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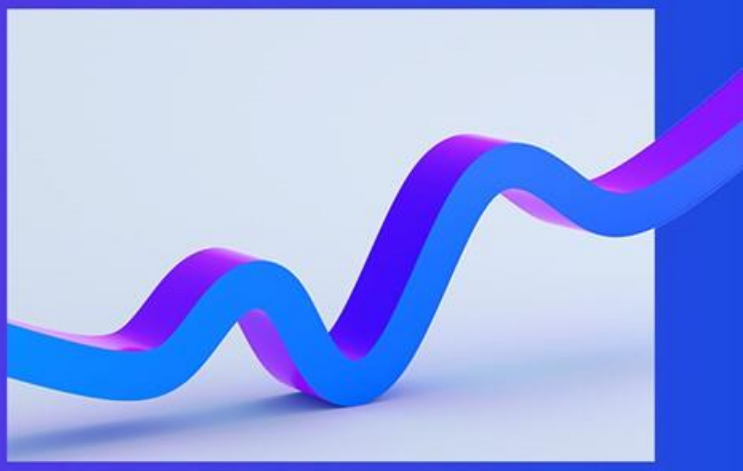

Back to Basics: The Origin of the Qualified Intermediary Program

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In the 1990s, the IRS acknowledged that sophisticated tax avoidance schemes and administrative burdens had resulted in extensive noncompliance, causing the withholding system to fall short of its goals. The IRS sought to revamp the system by standardizing and simplifying the reporting process, but needed to ensure that responsible entities would be fully aware of their obligations and equipped to handle their compliance burdens. Thus, the Qualified Intermediary program was born. In *Back to Basics: The Origin of the Qualified Intermediary Program* we review the developments that led to the emergence of the program and the creation of the QI agreement. In later installments, we will dive deeper into the requirements that QIs are tasked with when entering into these agreements with the IRS, and how the program has evolved to incorporate different reporting regimes.

Background

Before the Qualified Intermediary (QI) program was established, withholding agents were tasked with collecting certification forms through tiered intermediaries in order to identify tax residency for the purpose of withholding and reporting. Further complicating the matter, different standards were used across the varying payments. The tiered, decentralized approach meant that tax savvy individuals could use the system to their

advantage to avoid taxes. Likewise, withholding agents unfamiliar with the intricacies of the nuanced regime often failed their due diligence obligations. This resulted in underwithholding and ultimately underpaid taxes. The IRS recognized that cross-border transactions had increased significantly over the years, and that payees were readily deploying schemes to avoid taxation altogether. Thus, the IRS overhauled its withholding regime and implemented a new system, shifting reporting obligations to foreign intermediaries that it deemed to be "qualified."

High-level Overview of Withholding Rules

Sections 871(a) and 881(a) subject nonresident aliens (NRAs) and foreign corporations to 30% tax on most U.S. sourced income, aside from income effectively connected with a trade or business in the U.S. This includes interest, dividends, royalties, compensation, other fixed or determinable annual or periodical (FDAP) income and certain gains. Chapter 3 generally requires this tax to be collected at the time of payment. Notably, withholding at source occurs under section 1441(a) for payments to NRA individuals and foreign partnerships and under section 1442(a) for payments to foreign corporations. However, a withholding rate of 30% does not necessarily correlate to the applicable income tax rate, as treaties and other provisions of the code may reduce or exempt tax altogether.

A foreign payee that has had a payment subjected to the statutory 30% rate of withholding and that is eligible for a lower income tax rate is considered to be overwithheld upon and may seek a refund (e.g., an NRA individual may submit Form 1040-NR to claim overwithheld amounts). This process may be burdensome and costly for foreign investors and locks up capital that the investor would likely prefer to reinvest. Thus, the withholding provisions allow withholding agents to apply a reduced withholding rate when permitted by applicable tax provisions or income tax treaties. As the reduced withholding rate is contingent on the type of income and the status of the taxpayer, a withholding agent is only permitted to apply the reduced rate if it obtains the appropriate documentation. Withholding agents making U.S. source payments to foreign individuals and entities are also required to adhere to reporting rules (Forms 1042-S). In addition, withholding agents must also observe reporting and withholding rules when making payments to certain domestic payees. Notably, under section 3406 a payee that fails to provide its Taxpayer Identification Number (TIN) to the payor may be subject to backup withholding.[1] The current backup withholding rate is 24% (in the late 1990s that rate was 31%). As section 3406 reportable payments are defined primarily through domestic reporting provisions, foreign payees are generally exempt from backup withholding. However, the exemption is contingent on the payee providing a withholding certificate verifying its foreign status.

