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# Withholding Tax on Cross-Border Transactions Under Heightened IRS Scrutiny

## Strategies to Improve Compliance and Minimize Audit Risks

### A Live 100-Minute Audio Conference with Interactive Q&A

**Today's panel features:**

Cyrus Daftary, Partner, **Burt Staples & Maner**, Washington, D.C.

Laurie Hatten-Boyd, Partner, **KPMG**, Seattle

**Wednesday, June 24, 2009**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

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# **Withholding Tax on Cross-Border Transactions Under Heightened IRS Scrutiny**

## **Strategies to Improve Compliance and Minimize Audit Risks**

TAX

June 24<sup>th</sup>, 2009

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# Today's Speakers

- ◆ Laurie Hatten-Boyd, Principal, KPMG
- ◆ Cyrus Daftary, Partner, Burt, Staples & Maner, LLP

# Agenda

- ◆ **Background of International Tax Reform Legislation**
- ◆ **Legislative Proposals**
- ◆ **Regulatory / Qualified Intermediary Agreement proposals**
- ◆ **Improving Compliance**
- ◆ **Use of IRM to Prepare for Audit**

***Landscape Leading to International Tax  
Reform Legislation  
or  
How did we get here?***

# Basic Rules of NRA Withholding

- Generally, NRA withholding is required when:
  - A person who is a withholding agent;
  - Has control, receipt, custody, disposal of income;
  - Makes a payment;
  - Of an amount subject to NRA withholding (U.S. source);  
and
  - The payment is to a foreign person.
- The NRA withholding is 30%:
  - It may be reduced by statute or tax treaty.

# Doesn't This Look Easy?



Withholding Agent

*Who is the payee?*

U.S. Non-Exempt Recipient

Form 1099  
Form 945  
28% BUWH

U.S. Exempt Recipient

No Reporting  
No Withholding

Foreign Person

Form 1042  
Form 1042-S  
30% NRA W/H

# Impact on Organizations

## Operational Units

(Account Opening, Documentation Tracking and Retention, Account Classification, Payments, and Reporting)

## Computer Systems

## Process Flows

## Procedural Manual

## Training

# What does the IRS want?

- **Ensure compliance with the 1441 regulations.**
- **Give the IRS audit team access to relevant records and documentation.**
- **Allow the IRS to review procedures and systems.**
- **Ability to communicate directly with the teams responsible for the various compliance obligations/processes.**
- **Verify there are no unrecorded accounts that should be included as a part of the tax withholding and/or information return reporting process.**

## Historical Developments - Phase I (2001-2006)

- ◆ **IRS developed new withholding regulations and implemented QI regime**
  - U.S. Withholding Agents (USWAs)
    - Director's Memo on USWA audit plan
    - 2004 Section 1441 VCP for USWAs
    - Online Form W-8 initiative
  - Qualified Intermediaries (QIs)
    - Rev Proc 2000-12
    - QI Audit Guidance Rev Proc 2002-55
    - Experience gained with QI Audits
    - FAQ/Director's Memo "guidance"

## Recent Developments - Part II (2007-2009)

- ◆ **GAO audit of Withholding Program**
  - Recommended enhanced QI audit procedures
  - Cited weaknesses in NQI regime
- ◆ **IRS added extensive IRM Section addressing NRA withholding tax concepts and audits.**
- ◆ **IRS audited Total Return Swap (TRS) and Security Lending Transactions for foreign person dividend avoidance.**
- ◆ **Bill introduced in U.S. Senate (S.681) focusing on tax haven and tax shelter abuses.**
- ◆ **IRS investigated offshore accounts held at certain financial institutions (inc. JD Summons).**
- ◆ **IRS Commissioner testified before Congress on offshore accounts and dividend avoidance.**

