

COMPLIANCE WEEK

THE LEADING INFORMATION SERVICE ON CORPORATE GOVERNANCE, RISK AND COMPLIANCE

Cross-Border Withholding Compliance Crackdown

By Melissa Klein Aguilar — March 31, 2009

A government effort to crack down on withholding taxes for overseas employees could cause major compliance headaches for U.S. companies that make payments to certain non-citizens.

The Internal Revenue Service formally designated cross-border withholding as a Tier 1 audit issue (a label the IRS applies to high priorities) in December. That typically signals a serious increase in enforcement activity, because the IRS believes compliance heretofore has been lax.

“Enforcement activity has been limited in this area, but we believe that’s about to change,” says Michael Lloyd, a partner at the law firm Miller & Chevalier. “It’s a huge enforcement priority for the IRS.”

At issue is Section 1441 of the tax code, which experts say has an extremely broad reach. It stipulates that certain payments (interest, dividends, or royalties, to name a few) made to a non-U.S. citizen for services performed in the United States may be subject to cross-border withholding. Jim Stubbs, a director at BDO Consulting, says that provision can touch any financial institution that pays interest and dividends and any multinational corporations that make qualifying payments to foreigners. Entertainment, technology, energy, and pharmaceutical industries could all be especially vulnerable, as well as law and accounting firms and universities.

Lloyd says strict liability for withholding the tax attaches when an outbound payment that’s unsupported by the required documentation is made. The party on the hook for any non-compliant outbound payments is the withholding agent—that is, the taxpayer making the payment, which is usually the company.

Moreover, he adds, in some cases the tax executive responsible for the withholding can be held *personally* liable. As a result, experts warn taxpayers to pay close heed to their cross-border withholding procedures and take action to fix any gaps now, before the IRS comes knocking.

“This is a hot issue for the IRS,” says Cyrus Daftary, a partner in the law firm Burt, Staples & Maner. “They’ve spent the last two years training their examiners to be ready for this.”

The IRS has been ramping up for increased enforcement in cross-border withholding for several years, following a 2004 Voluntary Compliance Program that initially targeted financial institutions but also highlighted compliance issues at non-financial institutions as well. The IRS then published new audit procedures on cross-border withholding issues in the Internal Revenue Manual in 2008. In addition, a Senate sub-committee last year released two reports on systemic problems and compliance concerns involving cross-border withholding practices.

The financial crisis doesn't exactly help either, observers say. "In the current economic climate this area of compliance is a natural target area for the government," Daftary warns.

Since cross-border withholding documentation and reporting failures are easily identified by an audit, Lloyd says it is "an easy target" for IRS examiners. And the penalties for withholding compliance failures are steep.

Getting Compliant, Pronto

Lloyd and other experts say the biggest problem organizations face in complying with the regulations is that "many often don't even recognize that they have a withholding obligation."

While financial institutions typically have a better understanding of their tax compliance obligations because they have so many other related rules to follow, Daftary says companies outside the banking sector can struggle with compliance. Many different functions within a corporation can create various relationships that can implicate Section 1441, and that can create the risk that no particular department "owns" cross-border withholding issues.

One best practice is simply to withhold the required tax on any cross-border payment made, if the required documentation from the foreign recipient isn't available, Lloyd says. On the other hand, Daftary says, many companies are unaware they must file Form 1042 with the IRS, which reports the tax withheld to those persons.

While the ultimate compliance obligation often falls on the accounts payable department, those employees typically aren't trained to spot the issues. Too often, Lloyd says, by the time the tax department discovers it has a withholding problem, the payment has long since been made.

If a payment is made without the proper documentation and tax isn't withheld, he says the taxpayer should attempt to get the documentation to support the reduced withholding anyway. The IRS doesn't have to accept that late documentation, he warns, but it might do so if the documents are reliable.

