



INVESTMENT INDUSTRY ASSOCIATION OF CANADA  
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

# The Current and Future Landscape of U.S Qualified Intermediaries

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# Discussion Topics

- Self Tenders (Section 302 Events)
- Tax Free Savings Accounts
- Form W-8BEN
- QI Audits
- Basis Reporting
- Future Landscape
- Announcement 2008-98



# **Self Tenders**

## **Section 302 Events**



# Self Tenders – 302 Events

## Proposed Changes

### Contentious Issues

- Exclusion of Qualified Intermediaries
- 60 day escrow period in order to certify event treatment of all clients
- Disagreement between US depositories and withholding agents as to which events 302 is to be applied.
- No distinction of events
- DTC's decision to adopt procedures of the proposed legislation.
- Lack of issuer information in order to determine event treatment



# Self Tenders – 302 Events

## Proposed Changes

### **Primary Argument for Exclusion of Foreign Financial Institutions**

- Number of foreign owned shares of US publicly traded stock is unlikely to be of such a quantity that the owner position percentage would not decrease when shares are tendered.
  - Statistics supplied by members of the IIAC QI Committee of redemption events between January and April 2008 showed no clients would be subject to dividend treatment
  - Statistics supplied by the Association of Global Custodians showed that of their sample, only 21% of shareholders of distributing corporations were foreign, and 85% of those shareholders did not tender their shares.



# Self Tenders – 302 Events

## Proposed Changes

### Progress to Date

- IIAC submission of January 18, 2008
- IIAC presents at the public IRS hearing on proposed rulemaking in Washington DC on February 2008.
- Proposals from US entities which supported the arguments of the IIAC submission were submitted by the Securities Industry and Financial Markets Association [SIFMA], The Association of Global Custodians and Wall Street Concepts LLC.

### Current Status

Unresolved.

- Given that no final legislation has been drafted for public comment, Treasury acknowledges compliance under the current implementation date of January 1, 2009 is unlikely.
- Informal, verbal statement from senior IRS official that a 'presumption' for foreign financial institutions is under serious consideration.



# Tax Free Savings Accounts



# Tax Free Savings Accounts

- The new federally sponsored Tax Free Savings Account (TFSA) is expected to be very popular with Canadians.
- Become functional January 1, 2009.
- For brokerage firms, TFSAs are generally organized with a Trust Agreement, similar to an RRSP or RESP sponsored by a Trustee.



# Tax Free Savings Accounts

## Properties

- TFSA accounts do not have any unique status under the Canada/US Tax Treaty; are not pension trusts and therefore foreign distributions earned in the accounts are still subject to foreign withholding tax, including US withholding tax at the Canadian Treaty rate.



# Tax Free Savings Accounts

## QI Documentation

- Accounts must be documented for US purposes to receive treaty rates.
- TFSA accounts may be likely interpreted by the IRS as Grantor Trusts.



# Tax Free Savings Accounts

## QI Documentation Preference

### Summary: IIAC Position

- Members feel that the requirements for the Form W-8IMY and withholding statements for Grantor trust arrangements are unnecessary and create an unreasonable burden for QIs offering TFSA's structured as trusts.
- Members believe that given the legislative restrictions of the product, and the regulatory obligations already in place, it is both practical and logical to treat such accounts as accounts for individuals for QI purposes, and apply the Canadian KYC rules.



# Tax Free Savings Accounts

## QI Documentation Preference

- Until clear direction is received from the IRS, QIs must use their own discretion in determining their documentation requirements
- Currently, either the Grantor Trust option or the Individual option are planned by the QI community members.



# Form W-8BEN



# Form W-8BEN

## Proposed Changes

- Mandatory Foreign Tax Payer ID
- Restriction on Power of Attorney
- **Status Update**
  - Unresolved



# QI Audits



# QI Audits

## Revenue Procedure 2002-55

### Background- 2002 Audit

- Phase I – Information fact finding -
  - Requires documentation, withholding and reporting reviews only
- Phase II – Additional fact finding
  - Reviews not dealing with documentation, withholding and reporting although additional account testing may be required
- Phase III – Meet with IRS;
  - Fines, penalties and potential determination of extrapolation



# QI Audits

## Application for 2005 Audits

### Background- 2005 Audit

- Under 3% - No extrapolation
  - QI owes under withheld amount, interest on that amount, plus a failure to deposit penalty
- 3% to 5% - Probable Phase II additional testing
  - If additional testing confirms the first sample error rate, extrapolation likely
- Over 5% - Confirmed extrapolation



QI Audits

Recent IRS Announcements

September 2008

**For Error Rate Over 3% -  
Confirmed Extrapolation**



# QI Audits

## Extrapolation Example

- Assume a QI has a population of 50,000 direct non-U.S. accounts and a sample size of 321
- Assume, further, that during the course of the external audit 10 accounts are determined to be undocumented
- and the corresponding liability on those 10 accounts is \$10,000,
- and that the QI is able to cure all 10 accounts.



