



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

February 26, 2009

CC:PA:LPD:PR (Announcement 2008-98)  
Room 5203  
Internal Revenue Service  
P.O. Box 78604, Ben Franklin Station  
Washington DC 20044

**Re: Announcement 2008-98 “Proposed Amendments to Qualified Intermediary Withholding Agreement and to Audit Guidance for External Auditors of Qualified Intermediaries” (the “Proposed Amendments”)**

The Investment Industry Association of Canada (“**IIAC**”) appreciates the opportunity to submit its comments to the Internal Revenue Service (“**IRS**”) and the Treasury Department (“**Treasury**”) on the Proposed Amendments.

The IIAC is Canada’s equivalent to the Securities Industry and Financial Markets Association (“**SIFMA**”) in the United States, and represents over 200 investment dealers across Canada. The IIAC QI Committee is responsible for reviewing and commenting on proposed amendments to U.S. qualified intermediary (“**QI**”) legislation, regulation and policies, and develops positions on practical and conceptual matters surrounding U.S. tax reporting requirements, including audits and QI forms.

**GENERAL RESPONSE TO THE PROPOSED AMENDMENTS**

The IIAC was disappointed to receive notice of the Proposed Amendments to the Qualified Intermediary Agreement, Appendix, Rev. Proc. 2000-12, 2000-1 C.B. 387 (the “**QI Agreement**”) and to the Guidance for External Auditors of Qualified Intermediaries, Appendix, Rev. Proc. 2002-55, 2002-2 C.B. 435 (the “**Audit Guidance**”). While it is understood that the intent of these amendments is to “ensure that qualified intermediaries (QIs) are taking the steps necessary to comply fully with their obligations under the QI agreement”, it is the IIAC’s position that the majority of Canadian QIs invest significant resources to ensure high levels of compliance with their obligations, and additional costly and time-consuming requirements are not necessary in order to ensure continued compliance.

Furthermore, we believe that the requirements contained in the Proposed Amendments, which may be of assistance in increasing compliance in some jurisdictions, will be unduly burdensome for Canadian QIs and their external auditors. The new requirements imposed by the Proposed Amendments will create additional costs that will ultimately be borne by QIs, and will not likely result in a measurable reduction in the US “tax gap”. The application of the Proposed Amendments to all QIs, instead of only to those proven to have need of more stringent compliance requirements, unfairly penalizes compliant QIs in jurisdictions with existing high standards and transparent processes.

*The IIAC’s general recommendation is that it will be more effective for the IRS to recognize the differences between jurisdictions and to deal with foreign jurisdictions separately, using and enforcing existing provisions. When irregularities in compliance are found within certain jurisdictions, additional restrictions and procedural changes can be isolated within those jurisdictions, instead of requiring already compliant QIs to incur significant additional costs that will not generate increased US tax revenue or compliance with the QI Agreement.*

#### **A. PROPOSED AMENDMENTS TO QI AGREEMENT**

##### **1. Addition of “Material Failure of Internal Controls” as “Significant Change in Circumstances” in Section 11.03**

The IIAC has a number of concerns related to the Proposed Amendment to add new section 11.03(F) to the QI Agreement.

###### **(i) Inappropriate inclusion of a “material failure of internal controls” as a “significant change in circumstances”**

It is the IIAC’s view that it is inappropriate to add a “material failure of internal controls” to the list of changes in circumstances. The changes in circumstances currently identified in section 11.03 of the QI Agreement are changes of a relatively permanent nature that have an ongoing impact on the operations of the QI, such as an acquisition of the QI’s assets, changes in applicable laws, and changes in the QI’s business practices that affect the QI’s ability to meet its obligations under the QI Agreement. Events that are described in the proposals as being a “material failure of internal controls” reflect a failure to adhere to a policy or procedure, rather than a change in policies or procedures and would generally occur on an exception basis and as a result of errors. If a provision related to a material failure of internal controls is to be added to the QI Agreement, such a provision should be included in section 11.04 as an “event of default” which “occurs if QI fails to perform any material duty or obligation required under this Agreement”.

**(ii) Necessity to add a provision related to a “material failure of internal controls”**

It is unclear why there is a need to add a provision related to a “material failure of internal controls”. Section 11.04 of the QI Agreement already includes as an “event of default”, a QI’s failure “to implement adequate procedures, accounting systems, and internal controls to ensure compliance” with the QI Agreement. The effectiveness of the combination of procedures, accounting systems and internal controls is tested every three years when the QI undergoes an audit. If the results of the audit testing do not indicate that the QI is failing to comply with its obligations under the QI Agreement, it should be reasonable to conclude that the procedures, accounting systems and internal controls that the QI has implemented are adequate to ensure compliance. If the results of the audit testing indicate that procedures, systems and controls may have failed, there are provisions within the existing Audit Guidance to enable the IRS to request that the auditors carry out additional procedures to review internal controls as part of Phase 2 of the audit.

If a failure of internal controls leads to under withholding of tax or a failure to file forms and report on a timely basis, there are other provisions within section 11.04 which would include these as events of default under the QI Agreement. If a failure of internal controls does not lead to under withholding or failure to file forms, it could be argued the failure should not be regarded as a material failure.

