

***Mitigating the Challenges of
Withholding Tax Compliance in
an Evolving Global Economy***

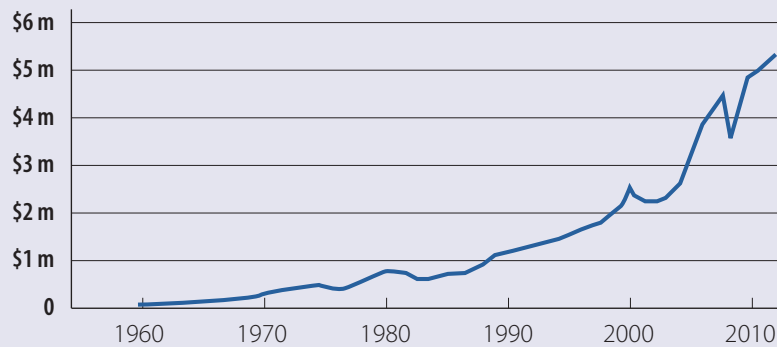


Introduction

In 1960, U.S. trade in foreign goods and services totaled \$48.3 billion. In 2014, the most recent year for which data is available, the total was \$5.2 trillion, a staggering 1,060% increase. With the rise of e-commerce and an increasingly globalized marketplace, aggregate international trade in the U.S. increased 245% from 1994 to 2014 alone, rising from \$1.5 trillion to \$5.2 trillion.¹ As new

withholding tax regimes impose a direct tax on payments made by a resident to a nonresident, whether in the form of payment for goods or services, dividends, rents, royalties, interest, or other forms of payment. They mandate that the payor of income to a non-resident withhold and remit a specified percentage of final payment to the local tax authority before it even reaches

Total Dollar Value of U.S. Foreign Business Transactions



emerging markets continually create additional global investment opportunities, conventional wisdom and economic forecasts suggest that this growth will only accelerate in coming years.

As the share of American business profit from foreign sources increases, and as foreign businesses generate greater U.S.-source income, the tax compliance burden on the business taxpayer only becomes greater and more complex. As if the breadth of the U.S. Tax Code were not sufficiently overwhelming, businesses with global operations increasingly must navigate the overlapping and equally complex tax codes of every jurisdiction in which they generate income in order to satisfy their tax compliance responsibilities across the globe. Often, this can seem an impossible task.

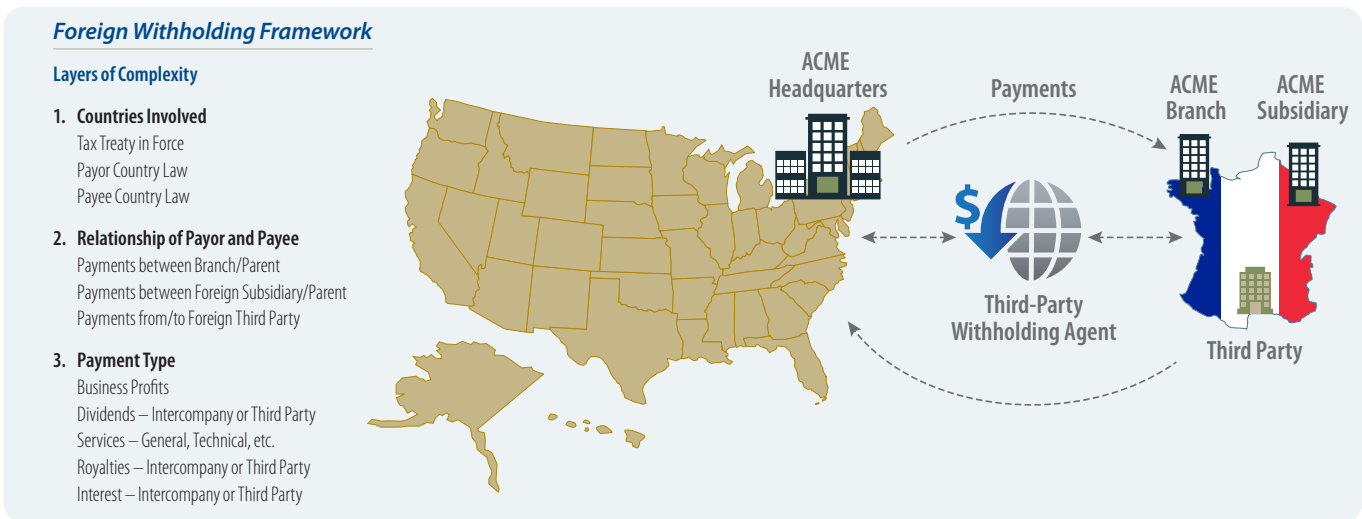
Foreign withholding taxes are especially rife with complexity and room for error. Foreign

