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For distribution to relevant parties within your firm

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U.S. Withholding Tax Rule Amendments

On March 4, 1998, Bulletin No. 2448 was issued to inform you of changes to the regulations governing U.S. withholding tax procedures. This bulletin is being issued to update a number of U.S. withholding tax issues that have been studied over the last number of months by the CBA/IDA U. S. Withholding Tax Working Group.

Implementation date for new regulations

At the time the bulletin was issued, it was the intention of the U.S. Internal Revenue Service ("IRS") that these new regulations be effective January 1, 1999. The IRS has stated publicly that there will be no further extension past **January 1, 2000**.

Option of becoming a Qualified Intermediary ["QI"]

As previously stated in Bulletin No. 2448, rather than comply with the onerous documentation requirements set out in the new regulations, a Canadian investment dealer has the option to enter into a withholding agreement with the IRS and become a Qualified Intermediary ["QI"].

What is a QI?

Basically, a QI is a non-U.S. financial institution which has agreed to become a withholding agent under U.S. tax law. It will perform certain procedures as required by the IRS to determine which of its customers are subject to information reporting as U.S. persons and which of its non U.S. customers are entitled, under statute or income tax treaty, to reduce rates of withholding on payments of income from U.S. sources.

How do I become a QI and should I become a Primary Withholding QI or a Non-withholding QI?

As previously stated in Bulletin No. 2448, the FAS Tax Subcommittee and the FAS Operations Subcommittee established a joint working group called the U.S. Withholding Tax Working Group whose major purpose was the development of a model withholding agreement for use by all Canadian investment dealers seeking Qualified Intermediary status. This working group has since agreed to work jointly with industry representatives from the Canadian Bankers Association ("CBA") through an expanded working group known as the CBA/IDA U.S. Withholding Tax Working Group. The joint working group, with the assistance of its consultants

Deloitte & Touche and Tory Tory DesLauriers & Binnington, has developed a proposed model withholding agreement to be used by Canadian financial institutions. This proposed agreement was submitted to the IRS for their review on July 6, 1998. At this point we are still awaiting communication back from the IRS to start the discussion of the proposed model agreement. Once the necessary revisions have been made, a Canadian investment dealer will be able to submit the model agreement to the IRS with its QI application. (Copies of the draft model agreement are available upon request from the IDA.)

As part of the deliberations of the working group a review of the type of QI a Canadian investment dealer may become was performed. It was determined that a dealer would likely choose to be one of two QI categories as follows:

1. A Qualified Intermediary that is performing the primary withholding function [known as a "Primary Withholding QI"]. This type of QI would generally receive payments at a rate of 100%, and remit any applicable withholding taxes directly to the IRS. As well, the prescribed tax filings would be completed by this type of QI or a person designated by the QI and forwarded directly to the IRS.

OR

2. A Qualified Intermediary that is not performing the primary withholding function [known as a "Non-withholding QI"]. This type of QI would receive payments from a U.S. Withholding Agent net of tax. The U.S. Withholding Agent would be responsible to remit the tax to the IRS on behalf of the QI. The QI or a person designated by the QI would still have to complete the prescribed tax filings and forward them directly to the IRS.

While the decision to become either a Primary Withholding QI or a Non-withholding QI is to be made by each dealer based on an assessment of which category is best for them, the working group is of the view that, for most dealers, becoming a Primary Withholding QI will not add significantly to the reporting requirements of the firm. Of course the major advantage of becoming a Primary Withholding QI is the opportunity to receive 100% of all U.S. sourced payments and to quickly pass these payments along to the dealer's customers, subject to withholding the appropriate amount of tax. Another significant issue in this decision process is the future role of CDS that is contemplated in the following section.

CDS Role under the QI Regime

CDS, for DTC and ACCESS securities, is currently reviewing their role of acting as the compiler of the information for all participants, and providing the prescribed withholding information to Harris Bank, who is currently the US Withholding agent for CDS participants. Under a proposal being discussed by the Working Group, CDS would no longer offer any services, except to maintain the bank account at Harris Bank, and pass the payments directly to participants at a rate of 100%. This would require that all CDS participants, who deal in DTC and ACCESS securities, become a Primary Withholding QI.