**(iii) Definition of “material failure of internal controls”**

Proposed new section 11.03(F) indicates that the term “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 and unintentional errors in performance on the part of other operational personnel” and that a “material failure of internal control” refers to lack of such activities, personnel or authority, to any intentional errors in performance of the QI agreement...and to unintentional errors.... The definition of “material failure of internal controls” is overly broad and inclusive, and is open to a number of different interpretations. The definition as drafted would include issues that are immaterial, such as unintentional clerical errors made by staff providing financial services to customers. The proposed amendment should exclude the word “material” when describing the types of activities that indicate “failures of internal controls” and separate guidance should be provided with respect to what would constitute a “material” failure – i.e., the words underlined above should describe a “failure of internal control” rather than a “material failure of internal control”.

*The IIAC recommends that proposed new section 11.03(F) be removed on the basis that existing provisions of the QI Agreement make the Proposed Amendment unnecessary. In the event that the IRS still feels that it is necessary to make amendments to the QI Agreement to address a “material failure of internal controls”, the proposed changes should be added to section 11.04 such that a material failure*

would be regarded as an “event of default” rather than a “change of circumstances”, the term “failure of internal controls” (excluding the word “material”) should be more clearly defined, and guidance be added to indicate what the IRS might consider to be a “material” failure of internal controls.

**2. Addition of “Failure to Notify the IRS of Material Failure of Internal Controls” as “Event of Default” in Section 11.04**

It is the IIAC’s position that it should be unnecessary for a QI to self report a failure of internal controls to the IRS. A failure of an internal control will not necessarily result in a failure on the part of a QI to comply with its obligations under the QI Agreement. However, if a failure of internal controls leads to under withholding of tax or a failure to file forms and report on a timely basis, there are existing provisions within section 11.04 which would treat these occurrences as events of default under the QI Agreement. Material failures that are not cured by the QI should be identified during a QI audit.

As a result of the flaw in the currently proposed definition of “material failure of internal controls” which results in all failures being included regardless of actual materiality and magnitude, proposed new section 11.04(X) would require QIs to notify the IRS of all events, regardless of true materiality, and whether or not it is determined that the failure actually resulted in a failure to properly withhold and report under the terms of the QI Agreement, and regardless of whether or not the failure has been corrected.

*The IIAC recommends that the Proposed Amendment to add new section 11.04(X) be removed. If our recommendation to remove proposed new section 11.04(X) is not adopted, we recommend that the proposal be amended such that the QI only be required to notify the IRS of confirmed failures of internal controls that actually result in a “material” amount of under withholding of tax, with a definition or guidelines provided with respect to the determination of “material”.*

**B. PROPOSED AMENDMENTS TO AUDIT GUIDANCE**

**1. Identification and Reporting of US Persons with Authority over Non-US accounts in Section 10.03(A)(5)**

Amending the QI Audit Guidance to add audit procedures that would test certain accounts for characteristics that suggest a US person has authority over the account would create a disproportionately large burden for the QI in preparing the files for audit, and would increase the time and cost of an external audit without any apparent additional benefit being derived.

Under the current terms of the QI Agreement, provided the QI has complied with other provisions of the QI Agreement (including section 5.10), the existence of a US person with authority over an account where the account holder is not a US person does not create any special obligations for the QI and is not an indicator that the QI has failed to comply with any of its obligations under its QI Agreement.

We understand that the IRS has indicated in various public forums that additional changes that will impact QIs are forthcoming, including changes with regards to looking through entities to the underlying owners. However, until amendments are actually introduced which change the compliance obligations of QIs with respect to US persons that have authority over an account, we feel that it is premature to introduce audit procedures and reporting related to these anticipated future amendments.

*The IIAC recommends that the Proposed Amendment to section 10.03(A)(5) of the Audit Guidance be removed until such time as the QI Agreement is amended to require the QI to perform additional procedures for non-US accounts that have a US person with some form of authority over the account.*

## **2. Identifying QI Personnel Charged with Oversight of QI Agreement in Section 10.03(E)**

It is not clear what purpose is served by amending the Audit Guidance to “identify the persons charged with oversight of the performance under the QI agreement and the authority given to them to prevent, deter, detect and correct such failures on the part of other operational personnel”.

If the audit procedures carried out in Phase 1 of the audit do not identify any significant issues regarding a QI’s compliance with its QI Agreement, these findings should provide a strong indication that the QI has adequate procedures, systems and internal controls in place to ensure compliance, and it should be unnecessary for the auditors to perform additional fact gathering procedures for the purpose of allowing the IRS to evaluate the risk of a material failure of internal controls.

If the Phase 1 audit procedures identify issues or concerns regarding the QI’s compliance, the existing Audit Guidance contains provisions which permit the IRS to request that the auditors perform additional procedures as part of Phase 2 of the audit, including identifying and interviewing employees responsible for certain QI compliance-related activities.