# QI Audits

## Extrapolation Example- con'td

- $\$10,000 \text{ liability} / 321 \text{ sample size} \times 50,000 \text{ population} = \$1,557,632 \text{ liability}$
- Will also be subject to interest and penalties
- Deduct \$10,000 for the cured accounts
- = \$1,547,632 projected tax payable



# QI Audits

## Other Potential Impacts

- The QI may have an opportunity to defend the remaining population that is the subject of the QI audit, in order to mitigate the projected tax due.
- However, that process may still result in additional auditor review and costs.



# Basis Reporting



# Basis Reporting New Rules

- New rules passed into law October 3, 2008 requiring brokers that issue Forms 1099-B for dispositions to report –
  - Cost base of securities sold, and
  - Whether gains are long term or short term
- Phased-in effective dates –
  - Jan 1, 2011 for stock in a corporation
  - Jan 1, 2012 for stock in open-end mutual funds and dividend reinvestment plans
  - Jan 1, 2013 for other securities
- Applies to securities –
  - acquired in the account on or after effective date, and
  - transferred to the account if basis information was received from transferor



# Basis Reporting

## 1099-B Reporting By QIs

### **Requirements for QI that is a non-US payor**

- Dispositions of US securities if sales are “effected” inside the US
- Dispositions of non-US securities if payment is “made” in the US

### **Requirements for QI that is a US payor**

- Essentially all dispositions for US non-exempt recipients (US and non-US securities)



# Basis Reporting

## Sales “effected” inside the US

- Under Treas. Reg. 1.6049-5(e), even if sale is completed at an office of broker (including QI) outside the US, sale will be considered effected inside the US in the following situations:
  1. Client opened an account with a US office of the broker;
  2. Client has transmitted instructions concerning this and other sales to a foreign office of the broker from within the US by mail, phone, electronic transmission or otherwise (unless isolated and infrequent);
  3. Gross proceeds of sale are paid to an account maintained in the US or mailed to client at an address in the US;
  4. Confirmation of sale is mailed to the client as an address in the US; or
  5. An office of the broker within the US negotiates the sale with the client or receives instructions from the client



# Basis Reporting

## Where payment is “made”

Under Treas. Reg. 1.6045-1(g)(3)

- Payment is considered to be made at the branch of the financial institution where it is credited to the client’s account, or
- Payment is deemed to be made in the US if client regularly contacts the financial institution from within the US



# Basis Reporting

## General conclusion re 1099 reporting requirements

- In most cases, payment will only be “made” in the US and sales “effected” in the US if US non-exempt recipient client actually lives in the US and regularly contacts QI from the US
- If true, QI generally required to 1099 report world-wide income and sales proceeds, and if undocumented, apply backup withholding for US residents other than US exempt recipients



# Basis Reporting Non-Withholding QIs

- QI that has NOT assumed backup withholding and 1099 reporting responsibility continues to be responsible for 1099 reporting of “reportable payments” (which include foreign source income and sales proceeds) unless another payor has agreed to undertake such withholding and reporting and QI is not aware of any failure by the payor to withhold and report



# Basis Reporting Highlights

- Must report in accordance with US rules which generally require FIFO method in US dollars
  - Canada uses average cost and translates cost into Canadian dollars at time of purchase
  - Further complicated by US rules that allow –
    - Different methods to potentially be applied to different types of assets
    - Individuals to elect to use different methods
  - US tax implications of Corporate Actions may differ from non-US treatment
- Must separately report short- and long-term gains



# Basis Reporting Highlights

- Short sales to be reported when sale is closed
- Reporting for options granted or acquired after December 31, 2012
  - Reporting on lapses or closing transactions in options on securities or on exercise of cash settled options
  - Premium related to acquisition of option is treated as an adjustment to gross proceeds from the subsequent sale or as an adjustment to client's cost base
- Filing deadline extended to February 15 from January 31
- Person that transfers securities to a broker must provide basis information in written statement within 15 days of transfer



# Basis Reporting

## Still to come

- IIAC QI Committee has made various submissions to US Senate, House and Treasury seeking an exclusion for QIs until there has been further consultation
- Treasury still needs to issue supporting regulations – should be released in draft form for discussion first
- IIAC will seek relief through the regulations



