

New US Withholding Tax Procedures Implications for Financial Intermediaries

Note: The following information is general in nature and should not be relied on as tax advice

Introduction

New US withholding regulations are going into effect on January 1, 2001. The implications of this for your businesses, for your operations will be significant. I would imagine it is going to affect every one of you, but potentially in different ways.

We are going to talk about special procedures for intermediaries. That is where the regulations will have the biggest impact: on institutions that are receiving income from US securities on behalf of other persons. We will talk about two different types of intermediaries where the implications and procedures are very different.

You have got qualified intermediaries (the QIs) and you also have non-qualified intermediaries (Non-QI). Completely different procedures apply to those two types of intermediaries. The biggest difference is that, for a QI, you have to sign an agreement with the Internal Revenue Service. We now have that final model QI agreement that we will talk about. In this area there are always developments. We actually had additional guidance issued last week. The IRS issued the final revisions to the final regulations, so we know now what the final rules are going to be.

For those of you who are holding out some last hope that the IRS would again delay the effective date of these regulations, I am sorry to report that the IRS did not. They are sticking to the effective date of January 1, 2001.

Background

New U.S. Withholding Rules for Nonresident Alien (NRA) Investors ¹

- ◆ Complete overhaul of NRA withholding procedures -- hundreds of pages of new rules
- ◆ Reduced withholding still available at source
- ◆ Key changes:
 - Tougher documentation standard to avoid full 30 percent NRA withholding
 - Increased IRS reporting requirements
 - New procedures for intermediaries, *including agreements with IRS* for "qualified intermediaries"
- ◆ Effective date: **1 January 2001**

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The US has completely overhauled its withholding procedures for non-US investors in US securities (i.e. income from US sources, also income from US companies that are traded on exchanges outside the US).

Investing in US companies, US corporate and treasury securities is going to be much more difficult and much more complicated going forward.

The good news is that reduced withholding is still going to be available at source. Take interest payments on treasury bonds - all of you are probably receiving that interest free from withholding taxes. That is still available, but you have to provide proper documentation to the US financial institution paying you that income. The difficulty is going to be: What is that proper documentation? This is the key change. You have a tougher standard now to get reduced withholding at source. The price you pay to get reduced withholding is going to be a little higher. There are also increased IRS reporting requirements and - another big change - new procedures for intermediaries. Therefore, if you are receiving income on US securities on behalf of somebody else who is the real owner of that income, you have to accommodate significant procedural changes.

It helps to understand what the IRS is after here. There are two main goals:

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IRS objectives

Two key IRS compliance goals --

- ◆ Identify U.S. persons investing through non-U.S. financial intermediaries
 - IRS wants income to these persons reported to IRS on Form 1099
- ◆ Eliminate potential treaty shopping abuses due to manipulation of "address rule" for dividends
 - IRS wants only true residents of a treaty country to enjoy lower treaty withholding

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For one, the IRS is after US tax cheats. They are trying to find US individuals who are investing in US securities, but who maintain their account outside the United States. Why is the IRS concerned about this? Well, if I have an account in the United States as a US person, the US financial institution is paying me interests, dividends and sales proceeds from those securities. They are going to report those payments to me and to the IRS. They also tell the IRS my name and my US tax ID number. The IRS matches that information against my tax return. And if I do not report that income, I get a friendly letter from the IRS saying "Oh by the way, you forgot to report your income, could you please report this." If I do not report the income and pay tax on it, then the IRS enforcement mechanisms trigger.

Now, if I have my account outside of the US, what happens? I am investing in US securities but I am going through a non-US financial institution. Chances are that my income is not getting reported to the IRS on Form 1099, an information document. If that information is not being reported - and I know it is not being reported - I might not be too motivated to report that income myself on my US tax return. That is what the IRS wants to stop. They want that information reported to them on Form 1099. They want to know of all US people worldwide who own US securities!

The second goal that the IRS pursues, is related to preferential withholding tax rates based on income tax treaties between the US and other countries. The standard withholding rate in the US is 30%. Treaties can reduce that, for dividends typically down to 15%. But the IRS wants to make sure that someone claiming a lower treaty rate is in fact a resident of a that treaty country. In the United States we have the so-called "address rule" where the dividend payer looks simply at the address on record of the share holder. If that address is in a treaty country, they withhold the treaty rate. The IRS does not like that, the congress does not like it either. Back in 1982 the congress directed the IRS to get rid of this address rule. The IRS is just now getting around to doing that. So they want to make sure that the person who ultimately gets that dividend (i.e. the beneficial owner of that dividend) is actually a resident of that treaty country. The address rule is gone beginning of next year.