# Consequences of 2007- '09 Developments

- ◆ **IRS Proposes Changes to QI Agreement and Audit Guidance (Notice 2008-98)**
- ◆ **Tier 1 Designation for Withholding**
  - What does this generally mean?
    - IRS believes issue of “high strategic importance”
    - Designation of Owner Executive/Issue Management Team
    - LMSB Technical Advisor
      - Significant Counsel Role in cases
      - Examiners must consider
  - What does this mean for withholding?
    - Potential increase in compliance audits (Tier 1 can have broad implications)
    - Increase focus on regulation changes
    - Increase in number of analysts

***Legislative Proposals:  
General Explanations of the Administrations  
Fiscal Year 2010 Revenue Proposals***

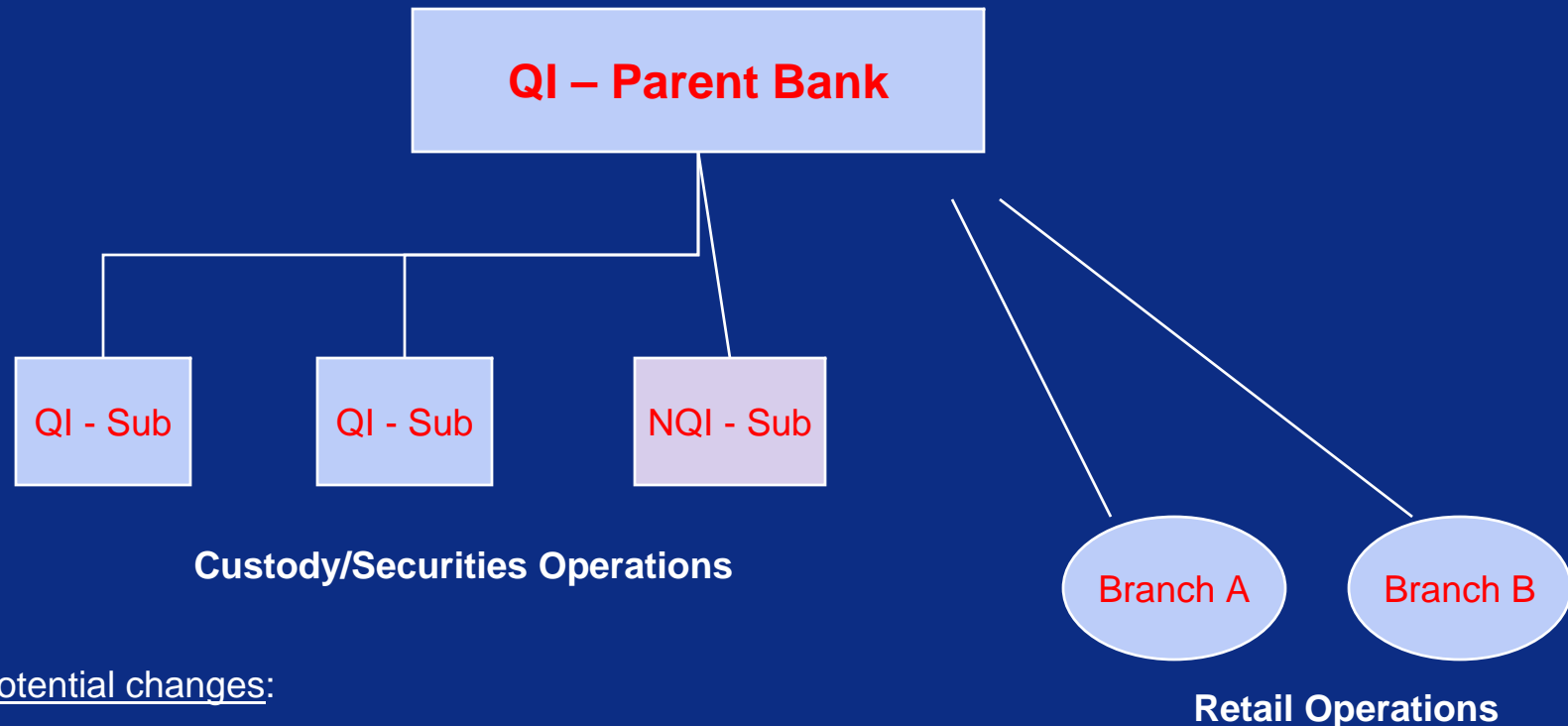
# Reforms Aimed at Cross-Border Activities: Total Return Swaps (TRS)

