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U.S. Withholding Tax Rules

The Internal Revenue Service (the "IRS") recently issued final regulations that completely overhaul U.S. withholding tax procedures. These regulations could have a significant impact on Canadian investment dealers, particularly those that acquire U.S. securities on behalf of their customers.

In order to minimize any disruption created by the final regulations, each Canadian investment dealer should understand exactly how it will be affected. Generally, the new rules are to be effective beginning January 1, 1999. What follows is a general discussion of these new regulations. Members should consult their professional tax advisors should they require more detailed information.

Scope of the new U.S. withholding tax procedures

In general terms, the new withholding tax procedures apply when a non-U.S. financial institution receives income (i.e., interest and dividend payments received) from U.S. securities, with certain exceptions, on behalf of its customers.

New customer documentation requirements

The new procedures generally will require a Canadian investment dealer to obtain a separate IRS Form W-8 or acceptable "documentary evidence" from each beneficial owner (which would include each partner in the case of a partnership) of U.S. securities in order to prevent the application of excessive U.S. withholding taxes. The Canadian investment dealer would then forward a copy of each Form W-8 (or documentary evidence) to the relevant U.S. financial institution (such as a foreign custodian bank). Furnishing such documentation will permit withholding at lower treaty rates or exempt withholding altogether for most interest payments. The current "address rule" for dividends (which permits treaty rate withholding based on the shareholder's address) is repealed.

Option of becoming a qualified intermediary

Instead of following the new documentation procedures outlined above, a Canadian investment dealer may (under the new procedures) enter into a withholding agreement with the IRS and become a "qualified intermediary". As a qualified intermediary, a Canadian investment dealer would be permitted to:

- (1) obtain documentation from customers under any applicable "know your customer" procedures; and provide the U.S. financial institution with only a single Form W-8 completed by the Canadian investment dealer, thus not disclosing the customer's identity.

The IRS has indicated, however, that qualified intermediaries will be required to disclose the identity of individual U.S. customers (and certain other U.S. persons) to the U.S. withholding

agent. In addition, the identity of certain non-U.S. entities claiming treaty rate withholding may need to be disclosed to the IRS to verify that the entity qualifies for benefits under the treaty.

Potential "model" withholding agreement for Canadian investment dealers

In light of the benefits of being a qualified intermediary, the FAS Tax Subcommittee and FAS Operations Subcommittee have established a joint working group (the U.S. Withholding Tax Working Group) to, among other things, develop a "model" withholding agreement for use by all Canadian investment dealers seeking qualified intermediary status.

Additional issues

The new IRS rules are extremely long and complex, affecting various other cross-border transactions. Other significant issues include the following:

- *Limited taxpayer identification number ("TIN") requirement to claim treaty benefits for certain payments.* The final rules require persons claiming the benefit of lower treaty rate withholding to obtain TINs from the IRS. Payments relating to publicly traded stocks and debt obligations, securities lending transactions, and certain other payments are excluded from this rule. Related party payments, however, are subject to this requirement if treaty rate withholding is claimed.
- *Securities lending transactions.* Final rules were also issued relating to "substitute" interest and dividends resulting from securities lending transactions. The IRS subsequently issued Notice 97-66 to provide relief from some of the more controversial aspects of these rules
- *Authorized foreign agents.* Non-U.S. persons may act as "authorized foreign agents," thus assuming a U.S. withholding agent's compliance requirements.

U.S. Withholding Tax Working Group

As mentioned above, the U.S. Withholding Tax Working Group has been established to provide direction to Member firms in dealing with this new legislation. At its first meeting, the working group agreed to the issuance of this bulletin, informing all Member firms of the importance of these legislation changes, and to the performance of a survey, to solicit issues of concern to all Member firms. The IDA working group has now joined together with the Canadian Bankers Association to form a joint group to deal with this issue. The working group intends to meet on an ongoing basis throughout the winter and spring months to develop, among other things, a model withholding agreement for the use of those Members interested in becoming a Qualified Intermediary and recommendations on the operational changes that need to be performed at each Member firm to accommodate these changes.

Any questions on the above should be addressed to Keith Rose, Vice President, Regulatory Policy at (416) 943-6907.

Lyn M. Gilchrist
Association Secretary

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