

Qualified Intermediary regime

A change in the political climate in the US is heralding proposed changes to the qualified intermediary (QI) regime which could mean that for:

"Investors who use financial institutions that do not agree to be qualifying intermediaries ... the assumption will be that these institutions are facilitating tax evasion, and the burden of proof will be shifted to the institutions and their account-holders to prove they are not sheltering income from US taxation."

US Treasury Press Release, 2009

The current system

The current QI rules were established in 2001. Initially criticised as time consuming and bureaucratic it has become an established part of the US tax system.

The rules impose US withholding tax (WHT) and collection requirements on those within the programme. Broadly speaking, most brokers, wealth managers and intermediaries who receive income from US securities, on behalf of their clients, are likely to be affected.

Failure to obtain or retain QI status can mean that relevant income payments will be subject to the full 30% US WHT, rather than reduced treaty rates.

Audit

The QI will be periodically subject to an external audit to provide assurance to the Internal Revenue Service (IRS) that QI status should be retained. Typically an audit will be conducted in the second and fifth years of a QI agreement. The external auditor must submit the audit report to the IRS by 30 June of the year following the year of audit.

Detailed guidance is provided by the IRS to ensure that audits are carried out to their satisfaction. This prescriptive method and in-depth discussion with the industry resulted in the creation of a three stage process. The number of stages

required to be fulfilled depends on the results of the previous stage.

The regime in essence encourages a high level of internal audit as those clients with good operating systems may only be required to perform one stage of the audit, saving both time and money. The role of the external auditor is to report their findings directly to the IRS who in turn will make the decision about whether a further audit stage is required. The three stages can be summarised as follows:

Stage 1

This consists of statistical sampling and comprehensive review whereby a sample of accounts will be selected and checked for errors. This will entail checks on withholding rate pools, inspection of Forms 1042, W-forms, other informational forms and the processes that show non-disclosed US persons have been correctly treated.

Stage 2

During this stage further investigation is required into the causes of any errors identified in stage 1 and the QI will need to provide details of the remedial action taken to correct these errors.

Stage 3

This is only required if the IRS are not satisfied with the previous results and requires a direct meeting with the QI.



Waivers

There are cases where the QI may seek an exemption from audit if certain conditions are met. However even in these cases work will still need to be performed by external auditors to verify that the necessary conditions have been met.

President Obama's proposed changes

A number of political changes in the last couple of years has led the US administration to question the effectiveness of the current QI regime. President Obama and many US Senators have made their intentions clear to clamp down on those who evade tax by placing funds offshore.

Signal of intent

This political determination was highlighted when it was recently announced that an additional 800 tax agents would be recruited to focus solely on international tax enforcement, with savings alone from these proposals forecast to reach nearly \$9 billion over 10 years. International tax enforcement measures, greater co-operation and a clamp down on tax havens are envisaged to be cornerstones of this reform.

US Investors

The proposals seek to significantly expand the reporting and compliance obligations for QIs in respect of their US non-exempt account holders. At the same time it seeks to push those who have invested with a non-qualified intermediary (NQI) to invest with approved QIs.

The proposed changes are designed to significantly expand the work required in the first phase of the audit, requiring new procedures and tests to be performed to ensure that there are no US persons behind seemingly non-US owned accounts. Under the previous regime some QI's used certification showing non-US status via a foreign nominee to establish the non-US status of a beneficial owner, even in the case that the QI knew that the actual beneficial owner was a US person.

New regime

Increased reporting

There may be increased WHT reporting requirements which will require subsidiaries of a QI, through their WHT reporting, to declare both US and non-US securities.

Changes to the internal audit function have also been proposed which will now require the auditor to report on the controls which exist at the QI. This will include personnel details, operational responsibilities and details of action. The

QI will now be required to have specific employees responsible for the oversight of the performance under the QI agreement and to ensure that they take steps to prevent, deter, detect, and correct failures.

There is a risk that W8 forms may have to be completed for all investors in a non-US fund. This would be unworkable for a retail fund.

Penal treatment of NQIs

All income paid to a NQI may be subject to 30% WHT. Substantively the US will have moved from a 'gross payments' jurisdiction to a 'tax reclaim' jurisdiction.

In tightening the requirements of the QI agreement, the IRS is seeking to ensure that any intermediary not registered as a QI and not in a country with suitable money laundering procedures will be hit with a 20% WHT charge on sale proceeds.

Entities in groups could be significantly affected and to avoid the negative consequences of not being in the QI regime, require a holding company to register as a QI.

Fund Managers/Funds

There is a risk that Fund Managers could now come under the QI regime as they could be classed as 'intermediaries'. Following the above, and assuming that they do not have QI status, this could lead to the punitive 20% WHT charge on sale proceeds.

Transparent funds may be severely disadvantaged by treaty obligations and in some cases lead to the 20% WHT charge on sale proceeds.

Lobbying

There is intense lobbying from industry on these proposed regime changes and it is therefore important to note that the proposed changes to the regime have not yet been finalised and are still in draft form.

"If these proposed changes to the QI regime are enacted in their present form, the major implications will be seen through a greatly expanded QI regime, more stringent rules for those who are in the regime, greater penalties for non-compliance and penal treatment for those who are non-QIs."

Our services

Our knowledge of the QI regime and experience of QI audits enables us to offer client specific advice with respect to an audit and to best prepare clients for this changing regime's requirements. The increased scrutiny will necessitate greater internal controls and procedures and our service offerings will allow QIs to comply with these standards.

Entry in to the QI regime

For those who are currently not registered as QI's, we can offer guidance on the impact of the proposed changes on your business, and if necessary guidance on registering as a QI.

Audit Services

We offer a full QI audit service with experience in a number of different financial intermediaries.

Waiver requests

For those entities who fall within the waiver boundaries we can prepare the waiver requests. This process will still require a limited review.

Staff training

To minimise the risk of failure we can help provide your staff with guidance on QI terms and definitions, presentations of the required documents and QI forms to ensure the best controls are in place.

We can also provide guidance under both the current and proposed system, as well as advice for the transitional period.

US presence

Through our US member firm we have extensive capabilities and industry knowledge in the US. Additionally, our working relationship with the IRS allows us to gain further insight into the regime through client specific negotiation.

Timeframe

There is no set date for this new regime but it is envisaged to come in to force some time in 2010.

Contact us

If you would like to discuss any of the matters raised in this release further, please contact one of our Financial Services experts:



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