to uncover potential areas of noncompliance that will be essential in sample design. Depth of analysis should depend on complexities of USWA systems as well as complexity and diversity of transactions. Where an in-depth system's analysis is not practical due to limited resources, analysis should focus on identifying types of payments made by USWA that may require reporting, and systems used to process the payments. This is crucial if information reporting documents (e.g. Forms 1042-S) or information from such documents are to be used as the sample unit.

Considerations	Resources

Examiners should request:
■ Written policies, procedures, manuals and training materials.
■ Presentation, sent 7 days before face-to-face (F2F), regarding how taxpayer complies with its withholding and reporting obligations, and the records that exist regarding this. Presentation should answer the following questions:
  − Is there a reliable system in place to identify and process Form 1042 payments?
  − How does the company ensure that all Form 1042-S income was reported?
  − How are payments classified?
  − How does the system work to correctly provide customer account coding? (income, exemption, country, etc.)
  − What documentation is available for the systems?
  − Are there penalties for failing to follow procedures? Is it documented?
  − Who to contact for clarifications on any part of the procedures?
	■ IRM 4.10.21.9.8 - *Use of Statistical Sampling*
	■ IRM 4.10.21.9.1.1 - *Review of Written Procedure and Training Manuals*
	■ IRM Exhibit 4.10.21-4 - *Sample IDR for Audits of Financial Services Companies*
	■ IRM Exhibit 4.10.21-5 - *Sample IDR for Audits of Nonfinancial Services Companies*

Step 2: Perform Systems Analysis (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures
Step 2

Considerations	Resources
▪ Examiners should request system flow charts. A system flowchart should identify the computer systems, departments and individuals involved in the processing of Form 1042 transactions. ▪ Internal and external audit reports should also be requested if available. The primary purpose of reviewing these reports is to determine how taxpayer identifies areas with weak internal controls for the internal audience, which is also part of taxpayer's books and records.	

Step 3: Perform Data Analysis

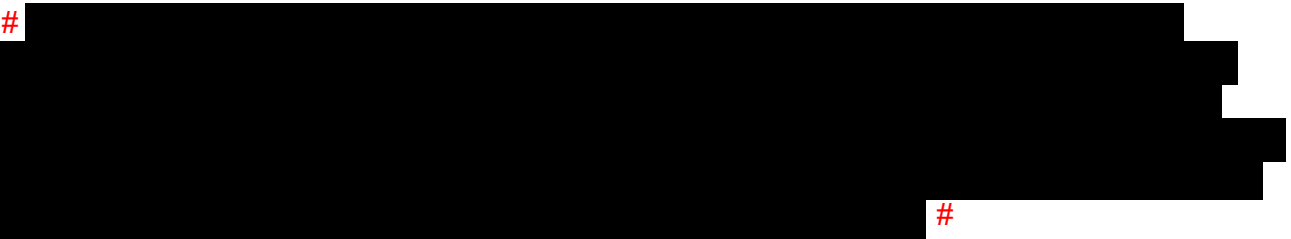## FDAP Payments - Statistical Sampling and Projection Procedures

Step 3

This step involves actual hands-on analysis of taxpayer data performed with the intent of identifying transactions that seem inconsistent on their face, as well as policies, procedures and systems that appear inadequate, such as classification inconsistencies. The examiner may decide to review these transaction outside of any sample, create a separate strata of such transactions within a sample, or just ensure these transaction are included in the population of any sample.

Considerations	Resources
▪ Use information from system analysis to request data from entities with weaker internal controls. This is especially useful for large corporations with a very large amount of Forms 1042-S filed. Concentrate on subsidiaries that lack procedures for FDAP payments. ▪ # #	▪ Publication 1187 - *Specifications for Electronic Filing of Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding For Tax Year 2018* ▪ IRM 4.10.21.10.3 - *Payment to Foreign Persons (Payees) -Three-Step Audit Procedure*

FDAP Payments - Statistical Sampling and Projection Procedures

Step 3

Considerations	Resources
▪ # ████████████████████████████ ████████████ ████████████████████████████████████ ████████████████████████████ #	▪ AW-I Version 2.0 Application ▪ AW-I Version 2.0 Tutorials ▪ AW-I V2.0 User Guide

Step 4: Design the Sample

FDAP Payments - Statistical Sampling and Projection Procedures

Step 4
A successful statistical sample involves the collaborative effort of the following people: FPP examiner, CAS/SSC and USWA. Careful planning of sample design phase will help improve the overall results of the statistical sampling.