the coffers of the business liable for the tax. Withholding taxes on income of non-residents are a powerful tool that tax authorities employ to combat tax evasion, as they enable the imposition of tax before a non-resident receives payment outside a country's territorial boundaries, where delinquent taxes are far more difficult to enforce. Unsurprisingly, every country in the world now imposes withholding on at least some payments made to nonresidents. Most often, the task of administering this withholding falls on third-party withholding agents, who juggle the tax codes of both payor and payee country as well as any tax treaty in force between them. This creates a large margin for error, managed exclusively by a third party with an inherently lower economic incentive to ensure withholding accuracy than the foreign business legally responsible for the tax. Consequently, the business earning the income possesses little control over the process.

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In addition to this external locus of compliance control, a business with income in several foreign jurisdictions can face hundreds of applicable withholding rates, which vary by the type of income generated, the respective entity classifications of the payor and payee, a domestic business's degree of foreign operations in a country, the foreign country in which the income is generated, any applicable tax treaty in force, a foreign government's particular interpretations of a treaty or underlying tax law, and the constant changes to relevant tax law. To many businesses, particularly those of small and medium size, navigating this labyrinthine system of withholding rates to ensure the accuracy of all payments seems an exercise in futility. In the face of this uncertainty, a presumption of accuracy often becomes the *modus operandi* when resources or expertise are lacking. Absent proper oversight, considerable overpayment of foreign withholding is commonly left completely undetected. For businesses with small profit margins, this can significantly impact fiscal stability and the viability of maintaining foreign operations.



Compounding this conundrum, even when overpayment is discovered, successfully recovering the excess amount is anything but certain. Foreign withholding recovery is logistically complicated, time-sensitive, expensive, and prone to denial by the foreign tax authority. This creates a quandary for the payee business—if recovery is not cost-effective, overpayment amounts are forever lost, but even if recovery is cost-effective, the business exclusively shoulders a heavy financial and administrative burden of correcting the mistakes of a third party. In either case, the business finds itself with less profit than it would have earned had withholding been administered properly. In short, both pursuing and declining to pursue recovery inflict an opportunity cost that is a tough pill for businesses to swallow.

While the myriad of risks associated with foreign withholding are daunting, they are not without remedy. A number of strategies are available to prevent or reduce the financial harm of withholding mistakes. With proper foresight and planning, a business can limit its exposure, verify the accuracy of withholding, and most efficiently seek recovery when necessary. These strategies chiefly involve integrating the tax processes of varying business units, improving the business processes for recording and verifying the accuracy of withholding payments, maintaining comprehensive institutional knowledge of applicable withholding tax law within these units and, where possible, adopting increasingly effective, automated tax compliance enterprise software.

This white paper identifies the most common risks that companies face in foreign withholding tax compliance and details these available solutions that can mitigate those risks.

Common Risks and Suggested Solutions

1 *Lack of Integrated Business Operations*

The common lack of integration between business divisions with withholding tax touchpoints makes verifying the accuracy of payments more challenging. The business units most directly impacted by withholding are the finance, accounting, and/or tax departments. The payment amounts received by a company's finance department and recorded by accounting are often not examined by tax compliance employees until a company's fiscal year end, at which point erroneous withholding is less likely to be detected, if withholding accuracy is even examined at all. Meeting tax filing deadlines is often of such paramount concern that a line-by-line crosscheck of every foreign payment is simply not feasible for many tax departments. Oftentimes, withholding-related documentation is either transmitted late between necessary business units or not at all, creating a verification dilemma—withholding accuracy may never be examined, and even if it is, the statute of limitations on recovery may expire before a foreign refund request can be submitted.

