

## Part III - Administrative, Procedural, and Miscellaneous

### Proposed Amendments to Qualified Intermediary Withholding Agreement and to Audit Guidance for External Auditors of Qualified Intermediaries

Announcement 2008-98

#### PURPOSE

This announcement sets forth, and solicits public comments regarding, proposed amendments that the IRS intends to make to the Qualified Intermediary Agreement, Appendix, Rev. Proc. 2000-12, 2000-1 C.B. 387 (QI agreement), and to the Guidance for External Auditors of Qualified Intermediaries, Appendix, Rev. Proc. 2002-55, 2002-2 C.B. 435 (QI Audit Guidance). These amendments are intended to ensure that qualified intermediaries (QIs) are taking the steps necessary to comply fully with their obligations under the QI agreement. These amendments are proposed to be effective for calendar years beginning after December 31, 2009.

#### BACKGROUND

In Treasury decision 8734 (1997-2 C.B. 109 [62 FR 533871]), the Treasury Department and the IRS issued comprehensive regulations under chapter 3 (sections 1441-1464) and subpart G of Subchapter A of chapter 61 (sections 6041-6050S) of the

Internal Revenue Code (the 1441 regulations). A key element of the 1441 regulations was the QI system. A QI is a foreign financial institution that has agreed with the IRS to undertake certain U.S. withholding and reporting responsibilities and has agreed to audits by an external auditor. Currently, several thousand foreign financial institutions have become QIs.

The 1441 regulations generally became effective January 1, 2001. Since that time, the IRS, U.S. withholding agents, QIs and external auditors have gained experience in applying those regulations.

In light of this experience, the IRS intends to amend the QI agreement and the QI audit guidance as follows:

(1) Notice of Material Failure of Internal Controls. A QI's compliance with the QI agreement depends in large part upon the QI's internal controls, i.e., the QI's own oversight of its performance under the agreement. To ensure compliance with the QI agreement, the QI must ensure that specific employees are responsible for oversight of the QI's performance under the agreement, and those employees must take steps to prevent, deter, detect and correct failures in performance.

Accordingly, the QI agreement will be amended to provide that a QI must notify the IRS whenever the QI becomes aware of a material failure of internal controls relating to its performance under the QI agreement, any employee allegations of such failures, or any investigation by regulatory authorities of such failures. Although any such failure may represent a significant change in circumstances that would give the IRS the right to terminate the QI agreement, the IRS does not contemplate

automatically terminating a QI agreement by reason of such notice. Instead, the IRS expects prompt notification to enable the IRS and the QI to work together to remedy such failures so that consideration of termination will not be necessary.

(2) Phase 1 Fact Finding for Evaluation of Risk. While the external auditor's initial fact finding in phase 1 of the QI audit provides much information that would enable an IRS examiner to evaluate risk, certain additional information is necessary to enable the IRS to assess the risk that foreign accounts may be subject to control by U.S. persons. Additional information is also needed to enable the IRS more accurately to assess the risk of a material failure of internal controls.

Accordingly, the QI audit guidance will be amended to add an audit procedure testing certain accounts for characteristics that suggest that a U.S. person has authority over the account. This information would enable the IRS in phase 2 of the audit process to evaluate the risk of any failure of controls and if necessary to request that the external auditor perform additional audit procedures.

The QI audit guidance will also be amended to add additional procedures for fact gathering by the external auditor relating to the IRS's evaluation of the risk of a material failure of internal controls. These procedures will include, for instance, identifying the persons charged with oversight of performance under the QI agreement and the authority given them to prevent, deter, detect and correct such failures on the part of other operational personnel. The external auditor will be required to report any facts or circumstances observed in the course of its audit that reasonably relate to the evaluation by the IRS of the risk of a material failure of internal controls.

(3) Audit Oversight and Review by U.S. Auditor. The QI system relies upon external auditors. The reliability of the external auditor depends upon the internal controls embedded within the audit process. A key feature of such controls is oversight and review by persons that are objective, accountable and knowledgeable about U.S. withholding rules.

Accordingly, the QI audit guidance will be amended to require the external auditor to associate a U.S. auditor with the audit and to require the U.S. auditor to accept joint responsibility for performance of the procedures under the audit guidance. The aim in joining a U.S. auditor is to assure appropriate application of U.S. withholding rules and to enhance accuracy and accountability in the audit process.

#### AMENDMENTS TO QI AGREEMENT

Pursuant to section 12.02 of the QI agreement, the IRS proposes to amend sections 11 of the QI agreement as follows:

(1) Section 11.03 of the QI agreement to add new section 11.03(F) to read as follows:

\* \* \* \* \*

Sec. 11.03. Significant Change in Circumstances. \* \* \*

(F) A material failure of internal controls relating to its performance under the QI agreement, any employee allegations relating to such material failures, or any investigation by any regulatory authorities relating to such material failures. 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 or unintentional errors in performance on the part of other operational personnel. The term “material failure of internal controls” refers to lack of such activities, personnel or authority, to any intentional errors in performance of the QI agreement detected by such personnel, and to unintentional errors detected by such personnel that appear to have originated with or been initiated by operational personnel charged with directly conferring with and providing financial services to customers.