Considerations	Resources
Examiner should work closely with CAS/SSC during the phase of sample design which involves the following steps: - Identification of the population to be sampled. - Selection of the appropriate sample unit. - # # - Stratification of sample, which is not judgmental but formula-based technique of determining strata boundaries (if it is decided to use stratification) - Determination of sample size. CAS may be able to advise on any minimum sample size and how increasing the number sampled may reduce the sampling error. The CAS and the FPP examiner should request taxpayer's input when designing the sample plan to improve the efficiency of the sample or raise other issues; however all decisions should be made by the IRS personnel. It must be noted that the use of statistical sampling as an audit tool by the Service does not require the approval of the taxpayer.	- IRM 4.47.3 - *Statistical Sampling Auditing Techniques*

Step 4: Design the Sample (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures

Step 4

Considerations	Resources
The next step in the sample design is population refinement. The purpose of population refinement is to be left with a population that contains items most likely to be adjusted. It's a form of risk analysis. Population refinement is a necessary step in creating a statistically efficient sample. Taxpayers may claim removing items before sample selection introduces bias, but it is an erroneous assertion because any identified deficiencies will only be projected to the population from which they were randomly selected. It is acceptable to use your judgment to remove items from the population before random selection is made. Examiners may eliminate from the population items they determine have no risk or low risk (e.g. payments withheld at 30% tax rate which is the maximum rate, payments under low risk income or exemption codes). The techniques used for population refinement include identifying items the examiner definitely wants to review (this could include determination of 100% certainty stratum) as well as removing items that have low or no potential for adjustment and will be accepted as filed. Sample stratification is sample design technique used to improve sample efficiency by grouping sample units with similar characteristics into separate strata. This can result in a reduced sampling error for a given sample size.	▪ IRM 4.46.3.3 - *Risk Analysis Process* ▪ IRM 4.46.3.3.5 - *Risk Analysis Factors to Consider* ▪ IRM 4.46.3.3.5.1 - *Overall Tax Impact* ▪ IRM 4.46.3.3.5.3 - *Materiality*

Step 4: Design the Sample (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures

Considerations	Resources
When designing FPP samples, populations may, at the discretion of the examiner, first be separated into types (often by income codes, exemption codes, or some combination of the two) to ensure coverage of certain transactions. Items might seem to satisfy criteria for more than one type, but each item must be assigned based on priority rules to a type then not considered for remaining types. Other factors that may be used in determining "types" include: ▪ Lines of business. ▪ Type of income (e.g. income codes per Form 1042-S). ▪ Exemption codes per Form 1042-S. ▪ Status codes per Form 1042-S. ▪ Beneficial owner vs. intermediary or flow-thru accounts/recipients. ▪ Direct vs indirect accounts. ▪ Type of withholding certificate expected. ▪ Withholding tax rates. ▪ Type of transaction (IRM 4.10.21.9.10). ▪ Recipient's country of residence for tax purposes per Form 1042-S. These types, if employed, can then be further stratified by dollar amounts such as risk measures (e.g. Maximum Potential Underwithholding) to reduce variability and improve sample precision.	▪ IRM 4.10.21.9.8 - *Use of Statistical Sampling*

Step 4: Design the Sample (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures
Step 4

Considerations	Resources
Once sample is designed and sample items selected, an IDR should be submitted to the taxpayer requesting documentation to support the rate of withholding for every selected sample item. This is the first IDR requesting documentation supporting sampled items. For Qualified Intermediaries, a safe harbor has been provided for statistical samples used during the course of a QI periodic review.	▪ Rev. Proc. 2017-15, Appendix II - Qualified Intermediary Agreement Safe Harbor Procedures

Step 5: Evaluate the Sample

FDAP Payments - Statistical Sampling and Projection Procedures
Step 5
FPP examiner evaluates all documentation provided by USWA in support of the amounts withheld on every sample unit selected for review.

Considerations	Resources
▪ FPP examiner needs to evaluate all relevant documentation supporting the amounts withheld on every sample unit selected (i.e., withholding certificates, withholding statements, formation documents or I.D., account file information, etc.) that is provided by USWA and determine errors, deficiencies resulting in additional withholding tax, or overwithholding. ▪ Withholding deficiencies can be attributed to various issues, e.g. incorrect withholding rate based on income type, or inadequate documentation. ▪ Defective Forms W-8s can be cured. If W-8s are signed over 1 year after repayment, additional documentation must support the affidavit of past status. ▪ After identifying deficiencies as the result of evaluating documentation provided by USWA in response to first IDR, the FPP examiner issues a second IDR. The second IDR informs USWA of a potential deficiency, as well as 60 day period in which IRS would delay proposing final projection of the deficiency, thereby giving USWA a 60 day curing period starting from the date the IDR is issued . ▪ 60 day period allows USWA to cure accounts.	▪ Treas. Reg. 1.1441-1(b)(7)(i)(B) ▪ Treas. Reg. 1.1441-1(b)(7)(ii)

Step 6: Project the Sample

FDAP Payments - Statistical Sampling and Projection Procedures
Step 6
Perform projection procedures.