Solution: Establish Business Processes and Protocols

The seemingly obvious fix for this dilemma is to establish strict business processes that mandate and ensure that documentation related to foreign payments is immediately shared between all necessary business units as it is created or received. Such protocol typically exists within businesses, but it often fails in execution amidst the day-to-day minutia of operating a business. Mandating and enforcing such procedures are critically important if a business is to verify that the net foreign payments to which it is entitled are properly received. Immediate communication and transmission of relevant documentation to all stakeholders allow for real-time verification of amount withheld and increase the likelihood that any necessary recovery effort is timely.

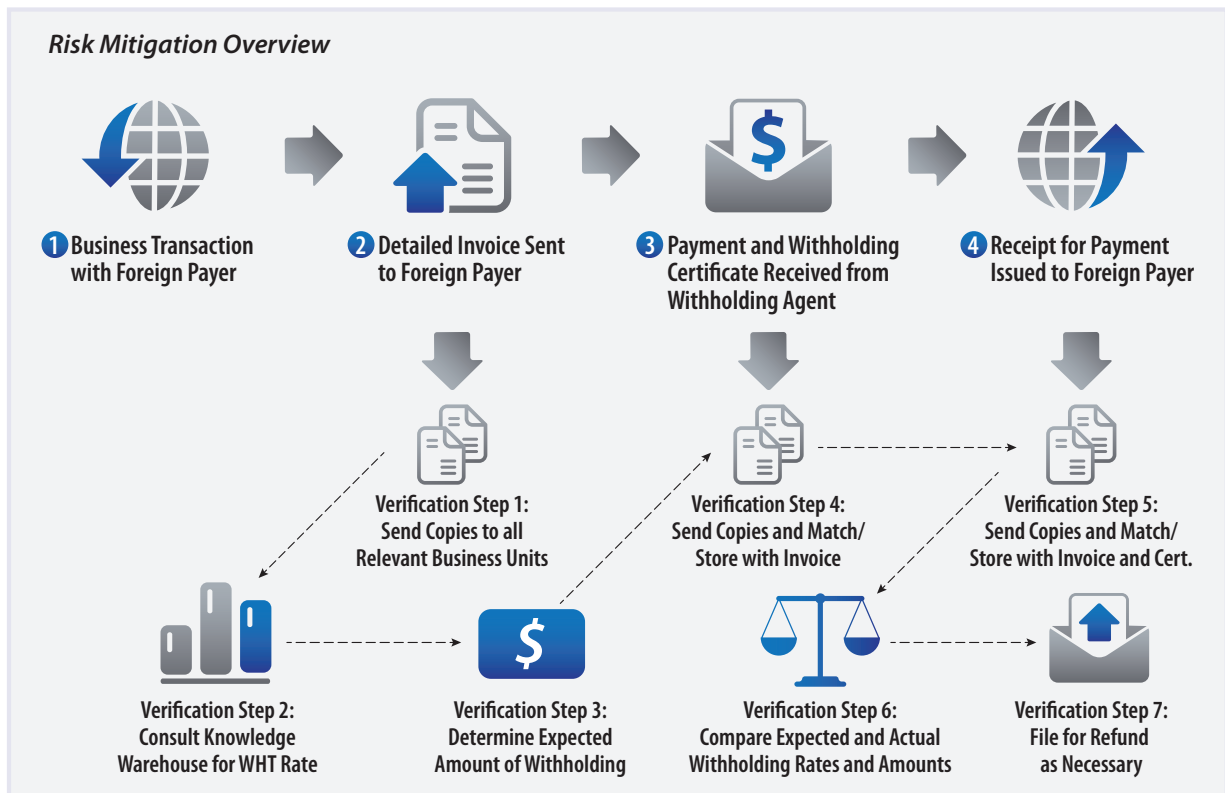
2 *Administrative Burden Inhibits Proper Documentation of Paper Trails*

Internally, foreign payments and corresponding withholding create a chronological paper trail that allows a tax department to examine each withholding amount for accuracy, provided that proper recordkeeping and communication are maintained. The paper trail typically includes a purchase order, invoice, withholding agent's statement of withholding, and a payment receipt. Depending on the payment type in question, some of these documents may be unavailable or inapplicable. Foreign dividend payments, for example, do not usually involve the issuance of an invoice by the payee business. Accordingly, it is necessary to identify which documents are relevant and needed for each type of payment.

