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Section 1441: What you need to know about tax information reporting and withholding

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Agenda

- Executive Summary
- What Does Section 1441 Require?
- IRS Examination
- Vendor Payments
- Qualified Intermediary
- What Can You Do?
- Conclusion
- Appendix: Documentation

Section 1441: What you need to know about tax information reporting and withholding

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What is the issue?

Many banks and investment banks are not properly withholding and reporting on payments to foreign vendors. If the withholding agent fails to withhold the proper amount of tax, the liability for the tax is effectively shifted from many payees to the single payor and can lead to significant exposure for tax, penalties and interest. The IRS is now pursuing this revenue stream and actively ramping up enforcement efforts.

Following recent events in the financial marketplace and the increasing budget deficit, the US Government is seeking ways to increase revenues and the Internal Revenue Service (IRS) is expected to take a more aggressive approach in revenue collection by focusing on closing the existing Tax Gap, which is the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time. The IRS has become smarter in recognizing areas of noncompliance.

The following activities can create an Nonresident Alien (NRA) information reporting and withholding obligation:

- Paying dividends, interest, or royalties to nonresident foreign persons.
- Licensing technology for use in the US from nonresident foreign persons.
- Paying nonresident foreign persons for services performed in the US (i.e., personal services, commissions, installation of machinery, honorariums and Board of Director fees).
- Making pension payments to nonresident foreign persons under a US plan.
- Making payments for legal settlements or litigation awards to nonresident foreign persons.
- Paying rent for real property located in the US to nonresident foreign persons.

Other types of payments

- Paying insurance proceeds from US sources to nonresident foreign persons.
- Paying sponsorships fees to nonresident foreign persons.
- Paying patent or copyrights royalties on US sales to a nonresident foreign person.
- Paying a foreign financial services branch or subsidiary for shared services as part of your operations.
- Having management responsibility or acting as a middleman for your clients' account and making FDAP payments to nonresident foreign persons.
- Using payment cards to purchase services from nonresident foreign persons.

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What Does Section 1441 Require?

Generally, NRA withholding is required when a withholding agent:

- Has control, receipt, custody, or disposal of income;
- Such payment is US source FDAP; and
- The income is paid to or beneficially owned by foreign person.

What Does Section 1441 Require?

What does Section 1441 require?

- 30% withholding unless the proper documentation is obtained (e.g., Forms W-8) from recipients prior to making such payment.
- Failure to properly withhold when required shifts the withholding tax liability to the payor (plus penalties and interest).
- These rules cover not only US domestic corporations, but also foreign subsidiaries that are more than 50% owned by a US company (controlled foreign corporations).

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Observations

The IRS continues to become smarter, more efficient, and more aggressive:

- A voluntary compliance program (VCP) that ended in 2006 raised many millions in taxes.
- The IRS has recently trained approximately 650 agents at recognizing NRA tax withholding and reporting issues.
- The IRS has also provided Agents with an Internal Revenue Manual (IRM) on Form 1042 examinations, which provides a detailed roadmap of potential issues and where problems may lie.

Observations

- Section 1441 examinations are subject to standard examination timeframes.
- No additional time will be allowed to remediate documentation failures discovered during the examination.
- Withholding agents that fail to perform “Health Checks” and remediate problems prior to an examination risk being assessed for taxes (plus interest and penalties) that should have been withheld.

The Internal Revenue Manual – Form 1042 Examination (Rev. Aug. 2008)

- Objectives
 - Verify that all subject payments are included in NRA withholding and reporting system, including identification of all NRA's receiving US source FDAP payments.
 - Verify customer documentation is complete and valid.
 - The IRS has a “strict liability” approach to all Forms W-8.
 - Verify the appropriate rate of withholding was applied.
 - Verify tax deposits are timely made.
 - Verify Forms 1042 and 1042-S are timely and accurately prepared.

