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Re: Comments regarding “Periodic Review” Requirement under QI Agreement

Ladies and Gentleman,

The Securities Industry and Financial Markets Association (“SIFMA”)¹ is pleased to provide comments regarding the “Periodic Review” requirement under the Qualified Intermediary Agreement (the “QI Agreement”). We appreciate the efforts of the Internal Revenue Service (“IRS”) to revise the QI Agreement to reflect changes brought about as the result of the enactment of the Foreign Account Tax Compliance Act (“FATCA”).

Need for Guidance

Under the prior QI Agreement, detailed procedures (Rev. Proc. 2002-55) provided qualified intermediaries (“QIs”) and their external auditors with sufficient detail to ensure that the audit was performed adequately. We suggest that some of the specific guidance in Rev. Proc. 2002-55 should carry over to the new QI Agreement, such as the exception for smaller QI operations. Although we appreciate the IRS's legitimate compliance objectives, the scope and detail of the audits needs to be reasonable to keep costs manageable.

¹ SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over \$2.4 trillion for businesses and municipalities in the U.S., serving clients with over \$16 trillion in assets and managing more than \$62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

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1. Who performs the Periodic Review

The QI Agreement allows that the Periodic Review may be performed by either: (1) an internal auditor (employee of the QI or Compliance QI) that is independent; or (2) an external auditor. While the QI Agreement states that the Periodic Review may be performed by a combination of internal and external auditors, we believe further guidance is needed on the potential role of QI employees (or Compliance QI employees), even if such employees are not independent.

- ***Proposal 1: Allow QIs to use employees (including quality assurance teams) in conjunction with internal/external audit***
 - o As long as the auditor (internal or external) signing off on the Periodic Review has sufficient independence, it should be immaterial who performs various components of the review.
 - o Some QIs have assigned quality assurance teams (or similar internal groups) to check various components of the QI process (onboarding, withholding, and reporting). These teams may not satisfy the technical "independence" requirements set out in the QI Agreement (see QI Agreement Sec. 10.04(A)(1)). Provided the work papers and other documentation evidencing the work conducted by these teams is reviewed by the auditor, and the auditor is satisfied with the quality of such work, we suggest that the auditor should be able to rely on such work as part of its Periodic Review.
 - o The revised QI agreement envisions the use of internal auditors to perform an accurate QI audit. We think that the integrity of QI audits should not be deemed impaired in cases where employees responsible for conducting the audits report directly to the RO or otherwise have a compliance oversight role in the firm (e.g., business risk management / operational risk management / legal & compliance functions) as long as such employees are not primarily responsible for the QI documentation, withholding or reporting functions (e.g., are involved in an advisory capacity or other second line of defense capacity under Basel 3²), and work in

² <http://www.bis.org/publ/bcbs292.pdf>

business units distinct from that of the people handling the primary responsibilities. The QI Agreement should recognize that Responsible Officers (“ROs”) may be senior officials with responsibility for many independent business units that are independent of one another and capable of overseeing another unit’s work.

2. Sampling methodology

The QI Agreement states that the Periodic Review is not required to include statistical sampling procedures for testing transactions, but must require that the auditor document its methodology for sampling determinations (QI Agreement Sec. 10.05). We would like more guidance to ensure that auditors are applying an acceptable methodology.

- ***Proposal 2(a): Allow auditors to use (as a safe harbor) the sampling methodology described in Rev. Proc. 2002-55, which generally "capped" the maximum sample size to 321 accounts. See Rev. Proc. 2002-55, Audit Guidance (AG) Sec. 10.04.2-.3.***
- ***Proposal 2(b): Allow alternative for QI to rely on reasonable sampling procedures established by FI's internal audit procedures that the FI follows consistently for sampling in the course of their internal audit review framework. This approach is supported in Section 4.05 of Rev. Proc. 2002-55 which allows an external auditor to use a QI's internal audit staff and internal audit reports to any extent the external auditor chooses. Extending this rationale, a QI should be able to rely on internal audit's established procedures for sampling.***

There is a balance between accuracy and the burden of compliance, and the small increases in statistical accuracy that can be achieved by increasing sample sizes over the cap in Rev. Proc. 2002-55 are not worth the burden that will be imposed on financial firms.