Considerations	Resources
▪ After receiving and evaluating documentation requested in second IDR, FPP examiner determines final sample deficiency. ▪ FPP examiner directs CAS to project sample results post-cure. ▪ Statistical Sample projections can only be made by CAS. ▪ Penalties are not projected.	

Definitions

FDAP Payments - Statistical Sampling and Projection Procedures

Description

- Cumulative Square Root of the Frequency - Method of locating stratum boundaries

- Cured Documentation - Generally refers to a form W-8 (Withholding Certificate) received by USWA after the payment is made to the nonresident alien (NRA) account holder. The form is intended to be documented at the time of that payment. Such documentation may be solicited by USWA if they feel the documentation in place at the time of the payment is insufficient to support the withholding rate applied. This includes instances in which USWA has incomplete or no withholding certificate at all.

  In a broader sense, Cured documentation might also include documentation received after the time of payment providing additional proof in support of the claim of foreign status or eligibility for reduced rate of withholding under the code or tax treaty. This could include not only a new withholding certificate, but could also include other documentation (e.g. documentation to refute indicia of U.S. status).

- 100% Certainty Stratum - A stratum, usually consisting of high value sample units with the most adjustment potential, in which every sample unit is evaluated.

- Optimum (or Neyman) Allocation - Method of sample allocation that considers both the number of sampling units in a stratum and the variability of the stratum.

- Population - Entire group of items on which the examiner wants to draw conclusion.

- Sample - Subset of a stratum in which the population characteristic is studied so that inferences may be made about the entire stratum.

Definitions (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures
Description

▪ Statistical Sample - In a statistical sample the probability of selecting any sample unit in a stratum for review is known, though not necessarily the same in every stratum. The probability of selecting any sample unit within a strata (or any sample unit within a simple random sample) is the same for all population units within that strata.
 	
 ▪ Stratified Sampling - Process of dividing the population into mutually exclusive groups of units called strata. Reasons for stratifying include:
   - Design a more efficient sample (i.e. reduced sample size for desired level of precision and reliability).
   - Ensure each subgroup within a population is adequately represented.
 	
 ▪ Withholding Agent - For chapter 3 purposes, withholding agent is a U.S. or foreign person, in whatever capacity acting, that has control, receipt, custody, disposal or payment of an amount subject to chapter 3 withholding.

Examples of the Process

FDAP Payments - Statistical Sampling and Projection Procedures
Description

The following example is not intended to cover all aspects and details of the sample design and execution process. It is intended to present a general framework of how the process might progress.

Example

An FPP examiner is auditing a medium size financial institution that has numerous payments of U.S. sourced FDAP income to accounts of NRAs being held in a fiduciary capacity. Along with these payments the USWA has filed numerous Forms 1042-S with the IRS. The examiner has determined it is not practical to review all the accounts, payments, or Forms 1042-S involved. The examiner, wanting to perform a pre-audit analysis, decided not to wait till they could meet with the taxpayer before requesting Forms 1042-S data. #

#

Steps

Step 1: Make Referral to CAS

The examiner requested CAS assistance through the LB&I Specialist Referral System (SRS).

Step 2: Perform Systems Analysis

The examiner and the CAS together performed a system's analysis of the taxpayer's system involved in making US Source FDAP payments to NRAs. Due to time and resource limitations they concentrated on identifying the range of payments the USWA made during the year(s) under audit, the USWA systems where the data resides in form complete enough to identify all the attributes that effect withholding; as well as the processes used to report and withhold on the payments. The customer onboarding process was also reviewed. This was all done to assist with identifying any potential misclassifying of beneficial owners as well as identifying payments that should have been reported and possibly withheld on; but were not. No particular weak spots were identified. Based on this determination the examiner was comfortable relying solely on data imported into AW-I (Forms 1042-S) as previously described.