The Internal Revenue Manual – Form 1042 Examination (Rev. Aug. 2008)

- Generally, the IRM can be summarized in three steps. The overall focus is on evaluating whether a business has sufficient controls in place to limit tax reporting compliance failures:
 1. Evaluate processes and procedures for handling payments to nonresident aliens;
 2. Determine payments being made to nonresident aliens;
and
 3. Determine the source of the income being paid.

Internal Revenue Manual – Form 1042 Examination (Rev. Aug. 2008)

- Evaluate processes and procedures for handling payments to nonresident aliens:
 - Technology assessment – process flowcharts, system and data architecture;
 - Account opening;
 - Documentation validation;
 - Vendor set-up;
 - Withholding, depositing and preparing information returns; and
 - Review will include interviews of responsible persons.

Internal Revenue Manual – Form 1042 Examination (Rev. Aug. 2008)

- Determine payments being made to nonresident aliens:
 - Review systems to identify indications of foreign status (e.g., foreign mailing address in system, EIN begins with “98”);
 - Review documentation (Forms W-9, W-8 and 8233);
 - Determine if presumption rules have been appropriately applied; and
 - Review systems to determine FDAP payments to NRAs.
 - Review information returns such as Forms 5471 and 5472.
 - Statistical sampling will be used.

Internal Revenue Manual – Form 1042 Examination (Rev. Aug. 2008)

- Determine the source of the income being paid:
 - Review invoices and supporting materials to determine source;
 - Review wire transfers, purchase cards, corporate credit cards, etc.; and
 - Ensure sourcing documentation was provided contemporaneously.
 - If source can't be determined, it will be presumed to be US source.

Common Compliance Mistakes

Common Compliance Challenges

- Documentation validation challenges:
 - Presumption rules.
 - Human error.
- Technology challenges:
 - Multiple addresses & country of residence for tax purposes.
 - Tax treaty rates.
- Documentation maintenance challenges:
 - Employee turnover.
 - Resolicitation.
 - Change in circumstances.

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Vendor Payments

High Level Vendor Payment Issues

Breadth Where are payments being made?	Source US or Foreign?	Character Type of payment?	Scope Payments for self or others?	Documents Are vendor docs and invoices sufficient?
<ul style="list-style-type: none">• Business Units• Departments• Local offices• Outsourced service providers• Payment Cards	<ul style="list-style-type: none">• US source to foreign vendor• Foreign source to foreign vendor• US Source to US vendor• Foreign source to US vendor	<ul style="list-style-type: none">• Goods• Services• Legal Fees• Medical Fees• Board of Directors• Rents	<ul style="list-style-type: none">• On behalf of Clients• As Trustee• As Custodian• As Fiduciary	<ul style="list-style-type: none">• Valid Form W-8 before first payment• Detailed Invoice showing where services performed

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Proposed Amendment to QI Agreement & QI AUP

- Amendments designed to provide greater transparency for purposes of locating US income recipients and detection of “bad acts”
 - QIs are required to have tighter controls to include whistle blowing provisions.
 - QIs must have designated personnel who are responsible for overseeing the QI program.
 - Non-US auditors must affiliate with a US auditor in order to conduct QI audits.

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What Can You Do?

What can you do?

- Assess your level of compliance by performing a “Health Check”. If necessary,
 - Remediate errors PRIOR to being notified about an audit.
 - Improve your internal systems and processes.
 - Develop and implement new policies and procedures.
 - Enhance training for all personnel responsible for implementing the NRA information and withholding rules.
- If exposure items are found, *carefully* consider voluntary disclosure. Historically, IRS review in a voluntary disclosure is generally less rigorous than during an audit.

What Can You Do?

Our Approach

PwC has developed a proprietary approach which merges strong Tax Technical, Process, and Technology knowledge and expertise. The key features of our approach are:

- Conducting simultaneous sample testing and process walkthroughs (Health Check).
- A multi-disciplinary team of professionals that have technical tax, process management and data/technology backgrounds with expertise in tax information and reporting.
- Team members who have extensive IRS experience.
- Through the execution of the Health Check (i.e., compliance diagnostic) we will provide a detailed description of the level and nature of non-compliant accounts.
- Uncover process, data, and documentation quality problems.

