

INTERNATIONAL ISSUES

New Cross-Border Tax Withholding Sparks Concern for International Directors

By Ralph Fatigate and Jim Stubbs

In response to a growing concern regarding the evasion of U.S. tax obligations, as well as to the recent prosecution of private bankers for allegedly assisting clients in evading their tax responsibilities, the Commissioner of the Internal Revenue Service (IRS) announced in December 2008 that cross-border tax withholding compliance was being elevated to a "Tier 1" audit issue.

Under this new legislation, certain payments, such as interest, dividends, and royalties, made to any non-U.S. person for services performed in the United States may be subject to cross-border withholding. In particular, this includes payments made to international board directors.

Why Now?

The years 2009 and 2010 will witness unprecedented scrutiny of financial institutions responsible for compliance with tax withholding regulations. Government officials worldwide have sought to identify citizens of their respective countries who have failed to pay income taxes as well as the financial institutions that maintained accounts on behalf of those persons or entities.

A July 2008 U.S. government report estimated that the United States loses \$100 billion in tax revenues annually due to offshore tax abuses, which represents a substantial portion of the annual U.S. tax gap. This tax gap has been estimated by the IRS to be approximately \$345 billion.¹ Due to this massive gap, the U.S. government has taken significant steps in tightening the regulations and enforcing financial and criminal penalties on individuals and institutions that have attempted to circumvent U.S. tax regulations.

Government Intervention

In February 2008, tax authorities in the United States and other countries commenced investigations

into taxpayers with accounts at Liechtenstein financial institutions. These efforts came in response to a case in which the U.S. government alleged that a U.S. citizen transferred large sums of money to four Liechtenstein foundations established with the assistance of a financial institution owned by the Liechtenstein royal family. The individual was advised by the financial institution to form shell companies, and the institution treated those entities as being owned by non-U.S. persons, despite an agreement with the U.S. government to report the account information of U.S. citizens and withhold appropriate taxes, ultimately shielding this individual's wealth using Liechtenstein's robust bank secrecy provisions.

In May 2008, the U.S. government arrested and prosecuted a Swiss private banker for allegedly assisting a U.S. taxpayer to avoid payment of U.S. taxes. Entering into a deferred prosecution agreement, the bank ultimately consented to steep fines, full account disclosure of certain U.S. customers of the bank's cross-border business and halting the provision of cross-border banking services to U.S. clients with undeclared accounts.

These events are truly historic. For the first time, the U.S. government attempted to circumvent Swiss bank secrecy laws by requesting assistance from a Swiss financial institution. This arrest and inquiry also demonstrated the vigilance with which the U.S. government is pursuing alleged violations of tax regulations.

In turn, the U.S. Senate Permanent Subcommittee on Investigations released a report in July 2008 titled *Tax Haven Banks and U.S. Tax Compliance*. The report claimed that, by the subcommittee's estimations, tax havens are currently maintaining trillions of dollars in assets for foreign citizens, including U.S. residents, and that financial institutions in tax havens actively facilitate tax evasion by U.S. clients. The subcommittee observed that bank secrecy serves as a cloak, not only for client misconduct, but also for misconduct by banks colluding with clients to evade taxes, dodge creditors and defy court orders.

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While the events that occurred in 2008 focused primarily on financial institutions in Switzerland and Liechtenstein, the increased federal scrutiny will likely apply to a broad range of financial institutions, foreign and domestic. U.S.-based financial institutions also are subject to the existing statutes, and compliance by those organizations will be closely monitored by federal agencies in 2009 and beyond. Understanding U.S. tax reporting laws and obligations and the importance of marrying anti-money laundering (AML) know-your-customer (KYC) procedures and U.S. tax reporting procedures is critical when implementing an effective compliance program or evaluating an existing program.

Section 1441 Regulations

Section 1441 of the U.S. Tax Code sets forth the requirements for the withholding of taxes whenever a U.S. entity makes certain payments to a Non-Resident Alien (NRA). This regulation requires financial institutions to identify NRA clients, obtain and validate required documentation that identifies residency status and report and withhold taxes on income paid to those account holders. Retaining forms without validating them first could cause an institution to grant withholding relief improperly, resulting in a tax liability as well as the liability for payment of interest and penalties. In addition, if information collected through KYC programs is inconsistent with that of the tax documentation, the institution could be considered to have actual knowledge that the tax claims are invalid and, thus, should not be honored. Financial institutions can mitigate this risk by cross-referencing identification information collected via KYC programs to determine whether the tax documents are consistent with the beneficial owners of the account and their tax obligations.

Qualifying payments made to an NRA must be U.S.-sourced Fixed, Determinable, Annual or Periodical (FDAP) income. Examples of FDAP payments made by a financial institution are interest and dividend payments. An entity making such payments is considered a withholding agent under Section 1441 and must withhold and report the income and the tax. FDAP income paid to an NRA is typically subject to a 30 percent tax on the gross amount paid. NRAs, however, may be eligible for a tax reduction (15 percent in many cases) on

dividends if there is a tax treaty between a foreign person's country of residence and the United States and if the person is eligible for, and appropriately claims, such relief. Additionally, under Section 1441 regulations, the IRS requires financial institutions to obtain a certified Taxpayer Identification Number (TIN) from all U.S. taxpayers and to report all income credited to them. If a U.S. person fails to provide his or her TIN, then the income will be subject to 28 percent backup withholding.

