



Securities Industry Association

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July 2, 1998

John T. Lyons,
Assistant Commissioner (International),
Internal Revenue Service,
950 L'Enfant Plaza South, S.W.,
Washington, D.C. 20024.

Re: Model Qualified Intermediary Agreement

Dear Assistant Commissioner Lyons:

On behalf of the Securities Industry Association, I am pleased to submit a proposed model qualified intermediary agreement (the "Model Agreement") that would apply to foreign branches and foreign affiliates of U.S. financial institutions.

Although the Model Agreement conforms to the requirements of Revenue Procedure 98-27 (herein, the "Revenue Procedure") in many respects, we have departed from those requirements in certain cases for the reasons discussed below. In general, where we have not followed the Revenue Procedure, we believe that the provisions of our Model Agreement are more appropriate than the corresponding provisions of the Revenue Procedure in the circumstances of a U.S.-based financial institution that is seeking to become a qualified intermediary ("QI"). We have also sought to address certain aspects of the Revenue Procedure that we believe to be problematic from the perspective of a U.S. withholding agent that is making payments to foreign-based financial institutions that have obtained QI status.

The Sections of the Model Agreement that depart from the requirements of the Revenue Procedure, or otherwise raise issues under the Revenue Procedure, are as follows:

1. Section 1. Section 1 of the Model Agreement permits a U.S. financial institution to designate one or more of its foreign branches to become QIs

under the Agreement. We do not believe, however, that the Service should be permitted to require that a U.S. financial institution designate particular foreign branches as QIs in order to include other branches within the scope of the Model Agreement, as contemplated in Section 5.01 of the Revenue Procedure.

Specifically, we believe that a U.S. financial institution is in a better position than the Service to judge which of its foreign branches have the resources necessary to become QIs and are located in jurisdictions where QI status makes sense. It is not clear to us what objective would be served by permitting the Service to require the inclusion of a particular foreign branch within the scope of the Model Agreement, and we are concerned that such a provision could effectively preclude a U.S. financial institution from becoming a QI. For example, if the Service seeks to include a branch that is located in a jurisdiction whose laws conflict in some respect with the requirements of the Model Agreement, the U.S. financial institution may not be able to comply with the Model Agreement without violating those local laws. Alternatively, in some cases, a U.S. financial institution may wish to exclude a branch that is relatively small and does not have sufficient resources to serve as a QI; if the financial institution is forced to include the branch, its ability to become a QI may depend upon whether it can make a sufficient commitment of capital and resources to that particular branch.

In addition, we note that a foreign branch of a U.S. entity that is not a QI will be required to comply with the information reporting requirements applicable to U.S. account holders in the same manner as if payments were made from a U.S. office of the financial institution. Therefore, we do not see any significant potential for tax avoidance in the event that one or more foreign branches are not included.

Second, we note that the Preamble to the Section 1441 Regulations indicates that QIs might be permitted to enter into “private arrangements”, modeled on the QI arrangement, with other intermediaries. The Revenue Procedure does not specifically mention these private arrangements. The Revenue Procedure does, however, contemplate that institutions that are unrelated to the QI and that serve as nominees, custodians or agents of persons that are customers of, and beneficial owners of income paid by, the QI may be “covered by” the Agreement. It is not clear whether this reference to unrelated institutions is intended to implement the Preamble reference to private arrangements and, if so, how an arrangement with an unrelated institution is intended to work. In particular, would the unrelated institution be a party to the QI Agreement? The Preamble does not seem to contemplate this, but the Revenue Procedure seems to imply that the unrelated institution would be a party. Further, certain procedural aspects of the arrangement are not clear, such as whether the

unrelated institution would have an exclusive arrangement with the relevant QI, or whether the unrelated institution might be a party to, or covered by, multiple QI Agreements. We would like to discuss these points with you and, in any event, we recommend that the Service provide additional guidance on the manner in which unrelated institutions are intended to participate in a QI Agreement.

