

Delving Deeper Into Digital: IRS Updates Electronic Standards

by Cyrus Daftary

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In this article, Daftary discusses recent regulatory changes affecting electronically transmitted IRS forms.

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Not too long ago, for a bank that was required to obtain a tax certificate, Form W-8, to document the non-U.S. status of an account holder, a “wet-ink” signature was necessary. It resulted in those dealing with U.S. withholding taxes having to tell someone, “We need the original. Yes, a hard copy. No, a fax or email won’t do.” And that was only back in 2013.

Since then, Treasury issued coordination regulations (REG-130967-13) in 2014 that changed this practice. The new regulations harmonized requirements between the traditional nonresident withholding rules and the new Foreign Account Tax Compliance Act provisions. For payments made after March 6, 2014, a withholding agent didn’t need to push back on its hard-copy-only approach and could rely on an electronic version of Form W-8.

The IRS loosened this rule even further in updated guidance (T.D. 9808 and T.D. 9809) issued in January, stating that forms transmitted electronically, such as by email or fax, may be accepted for payments made on or before March 6, 2014, as well. This provided much-needed relief to

banks and withholding agents that might still be trying to solicit forms from account holders for older accounts as part of a proactive remediation program or an IRS audit.

The January regulatory updates contained other provisions on the electronic front. It allows the use of electronic signatures and third-party digital document repositories. This new guidance suggests the IRS is moving deeper into digital. It also highlights the crucial role of the exchange of information between the industry and government in this niche area of tax compliance. As information reporting and withholding rules become more complex and global in scale, electronic systems and processes have become an integral part of the overall compliance process for many institutions, big and small.

The Saga of the Wet-Ink Form

Different forms have different electronic standards, which is especially apparent in comparing Forms W-8 and Forms W-9. For a long time, an account holder could send a Form W-9 (documenting the account holder’s U.S. status) by fax to a withholding agent. Unfortunately, the same rules didn’t apply to Form W-8 because these two form types were governed by separate guidance.

IRS auditors could, and often did, treat a Form W-8 as invalid if they saw a fax line on the form with the originating fax machine number, because that indicated it was not the “original.” This meant that the withholding agent should have withheld on payments to the account holder at the highest statutory rate, even though the information on the faxed form might have told the withholding agent otherwise.

A Form W-9 could be received by fax, and in practice withholding agents accepted copies. Form W-8 always required a wet-ink signature for the person supplying the form. Signers needed to

sign multiple copies, especially if they came from an institutional investor that regularly opened accounts with multiple banks or brokers. Each form also had to be mailed by post to its intended recipient. The withholding agent was always watching the mailbox in search of the original form with that wet-ink signature.

That made little sense for businesses. Legal and business documents were commonly transmitted via fax and email, and their validity was unquestioned. The inability to use email to send a Form W-8 seemed antiquated, and the distinction between being allowed to transmit a Form W-9 electronically while not being able to do so with a Form W-8 did not help rationalize that practice. Moreover, it was difficult to argue that wet-ink signatures were crucial to proper tax compliance given the inefficiencies that this caused to business operations.

After much industry persuasion for the IRS to accept electronically transmitted Forms W-8, a 2012 IRS counsel memorandum, AM 2012-008, indicated that the IRS was finally shifting gears. The memorandum argued that a Form W-8 could be transmitted by fax or email if there were specific procedures in place. Under those procedures, the withholding agent receiving the form should be able to verify that it was transmitted by the signer or an authorized agent. Unfortunately, the memorandum was not law. Many withholding agents still did not accept Forms W-8 electronically until new regulatory guidance was issued.

The coordination regulations in 2014 stipulated that a withholding agent could rely on a Form W-8 that was received by fax or electronically. The withholding agent could rely on such transmission unless it knew that the form was transmitted by a person who was not authorized to do so. That seemed to have lowered the standard of knowledge on the part of the withholding agent. Each withholding agent could create its own procedures to comply with this actual knowledge standard. The rule was effective for chapter 3 provisions and FATCA withholding for payments made after March 6, 2014; with the January regulatory update, the rule is effective for any payments whenever they were made. It's

been a long time coming and the result of years of industry and government dialogue, but the industry is finally moving beyond wet ink only.

Digital Signatures

In addition to loosening of the standard for electronic forms, the January regulatory update stated that a withholding agent could now rely on a tax form with an electronic (digital) signature, as long as specific requirements are met. Electronic signatures are now allowed regardless of whether the withholding agent is the person that maintains the electronic system where the signer digitally signed the form.

To understand some ramifications of this new rule, it is important to uncover related pieces of the puzzle. The first piece concerns the provisions within the information reporting regulations that allowed the use of an electronic system for collecting tax forms.

