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New Withholding Rules for Banks May Be on the Horizon Under New Obama Proposal

On May 7, 2009, the White House issued its proposed budget for fiscal year 2010, which outlines the Obama administration's plan to reform certain of the Internal Revenue Code's provisions on the taxation of international transactions. Proposed changes to the rules on withholding taxes, which are aimed at reducing tax evasion by U.S. citizens and residents and improving collection efforts for taxes owed by foreigners investing in the U.S., are of specific interest to many domestic and foreign banks engaged in cross-border transactions. Significantly, the changes discussed below can be implemented through regulations issued by the Treasury, which means there is an increased likelihood that these proposals will be implemented, since congressional approval is not required.

Under current law, payors ("Withholding Agents") of certain types of U.S.-sourced income paid to foreign individuals or entities are required to withhold a percentage of the income and remit that amount to the IRS. In some instances, the foreign recipient can provide documentation to the withholding agent that reduces or eliminates withholding. For example, a tax treaty may apply. This can be a relatively straightforward process if the beneficial owner of the income is the direct recipient. But the process becomes much more complicated when

a foreign intermediary, such as a foreign partnership or a foreign bank acting as a nominee, sits between the withholding agent and the beneficial owner.

Currently, a foreign intermediary may become a qualified intermediary ("QI") by entering into an agreement with the IRS to properly withhold and remit appropriate tax amounts. The benefit to the QI for voluntarily complying with this program is that the IRS will not generally audit the QI's withholding records as long as they are audited by an outside independent auditor. The QI program also shifts the responsibility for withholding from the U.S. payor to the QI, which in some instances allows the QI to control the amounts withheld and remitted to the IRS without disclosing the identities of the beneficial owners to the U.S. payor or the IRS.

Foreign intermediaries that do not elect QI status are referred to as nonqualified intermediaries. There is nothing inherently wrong with a nonqualified intermediary, but because these entities do not voluntarily subject themselves to IRS scrutiny, there may be a perception of potential abuse by beneficial owners receiving income via such entities.

The Obama administration proposes to levy a withholding tax against all payments made through a nonqualified intermediary

without the possibility of reduction. A beneficial owner who, under current law, would be able to reduce or eliminate withholding tax by providing appropriate documentation, would instead be subject to withholding at the full rate and would then be forced to file a tax return claiming a refund if one is due. Conversely, beneficial owners investing through a QI could continue to avoid withholding tax when appropriate by simply providing the proper documentation.

The Obama administration also proposes to limit a QI's ability to affiliate itself with nonqualified intermediaries. This would restrict organizations from housing certain types of investors in a nonqualified intermediary affiliate while gaining the benefit of QI status for their remaining businesses.

Perhaps the most significant change proposed by the Obama administration

is that a QI would be forced to comply with enhanced reporting standards equal to those of U.S. financial intermediaries. While information is not currently available on exactly what information would be reported under the new standards, a significantly higher level of transparency and disclosure seems imminent under the proposal.

If the changes are enacted, banks should assess their obligations under the new rules from several perspectives. Specifically, banks acting as payors of U.S.-sourced income should determine their withholding obligations, as well as the kinds of documentation that will be required of foreign payees requesting a reduction in withholding. Foreign banks acting as nominees should weigh the benefits of electing QI status against the potential reporting burdens, especially considering the privacy issues that may be implicated under the new

QI disclosure standards. In addition, foreign banks should assess their own corporate structures to determine if affiliations exist between QI and nonqualified intermediary subsidiaries.

The tax lawyers at Hunton & Williams LLP have extensive experience working with the withholding tax provisions of the Internal Revenue Code and are able to help you determine the impact of the administration's proposed changes on your business as well as aid you in planning for any restructuring that may be necessary. If you would like to receive more information about President Obama's proposal or if you would like to discuss issues regarding the qualified intermediary program generally, please contact any of the lawyers listed on this alert.

[Click here](#) for the president's budget for fiscal year 2010.

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