- ◆ **Concern: Withholding tax avoidance on dividends**
- ◆ **Proposal:**
  - Treat swaps that do not meet all of the specified characteristics as generating U.S. source income
  - Characteristics include: max. 20% collateral percentage; no cross-in/cross out; no physical hedge requirement; swap term 90 days or more
  - Treasury can provide additional exceptions to U.S. sourcing
- ◆ **Proposal issues: consider as a safe harbor? Impact on current audits?**
- ◆ **Security lending left for regulatory fix (i.e. Notice 97-66)**
- ◆ **Effective date: payments made after December 31, 2010**

# Reforms Aimed at Cross-Border Activities: Increase Reporting Requirements for QIs

- ◆ **Concern:** Identification of U.S. persons; applying proper withholding rules; report on IRS forms
- ◆ **Proposal:**
  - QIs must identify all U.S. account holders and report all reportable payments on Forms 1099 (essentially treat the QI as if they are a U.S. payor)
    - Key change is that QIs must report foreign source income and broker proceeds of U.S. persons
  - Grant IRS regulatory authority to change QI eligibility rules, esp. when commonly controlled foreign financial institutions exist.

# Expanded Reporting by QIs



## Potential changes:

- For existing QI subs, Form 1099 reporting would be required for U.S. **AND Non-U.S.** securities
- Retail operations (Branches A & B) would file Forms 1099 for deposit interest, etc.
- Regulations could require NQI sub to become a QI
- Regulations could require QIs to obtain information of beneficial owners of foreign entity account holders and report any U.S. beneficial owners

# Proposed Changes for Foreign Entities

## ◆ 30% withholding presumption on payments to non-U.S. persons

- Any withholding agent (presumably including a QI) would be required to withhold 30% on income paid to a non-U.S. entity, unless the entity provides documentation of its beneficial owners.
- Exceptions would be granted for certain entities (e.g., publicly traded companies, pension plans).
- Treasury also could provide an exception in regulations for entities that enter into an agreement with the IRS to report all U.S. non-exempt persons (e.g., individuals) to the IRS.
- So, potential to expand the QI Agreement program to include “Qualified Beneficial Owners”

# Reforms Aimed at Cross-Border Activities: Require Withholding on Payments thru NQIs

## ◆ Concern: tax avoidance by dealing with NQIs

## ◆ Proposal:

- FDAP payments to NQIs considered made to unknown person and subject to 30% withholding (exceptions made for certain recipients).
- Gross proceeds paid to NQIs in “treaty deficient” jurisdictions subject to 20% withholding.
- Refunds for overwithholding can be claimed by foreign person filing U.S. tax return.
- Effective date: after December 31 of year of enactment.

# Reforms Aimed at Cross-Border Activities: Require 3<sup>rd</sup> Party Reporting for New Offshore Entities

- ◆ **Concern:** IRS cannot monitor reporting compliance as it does not know when foreign entities exist
- ◆ **Proposal:**
  - Any U.S. person or QI that forms or acquires a foreign entity on behalf of a U.S. person would be required to report that formation/acquisition
  - Effective date: after December 31 of year of enactment

# **ANNOUNCEMENT 2008-98**

# Proposed Changes to QIA

## ◆ Background

- Perceived weaknesses in QI system resulted in proposed changes that were announced in 2008 (Ann. 2008-98)

## ◆ Increased External Audit Scrutiny – Indicia of U.S. Control

- External auditor would report if U.S. person has signature or “other authority” over account, such as:
  - Authority to withdraw funds, trade, give instructions; or
  - Receive account statements, confirmations, or other information.
- Unclear what conclusions must be reached if such evidence exists.