Even though the IRS generally did not allow Forms W-8 to be provided electronically before 2014, Treasury regulations did permit and continue to permit a withholding agent such as bank to create and maintain an electronic form collection system. A bank that maintains this system might send a customer a link to a website, where the customer would complete and provide the withholding tax form online.

The electronic document collection system was acceptable if it met the following requirements:

- guaranteeing the information received by the withholding agent is the information sent by the user;
- providing documentation of all instances of user access; and
- ensuring that the design and operation of the system would make it reasonably certain that the person accessing it and submitting the Form W-8 is the person named in the form.

There is a large emphasis on user and data authentication. Part of this authentication process is built into an electronic signature requirement. According to the Treasury regulations, the system must require an electronic signature by the person whose name is on the electronic Form W-8. The signature

must also authenticate and verify the submission. It must be the final entry in the person's Form W-8 submission. In practical terms, this could be the input of a personal identification number provided to the account holder through an authenticated email address.

Let's say there is a bank and its customer was not the person signing the form itself. The customer is an intermediary or a flow-through entity such as a partnership. For tax documentation purposes, a financial intermediary or partnership generally must provide a tax form, Form W-8IMY, indicating its status and the tax forms for its underlying beneficial owners or partners. The bank does not have a direct customer relationship to those underlying beneficial owners. Even if it maintained an electronic document collection system, the bank could not practically send indirect beneficial owners a link to complete a Form W-8 electronically.

Now here is the second piece of the puzzle. Could partnerships and intermediaries make use of these electronic documentation collection systems? This presents an issue especially in the world of investment funds and hedge funds, which may have countless investors, with the funds opening trading accounts with multiple banks and brokers.

The industry has been seeking clarity and a more efficient route. One suggested approach was that investment partnerships could maintain the electronic system and send a link to where an investor could complete an electronic Form W-8. This would increase efficiency because the partnership has the direct customer relationship with these investors. Then the partnership could print out the electronic Forms W-8 completed on its system and send them along with its Form W-8IMY to the bank or broker where an account was being opened.

Banks and other withholding agents, however, were nervous about accepting these printed copies. Given prior guidance over wet-ink signatures, would forms electronically completed on a system that was not maintained by the bank be acceptable?

The January regulatory update specifically allows a withholding agent to accept forms electronically signed as long as it meets the

standards of an electronic system, regardless of whether the withholding agent is the one maintaining it. The new standards, however, require that the form reasonably demonstrate that the person named has also electronically signed it. It notes, in particular, that "a withholding agent may treat as validly signed a withholding certificate which has, in the signature block, the name of the person authorized to sign, a time and date stamp, and a statement that the certificate has been electronically signed."

That is a significant change that has evolved through a series of conversations between the industry and the IRS. Participants initially raised concerns over the intermediary form transmission issue in a comment letter through the Association of Global Custodians in 2015. The IRS first tried to address this through a proposed change in the standard of knowledge rules in Notice 2016-08, 2016-6 IRB 304. Ultimately, however, the IRS sought to address the issue by simply accepting electronic signatures.

The good news is that intermediaries or flow-through entities can now use an electronic system to collect forms from underlying beneficial owners and pass them to the withholding agent. Allowing electronic signatures and leveraging electronic documentation systems opens up new possibilities for investment funds and similar intermediaries. Both industry participants and the IRS benefit from this shift to electronic form collection. Forms collected electronically are legible *and* machine readable. Systems can also be used to validate a form for consistency and reasonableness by requiring the completion of certain fields to avoid missing information. This solves the operational challenge of having incomplete forms that require additional contact between a withholding agent and an underlying beneficial owner. Incomplete forms can also trigger withholding events even though the failure of the form may be inadvertent and easily correctable. When electronic systems are connected to account records, they monitor for changes in circumstances that might affect the validity of a form and require a new form to be provided.

In each of these circumstances, electronic form collection by an intermediary or flow-through entity creates efficiencies for themselves and their

customers, and it increases the likelihood of tax compliance. Moreover, IRS agents are quickly realizing that these systems provide a consistent, accessible data source for IRS audit.

Third-Party Repositories

In many financial transactions such as swaps or forwards on currency, counterparties must exchange some standard documentation with each other. The types of documents are generally specified in master agreements governing the transaction. This information exchange is much more efficient in a digital world. One counterparty uploads documents to a digital third-party repository and permissions access to its opposing counterparty. Oftentimes within these types of transactions, counterparties will upload multiple document types, including tax documentation such as tax withholding forms.