FDAP Payments - Statistical Sampling and Projection Procedures

Description

Example (cont'd)

Steps (cont'd)

Step 3: Perform Data Analysis

\# ██

██

██

██

████████████████████████████ \#

Step 4: Design the Sample

Based on an analysis of all forms filed, prior experience of FPP examiner and CAS, and consultation with the USWA, the examiner decided to create a sample population, eliminating all payments with Maximum Potential Underwithholding less than $500, using the AW-I "Export Population" function located on the "Audit" ribbon of AW-I. The file was successfully exported, and then zipped and e-mailed to the CAS assigned to the audit.

The CAS imported the file into the CAS Statistical Sampling Package. In consultation with the FPP examiner, and with input from the USWA, the final sample design was determined by the CAS. The sample consists of 3 strata with sample units selected randomly, and a fourth certainty stratum of 30 items in which all sample units are to be reviewed. Maximum Potential Underwithholding was used to determine strata boundaries; each of the strata containing approximately the same total amount of Maximum Potential Underwithholding. The selected sample consisted of 30 sample units per strata for a total sample size of 120.

FDAP Payments - Statistical Sampling and Projection Procedures

Description

Example (cont'd)

Steps (cont'd)

Step 4: Design the Sample (cont'd)

A popular alternative design not used in this instance, that may result in reduced variability within stratum, and therefore a more efficient sample, might have the CAS initially split the population into 3 pools: #

██
██
████████████████ #

Once these pools are formed they might be further stratified based on Maximum Potential Underwithholding, including the formation of certainty strata. Maximum Potential Underwithholding could again be used to determine strata boundaries. Each stratum could contain approximately the same total amount of Maximum Potential Underwithholding.

Alternative methods of determining strata boundaries or the number of sample units to allocate per strata include the "cumulative square root of the frequency" and the optimum (or Neyman) allocation method respectively. Additionally, sample units pertaining to a particular tax issue or area of exposure that the FPP examiner feels confident in identifying using information on the Form 1042-S can be eliminated before the final population is formed. Depending on the volume of these transactions, they can be reviewed in their entirety or by use of judgement samples.

Any line marked with # is for Official Use Only.

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FDAP Payments - Statistical Sampling and Projection Procedures

Description

Example (cont'd)

Steps (cont'd)

Step 4: Design the Sample (cont'd)

During the consultation with the USWA, the USWA was informed that once the sample was evaluated the taxpayer will be given an IDR granting the USWA a 60 day period to cure any failed documentation. The IRS will not propose a final adjustment, including sample projection, until the 60 days has passed and the examiner has completed reviewing all newly submitted documentation. The USWA was also informed that when projecting sample results, all valid curative documentation in possession of the USWA at the time of projection will be given full weight when determining if underwithholding has occurred (i.e. projection should be on a post cure basis regardless of whether the documentation was obtained as a result of the sample review; and regardless of whether any attempts were made to remediate any similar withholding issues in the population).

Step 5: Evaluate the Sample

Once selected, the CAS sent a file to the FPP examiner to import into AW-I. The examiner submitted an IDR to the taxpayer requesting documentation supporting the amounts withheld on every sample unit selected. Subsequently, the examiner evaluated all relevant documentation supplied by USWA and recorded the results using the Record Audit Results feature located on the "Audit Ribbon" of AW-I. The examiner determined there were 20 sample units with errors that resulted in a deficiency of withholding tax. All the adjustments to the sample units were located within random strata.

Examples of the Process (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures
Description
Example (cont'd) Steps (cont'd) Step 5: Evaluate the Sample (cont'd) Upon completion of evaluating the sample, the examiner issued an IDR informing the USWA of a preliminary projected deficiency and the amount of that deficiency. The IDR informed the USWA of a 60-day period in which the Service would delay proposing a final projection of any deficiency. This 60 day period began on the date the IDR was issued and was intended to allow the USWA time to cure accounts identified as having inadequate account holder documentation resulting in a deficiency. The IDR also informed the USWA that the Service intended to project the sample results once the 60 day period has expired and the Service has evaluated all new documentation submitted by the USWA during the 60 day period. When projecting sample results, all valid curative documentation in possession of the USWA at the time of projection will be given full weight when determining if underwithholding has occurred (i.e., cures can be based on both pre-cure and post-cure evidence). During the 60 day period the USWA presented curative documentation (Forms W-8 and supporting evidence) for 10 of the 20 sample units that the examiner had determined were underwithheld on. Upon further analysis the examiner determined that the documentation for all 20 was provided more than 1 year after the payment; however, while all 20 had acceptable affidavits signed and dated under the penalties of perjury stating the information on the withholding certificate was accurate at the time of payment, only 5 had additional documentary evidence. When questioned, the USWA stated they could not provide such documentary evidence for the remaining 15 sample units.