Section 1441 Overhaul

In the 1990s, documentation was problematic, as requirements varied drastically by type of payment. For most payments, the foreign beneficial owner was required to provide the withholding agent with an early version of Form W-8, *Certificate of Foreign Status,*[2] or Form 1001, *Ownership, Exemption, or Reduced Rate Certificate*,[3] a simplistic form that captured a wide array of payment types that was ultimately replaced by the Form W-8 series. The rules occasionally created disparate standards for the same payment type, depending on whether the payment was being made to a domestic or foreign payee. For example, a U.S. broker redeeming a short-term obligation held by a foreign financial institution (FFI) was permitted to exempt the

[1] For detailed information on backup withholding responsibilities, see the May 20, 2022, blog article, *Backup Withholding – IRS Notices and Payor Responsibilities* at https://tax.kpmg.us/insights/irw-tax-ops-quick-tips-updates.html.
[2] See the 1991 Form W-8 at https://www.irs.gov/pub/irs-prior/fw8--1991.pdf.
[3] Form 1001 was phased out through use of the Form W-8 series, beginning in 1999. See Form 1001 at https://tax.kpmg.us/content/dam/tax/en/pdfs/2023/form-1001-expired-1999.pdf. See 1999 Instructions for Form 1042-S at https://www.irs.gov/pub/irs-prior/i1042s--1999.pdf. The IRS granted transitory relief, permitting continued use for certain forms through the end of 2000. See T.D. 8856 at https://www.irs.gov/pub/irs-regs/td8856.pdf.

payment from both backup withholding and the 30% tax on NRA individuals. The FFI could then forward the payment to a foreign payee without any additional documentation but, if the payment was sent to a person through a U.S. office, the FFI fringilla sapien. Class aptent taciti sociosqu ad litora torquent per conubia nostra, per inceptos himenaeos. was required to obtain a certification.[4] In addition, documentation could change the nature of the payment, as interest on registered obligations would not be considered portfolio interest unless the withholding agent received a statement that the beneficial owner was not a U.S. person.[5]

Despite of, or due to, the nuanced documentation rules, an FFI would often provide the certification form in its own name even when it was acting as an intermediary. Further, a foreign beneficial owner seeking a reduced rate for dividends did not need to provide certification of foreign status. Rather, the withholding agent merely had to ensure that the beneficial owner's address was in a treaty country in order to apply a reduced withholding rate. As with the tax certificates, in practice, withholding agents were reducing the withholding on dividend payments made to FFIs based on their treaty address, unaware that they were not the beneficial owners.

The IRS noted that the reduced rate at source regime was still desirable, as it limited the need to apply refund procedures and decreased the administrative burden and costs for both the IRS as well as foreign investors. The IRS pointed out that the success of the regime was dependent on withholding agents performing compliance functions properly, including collecting documentation and substantiating claims of foreign status and reduced withholding. However, the IRS was well aware of the issues discussed above and recognized that the proliferation of cross-border economic activity would escalate problems within the system. Accordingly, the IRS sought a way to standardize the system to ensure equitable treatment and streamline administrative obligations. This led to an overhaul of the section 1441 withholding regime, beginning with the issuance of proposed regulations in 1996 (the 1996 Prop. Regs.).[6]

The 1996 Prop. Regs. proposed to establish much more robust documentation requirements in order for a foreign person to obtain a reduced rate of withholding at source. It also described the possibility of certain foreign intermediaries being able to enter into agreements with the IRS (making them "qualified intermediaries"). By entering into such an agreement, a withholding agent would be able to rely on documentation and certifications from the intermediary (only) rather than requiring all of the underlying beneficial owner documentation. Likewise, the proposal permitted an upstream intermediary to rely on documentation and certifications from a downstream QI, without the need for the downstream QI to pass up all of the documentation for the account holders for which it acted. Per the proposal, the QI would need to agree with the IRS to obtain certain documentation or certifications as specified under the agreement, along with other proposed requirements. Later that month, the IRS issued Announcement 96-23,[7] proposing the application procedures that foreign persons would need to follow in order to enter into a QI agreement. Interestingly, this early version contained a proposal for the IRS to periodically publish a list of QIs with valid, terminated, and suspended withholding agreements.[8] The section was removed in the final version of the procedures, but the concept of a published QI List resurfaced in the 2022 QI agreement and is currently being developed by the IRS.

Without the QI regime, implementation of the proposed withholding and reporting regime would prove to be problematic. Per IRS guidance, "In the case of multiple financial institutions between the beneficial owner and the person otherwise required to withhold, this certificate must be given by each financial institution to the one

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[4] For a complete discussion on this issue, see 61 FR 17614, *General Revision of Regulations Relating to Withholding of Tax on Certain U.S. Source Income Paid to Foreign Persons and Related Collection, Refunds, and Credits; Revision of Information Reporting and Backup Withholding Regulations; and Removal of Regulations Under Part 35a and of Certain Regulations Under Income Tax Treaties* at https://www.federalregister.gov/documents/1996/04/22/96-8936/general-revision-of-regulations-relating-to-withholding-of-tax-on-certain-us-source-income-paid-to.

[5] See *id.*

[6] See *id.*

[7] See Announcement 96-23 in Internal Revenue Bulletin 1996-18 at https://www.irs.gov/pub/irs-irbs/irb96-18.pdf.