# Future QI Landscape



# Future QI Landscape

## Recent Reports

- Recent reports have raised concerns about weaknesses in existing QI rules that have allowed US taxpayers to avoid US tax
  - GAO Testimony to Senate Finance Comm – May 2007
  - GAO Report to Senate Finance Comm - Dec 2007
  - GAO Report - July 2008
  - Joint Committee on Taxation Report - July 2008
  - Permanent Subcommittee on Investigations Report – July 2008
- IRS committed to making changes to strengthen US information reporting rules and obligations of QIs



# Future Landscape

## Identified weaknesses and gaps

- QIs are not required to report the identity of corporate owners and beneficiaries of complex trusts
- QI auditors are not required to follow up on indications of fraud or illegal acts
- Data IRS needs to effectively administer QI program not readily available or no longer exists
- IRS does not make effective use of data it receives from withholding agents to ensure they perform duties properly
  - 2003 reporting of \$7 billion by US withholding agents and QIs to “unknown recipients” and “undisclosed countries” with only 3.4% tax withheld
- US owners of foreign corporations, trusts, etc have obligations to report these interests but with no independent 3<sup>rd</sup>-party reporting, compliance is poor



# Future Landscape

## Possible Changes

- Require QIs to identify and report to the IRS the US beneficial owners of offshore companies, trusts, etc
- Require QIs to report all income and gains to all US non-exempt recipients
- Require QIs to report to US exempt recipients
- Require more electronic filings of forms
- Expand scope of QI audits – e.g., include all accounts that receive Reportable Payments even if no Reportable Amounts; Additional testing and reporting related to US non-exempt recipients
- Require auditors to report indication of fraud and other serious compliance issues



# Future Landscape

## What will change and when?

- Changes could be effected through a number of options –
  - Changes to the Internal Revenue Code
  - Changes to the Regulations
  - Changes to QI Agreements - IRS can change at any time
  - Changes to Audit Guidelines (Revenue Procedure)
  - Directors' Memorandum
- Phase 1 – Announcement 2008-98
- What's next and when???



# Announcement 2008-98



# Announcement 2008-98

Proposed Changes to the QI Agreement [Rev Proc 2000-12]

Proposed Changes to the QI Audit Guidelines [Rev Proc 2002-55]

## Changes to the QI Agreement [RP 2000-12]

- Proposed changes will make it mandatory for a QI to report any material failure of internal controls relating to the performance and compliance under the QI Agreement. Failure to report such material failures within 60 days will constitute an event of default.
- ‘Internal Controls’ refers to the activities of QI personnel charged with oversight of performance under the QI Agreement and the authority given them to prevent, deter and detect intentional or unintentional errors in performance and compliance of the QI Agreement.
- ‘Material Failure’ of said Internal Controls refers to the lack of personnel, activities or authority to detect, deter and prevent; intentional errors detected by such personnel and unintentional errors detected by such personnel.



# Announcement 2008-98

Proposed Changes to the QI Agreement [Rev Proc 2000-12]

Proposed Changes to the QI Audit Guidelines [Rev Proc 2002-55]

## **Changes to the Audit Guidelines [RP 2002-55]**

Proposed changes include:

- Phase 1 fact finding for evaluation of risk
  - Review of ‘account holders file’ to determine if a US person has control over the foreign account.
  - Report facts and circumstances observed in the course of an audit which will help the IRS to determine if the QI is or may become in material failure of internal controls.
  - Report personnel and positions held of those with oversight of performance and compliance under the QI Agreement.
- Audit Oversight and Review by a U.S. Auditor



# Announcement 2008-98

Proposed Changes to the QI Agreement [Rev Proc 2000-12]

Proposed Changes to the QI Audit Guidelines [Rev Proc 2002-55]

## Specific Concerns

- **Proposed Changes to the QI Agreement [RP 2000-12]**
  - The definition of ‘material failure’ is open to interpretation and must be more clearly defined.
  - The requirement to list personnel responsible for compliance is unrealistic.



# Announcement 2008-98

Proposed Changes to the QI Agreement [Rev Proc 2000-12]

Proposed Changes to the QI Audit Guidelines [Rev Proc 2002-55]

## Specific Concerns

### Proposed Changes to the Audit Guidelines [RP 2002-55]:

- The proposed definition of ‘account holders file’ is all encompassing and will add considerable time in both audit preparation and review.
- The requirement of a QI auditor to report facts and circumstances with no specific guidance as to what facts and circumstances should be regarded as pertinent to the evaluation of risk would seem to force the QI auditor into making subjective observations and decisions.
- If a U.S. presence is noted on the foreign account it will immediately trigger a Phase II inquiry.



# Announcement 2008-98

Proposed Changes to the QI Agreement [Rev Proc 2000-12]

Proposed Changes to the QI Audit Guidelines [Rev Proc 2002-55]

## Status

- IRS request for comment February 28, 2009
- Engage other interested foreign Associations



**Questions?**