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Why should you care?

- ◆ Significant customer relations issues.
- ◆ If proper documentation not provided, excessive withholding may result.
- ◆ Difficulty in obtaining refund -- U.S. tax return (including tax identification number) may be required from non-U.S. investor.
- ◆ Potential competitive disadvantage if other institutions are prepared for new rules.

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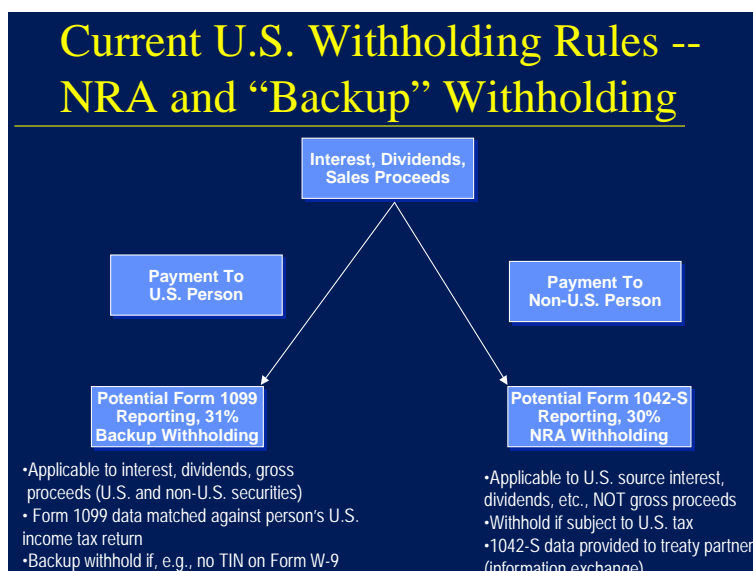
Why should you care? The reasons why you need to care about these rules will vary depending on the type of business that you have, but ultimately you have got some major customer relation issues. If your customers right now are receiving interest on treasury bonds or corporate bonds at a zero withholding rate and if they are receiving dividends at a lower rate of 15 % due to a treaty, and you do nothing between now and the end of the year, and all of a sudden the withholding rate goes from 15 % to 30 %, what do you think is going to happen? Your customers are not going to be too happy. You will have a significant amount of customer friction as a result of these rules, if you are not prepared.

Now you may think that if the withholding rate increases, and if your clients are entitled to a lower rate, they can get a refund. The problem with the US rules is that getting a refund is not easy. You have to file a full blown US income tax return, plus you have to have a tax ID number from the IRS. It is not an easy process and not the most customer friendly procedure you can have.

There are some significant competitive issues: If institutions are prepared for these rules and they continue to give their clients the benefit of reduced withholding at source on US securities, they will be better positioned than institutions that are not able to do that.

Withholding reporting process

I have to give you a quick run through the US withholding reporting process, because essentially the IRS is exporting US compliance procedures to the rest of the globe. If you want to continue having US securities in custody for your customers you are going to have to deal with these rules.



In the United States we have two different withholding reporting regimes operating side by side for investment related income. On the top of the pyramid you have generic investment related income: interest, dividends and gross sales proceeds. The left hand side is dealing with payments to US persons, US citizens, US residents, like my account in the United States. For those payments there is this 1099 Form that is filed by the payer to me and to the Internal Revenue Service. The IRS uses this information for the matching program where they look if I am reporting that income on my tax return. Typically taxes are not withheld on those payments provided that I give the payer of that income my US tax ID number. That ID number is critical to the IRS in order to match the income against my tax return.

If I do not give a tax ID to the payer of the income, 31% backup withholding will be deducted on interest, dividends and gross sales proceeds. If you want to get a customer's attention you will apply a 31% tax to a gross sales proceed. Note: not on the gain, but on the gross sales proceeds! If they are selling at a loss it is increased by 31%. Your customers will get very upset by that. That is the program for US recipients of income.

Payments to non-US persons is subject to a totally different set of rules. US source interest and dividends are potentially subject to 30% withholding tax. That is the statutory rate, the starting point. As we see in the next slides there are a lot of reductions, a lot of exceptions to the 30% rate. It does not apply to sales proceeds though. Also there is a 1042-S reporting requirement that is very important to understand. Form 1042-S reports payments of US source interest and dividends to non-US investors. The form is sent to the investor and to the Internal Revenue Service. What does the IRS do with that 1042-S information? They automatically share that information with the tax administrations of every treaty country. Those foreign tax administrations can then use this information for their own internal compliance purposes.

