

OP•ER•A•TIONS CLAR•I•FIED **OP•ER•A•TIONS CLAR•I•FIED**

Benefits from Stricter Tax Regulations...Really

Changes to personal income taxes or corporate payroll taxes may grab all the headlines, but a change currently underway in the area of withholding taxes, a little-known part of the U.S. tax code, could have major implications for dealers and investors both foreign and domestic.

Though obscure, withholding taxes are levied on all U.S.-sourced investment income. Determining the correct amount of withholding is a complex and operationally-intensive process.

Withholding Taxes, Hardly Smooth Sailing

The burden of collecting withholding taxes falls on the party responsible for distributing U.S.-sourced income, typically banks referred to as 'withholding agents'. The withholding rate of a particular client or counterparty is driven by income type and tax status, the latter being a function of tax residency and client type. If the proper amount is not withheld, withholding agents are liable for any shortfall. Tax status is determined by collecting tax forms from clients—W-9s for domestic, W-8s for foreign.

The W-8 forms are the most burdensome because withholding agents are required to have signed originals, which must be renewed every three years. These forms need to be completed by institutional investors in hard copy for all dealer or custodian counterparties, often multiple times. The paper burden for all sides is substantial and has significant cost implications for both buy-side and sell-side institutions.

A Gathering (Withholding) Storm

Though the paper work for withholding agents is already onerous, the U.S. Government seems determined to compel these banks to go even further. For example, the **Internal Revenue Service** may require withholding agents to determine a client's birthplace, despite its irrelevance for tax status.

The IRS has been trying to 'crack down' on U.S. persons who have not declared their assets overseas. Further scrutiny has been placed on Qualified Intermediaries (QI), foreign institutions that agree to adhere to U.S. regulations, in the belief that QIs may directly or indirectly be helping U.S. persons facilitate tax evasion. And perhaps most controversially, the proposed Foreign Account Tax Compliance Act of 2009 could have far reaching

implications for U.S. withholding agents, QIs, and even Non-Qualified Intermediaries (NQIs).

Cue the Silver Lining

Ironically, these stricter requirements may actually spur industry-wide change required to effectively apply the new regulations. The IRS appears to recognize that the desire for stricter regulations must be coupled with increased flexibility for meeting those requirements.

Recently, the IRS has encouraged withholding agents to use online questionnaires with clients to produce 'original' tax forms as PDFs. Since the most significant burden is the current requirement to collect and validate original W-8s—a process that often includes back-and-forth mailing of paper forms between withholding agents and clients—an electronic format will increase the speed and accuracy with which forms are processed. Equally revolutionary could be the IRS's authorization for withholding agents to 'share' original tax forms. Although this has been allowed for years, the industry has never managed to muster a critical mass of withholding agents to take advantage of it. This appears to be changing.

Online document repositories can be combined with third party electronic validation tools to realize the full potential of sharing tax forms. Institutional clients gain by doing a tax form once rather than one for each withholding agent. Withholding agents gain by automating the validation process and accessing various tax data electronically rather than the current manual exercise. Such a combination of tax form sharing and electronic validation has long been desired throughout the industry and users expect to gain significant efficiencies even with the possibility of tighter regulations.

Though it is hard to imagine added tax requirements having a silver lining, the emerging changes to withholding tax compliance, by spurring further automation and work-flow consolidation, might just be a blessing in disguise.

Operations Clarified breaks down key issues in the operations industry. This week's installment was written by Lansing Gatrell, director of Markit's Document Exchange offering.