What Can You Do?

An overview of compliance



What Can You Do?

Compliance Health Check and Training is Focused on Three Areas

Tax Technical	Process	Technology
<ul style="list-style-type: none">• Review of Compliance with VCP• Documentation Validation• Tax Form Checklists• Remediation• QI Audits• Voluntary Disclosure/ Exam Support	<ul style="list-style-type: none">• Process Mapping• Withholding Review• Organizational and Corporate Governance• Change Management• Business Rules Documents• Policies & Procedures• Remediation Plans• Integration with KYC & AML	<ul style="list-style-type: none">• Information Management & Data Warehouse• Data Forensics• Exposure Calculations• eFile & Paper File Reconciliation• Remediation – process improvements

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Conclusion

Many banks and investment banks are not properly withholding and reporting.

Many banks have “untrained” personnel managing the tax withholding and reporting process.

Noncompliance can lead to significant exposure for tax, penalties and interest.

The IRS is actively ramping up their enforcement efforts in this area and has become smarter in recognizing areas of noncompliance.

Congress is looking at the IRS' enforcement efforts as a method towards reducing the Tax Gap . . . including US citizens hiding behind QIs.

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The Forms

- W-8BEN
- W-8ECI
- W-8IMY
- W-8EXP
- Form 8283

Form W-8BEN

- Provided by a foreign person to certify that:
 - They are a foreign person
 - They are the beneficial owner of the income
 - They are entitled to treaty benefits
- Generally provided by:
 - Individuals (except for personal services – Form 8233)
 - Corporations
 - Complex trusts
- The form is generally valid for the year of receipt plus 3 years
- Form must be an original, unless attached to a Form W-8IMY

Form W-8ECI

- Provided by a foreign person to certify that:
 - They are a foreign person
 - They are the beneficial owner of the income
 - The income in question is effectively connected to a US trade or business
- Generally provided by:
 - Corporations
 - Partnerships
 - US branches of foreign corporations
- The form is generally valid for the year of receipt plus three years

Form W-8IMY

- Provided by a foreign person to certify that:
 - They are a foreign person
 - They are NOT the beneficial owner of the income
 - The income in question belongs to others
- Generally provided by:
 - Foreign financial institutions that are a qualified intermediaries
 - Foreign partnerships (withholding and nonwithholding)
 - Foreign trusts (withholding and nonwithholding)

Form W-8IMY (con't)

- Form is generally valid indefinitely
- Form must be accompanied by a withholding allocation statement and documentation (Form W-BEN, W-9) from the underlying beneficial owners
 - Exception – Generally, qualified intermediaries, withholding foreign partnerships and withholding foreign trusts are not required to attach documentation

Form W-8EXP

- Is used to claim a reduced rate, or exemption from, withholding by:
 - Foreign governments, or governments of a US possession
 - International organizations
 - Foreign central banks of issue
 - Foreign tax-exempt organizations, or
 - Foreign private foundations
- Form is generally valid for the year of receipt plus 3 years
- Foreign tax exempt entities and must attach a determination letter from the IRS or an opinion from US counsel

Form 8233

- Provided by a nonresident alien individual for independent personal services
- Certifies:
 - Foreign individual is the beneficial owner and
 - Entitlement to a reduced rate of withholding under a tax treaty or withholding exemption
- Form is valid only for one year
- Withholding agent signs the form
- Withholding agent must forward Form 8233 to the IRS within 5 days of receipt and should not make a payment until 10 days after filing the form

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The information contained in this document is provided 'as is', for general guidance on matters of interest only. PricewaterhouseCoopers is not herein engaged in rendering legal, accounting, tax, or other professional advice and services. Before making any decision or taking any action, you should consult a competent professional adviser.

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