# Proposed Changes to QIA

## ◆ Increased External Audit Scrutiny – Documentation Reviewed

- Additional account information to be reviewed, including AML/KYC documents, or any other account information.
- Represents significant expansion of documents to be reviewed.

## ◆ Strengthening internal controls and disclosing “material failures”

- QI must have sound governance, including adequate internal controls.
- QI must notify IRS within 60 days of discovering: (1) a material failure; (2) any employee allegations relating to such a failure; or (3) any investigation by a regulatory authority.

# Proposed Changes to QIA

- ◆ **External auditor “oversight” and review by U.S. auditor**
  - As a quality control measure, any non-U.S. auditors would need to be associated with a U.S. auditor.
  - The U.S. auditor would have joint responsibility for the audit and cosign the report.
  - Could substantially increase external audit costs.
    - Keep in mind not a true ‘audit’ rather an ‘agreed upon procedure’ (“AUP”).
  
- ◆ **Alternatively, IRS suggests QIs consider “external audit waiver” option set forth in section 10.01.06 of the External Audit Guidelines (Rev. Proc. 2002-55).**

# **IMPROVING COMPLIANCE / PREPARING FOR AUDIT**

# Improving Compliance

- ◆ **Documentation Validity**
- ◆ **Due Diligence requirements**
  - Complete Form
  - US Address
  - Address Outside Treaty Country
  - Standing Instructions
- ◆ **Presumption Rules**
- ◆ **Obtaining retroactive documentation**