The bottom line, experts say, is that companies need to take a hard look at their cross-border withholding procedures and act quickly to correct any deficiencies. That means

conducting internal “health checks” to figure out whether they’re making payments to foreign citizens, and if so, what types, says Daftary.

Stubbs says taxpayers now discovering that they have withholding or reporting problems have two choices: “Get up to speed quickly, or ask for help to go in assess their position,” he says. “Time is running out.”

Lloyd agrees. “If you’ve screwed up, it’s better to say you’ve looked at the issue and fixed it yourself, rather than waiting for the IRS to show up,” he says.

Daftary further warns that any financial institution that didn’t participate in the Voluntary Compliance Program should be prepared for an audit. He suggests companies should look at the IRS manual to get a better understanding of what IRS examiners will be looking for.

Lloyd says companies should also review their procedures and training materials, and “if they don’t have any, they’d better create them.” He recommends training employees in the accounts payable and treasury functions on the regulations, since “they are the last line of defense to identify these types of payments.”

Daftary notes that new IRS regulations on the subject are expected later this year. (The comment period on proposed regulations has already closed.)

“We’re not quite sure yet what all of the new changes might include,” he says. However, he says there’s “some concern” that the IRS could issue a new set of Form W-8s that will require more information, such as a foreign tax identification number that would let the agency exchange information with other countries.

That requirement would “cause the industry some heartburn,” he says.

IRS ON WITHHOLDING TAX

Remarks of Commissioner Douglas Shulman before the 21st Annual George Washington University International Tax Conference:

Today, the IRS will add withholding taxes to the Tier I list of issues. The tier issue process will provide the needed organizational priority and coordination to ensure taxpayer compliance with the U.S. withholding tax provisions. Our compliance efforts will span efforts to ensure individual, business and corporate taxpayers understand and fulfill their withholding tax filing obligations to addressing transactions that attempt to circumvent withholding taxes or claiming improper tax treaty withholding rates.

Let me also point out that this past September, the Senate Permanent Subcommittee on Investigations held a hearing looking into how the IRS has been investigating certain investment banks who have been trying to help their clients—mostly hedge funds—avoid

dividend withholding tax. During the hearing, there was also extensive discussion about securities lending transactions and Notice 97-66. Let me bring you up to date on the issue.

IRS is reviewing the notice. However, in the interim, we're examining very carefully those transactions whose primary purpose is to avoid dividend withholding tax and will propose adjustments as needed.

Turning now to the individual area, our current focus is on unreported off-shore accounts. Here too we have a combination of tools at our disposal – all of which we're using simultaneously.

Think of a detective working a case who may employ everything from eyewitness accounts, physical evidence, paper trails and the cooperation of law enforcement officials in other states. That's similar to what we're doing with the following tools.

One of our best is the Qualified Intermediary Program. QI gives the IRS an important line of sight into the activities of foreign banks and other financial institutions. It also provides detailed information reporting that the IRS did not receive before this program was implemented.

Indeed, the QI program is critical to facilitating sound tax administration in a global economy. By bringing foreign financial institutions more directly into the U.S. tax information reporting system, we can better ensure that U.S. persons are properly paying tax on foreign account activity, and that foreign persons are subject to the proper withholding tax rates.

Admittedly, the QI program is a maturing, and complex program and there are flaws that must be addressed. I became convinced early in my tenure that we need to shore up the QI program and continuously enhance, improve and strengthen it. And we are.

In mid-October, we issued a set of proposed QI amendments for comment which I believe will make QI audits more useful and help give us that clear line of vision and transparency we need in tax administration.

Under the proposed changes, financial institutions that are QIs must provide early notification of material failure of internal controls. They must also improve evaluation of risk of circumvention of U.S. taxation by U.S. persons. And they must include audit oversight by a U.S. auditor. I certainly look forward to your comments and suggestions after you review this important proposal.

Source

Speech by IRS Commissioner Doug Shulman (Dec. 8, 2008).