(2) Section 11.04 of the QI to add new section 11.04(X) to read as follows:

\* \* \* \* \*

Sec.11.04. Events of Default. \* \* \*

(X) QI fails to notify the IRS of any material failure of internal controls described in section 11.03(F) within 60 days of discovery of its occurrence.

\* \* \* \* \*

#### AMENDMENTS TO QI AUDIT GUIDANCE

The IRS proposes to amend sections 10.02, 10.03(A)(5), and 10.03(E) of the QI Audit Guidance as follows:

(1) Section 10.02 of the QI Audit Guidance to add new section 10.02.3 to read as follows:

\* \* \* \* \*

10.02.3 Associating U.S. Auditor. Any external auditor that is a foreign person or foreign accounting firm or foreign branch or associated accounting firm of a U.S. accounting firm and that conducts an audit or any part of an audit under section 10 of

the QI Agreement must associate a U.S. accounting firm or a U.S. branch or U.S. associated accounting firm with the QI audit, and the U.S. accounting firm, U.S. branch or associated U.S. accounting firm must accept joint and several liability for the conduct of the QI audit and must cosign the audit report. The U.S. auditor shall footnote in the phase 1 external auditor's report any facts or circumstances observed in the course of its oversight and review that reasonably relate to the evaluation by the IRS of the risk of a material failure of internal controls.

\* \* \* \* \*

(2) Section 10.03(A) (5).1 to revise the first sentence of Step 9, to add new Step 9(e) and new Step 10(c); section 10.03(A) (5).2 to add new Report 10(e); section 10.3(E).1 to add new Steps 2 and 3; and section 10.03(E).2 to add new Reports 2 and 3 and to revise Report 11 to read as follows:

\* \* \* \* \*

10.03 (A)(5).1 \* \* \*

Step 9: For each account determined to be documented under Steps 3 through 8, examine the most recently updated information for the audit year drawn from the account opening statement, any other account documents or memoranda, any account correspondence associated with the account, any documents, reports or other information generated or received for purposes of anti-money laundering, know-your-customer, tax or other laws, and any other account information (for purposes of this section, "the account holder's file"). \* \* \*

(e) The account holder's file shows that a U.S. person or a person within the

United States has signature or other authority (including authority to withdraw funds, trade, give instructions, or receive account statements, confirmations or other information, notices, advice or solicitations with respect to the account), or has given or received a power granting such authority to or from a foreign person.

Step 10: \* \* \*

(c) For each account included in Step 10 (a) and (b), determine whether the account holder's file shows that a U.S. person or a person within the United States has signature or other authority (including authority to withdraw funds, trade, give instructions, or receive account statements, confirmations or other information, notices, advice or solicitations with respect to the account), or has given or received a power granting such authority to or from a foreign person.

\* \* \* \* \*

10.03(A) (5).2: \* \* \*

Report 10: \* \* \*

(e) Described in Step 9(e).

Report 11: The number of accounts described in each of (a), (b) and (c) of Step 10.

\* \* \* \* \*

(3) Section 10.03(E) to add new section 10.03(E).1 Step 2 and new section 10.03(E).2 to add new Report 2 to read as follows:

\* \* \* \* \*

10.03(E).1 \* \* \*

Step 2: Identify the QI personnel charged with oversight of performance under the QI agreement, their posts of duty, job descriptions and the persons to whom they report and the positions of those persons within the QI's organization. Determine the extent of the authority of such QI personnel over other operational personnel of the QI. Identify any significant actions to prevent, deter, detect and correct errors in performance of the QI agreement (including examinations, auditing and testing procedures, investigations, and training conducted) taken by such QI personnel since the last QI audit year. Determine whether QI has any procedures in place for receiving and investigating allegations of material failures of internal control by QI employees.

Step 3: Review whether any facts or circumstances observed in the course of its audit reasonably relate to the evaluation by the IRS of the risk of a material failure of internal controls.\* \* \*

10.03(E).2 \* \* \*

Report 2: Report the information collected in Step 2 in list format.

Report 3: List and describe any facts or circumstances observed in the course of its audit that reasonably relate to the evaluation by the IRS of the risk of a material failure of internal controls.

\* \* \* \* \*

#### REQUEST FOR COMMENTS

The IRS and Treasury Department request comments regarding the proposed amendments to the QI Agreement and the proposed amendments to the QI Audit Guidance.

Comments should be submitted on or before February 28, 2009, and should include a reference to Announcement 2008-98. Send submissions to CC:PA:LPD:PR (Announcement 2008-98), Room 5203, Internal Revenue Service, P.O. Box 78604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Announcement 2008-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044, or sent electronically, via the following e-mail address: [notice.comments@irscounsel.treas.gov](mailto:notice.comments@irscounsel.treas.gov). Please include "Announcement 2008-98" in the subject line of any electronic communication. All material submitted will be available for public inspection and copying.

#### DRAFTING INFORMATION

The principal author of this notice is Kay Holman of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Kay Holman at (202) 622-3840 (not a toll-free call).