Before the allowance of electronic transmission of Forms W-8, counterparties could obtain a PDF of a tax form from a third-party repository and then send the originals with the wet-ink signature to the opposing counterparty. With the change in guidance of the 2014 coordination regulations, new questions arose from withholding agents about the use of these third-party repositories, specifically since emailed Forms W-8 were now allowed. Could the withholding agent simply retrieve a tax form from the repository without having to call the counterparty or account holder for forms with wet-ink signatures?

Those questions created more industry uncertainty. In 2015 the IRS issued an FAQ that highlighted that a Form W-8 will be considered as being received electronically by the withholding agent if the form is uploaded to a third-party repository. It assumed, however, that when the withholding agent requests a Form W-8, the payee would send an email with a link to the repository site for the withholding agent to download the image or PDF of the stored form. The withholding agent, however, must not have knowledge that the email containing the link had been transmitted by a person who was not authorized to do so.

Questions remained. Was an email always required to be sent from the payee? Or could the withholding agent simply retrieve the form as

needed from the repository? Another question was whether this reliance on repositories applied only to Form W-8 rather than Form W-9. Previously withholding agents seemed ready to accept “copies” of Form W-9. The new FAQ raised more concerns regarding the use of Forms W-9 obtained from repositories because the FAQ only referenced Form W-8.

In the January regulatory update, the IRS stated that a withholding agent could rely on a tax withholding certificate obtained from a repository. However, the new regulations set forth their own nuanced requirements. Withholding certificates must be uploaded or submitted to a repository that had specific processes in place. Repositories need to ensure that a withholding certificate can be tied back to a specific request from a withholding agent and a specific authorization from the person providing the certificate. The regulations also stated that each request and authorization must be associated with a specific payment and a specific obligation.

The government’s concerns about associating forms on a payment-by-payment basis stemmed from the fact that a payee may have multiple forms depending on its role. For example, the payee could use a Form W-8ECI for income related to a U.S. trade or business, a Form W-8BEN-E for income that is for its own purposes, or perhaps a Form W-8IMY for when it is acting as an intermediary. The IRS highlighted that a payee should provide the withholding agent authorization for a specific form within a repository on a payment-by-payment basis.

Thus, despite the promise of being able to rely on third-party repositories, two important problems remain as roadblocks for withholding agents.

While the regulations reference “withholding certificates,” which include both Forms W-8 and Forms W-9, withholding agents have been unable to obtain confirmation from the IRS that a repository could be used for Forms W-9. As previously mentioned, withholding agents were willing to obtain electronic transmissions for Forms W-9 based on separate guidance. International agents at the IRS seemed to suggest that because a separate IRS group oversees Forms W-9, that group would presumably need to review the use of repositories in that context.

The other issue that has now become an operational quandary is the payment-by-payment requirement for obtaining a form. If a withholding agent must make a separate request for every form, and the payee needs to do separate authorizations for each payment, operational efficiency reduces dramatically. If the payee is communicating with the withholding agent on each payment, it might be just as easy to include a form as an email attachment.

Despite those issues, the IRS should continue its dialogue with industry participants in order to solve the third-party repository hurdles. Using a third-party repository is efficient for banks and brokers and has benefits for the IRS. It enables a user authentication system to track the person uploading a tax form and the party retrieving it. This type of authentication addresses one of the main concerns that the IRS had in the first place: the ability to ensure that the form is indeed provided by the named person or an authorized agent. Also, third-party repositories have established standards and consistent requirements for users uploading tax forms. Repositories coupled with some technology systems can be used to validate tax forms for consistency and reasonableness to enhance overall compliance.

The good news is that the dialogue between industry participants and the IRS has been a healthy and open conversation. In the area of withholding tax, such as chapter 3, FATCA, or domestic reporting, much progress has been made. There are, of course, the usual submissions of industry comment letters, but there have also been special industry liaison groups such as the legacy Electronic Tax Administration Advisory Committee and the Information Reporting Program Advisory Committee that have pushed discussions forward.

The Electronic Tax Administration Advisory Committee, for example, was a group that conveyed the industry's views around the IRS electronic tax administration activities, until its membership was disbanded and the group was repurposed. The Information Reporting Program Advisory Committee offers a public forum for the IRS and members of the information reporting community in the private sector to discuss relevant information reporting issues.

Whether it is wet-ink originals or the use of third-party repositories, both industry participants and the government must work together to achieve a favorable outcome for all. As transactions become more complex and operations require the need to address both global and local rules across multiple tax frameworks, access to electronic systems is key. Organizations and the IRS both have a stake in redefining and enhancing this niche area of tax compliance. Through continuing the dialogue and creating a strong framework around digital, the industry as a whole will benefit from a more grounded operational reality and greater taxpayer compliance. ■