# Improving Compliance, Cont.

## ◆ Withholding Systems

- Rates
- Overrides

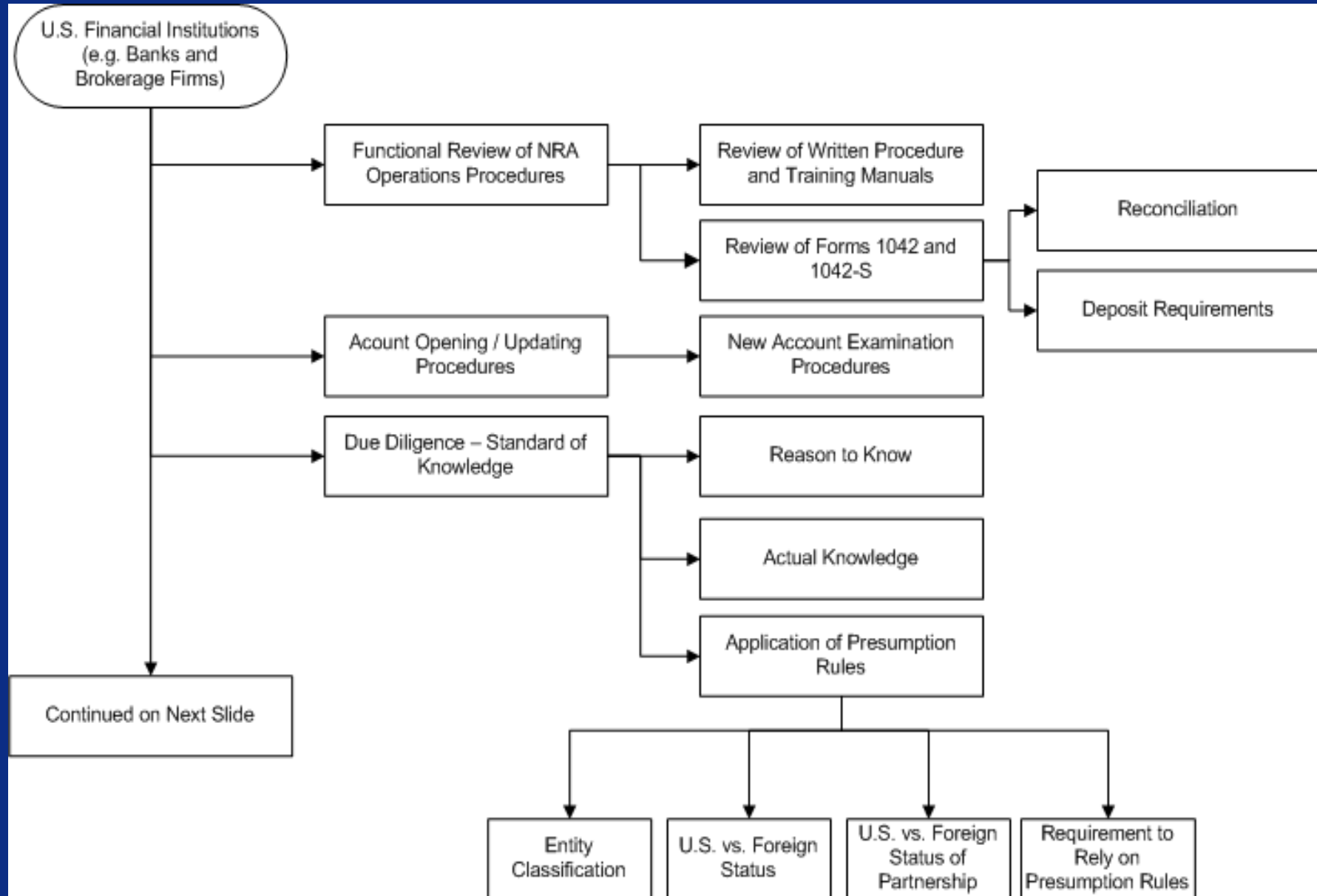
## ◆ Reporting Systems

- Reconciliations of Forms 1042-S received and issued
- Ensure all income has been accounted for