Finally, we also question the need for the requirement in Section 4 of the Revenue Procedure that a financial institution applying for QI status provide a list of its officers and directors and all employees responsible for performance under the Agreement, as well as a list of assets in the United States. For most large financial institutions, these lists are likely to be extensive and difficult to compile. Further, any such lists are likely to change on a frequent basis - perhaps daily, in the case of U.S. assets - so that any list furnished at the time of application is unlikely to be entirely accurate at the time an Agreement is signed or at any point during the term of the Agreement. We recommend, therefore, that the information required for purposes of the application be limited to key employees and substantial assets or categories of assets. Further, we suggest that a financial institution be permitted to furnish, as an alternative to a list of its substantial assets, either certified financial statements or any Internal Revenue Service Forms (such as Form 5471) that the institution is otherwise required to file and that include information regarding the U.S. assets of the entities covered by the QI application.

2. Section 2(b)(ii). Section 5.02(2) of the Revenue Procedure would permit foreign branches of U.S. financial institutions, but not controlled foreign corporations or partnerships, to assume primary withholding and reporting responsibility with respect to payments made to U.S. persons. Virtually all U.S. securities firms conduct their foreign businesses through separate legal entities for regulatory reasons. Therefore, we suggest that the Service consider allowing controlled foreign corporations and partnerships to assume this responsibility in appropriate circumstances, *i.e.*, where such an entity wishes to assume the responsibility and can establish that it is capable of performing the necessary collection and reporting functions.

3. Section 2(c)(iii). The Model Agreement would permit a QI to elect to assume responsibility for information reporting and backup withholding with respect to reportable payments made to U.S. account holders, rather than furnish Forms W-9 or similar information regarding those account holders to a withholding agent. In many cases, competitive concerns may preclude a U.S. financial institution from disclosing the identities of its U.S. customers to a withholding agent. The election provided in clause (iii) would avoid the need for such disclosure to competing financial

institutions, while ensuring that proper information reporting and backup withholding occurs.

Also in this regard, some members of our Committee have expressed the concern that the Model Agreement, and indeed any qualified intermediary withholding agreement that is structured in accordance with Revenue Procedure 98-27, cannot function appropriately in a jurisdiction that imposes bank secrecy laws. This is because the QI would be forced to violate those local laws in order to comply with the disclosure requirements of the agreement. Although we recognize the Service's significant compliance concerns, we continue to believe that an appropriate solution to this problem must be found as a practical matter in order for the qualified intermediary concept to achieve its full potential.

4. Section 2(d)(iii). The Model Agreement would not require a QI to identify classes of assets held by foreign payees on a country-by-country basis. Although Section 5.02(4)(c) of the Revenue Procedure would require this, that requirement is inconsistent with the provisions of Treasury Regulations Section 1.1441-1(e)(5)(v)(B), which does not require a country-by-country allocation. Moreover, since a large financial institution may have an international customer base that represents fifty or more different countries, requiring a country-by-country allocation would impose a significant administrative burden, would be costly to implement, and would substantially eliminate an important benefit of QI status. Finally, it is not clear to us what purpose would be served by requiring a country-by-country breakdown of assets. In the absence of information regarding the identity of the payees in each country, such a breakdown would seem to be of little use for enforcement purposes. We recommend, therefore, that this requirement be eliminated from the Revenue Procedure.

With respect to the asset classes referred to in clause (A), we recommend that, subject to the agreement of a withholding agent, a QI be permitted to combine different types of income in a single class or account where all of the beneficial owners of the income are subject to the same withholding rate on each type of income. For example, a class might include assets that produce interest income and assets that produce dividend income where all beneficial owners of those assets are entitled to a 0% withholding rate on interest and a 15% withholding rate on dividends. Alternatively, a QI might agree with the withholding agent in such a case to segregate the interest-producing assets and the dividend-producing assets in separate classes or accounts.