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Examples of the Process (cont'd)

FDAP Payments - Statistical Sampling and Projection Procedures

Description

<u>Example (cont'd)</u>

<u>Steps (cont'd)</u>

<u>Step 5: Evaluate the Sample (cont'd)</u>

At this time, the USWA did not commit to remediate the portion of the population containing the 20 sample units that were originally determined to have been underwithheld on. If projection were performed Pre-Cure, the projection would be based on 20 sample units having an error resulting in a deficiency. If projection is performed Post-Cure, the projection would be based on 15 sample units having an error resulting in a deficiency. The projection will be performed by the CAS on a Post Cure basis. Therefore, all valid curative documentation in possession of the USWA at the time of projection will be given full weight when determining if underwithholding has occurred (i.e. projection should be on a post cure basis regardless of whether the documentation was obtained as a result of the sample review; and regardless of whether any attempts were made to remediate any similar withholding issues in the population).

<u>Step 6: Project the Sample</u>

Once final audit results are recorded in AW-I, the examiner will select "Export Results" from the Audit Ribbon of AW-I to create a file to send to the CAS. This file can be directly imported by the CAS into the CAS Statistical Sampling Package to use for projection. The CAS will present the final projection to the CAS. Both will discuss with the USWA.

Other Considerations / Impact to Audit

FDAP Payments - Statistical Sampling and Projection Procedures	
Considerations	**Resources**
# ███████████████████████████████████ ████████████████████████████ █████████████████████████████████████ ███████████████████████████████████ █████ ██████████████████████████████████████ █████████████████████████████ #	

Index of Referenced Resources

FDAP Payments - Statistical Sampling and Projection Procedures
Pub.1187 - *Specifications for Electronic Filing of Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding For Tax Year 2018*
Treas. Reg. 1.1441-1 - *Requirement for the deduction and withholding of tax on payments to foreign persons*
Form 1042 - *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and Instructions
Form 1042-S - *Foreign Person's U.S. Source Income Subject to Withholding*, and Instructions
IRM 4.10.21 - *Examination of Returns, U.S. Withholding Agent Examinations - Form 1042*
IRM 4.46.3 - *LB&I Examination Process, Planning the Examination*
IRM 4.47.3 - *Computer Audit Specialist, Statistical Sampling Auditing Techniques*
Rev. Proc. 2017-15, Appendix II - Qualified Intermediary Agreement Safe Harbor Procedures

Training and Additional Resources

FDAP Payments - Statistical Sampling and Projection Procedures	
Type of Resource	**Description(s)**
Issue Toolkits	▪ AW-I Version 2.0 Application
Other Training Materials	▪ AW-I Version 2.0 Tutorials ▪ AW-I V2.0 User Guide

Glossary of Terms and Acronyms

Term/Acronym	Definition
ADR	American Depository Receipt
CAS	Computer Audit Specialist
CUSIP	Committee on Uniform Securities Identification Procedures. The CUSIP number is a unique identification number assigned to all stocks and registered bonds in the United States and Canada, and it is used to create a concrete distinction between securities that are traded on public markets.
ECI	Effectively Connected Income
FDAP	Fixed Determinable Annual Periodical
FIRE	Filing Information Returns Electronically
FPP	Foreign Payments Practice
IDR	Information Document Request
IRMF	Information Returns Master File
IRMF Query Tool	A tool for examiners to get information returns (see intranet)
JBK	Extension on the file provided to an examiner who requests 1042-Ss using an IRMF query tool
NQI	Nonqualified Intermediary, any intermediary that is not a U.S. person and not a qualified intermediary
NRA	Nonresident Alien
QI	Qualified Intermediary

Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
SRS	Specialist Referral System
SSC	Statistical Sampling Coordinator
USWA	U.S. Withholding Agent
WP	Withholding Partnership
WT	Withholding Trust

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
9424.01	*FDAP Payments - FDAP Income*	RPW/C/08_01-01 (formerly RPW/CU/P_08.1_02(2016))
9424.01	*FDAP Payments - FDAP Withholding under Chapter 3*	RPW/C/08_01-03 (formerly RPW/CU/P_08.1_03(2016))
9424.01	*FDAP Payments - Source of Income*	RPW/C/08_01-02 (formerly RPW/CU/P_08.1_04(2016)a)
9442.01-01	*Overview of FDAP*	WIT/C/15_01-01 (formerly WIT/CU/P_15.1_01(2014))
9442.01-10	*Payee Documentation for Treaty Benefits*	RPW/T/08_01_01_03-01 (formerly RPW/9424.01_03(2015))