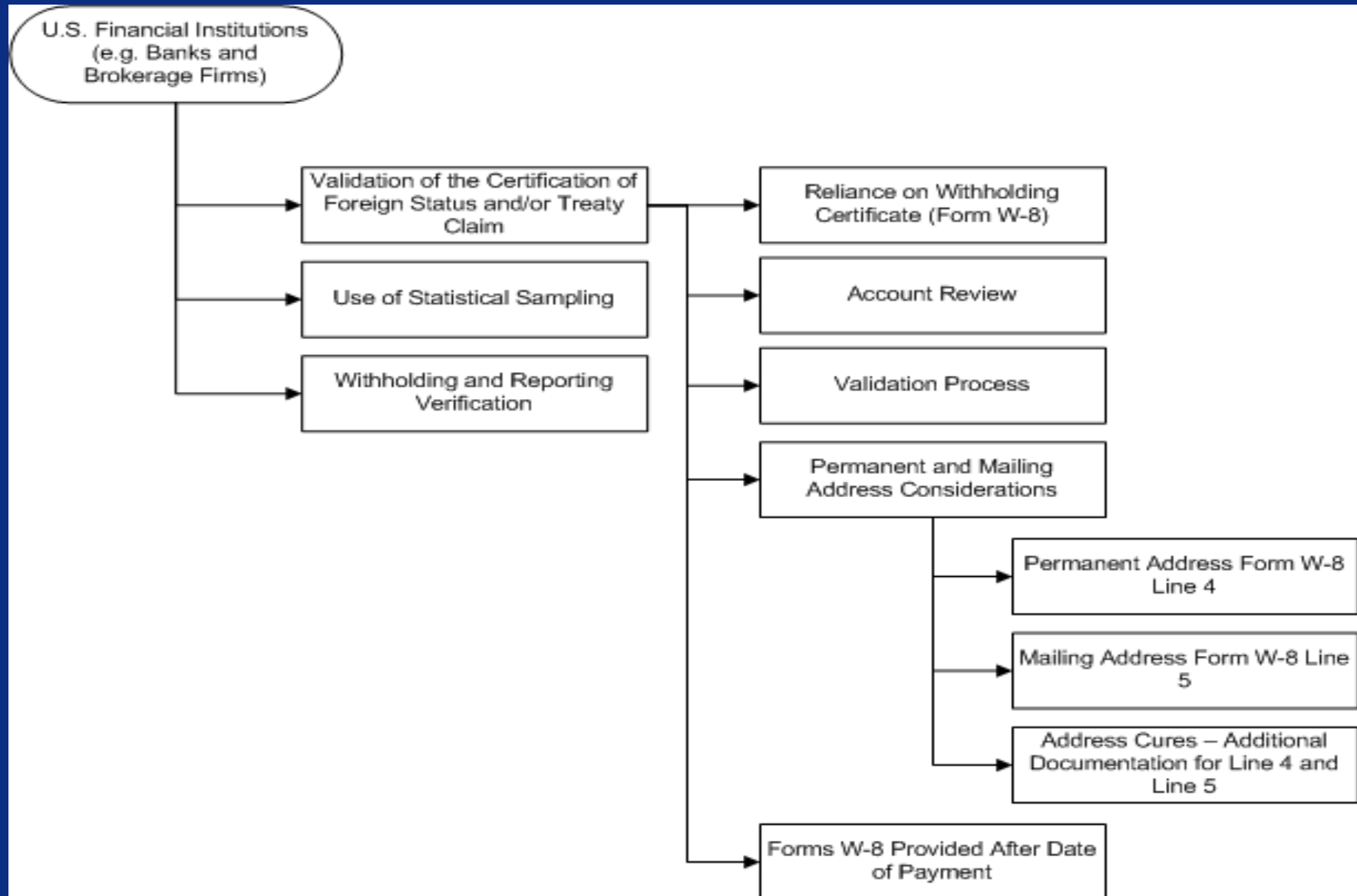
# Use of IRM to Prepare for Audit

- ▶ 4.10.21.8.1.1 of the U.S. Withholding Agent Examinations Form 1042 IRM (<http://www.irs.gov/irm/part4/ch09s24.html>) references a functional review of NRA operational procedures:
  - Summaries of withholding tax systems;
  - System flow charts covering payments made to account holders;
  - Internal control, audit reports or other information which relate to the withholding tax function;
  - Manuals related to functions that may have withholding tax implications; and
  - Training manuals for personnel for departments that control the NRA tax withholding determinations; new account opening process, and information return reporting process.

# The IRM in a Process Flow



# The IRM in a Process Flow cont.



# How do you Prepare for the Future?

- ◆ Consider pre-audit defense measure.
- ◆ Know your problems and issues before the IRS audit begins.
- ◆ Fix any problems identified while you have the time to do so.

# Use the IRS Provided Guidance

- ◆ **The IRM and the Industry Directive are great guidelines**
  - Review account opening and document validation procedures – should be able to produce comprehensive procedures manual
  - Review documentation for proper classification of payees
  - Analyze the withholding system – default logic and withholding rules must be in place
  - Review the Form 1042-S reporting
  - Reconcile Form 1042 to Form 1042-S amounts
  - Understand the income types and implications

# Who Needs to be Involved?

- ◆ Senior management for support and policy issues
- ◆ Business operations units for data
- ◆ Tax reporting units, if separate from business operations
- ◆ Client relations personnel for client communications issues.
- ◆ IT and systems professionals
- ◆ Internal Audit

# What Types of Payments Do You Review?

- ◆ FDAP
- ◆ Vendor Payment

# What To Do If There Are Problems?

- ◆ Remediate
- ◆ Consider whether to amended Forms 1042-S and Form 1042 or
- ◆ Make a disclosure to the IRS at the opening conference

# Concluding Thoughts

- **Expand your perspective about documentation beyond Forms W-8 and documentary evidence**
- **Use the IRM as your guide to do a comprehensive health check and assemble what the IRS wants**
- **Review your materials and check:**
  - For last updates
  - Ensure accuracy of content
  - Check for under/over withholding
  - Based on known deficiencies – use this information to influence your statistical sample plan.
- **Don't get surprised about what you have or don't have by responding to IDRs**

# Questions & Answers



# Today's Presenters

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