Further, with respect to the asset classes listed in clauses (B) and (C), we note that these classes could be combined into a single class of documented U.S. payees in the case of a QI that has elected to perform information reporting under

Section 2(c)(iii) of the Model Agreement. In other cases, it would be necessary to divide these payees into two classes - exempt and non-exempt recipients - as shown in the Model Agreement so that the withholding agent could perform information reporting.

5. Section 3(a)(ii). With respect to the treatment of foreign partnerships, we note that SIA has previously commented on certain aspects of Treasury Regulations Section 1.1441-5 that we believe to be unworkable as a practical matter. (See Letter of Darryl Vines dated July 17, 1996 to the Internal Revenue Service, a copy of which is attached hereto.) In particular, we do not believe that withholding agents will be able to withhold accurately on payments made to foreign partnerships (whether directly or through a QI) if withholding agents are required to keep track of an ever-changing allocation of assets and income among the partnership's partners. For that reason, we recommended that a foreign partnership be required to become either a "full QI" or a "partial QI" as described in our July 17, 1996 letter. If a foreign partnership did not choose either of these options, payments to the partnership would be subject to 30% withholding and the partners would be able to apply for refunds of any overwithheld tax.

6. Section 3(b). As an initial matter, we do not believe that any documentary evidence standard should be subject to a penalties of perjury requirement. Such a requirement would eliminate a substantial benefit of the documentary evidence option without substantially enhancing compliance.

Second, we have not undertaken in the Model Agreement to provide guidelines on the particular types of documentary evidence that would be acceptable in each country in which a QI may be doing business. SIA members conduct securities businesses through branches and affiliates located in a large number of foreign countries - so many that it was not feasible to develop documentary evidence guidelines for relevant countries prior to the deadline for submission of model agreements.

We do intend, however, to comment on the submissions of other industry groups in this regard. In particular, we believe that the "know-your-customer" rules may vary in certain countries for different types of businesses, and we would like to discuss these differences with you at a later date. In addition, to the extent that the submissions of other groups do not cover particular countries that are important to our members, we may provide you with suggested guidelines for those countries, and we would be pleased to work with you in developing guidelines for any country if our assistance would be useful to you.

7. Sections 3(c) and 7(c). Section 5.03(3) of the Revenue Procedure would require a QI to obtain a certification from an account holder (other than an individual) that the account holder meets the requirements of the Limitations on Benefits article of any treaty that the account holder invokes and the representations set forth in Treasury Regulations Sections 1.1441-6(b)(4)(i) and 1.894-1T(d).

As an initial matter, this requirement would seem to be largely duplicative where the QI has obtained an appropriate Form W-8 from the account holder that contains a certification as to eligibility for treaty benefits. Accordingly, the Model Agreement contemplates only that the QI will obtain a representation as to eligibility for treaty benefits where the QI has not obtained a Form W-8. In addition, any such representation shall be in the form set forth on the Form W-8.

Further, the Model Agreement provides that the QI may elect whether or not to obtain this representation. If the QI chooses not to obtain the representation, then the QI must disclose the identity of the account holder to the Service upon request under Section 7(c) of the Agreement. Where the QI does obtain the representation, or has obtained a Form W-8, disclosure would not be required under Section 7(c). A requirement that the QI disclose the identity of all or a substantial number of payees, albeit on request by the Service, could result in a QI being forced to bear a significant administrative cost that should be largely unnecessary where the QI has performed its withholding and other responsibilities in reliance on a Form W-8 or other representations by each of its payees. (In fact, in some cases it is possible that the prospect of this cost could dissuade a financial institution from becoming a QI.) We do believe that a QI should be required to assist the Service in conducting a targeted audit of a particular payee in appropriate circumstances, and we believe that such cooperation would in any case be required under applicable law. We firmly believe, however, that a QI Agreement should not contemplate, as a general matter, that a QI can be required to disclose the identities of large groups of payees without substantial evidence that such disclosure is necessary for enforcement purposes.