Prescribed Reporting Requirements of a Qualified Intermediary

The following represents the tax reporting requirements of a QI under the new withholding tax regulations. The internal procedures noted below must be complied with regardless of the status of the QI as a primary or non-withholding agent.

A. *Non U. S. persons reporting*

1. W-8IMY - Certificate of Foreign Intermediary

This form will be utilised by QI's in two ways:

- (a) This form will be presented by the QI to their U.S. Withholding Agents to confirm their QI status, and allow the U. S. Withholding Agents to pay U. S. source income at a rate of 100% to the QI without any additional reporting requirements in terms of the underlying clients.
- (b) This form will be requested by the QI from any new account holder who is a financial institution to ascertain the reporting status of the entity. The new account holder will have to certify that it is either a QI or a primary U.S. Withholding Agent. If so, the QI will pay any U.S. source income to the new account holder at a rate of 100%, without any additional reporting in terms of the identity of the underlying clients.

2. Form 1042 - Annual Withholding Tax Return for U.S. Source Income of Foreign [non U.S.] Persons

Under the new regulations, if the dealer is not a QI, filing of the Form 1042 by its U.S. Withholding Agent would also include information returns (through completion of Form 1042-S for each customer) which specifically identify the non U.S. persons (customers of the dealer) that are owners of the income reported.

If the dealer is a QI, the identity of the non U.S. persons (customers of the dealer) generally will not be disclosed. Rather, a Form 1042 filing will include only a summary schedule of payments made to non U. S. persons during the year and any U. S. withholding taxes applied to those payments along with details of the applicable withholding rate applied. In the Revenue Procedures issued by the IRS, the QI must provide detailed breakdowns of the payments by asset class but needn't provide individual customer detail. Generally speaking an asset class is a group of assets that will produce the same type of income. The payments must be summarised as noted below in terms of the following asset classes (or withholding pools) that may exist. Therefore, it is our expectation that the existing form will be modified for QI reporting.

- (a) Assets producing interest earned by foreign account holders claiming the portfolio interest exemption at source (withholding = zero)
- (b) Assets producing dividend income earned by foreign account holders claiming the 15% reduced rate at source under an income tax treaty (withholding = 15%)
- (c) Assets producing dividend income earned by foreign account holders residing in a non treaty country (withholding = 30%)
- (d) Assets producing interest income earned by each U.S. account holder (withholding = zero)
- (e) Assets producing U.S. source income for undocumented payees (withholding = 30%)
- (f) Assets producing U.S. source income for subordinate QI's who are assuming primary withholding responsibilities (withholding = zero)
- (g) Assets producing U.S. source income for subordinate QI's who are not assuming primary withholding responsibilities (withholding = various rates by country)

B. U.S. persons reporting [i.e., those identified by the QI under the know-your-client procedures as U. S. persons]

1. W-9 - Request for Taxpayer Identification Number and Certification

If a QI's procedures indicate that a customer is a U.S. person, the QI will be required to ask the customer to complete a W-9 form. This is a form which U.S. persons use to certify their taxpayer identification number and their status for the purpose of annual information reporting on Form 1099 (the U.S. equivalent of a T-5). Where this account earns U.S. income, no U.S. withholding tax will apply. If this form is not submitted for a particular U. S. person, the client is then subject to backup withholding at a rate of 31%. Separate reporting is required for U.S. persons depending upon their information reporting status.

2. Form 1099

This is the general term for several IRS forms (1099-B, 1099-DIV, 1099-MISC, 1099-OID). This form is required to be filed annually to report any payments made to U.S. persons, other than Exempt recipients.

3. Form 945 - Annual Return of Withheld Federal Income Tax

This form is required to be filed annually by the QI to summarise any backup taxes withheld during the previous year.

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