It is the IIAC’s position that identifying the names of QI personnel as part of Phase 1 of each audit is inappropriate as there will always be issues of turnover, requiring a constant updating of information. We believe that ensuring a QI’s compliance with the QI Agreement is more dependent upon the implementation, maintenance and monitoring of an infrastructure that incorporates positions that include QI oversight

roles and responsibilities, than the particular individuals in those roles – i.e., the scope of a position mandate is more critical than the individual that fills the position.

*We recommend that the Proposed Amendments to sections 10.03(E).1 and (E).2 of the Audit Guidance be deleted and that the IRS use existing provisions in the Audit Guidance to instruct the auditors, where the findings in Phase 1 indicate that additional review is required, to gather additional information in Phase 2 regarding controls, procedures and employees responsible for performing procedures that ensure compliance with the QI Agreement.*

*In any event, if information is required as to the “significant actions” taken to “prevent, deter, detect and correct errors in performance of the QI agreement”, a clearer definition of “significant actions” will be required. External auditors require clear procedures, and will not likely be able to comply with changes that require subjective judgment (e.g., determining what actions qualify as “significant”).*

### **3. Audit Oversight and Review by U.S. Auditor in Section 10.02.3**

The IIAC believes in the importance of the role of the external auditor to the QI system, and the need for auditors to be objective, accountable and knowledgeable about US withholding tax rules. However, it is not clear how the accuracy and accountability in the audit process with respect to Canadian QIs would be enhanced through the association of a US auditor, and through the requirement to have a US auditor accept joint responsibility for the performance of the procedures under the Audit Guidance.

The reasons for the inclusion of new section 10.02.3 to the QI Audit Guidance have not been clearly articulated, and the need for the association of a US auditor has not been demonstrated with respect to Canadian QIs. This provision essentially puts the onus on QIs to deal with the perceived inability of certain non-US auditors to perform effective and independent audits. The new requirement will have a significant impact on the cost of the audit process, which can only be interpreted by QIs as a form of penalty which should more appropriately be borne by auditors, if and when it is shown that they are not able to carry out the performance of the procedures under the Audit Guidance to the satisfaction of the IRS.

If the aim of this proposed amendment is to cure unacceptable audit practices in certain jurisdictions, provisions to deal with this non-compliance already exist within the QI Agreement. Acceptable auditors are listed in Appendix B of the QI Agreement, and section 10.02 of the QI Agreement gives the IRS the right to reject a proposed external auditor if, at the sole discretion of the IRS, it reasonably believes that the auditor is not independent or cannot perform an effective audit under the QI Agreement. There should be no need to amend the Audit Guidance to require a US auditor to be associated or to accept joint liability, but merely a need to enforce the provisions that already exist.

If the IRS has specific issues with the performance of certain audit firms or with audit firms in certain jurisdictions, it would be far more reasonable and effective for the IRS to deal with these firms and jurisdictions directly rather than with a "broad brush" approach that will place onerous requirements upon all firms and all jurisdictions and impose the burden of increased audit costs on QIs.

Finally, it is not clear what advantage could be gained by associating a US auditor or requiring a US auditor to accept liability for an audit completed by a Canadian audit firm, given that they would be following the same procedures, causing unnecessary expense as the US auditors would likely be completing duplicative tasks in order to satisfy their requirements.

*The IIAC recommends that the proposed amendments to add section 10.02.3 of the Audit Guidance requiring the association of a US auditor be removed, and that the IRS focus its efforts on enforcing its existing right to approve external auditors under the QI Agreement. Again, this is an issue that may be best addressed on a jurisdiction-by-jurisdiction and firm-by-firm basis.*

### C. EFFECTIVE DATE OF AMENDMENTS

The Announcement indicates that the Proposed Amendments are to be effective for calendar years beginning after December 31, 2009.

*It is the IIAC's position that changes to the Audit Guidance should be effective the year following the year in which changes to the QI Agreement take effect. It would be inappropriate to have changes to the Audit Guidance apply to an audit of the 2009 year that takes place in 2010.*

As we anticipate that other changes to the rules affecting QIs are expected in the near future, we reserve the right to make additional comments after additional proposals are released. It is with these anticipated changes that we make our final recommendation:

*The IIAC strongly recommends that a direct and more frequent means of communication be established between US Treasury, the IRS and the global QI community. It is recommended that such a forum take place prior to the drafting and release of proposed changes to the QI Agreement [Revenue Procedure 2000-12] or Audit Procedures [Revenue Procedure 2002-55]. Such a forum would provide US Treasury and the IRS with a platform in which to discuss their issues, intentions and expected results, while also giving the QI community the opportunity to comment on the impact of proposed changes within their jurisdictions and to offer alternative solutions. We believe such a forum would expedite this process in that once proposed changes are drafted, all sides have had input into the final result.*

The IIAC appreciates the opportunity to provide you with these comments and would very much like to meet with the IRS to discuss our position and recommendations. Alternatively, the IIAC QI Committee is available to answer any questions that you might have, or to speak with you at any time to clarify and expand on these comments in the Canadian context.

Sincerely,

A handwritten signature in black ink that reads "J Rando". The signature is written in a cursive style with a large, stylized "J" and "R".

Jack Rando,  
Director, Capital Markets  
Investment Industry Association of Canada  
[www.iiac.ca](http://www.iiac.ca)