In the event that disclosure is required under a QI agreement, we believe that the \$100,000 threshold (for annual payments of treaty-benefitted income) contemplated by the Revenue Procedure in order to identify payees subject to disclosure is far too low. For larger financial institutions, this threshold would be essentially meaningless in that it would result in a requirement to disclose all or substantially all of the institution's foreign customers. A more appropriate threshold, we believe, would be \$1 million. In the case of large financial institutions, this figure would cover most institutional investors and high net worth individuals. Thus, we believe that the Service's compliance objectives would continue to be served at this higher

threshold, while the compliance burden of a potential QI would be substantially reduced. Further, we suggest that the Service consider a higher threshold for certain financial institutions that have a customer base consisting entirely or primarily of institutional investors and other high net worth customers.

8. Section 3(d). Clause (iv) of this section provides that a QI must reach an agreement with a withholding agent to establish a separate account for assets that are attributable to a lower-tier QI that has assumed primary withholding responsibility, or otherwise to identify such assets. In this regard, we note that the mechanics for handling multiple tiers of QIs that in some cases have assumed withholding responsibility and in other cases have not are not clear under the Revenue Procedure and the Regulations. We believe that the only practical method for dealing with this situation in most cases will be the segregation of the relevant assets in separate accounts throughout the chain of payment. Additional guidance is needed, however, and in any event we believe that the method for dealing with this situation should be subject to the agreement of a withholding agent. For some withholding agents, it may be too difficult as an administrative matter to segregate these payments. Thus, we believe that this should only be required where a withholding agent can handle the administrative complexities.

We note also that our letter of July 17, 1996 discussed certain aspects of the rules of the Section 1441 Regulations relating to non-qualified intermediaries that we believe are unworkable as an administrative matter from the perspective of a withholding agent. We continue to have these concerns.

9. Section 3(f). A Form W-8 that includes a taxpayer identification number for the beneficial owner is not subject to the normal three-year renewal requirement for beneficial owner documentation (unless it relates to effectively connected income). The documentary evidence collected pursuant to Section 3(b) of the Model Agreement is intended to substitute for a Form W-8. Accordingly, such documentary evidence should also be exempt from normal renewal requirements if the QI has obtained the beneficial owner's taxpayer identification number.

10. Section 9(b). The Model Agreement would permit the use of an external auditor to audit the compliance of foreign branches. The same jurisdictional concerns that led to the adoption of the external audit rules in connection with foreign subsidiaries and foreign-based financial institutions exist in the case of foreign branches, and we believe that the exclusion of foreign branches from the scope of the external audit rules would place the foreign branches of U.S. financial institutions at a competitive disadvantage relative to foreign subsidiaries of U.S. financial institutions and foreign-based financial institutions. Further, we note that permitting external audits

of foreign branches would reduce the administrative burden to the Service of administering the QI system.

11. Section 9(d). Section 5.09(3)(d) of the Revenue Procedure contemplates that the Service would be permitted to review the workpapers of the external auditor. We are concerned that such workpapers may include information regarding customer identities that the QI is forbidden to disclose under applicable national law in some countries. Accordingly, the Model Agreement provides only that the Service will be permitted to review the procedures followed by the external auditor. Any additional provisions that might be contained in an agreement with regard to the Service's review procedures should be jurisdiction-specific, taking into account the requirements of local law regarding access to documentation.

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Please contact Patricia McClanahan of the Securities Industry Association at (202) 326-5324 with any questions you may have regarding our Model Agreement and the foregoing comments.

Sincerely yours,

Steven A. Neiss
Chairman,
Tax Compliance and
Administration
Committee

(Enclosure)

cc: Mr. Michael Danilack
Mr. Philip Garlett
Mr. Carl Cooper
Mr. Garrick Shear
Mr. John Manton
(Internal Revenue Service)

John T. Lyons

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Mr. Philip West
Ms. Patricia Brown
(Department of the Treasury)