U.S. Treasury targets securities industry client tax reporting lapses; adds to fiduciary challenges

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By Richard Satran

Financial firms have long avoided giving tax advice to clients since it requires specialized expertise and the ability to review the comprehensive personal information that accounting firms examine for filing returns. But pressure may be growing on investment firms after U.S.Treasury inspectors last month identified them as the leading sector for reporting lapses.

The Treasury Department's findings could loom as a larger concern for investment firms since the Securities and Exchange Commission's Regulation Best Interest for brokers and fiduciary rules for investment advisers puts a spotlight on retail practices and retirement savings. Firms will be required to explain the level of care they offer and could face pressure to disclose more clearly under the new Form CRS Relationship Summary what their tax-advantaged retirement plans include.

A Treasury Inspector General report last month identified widespread problems in the way investment firms process payments made to the Internal Revenue Service for taxable transactions and agreed to reach out to the financial services industry to fix problems. For firms' clients the information gaps could lead to unexpected tax payments or penalties.

Best Interest, fiduciary rules could be taxing concern
While IRS issues do not rank as a top concern of financial firms' compliance, the study suggests the securities industry could face more client complaints and scrutiny from its own regulators over mishandling of tax withholding and suspicious foreign accounts.

A number of enforcement actions in recent years by the SEC and the Financial Industry Regulatory Authority showed regulators citing firms over the suitability of tax-advantaged investments, including municipal bonds and college accounts.

Regulation Best Interest and related sales practices and Form CRS require firms to take a broader view of customer care. Firms will need to consider the tax-management strategies and tax-advantaged products they offer, especially in retirement accounts.

Taxes a "critical component" of retirement savings
"Firms have avoided tax advice because it's complicated, and people handling

accounts usually don’t have a full picture of clients’ financial information,” said Mark Alcaide, of the legal compliance firm Foreside. “But firms are charging a lot for their services and I can’t see how tax impact won’t grow as a concern of regulators. If I execute perfectly on short term investments instead of long-term I have not fulfilled fiduciary responsibility.”

Tax concerns are “a critical component” of savings and should be “part of the conversation” with clients in how they manage accounts, although investment firms are not likely to change their position that it is outside their expertise,” said Alcaide. While large diversified firms are “not likely to march into the space en masse,” smaller firms could have an opening to specialize in tax-efficient practices, he added.

Firms immediate concern of “questionable” tax reporting

A more immediate concern for firms will be a new study from the IRS on financial firms’ high rate of “questionable” information returns – the reports businesses must issue on a wide range of transactions from real estate to insurance payments that fall outside payroll income.

The report found that the 81.2% of the questionable returns came from 41 payers in the brokerage and mutual fund industry. The IRS agreed with the Treasury Inspector General to contact firms to examine controls and processes to understand the cause of the problem. In addition to withholding payments, the IRS has found a significant number of suspicious accounts, poorly documented foreign accounts and accuracy of beneficial ownership data.

The IRS study could push firms to review the way they handle tax reporting more broadly – and to enter an area most would rather avoid. Investment firms often have rules restricting financial representatives from offering tax advice and typically refer questions to tax specialists.

“Nobody wants to jump into tax advice, “ said Jaqueline Hummel, a partner in Hardin Compliance Consulting LLC. “Investment advisers don’t want to take on that liability and deal with the consequences if they are wrong.”

Some will see opportunity in tax work

The immediate pressure of an IRS review of transaction reporting could be an opportunity for firms to review their exposure to tax reporting requirements. The industry has seen a growing number of investment advisers that have accountants inside their practices to offer tax-efficient portfolios or to set up trusts and other specialized accounts.

Changing sales practice rules and IRS scrutiny could become part of the review firms make of their care standards in the context of the fiduciary and Best Interest rules that take effect on June 30 next year. The SEC has focused on retail investors, which could heighten enforcement risk for firms that lack processes to protect clients, particularly those handling retirement accounts and in senior accounts where a rising wave of minimum distributions requirements will loom in years to come.

Since a large share of retail investment is parked in tax-advantaged retirement funds the pressure could grow for firms to have clear processes in place, and to understand clients' expectations in order to meet new SEC sales practice rules.

"The problem is that advisers don't know the total circumstances of their clients," said Alcaide. "A conversation is needed, but it will be hard for the industry to drive those conversations. Tax issues can be immensely complex for the firm and clients. It could be fraught for both sides."