After a purchase order is received, a business's finance department issues an invoice. When payment is received, whether through prepayment or after goods and services are provided, it is customarily accompanied by the withholding agent's certificate documenting amounts withheld and remitted to the foreign tax authority. Treasury then issues a receipt to the payor memorializing the acceptance of payment and detailing the full or partial satisfaction of the underlying invoice. The amounts receivable as reported on the initial invoice, ideally, would match the subsequent payments plus any amounts withheld. Occasionally, third-party documents (i.e., the purchase order and withholding statement) are never received. In such an event, it is critical that request for these documents be made.



While a paper trail with only four components may seem trivial, it can become an avalanche of documentation when a business receives hundreds, if not thousands, of withholdable foreign payments annually. This overload increases the potential for inaccuracy and may conceal opportunities for recovery. Associating and maintaining records of all documents related to any one payment can become an administrative nightmare. It is incumbent upon businesses to maintain rigid procedures to ensure that all documentation associated with a foreign payment is received, recorded, and maintained in a manner that makes it readily available to all parties with the responsibility of ensuring withholding accuracy. However, the procedures need not be entirely manual, as enterprise applications that enable fully or partially automated recordkeeping, verification, and recovery applications of foreign withholding are becoming increasingly efficient and cost-effective.



Solution: Robust Recordkeeping Procedures and Real-Time Withholding Verification

Much like the volume of documentation, foreign payment complexities, if unrecognized, can scuttle the verification process. Partial payments, exchange rate fluctuations, the imposition of other direct taxes, and other payment process variations commonly render the process far more than a simple exercise in addition and subtraction. In particular, additional direct taxes, such as local sales and use taxes and value-added tax (VAT) amounts, can create the appearance of overpayment where none actually occurred. Unfortunately, withholding statements do not typically report these amounts. Accounting for them often requires a careful examination of documentation and local tax law in the foreign jurisdiction in question, especially if a foreign payor does not include an itemized statement detailing all amounts remitted to tax authorities and net payment, another piece of useful documentation that companies should request when available.

When copies of purchase orders and invoices are transmitted to a tax department as they are issued, it enables them to iteratively manage the onslaught of documentation, properly record invoice amounts, account for irregularities, and establish a baseline of anticipated net payments against which actual net payments received can be more readily compared. When these anticipated net payments are documented in advance, inconsistencies can be recognized as they arise, rather than creating a backlog of potential inaccuracies that year-end tax compliance might otherwise shift to the backburner, often never to be addressed.

While contemporaneous communication and transmission of withholding documentation ensure a more seamless verification process, proper backend recordkeeping is of equal importance for both compliance and verification purposes. Too often, the difficulties of day-to-day business administration allow for the mishandling or misplacement of critical documents, resulting in missing invoices, receipts, or withholding certificates. This can make it difficult or impossible for tax personnel to verify the accuracy of payment withholding. Maintaining an inventory of documentation, ensuring that all documents are received and recorded, and requesting missing copies can effectively combat this problem.

Lastly, storing all relevant records of each transaction together is of critical importance for any business that wishes to ensure that it pays only the tax it actually owes. Often, the opportunity to reclaim overpayment amounts is defeated by delays in locating all documentation related to a particular purchase. Storing these documents together, whether on paper or in electronic form, helps avoid this lag and, again, can be achieved through tax compliance enterprise software solutions.

