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Foreign Financial Institutions Affected by Proposed Changes to the Qualified Intermediary Program

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Foreign banks, foreign brokerage firms and foreign branches of U.S. banks (collectively referred to as "foreign financial institutions") should take note of changes proposed in the President's 2010 Budget "Greenbook" released on May 11, 2009, and proposed Internal Revenue Service ("IRS") regulations that will affect participation in the IRS's Qualified Intermediary ("QI") Program. Pursuant to the proposed IRS rules and possible legislative changes, foreign financial institutions participating in the QI Program may have to disclose the identities of their customers, comply with additional U.S. tax reporting obligations, and collect U.S. withholding tax when receiving payments of interest, rent, dividends or royalties on behalf of customers. If a foreign financial institution does not participate in the QI Program, payments received by the foreign financial institution from a U.S. person will be subject to 30 percent withholding.

The QI Program

Under the QI Program, a foreign financial institution becomes a QI by entering into an agreement with the IRS. A QI agrees to certify the eligibility of its account holders, without disclosing their identities, for an exemption or reduced U.S. withholding tax based on information the QI obtains regarding the country of citizenship or residency of the account holder (*i.e.*, under so-called know-your-customer rules or foreign residency certification on IRS Form W-8BEN). A QI either withholds the appropriate amount of U.S. tax from interest, rent, royalties or dividends, or advises the U.S. agent responsible for withholding and reporting to the IRS of the appropriate amount of U.S. tax to be withheld from the income.

Proposed IRS Regulations Would Affect the Operations of a QI

Under the proposed IRS regulations, the QI must notify the IRS within 60 days whenever it becomes aware of a "material" failure of its compliance with the terms of the QI agreement. Although the term "material" is not defined in the proposed regulations, an inadvertent mistake such as accidentally certifying a U.S. account holder as a resident of a foreign country would most likely be an immaterial failure, while an intentional disregard of the rules for verifying the citizenship or country of residency of an account holder could be considered a material failure of compliance with the QI agreement.

A QI will be required to establish a procedure to test accounts to determine whether a U.S. person has signature or other authority over the account with the QI. The proposed regulations do not state the characteristics a QI should look for when testing accounts for signature or other authority. One potential consequence of this testing procedure would be disclosure of the

identities of individuals who do not have a beneficial ownership in the account but have signature or other authority over the account, such as an attorney or corporate officer.

Finally, the proposed IRS regulations require the QI's external auditor to associate with a U.S. auditor for the audit of the QI. Both auditors would assume joint responsibility over the QI's external audit.

Additional Reporting Obligations for Foreign Financial Institutions that are QIs

Under the President's proposed legislative changes, a QI would be required to identify all U.S. persons who hold accounts with the QI ("U.S. account holders") even if disclosure of their identities is prohibited by local law. In addition, the QI would be required to report to the IRS all payments received on behalf of U.S. account holders including any interest, rent, royalties or dividends paid by a foreign person or company.

A QI that opens a foreign bank account on behalf of a U.S. person would be required to report to the IRS the account and initial transfers the QI makes to the account. Also, a QI would be required to report to the IRS any subsequent transfer in excess of \$10,000 made on behalf of a U.S. account holder to or from a foreign bank account. A QI that forms or acquires a foreign entity on behalf of a U.S. person would be required to file an informational return with the IRS disclosing the foreign entity.

Foreign Financial Institutions Encouraged to Participate in the QI Program

The President's proposed legislative changes also would encourage foreign financial institutions to participate in the QI Program. The purpose would be to discourage U.S. persons from holding accounts or making payments to foreign financial institutions that do not participate in the QI program.

When a U.S. party makes payments of interest, rent, royalties or dividends to a foreign financial institution not participating in the QI program, the U.S. party would be required to withhold 30 percent of the payment, regardless of whether an income tax treaty with the United States provides for a lower or exempted withholding rate on the payment. A foreign account holder qualifying for a lower or exempted withholding rate would have to apply for a refund of the excess withholding by proving to the IRS qualification for a lower or exempted withholding rate under the applicable income tax treaty with the United States.

U.S. persons would be required to report on their U.S. income tax returns transfers of \$10,000 or more to or from foreign accounts owned by the U.S. person at a foreign financial institution that is not participating in the QI program. In comparison, transfers to or from foreign accounts held at QIs would be exempt from reporting on U.S. income tax returns. A penalty equal to the lesser of \$10,000 per transfer or 10 percent of the cumulative amount or value of the transfers would apply to U.S. persons who fail to report the transfers on their U.S. income tax returns.

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