[8] See *id.*, Section 5: Listing of QI's.

above it in the chain."[9] Thus, to qualify for certain exemptions and reduced rates of withholding, each intermediary in the chain would be required to pass up the requisite underlying beneficial owner documentation, along with complex withholding statements that, among other things, were required to allocate the payments to each of the beneficial owners. The Institute of International Bankers (the Institute) had pointed out that this arrangement was impermissible in many countries for privacy reasons, as foreign banks are subject to the bank secrecy laws of each jurisdiction.[10] In fact, some countries prohibit disclosure of a bank's customers' identities even where a valid waiver is provided from the customer, enforceable through civil and criminal penalties. In addition, foreign banking tends to occur in competitive circles. Requiring an FFI to pass client information through tiered structures opens the entity to competitive poaching by upstream entities. Commentators pointed out that the rules would lead to full withholding at the default rates, followed by application of the refund procedures, or a failure to properly withhold. After considering the plethora of industry commentary, the IRS pushed forward, adopting the comments as necessary, and began developing the new Qualified Intermediary program.

Introduction of the QI agreement

Following extensive discussion, the building blocks of the regime began taking shape a year later when the final regulations were released in October 1997 (1997 Final Regs.).[11] Announcement 96-23 was replaced in April 1998 by Rev. Proc. 98-27,[12] setting forth final guidance on the procedures required to apply to become a QI. Early versions of the application procedure were fairly rudimentary, requiring applicants to mail the IRS a letter containing a request to enter into an agreement, along with specifics that would demonstrate that the entity would be able to fulfill the documentation, withholding, and reporting requirements. Eligible persons could also setup conferences with the IRS to discuss the application prior to submission. Given the number of agreements expected under the QI program, this was clearly going to be an onerous task for IRS representatives. Fortunately for both sides, this process evolved significantly over the years, as the IRS shifted the application to an official standardized form[13] (and then, today, to an online application system).[14]

Initially, the IRS also requested that applicants provide their own proposed QI agreement (granted the proposal had to meet specifications provided by the IRS). In tandem with Rev. Proc. 98-27, the IRS published Notice 98-16,[15] restating its intent to apply the QI program broadly to as many FFIs as possible. To further this goal, the IRS announced that it would be issuing a series of model agreements, each of which would apply to a class of persons. Any person falling within that class would be able to accept, sign, and submit the agreement to the IRS without the need for individual negotiations. At the time, the IRS envisioned that separate model agreements would be created for specific countries, or groups of countries with similar laws and practices. Thus, the IRS set forth a path to transition from individually negotiated agreements to a standardized, unilateral, agreement.

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[9] See Temp. Reg. § 35a.9999-5(b), A9 at https://www.govinfo.gov/content/pkg/CFR-2000-title26-vol14/pdf/CFR-2000-title26-vol14-sec35a-9999-5.pdf.
[10] For further details, see the September 16, 1996, letter from the Institute of International Bankers to the IRS, *Re: Proposed Regulations Relating to Withholding Taxes, Information Reporting and Backup Withholding Tax on Payments Made to Non-U.S. Persons.*
[11] See T.D. 8734, *General Revision of Regulations Relating to Withholding of Tax on Certain U.S. Source Income Paid to Foreign Persons and Related Collection, Refunds, and Credits; Revision of Information Reporting and Backup Withholding Regulations; and Removal of Regulations Under Part 35a and of Certain Regulations Under Income Tax Treaties* at https://www.federalregister.gov/documents/1997/10/14/97-25998/general-revision-of-regulations-relating-to-withholding-of-tax-on-certain-us-source-income-paid-to.
[12] See Rev. Proc. 98-27 at https://www.irs.gov/pub/irs-drop/rp98-27.pdf.
[13] See Form 14345, *Qualified Intermediary Application* at https://www.irs.gov/pub/irs-utl/58766k11.pdf.
[14] See the IRS webpage *Qualified Intermediary (QI), Withholding Foreign Partnership (WP), and Withholding Foreign Trust (WT) Application and Account Management System* (known as QAAMS) at https://www.irs.gov/businesses/corporations/qualified-intermediary-system.
[15] See Notice 98-16 at https://www.irs.gov/pub/irs-drop/n-98-16.pdf.

A year later, the IRS determined that a series of model agreements, constructed separately for different classes of persons and countries, was unnecessary and issued a proposed model agreement in Notice 99-8.[16] Following industry and professional feedback, the IRS decided that it would supplement the model agreement with "know-your-customer" rules for each country and make other specific adaptations only if necessary. Finally, in 2000, the IRS issued Rev. Proc. 2000-12,[17] setting forth the first QI agreement. The application procedures eventually merged into the same document setting forth the QI agreement.

Going Forward

The QI program has evolved significantly over the past two decades as the IRS has broadened its scope and incorporated new reporting regimes. To ensure continued adherence to the rules laid out in the QI agreement, the IRS has implemented a Responsible Officer Compliance Program requirement, yet still requires regular internal or third-party reviews. In later installments, we will discuss the evolution of the program, new forms of intermediaries, and the reporting requirements that QIs must perform.

[16] See Notice 99-8 at https://www.irs.gov/pub/irs-drop/n-99-8.pdf.
[17] See Rev. Proc. 2000-12 at https://www.irs.gov/pub/irs-drop/rp-00-12.pdf.

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