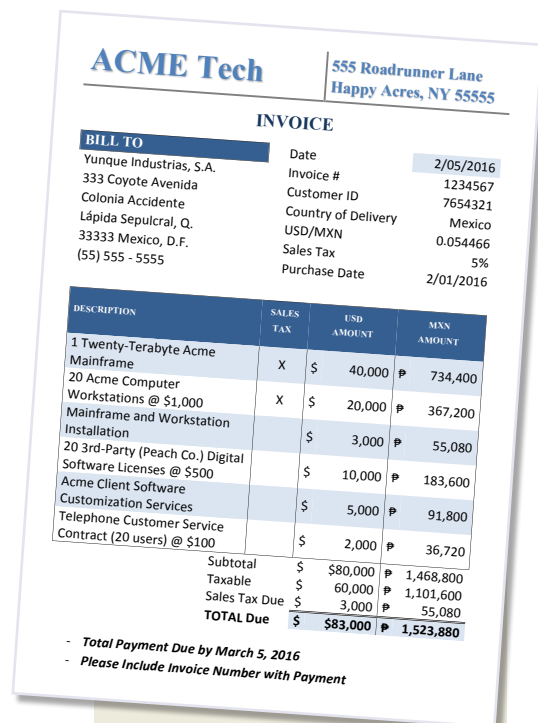
3 Poor Invoicing Procedures

Another common pitfall of foreign withholding is poor invoicing procedures, which can both result in overwithholding and complicate the verification process. Businesses often do not generate invoices with the level of detail that a withholding agent needs to determine and impose the correct withholding rate, which can lead to the withholding agent imposing incorrect rates. Further, without sufficient invoice detail readily available, tax personnel face more burdensome verification and recovery steps. In short, insufficient invoice specificity can generate overwithholding that is difficult both to detect and to substantiate in a subsequent recovery effort.

Solution: Comprehensive Invoicing

At a minimum, invoices should include the purchase order date, the price charged for the business transaction, the date of invoice issuance, the payment due date, the foreign exchange rate between payor and payee country on the date of invoice issuance, payment amounts in both local currency and that of the payee business's country of residence, and a detailed description of every item included in the purchase. Additionally, every transaction should have a unique identifier used across its corresponding purchase order, invoice, withholding certificate, and payment receipt, as this allows for simpler recordkeeping and document association.

To a withholding agent, the most critical information on an invoice is a detailed, itemized description of each item purchased. Each type of payment has its own corresponding



Ideal Invoice

An ideal invoice itemizes each component of the underlying transaction, describing each in sufficient detail to inform a withholding agent of the types of payments included and enable him to identify the applicable withholding rates. Other details that affect final net payment, such as foreign exchange rates and sales taxes, are also crucially important.



withholding rate, whether general sales and business profits, service payments, royalties, dividends, or interest. Because different categories of foreign income are subject to different withholding rates, this information is vital in determining which is applicable. The more general in nature an invoice is, the more difficult it becomes for a withholding agent to impose the correct rate. Generically describing amounts as “royalties,” “service payments,” etc. does not suffice, as countries differ greatly in their characterization of certain transactions. For example, payments for IT consultancy services are characterized as services by most foreign tax authorities. However, several characterize these transactions as the provision of know-how or company-specific business acumen and treat corresponding payments as royalties for tax purposes. In such a case, the specific nature of the services dictates a withholding rate that deviates from conventional wisdom. As such, a highly specific description of any transaction can mean the difference between accurate and inaccurate withholding.

Another common invoice complication arises when a business consolidates multiple purchase orders on one invoice or where a transaction includes multiple items that fall into different payment categories. When businesses do not itemize the components of an invoice or provide specific descriptions of each, a withholding agent may be unable to impose accurate withholding. With no means of segregating items on an invoice, the withholding agent is often left with no choice but to subject the entire payment to the highest rate applicable among the payment types on the invoice. Because withholding rates can vary wildly between payment types, this can result in significant overwithholding.

Invoices that consolidate multiple payment types are often problematic even where their components are itemized and sufficiently detailed. Some jurisdictions do not mandate that withholding agents segregate portions of an invoice for withholding purposes. Faced with such an invoice, an unscrupulous or careless withholding agent might impose the highest applicable rate upon the entire payment. This tendency is particularly problematic for businesses specializing in information technology, whose transactions often involve hardware sales, software licensing, and IT services—three separate payment types each subject to its own withholding rate. The easiest solution to this problem is to issue separate invoices for transactions with a mixture of payment types. Although this increases the administrative burden on both the business and client, it ensures that a business’s tax burden is no greater than necessary. It also creates a more robust paper trail that can be useful in an audit or recovery process.