Voluntary compliance program

In 2004, the IRS provided withholding agents the opportunity to participate in a Voluntary Compliance Program (VCP). The VCP provided organizations the ability to pay any cross-border withholding taxes due to past noncompliance without having to pay additional penalties. The VCP ended in 2006, but the IRS gained valuable insight into the types of transactions that seemed to result in widespread noncompliance with Section 1441, as well as into the common deficiencies found within a broad range of institutions' internal controls. While the list of organizations participating in the program was never published, financial institutions made up a significant portion of the participants, and their apparent compliance weaknesses foreshadowed future IRS audits.

Risks and Intent

Noncompliance exposes organizations to significant risks that can be potentially crippling or lethal. Financial liabilities can be severe, including the payment of all back taxes, interest and penalties. This financial impact could translate into millions or even billions of dollars for a financial institution. In addition, employees can be held criminally responsible for circumventing withholding regulations, resulting in severe criminal charges and jail time if convicted. It almost goes without saying that a financial institution can also face reputational damage, with media and government agency reports eroding client confidence in an institution, negatively impacting the bottom line and causing potentially irreparable damage.

Many institutions erroneously believe that non-compliance involves only criminal intent. A financial institution may have a serious cross-border

withholding problem without having intentionally avoided complying with these complex requirements. Intent is not at issue. Financial institutions trying to manage tax compliance, even if confident of the integrity of their relationship managers, must develop and implement a comprehensive tax withholding compliance program to minimize their firms' exposure to risk.

Collaboration

Tax compliance affects various divisions within a financial institution, from front-office business lines to marketing to the board of directors. A financial institution may first identify an existing department or form a new group to take ownership of this compliance function and issue policies and procedures that can be implemented to manage all processes.

Several other internal departments could also collaborate with the group responsible for tax compliance to achieve an effective, enterprise-wide approach. This collaboration will include groups privy to personal client information. Relevant information, technology and personnel from the various departments can be leveraged to enhance the efficiency of all groups. For example, KYC information maintained by an AML department or a lending division could be used to identify the beneficial owners of an account and compare their residency status to that provided on tax documentation.

Record Validation and Preservation

Section 1441 compliance requires securing and maintaining proper documentation of client files to ensure that taxes on income paid to NRAs are properly withheld, remitted and reported. This is a significant undertaking when considering the number of clients that financial institutions service and the volume of documentation that must be retained by law, which can easily expire—exposing the institution to noncompliance. Tax compliance groups must be vigilant in working with business-line relationship managers to ensure that proper documentation is received and client files are updated. Software technology solutions that streamline the process of document collection and validation as well as ensure that the proper tax rate withholdings are applied are a worthwhile investment.

Proper documentation must also be recorded when considering any and all overseas payments and transactions, including those to board directors. It is the responsibility of both the company and board director to ensure that these payments receive the proper treatment under the new regulations.

Training

Another aspect of the compliance program is the initial training of a range of employees on Section 1441 compliance and the creation of an associated training manual. Subsequently, the training can be conducted on a periodic basis or as new issues/regulations arise. Employees with oversight of the institution's tax compliance must be well versed in the applicable regulations and how the firm manages the associated risks.

Internal Auditing or Other Self-Policing

The role of the self-review is important to consider in the context of any tax compliance program. The IRS' Internal Review Manual, specifically Section 4.10.21.8 entitled "U.S. Financial Institution Withholding Agent Audit," discusses, in detail, how the IRS will conduct the examination of U.S. financial institutions in order to determine if they satisfy withholding and reporting requirements in connection with their activities on behalf of foreign payees. The examination will likely include a determination regarding the proper withholding of payments to foreign account holders and whether those amounts were properly reported. The IRS auditor must also evaluate NRA operational procedures, as well as assess training manuals, reconcile tax forms, and examine and update account opening procedures. Every one of these steps can and should be performed by an institution, either internally or with the assistance of outside specialists, in order for an institution to identify problems and remediate any discrepancies or weaknesses before the IRS conducts its audit.

Conclusion

In 2009, new regulations undoubtedly will be enacted in response to the current financial crisis, as well as to the apparent abuse of the system by U.S. taxpayers and some financial institutions. U.S.

government officials have expressed their opinions about the causes of the economic downturn and will enact laws to promote greater transparency and accountability of the nation's financial institutions. Being a board director has never been more challenging, and with the increase in government regulation and scrutiny of tax and other financial treatments both in the U.S. and abroad, it will only become more difficult.

While lax compliance with cross-border withholding requirements was not considered a direct cause of the current recession, enforcement of the regulations will likely be viewed as a revenue stream during these difficult economic times. This places

increased pressure on the financial services field and their board directors to not only understand, but also fully comply with the present tax regulations and to be prepared for forthcoming changes. Assessment and optimization of a firm's existing compliance programs can safeguard boards and institutions against the risks of noncompliance with Section 1441.

Note

1. U.S. Senate Permanent Subcommittee on Investigations, *Tax Haven Banks and U.S. Tax Compliance*, 110th Cong., 2d sess., July 17, 2008, http://hsgac.senate.gov/public_files/071708PSIReport.pdf