3. Sampling scope

The scope of *accounts* to be sampled also needs to be defined. The QI Agreement states that the auditor must review QI’s accounts -- using a sample of the “*QI designated accounts*” – to determine if proper documentation has been obtained. See QI Agreement Secs. 10.05(A)(4)-(8). This category of accounts is too broad because it may include accounts that did not receive reportable amounts (generally, U.S. source income) during the review period. Accounts that receive no U.S. source income, however, are exempt from NRA withholding and have little relevance to the QI agreement. In contrast, accounts that receive reportable amounts are subject to the documentation, withholding, and reporting requirements of the QI Agreement.

The IRS faced the identical issue when drafting the prior audit guidelines. As explained in Rev. Proc. 2002-55, the IRS ultimately agreed with industry recommendations to limit the sample to

accounts that received reportable amounts. The IRS stated that "efficiency may be served by the initial selection of accounts based on receipt of *reportable amounts*, provided that reportable payments received in those accounts may be examined when required under the Audit Guidance." Rev. Proc. 2002-55, Sec. 4.02(i) (emphasis added). Consequently, the sample included "accounts covered by the QI Agreement," defined as accounts to which the QI made payments of reportable amounts from the QI's accounts with withholding agents that the QI has designated as QI accounts. Rev. Proc. 2002-55, Audit Guidance Sec. 10.01.1. We recommend that the IRS take the same approach with the new audit guidelines.

- ***Proposal 3(a): Samples should be drawn from accounts to which QI has made payments of reportable amounts from the QI's accounts with withholding agents that the QI has designated as QI accounts. The same approach was taken in Rev. Proc. 2002-55, AG Sec. 10.01.1.***

The QI Agreement also suggests that *separate* samples are required to perform "test checks" of the withholding rates applied. It is unclear why a different set of accounts would be required from those sampled to review documentation.

- ***Proposal 3(b): The same accounts sampled for purposes of documentation should be reviewed to determine proper withholding rates. Furthermore, only a "spot check" of such accounts should be required, similar to the standard applied by Rev. Proc. 2002-55 (see AG Sec. 10.04.7).***

4. Required tasks for the Periodic Review

The Periodic Review would require the auditor to *review procedures* and *interview employees* in order to determine if the QI has complied with client documentation and established the proper withholding rates pools. This is unnecessary if the sampled accounts demonstrate that the proper documentation is in place and the correct amount of tax has been withheld. In contrast, the prior audit guidelines did not require procedure reviews or employee interviews unless a "Phase 2" audit was required.

- ***Proposal 4: The Periodic Review should follow a similar pattern of Phase 1, 2, and 3 audits under the prior audit guidelines. Under this approach, reviews of procedures and interviews of employees would only be required under a Phase 2 audit. See "Summary of Procedures" section at the end of Rev. Proc. 2002-55.***

5. Exceptions for smaller QIs

In order to minimize costs and streamline the QI compliance process, the IRS previously has excluded smaller QIs (subject to conditions) from external audits. Smaller firms will not have the

expertise internally nor the independence to effectively conduct compliance QI reviews.

We recommend that the IRS not only *continue* the audit exclusions under prior guidelines, but also *increase the thresholds* in order to expand their scope and enhance the relief for financial institutions. The prior exclusions, and the recommended changes to the thresholds, are listed below:

- \$1,000,000 or less of reportable amounts for the audit year (Waiver One). Rev. Proc. 2002-55, Sec. 4.01(i).
 - We recommend that the IRS raise this threshold to **\$2,000,000**.
- More than \$1,000,000 but not more than \$4,000,000 (Waiver Two), available only for the second audit year of any QI Agreement term.
 - We recommend that the IRS raise these thresholds to \$2,000,000 (based on the threshold mentioned above) and \$8,000,000.
- ***Proposal 5: The IRS should continue to exclude smaller QIs from a Periodic Review requirement, similar to the audit exceptions provided in Rev. Proc. 2002-55 (Sec. 4.01).***

6. FATCA compliance covered by Periodic Review and Periodic Certification

The QI Agreement requires the Periodic Review (and the related Periodic Certification) to cover FATCA requirements under a Model 1 IGA. See Sec. 10.03(A)(2) (certification of internal controls), 10.03(D)(1) (material failure definition includes FATCA failures), and 10.04(A)(1)-(3) (internal or external auditor must consider compliance with FATCA). The primary responsibility of enforcing compliance under a Model 1 IGA, however, rests with the local tax authority, not the IRS. It does not seem appropriate, therefore, that the IRS is attempting to ensure compliance with a Model 1 IGA indirectly via the QI Agreement. Example: the IRS does not have jurisdiction under the Model 1 IGA for Canada. The IGA, along with local statutes, are the statutory foundation for compliance. Audits are done by the local authority, in this case the CRA. Additionally in Canada, the responsibility for FATCA does not directly rest with the QI; it is with the FI that maintains the beneficial owner accounts. The QI provides prescribed services to the PFI for FATCA compliance.