Other Steps for Creating a Best-in-Class Withholding Tax Compliance Program

Create a Thorough and Current Knowledge Warehouse

Reliance on internal personnel to identify appropriate withholding tax rates for verification purposes adds an increased burden on already busy tax departments. Insufficient institutional knowledge frequently results in missed opportunities for relief. The daunting complexity of ever-changing foreign tax codes and superseding tax treaties often leave a business with confused or insufficient recognition of applicable withholding rates. Creating and maintaining an internal knowledge warehouse, while labor intensive and an unavoidably ongoing task, are necessary if withholding accuracy is to be verified. While the continual responsibility of maintaining thorough institutional knowledge is indeed challenging, it need not be so great that compliance is frustrating. Undertaking this challenge is a determining factor in assessing withholding accuracy.

The rate applicable to any one payment can be distilled to three pieces of information: the type of payment, the statutory rate applicable in the foreign jurisdiction, and any rate designated by an applicable tax treaty. Again, most foreign jurisdictions impose separate withholding rates on different payment categories. Consulting the tax code of a foreign country is usually simpler than one would think. Many publicly available sources report current foreign withholding rates, many of which report these amounts in English and are updated as changes are made. Consulting treaties in force is of particular importance, as they always supersede statutory rates and often provide relief from a higher statutory rate. Tax treaties in force between payor and payee country are customarily publicly available as well, often with English translations. Ensuring the competency of any English translator is necessary before relying on a translated foreign tax code or treaty, as the text of tax codes and treaties is highly complex and specific. When statutes or treaties are only available in a foreign language not easily translated, consulting a foreign tax expert familiar with the country in question may be necessary.

Maintaining a current repository of withholding rates by payment type, statute and/or treaty distinction, and by relevant foreign jurisdiction, enables a business to more readily verify the accuracy of withholding imposed on its foreign revenue. Familiarizing tax personnel with the availability of this information and assigning the responsibility of properly maintaining it can reduce the time and effort necessary to ensure that one's compliance burden has been met and that no amounts were improperly withheld.

Consider an Enterprise Solution for Withholding Tax Automation

As concern about withholding and the processes necessary to verify it grow, so too does the attractiveness of an automated foreign withholding solution that can manage remarkable tax complexity, limited resources, and the logistically complicated verification process in a timely manner. A comprehensive, automated system that encompasses data gathering, processing, reporting, compliance, and verification indeed can resolve all of the withholding risks identified here.



Tax automation can take many forms. It can be as simple as configuring a set of tax code and rates in an enterprise resource planning (ERP) system, or it can be as complex as implementing a third-party tax engine to automatically determine the taxability, tax rate, and reporting obligations for VAT, goods and services tax (GST), or other transaction taxes. However, certain taxes such as withholding tax often fall outside the scope of these solutions, representing a significant problem for multinational organizations.

While the enabling tax technology industry has grown and is delivering more sophisticated and powerful solutions, unfortunately tax technology is still misunderstood and under-utilized as an enabling tool by most tax functions. Increasingly, although technology typically falls within the realm of the IT function, the onus is moving onto the tax function to ensure that the chosen system has the right activity, mechanisms, and technology to properly process the financial information that must be reported in every business line and jurisdiction in which they operate.

In an ideal environment, international organizations would invest in a fully compliant, capable ERP solution that has applications which could keep up with the changing tax environment. Some organizations have decided on tax technology strategies that are part manual, part automated to manage their processes, tax computations, and reporting. Others have adopted complex and costly IT-based custom-built solutions to solve specific jurisdiction or tax-related issues. Many more have yet to determine their tax technology strategies, preferring to rely on inefficient and time-consuming manual processes to manage the complexities related to withholding determination and calculations. In cases where the entire financial process is manual, they are creating ongoing risk through potential exposure for under- or overwithheld taxes, interest, and penalties. Invariably, because a complete solution is so costly and hard to implement, the majority of the strategies adopted are not maximized. They typically end up only delivering 80% compliance, leaving numerous international organizations vulnerable and open to errors and inaccuracies.