- ***Proposal 6: The IRS should not include compliance with an IGA Model 1 as part of the Periodic Review and Periodic Certification requirements under the QI Agreement.***

7. Timing of the Periodic Review

Under the QI Agreement, all Periodic Reviews are required to be performed for the *most recent* calendar year. QI Agreement Sec. 10.05. The Periodic Certification, however, is due the following July 1. In addition, the IRS has stated that 2014 and 2015 will be “transition years” (see Notice 2014-33).

- *Proposal 7:*

- (i) *Allow QIs to schedule periodic reviews throughout the certification period (either by QI function or location), not just the most recent calendar year, in order to coordinate with other FATCA and non-FATCA audits being performed. From a location perspective, allow flexibility to review complete locations in different years or just QI functions at a location in different years. For example, in year one of the audit cycle, the internal auditor could review the QI’s processes and procedures governing client documentation and check a sample of the forms or documentary evidence on file to ensure that the validation process is consistent with written guidelines. In year two, the internal auditor could review the withholding process. If any errors in withholding or other QI areas reviewed were disclosed in such review, the internal auditor would need to confirm if such errors had happened on a one-off basis or whether such errors were symptomatic of a systemic glitch in the withholding / other QI process overall. If the latter result applied, then the QI would agree to fix any such systemic withholding errors / other QI errors relating back to both year one and year two of the current QI audit cycle, and provide procedures to track the systemic solution. Part of the RO’s certification in the third year would include effectiveness as to the remediation process undertaken in years one and two.*
- (ii) *QIs should be permitted to request a six-month extension of time from July 1st of the year following the certification period to provide the Periodic Certification, in order to allow sufficient time for the Periodic Review to be completed.*
- (iii) *The first Periodic Certification should follow the transition years of 2014 and 2015, unless the QI has not made good faith efforts to comply. Subsequent Periodic Certifications could relate solely to the year subject to Periodic Review.*

8. QI Agreement voluntarily terminated during compliance period

Consistent with the previous audit approach, QI's voluntarily terminating their agreement prior to the conclusion of the certification period and Responsible Officer certification, will not be included in the review and RO certification.

9. Withholding on Amounts Paid to a Qualified Derivatives Dealer (QDD)

IRS Notice 2010-46 provides for an exemption from withholding on substitute dividends paid to Qualified Securities Lenders ("QSLs") in securities lending transactions. Some QSLs are QIs. However, this relief is limited to dividend paying securities. The Treasury Department has proposed to transition from the QSL regime described in Notice 2010-46 to a new and expanded Qualified Derivative Dealer (QDD) regime, as explained in the preamble to the proposed regulations under IRC § 871(m). Dividend Equivalents from Sources Within the United States, 80 Fed. Reg. 56,866, 56,877 (2015). As part of this transition, we would urge the Treasury Department to consider expanding the exemption to cover substitute interest payments on fixed income securities as well as substitute dividends.

10. Section 302 payments

The IRS and Depository Trust Clearing Corporation ("DTCC") treatment of Section 302 requirements are impractical to operationalize. The current requirement to obtain certifications from the beneficial owner is unreasonable, particularly in the case where the QI "Firm A" is to complete a certification that would include holdings from itself and QI "Firm B," and such a scenario could result in duplicative certification. We recommend that the issuer should have the requirements to determine if Section 302 applies to the specific transaction and to develop the necessary certification form blanks to be sent to end customers. It would be helpful if this issue were addressed or clarified in the final regulations.

* * *

We appreciate your consideration of our views and concerns. Please do not hesitate to contact me at 202-962-7300 or at ppeabody@sifma.org with any questions.

Sincerely,

A handwritten signature in blue ink that reads "Payson R Peabody". The signature is written in a cursive style with a long, sweeping tail on the final letter.

Payson R. Peabody
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