Ryan Case Study

Managing Withholding Tax Complexity with SAP Solutions²

Recently, Ryan professionals successfully implemented a working solution harnessing the Business Rules Framework plus (BRFplus) Solution for automating withholding tax for a Fortune 50 global organization. The solution was among the first to be deployed in a multinational organization in more than 50 countries, functions, complex supply chains, and multilevel tax regimes, and is still successfully carrying out determination of withholding tax in more than 30 countries. In the meantime, the ERPs that accommodate withholding tax already enable a considerable reduction in the costs and labor necessary to implement and verify withholding accurately. Even small and medium-sized businesses can significantly benefit from these solutions. Carefully considering the various solutions available is a worthwhile endeavor for any business with foreign operations.

REFERENCES

¹ U.S. Trade in Goods and Services – Balance of Payments (BOP) Basis, U.S. Census Bureau. June 3, 2015. <http://www.census.gov/foreign-trade/statistics/historical/gands.pdf> (last visited January 21, 2016).

² This case study was extracted from a Ryan white paper of the same title, found here: [Managing Withholding Tax Complexity with SAP Solutions](#).

The Solution

Ryan's team of professional tax and technology experts first carried out an in-depth assessment of all existing systems and processes across all global functions and operations. Ryan also had in-depth discussions with all functional stakeholders before reviewing the various options. At this stage, Ryan considered the standard solutions with custom development and the use of third-party solutions that could work for a number of jurisdictions but not for all. The solutions reviewed were unsatisfactory—they were costly and not fully compliant with the requirements. The Ryan team knew that the recommended solution had to be a centralized solution that could be effectively maximized across all jurisdictions in which the company operated.

Although BRFplus was a relatively new system for the organization, Ryan was able to demonstrate the added value and benefits of BRFplus in comparison to the other options under consideration, including a custom-built solution.

Furthermore, Ryan highlighted the fact that as they already had the system in place, the organization only needed to build the solution within the application, thus eliminating more costs, issues with buy-in across the organization, and a lengthy project before the implementation could be deployed.

Over the next six months, Ryan worked in tandem with the organization's global operations, incorporating all business lines and global locations to develop the concept and manage the deployment of the solution in eight Latin American countries, along with Brazil—the first complex jurisdictions to go live. In the following two years, BRFplus was deployed in another 21 countries across Asia Pacific, Europe, North America, and Central America, including India, the United States, Canada, and Mexico.

Among the challenges identified were working with the individual users on the various locations and ensuring they were on board and able to use the system correctly. Ryan, therefore, focused on user buy-in and knowledge sharing with all teams in the organization, ensuring the solution was in place and working successfully in every location.

The organization is now benefitting from the many advantages of withholding tax automation using BRFplus, including less time spent by the tax teams reviewing withholding tax invoices after the fact.

Conclusion

As businesses become more globalized and as world economies become more integrated, the challenge of meeting tax burdens will only increase. Between open and closed economies, tax systems vary considerably in their laws, approaches, and mechanisms for taxing income. While the challenge of tax compliance will certainly increase as the world economy becomes more integrated, there are simple steps that businesses can take that mitigate the risks of over- and underpayment. Foreign withholding tax is one such area that need not cause as much heartburn as it does presently. Improving communication and recordkeeping between business units with withholding touch points, maximizing the utility and scope of information on sales documentation, improving institutional knowledge of foreign withholding rates, and implementing automated tax withholding solutions can significantly improve a company's compliance efforts and ensure that all revenue due a business is properly received.



About Ryan

Ryan is an award-winning global tax services firm, with the largest indirect and property tax practices in North America and the seventh largest corporate tax practice in the United States. With global headquarters in Dallas, Texas, the Firm provides a comprehensive range of state, local, federal, and international tax advisory and consulting services on a multi-jurisdictional basis, including audit defense, tax recovery, credits and incentives, tax process improvement and automation, tax appeals, tax compliance, and strategic planning. Ryan is a three-time recipient of the International Service Excellence Award from the Customer Service Institute of America (CSIA) for its commitment to world-class client service. Empowered by the dynamic *myRyan* work environment, which is widely recognized as the most innovative in the tax services industry, Ryan's multi-disciplinary team of more than 2,100 professionals and associates serves over 12,000 clients in more than 40 countries, including many of the world's most prominent Global 5000 companies. More information about Ryan can be found at ryan.com.



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