Payments eligible for withholding relief

We are going to focus on the right hand side of the last diagram "payments to non-US persons". We have a general statutory withholding rate of 30% on US source interest and dividends. But in reality it rarely happens because there are so many exceptions in the United States:

Payments Eligible for NRA 5
Withholding Relief

Relief from 30 percent NRA withholding for:

- ◆ Portfolio interest (Treasury bonds, corporate debt issued after 18 July 1984)
- ◆ Treaty income
- ◆ Foreign governments, exempt organizations
- ◆ Bank deposit interest
- ◆ 183-day or less debt obligations (OID)

Without appropriate documentation, full 30% NRA withholding applies (31% for deposit interest, 183-day or less OID)

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You have portfolio interest which is a very broad exception. Basically any publicly traded debt instrument (treasuries, corporate bonds) issued after July 18, 1984 is eligible for that exception. That is why you are generally not seeing withholding on US source interest payments today. You also have treaty based exceptions, which are typically used for dividends. They reduce the withholding rate usually from 30% down to 15%. There are some more special exceptions for non-US governments, tax exempt organizations and there are separate exceptions for US source bank deposit interest and short-term discount obligations like Treasury Bills and Commercial Paper (those have a special status in the rules but they are also exempt from withholding). The key thing here is that you are entitled to reduced rates of withholding based on those exceptions, but you have to make sure that the proper documentation is provided from the non-US person to the US financial institution that is paying you that income. If the US financial institution does not have the right documentation, the full withholding of 30% applies. In the case of bank deposits, or short-term Original Issue Discount the rate is 31% backup withholding.

Current documentation practice

NRA Documentation - What is the current practice?

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- ◆ Common industry practice today:
 - U.S. withholding agent (custodian bank, etc.) accepts a **single** Form W-8 from its non-U.S. customer
 - Form W-8 provider may not be beneficial owner
 - With Form W-8 in hand, interest is generally exempt from withholding, and dividends are subject to treaty withholding (if treaty country address provided on the form)

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The key item here is documentation. The current practice is pretty simple: The US withholding agent, custodian bank or broker/dealer is frequently just taking a single form, the Form W-8, which is a certification of non-US status, from its non-US customer. In reality that Form W-8 is frequently provided and also signed by someone who is not the beneficial owner of the income, i.e. by someone who is just a nominee, let's say a financial institution receiving income on behalf of other people. With that W-8 form in hands the US institution is typically not withholding any interest due to the portfolio interest exemption. Also, if there is a treaty country address on that Form W-8 the US intermediaries apply a treaty rate withholding, usually 15% on dividends, a fairly straight forward process. This is gone by the end of this year. To the extent that you have been enjoying this procedure, it is not going to apply past December 31, 2000.

What are the documentation requirements under the new law?

NRA Documentation - What is required under new law?

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- ◆ Different -- and more complicated -- forms required based on type of payee
 - **Form W-8BEN**: Beneficial owner certification to claim non-U.S. status and treaty benefits
 - **Form W-8ECI**: Effectively connected income
 - **Form W-8EXP**: Foreign governments, etc.
 - **Form W-8IMY**: Intermediaries, partnerships, certain U.S. branches
- ◆ Taxpayer identification numbers (TINs) in limited circumstances
- ◆ Documentary evidence for offshore accts.

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We have some new forms to deal with, much more complicated forms. The current Form W-8 - for those who are familiar with it - is really very simple. The new forms are not simple at all. The most important ones: We have a Form W-8BEN which is to be completed by a non-US beneficial owner of the income. It is specifically designed for beneficial owners. They certify on that form their non-US status (i.e. that they are a non-resident alien or that they are a non-US person) and - if they are a treaty country resident - they separately certify treaty eligibility on that form.

There are special forms for US branches of foreign companies (the W-8ECI) and also for foreign governments and exempt international organizations (the W-8EXP). The next most important one that you need to consider is the Form W-8IMY. It is to be completed by persons who are non-US but are intermediaries, i.e. they are not the beneficial owners of the income. For the first time we have a very clear delineation between what forms are filled out by beneficial owners and what forms are filled out by intermediaries.

Tax ID numbers issued by the IRS are required in very limited situations, mostly dealing with treaty based claims where it is on non-publicly traded securities, so I do not want to get down on that. There is also this additional twist in the US rules that we call "documentary evidence for offshore accounts" (i.e. accounts that are maintained outside the US), a standard which can be similar to a Form W-8BEN but it could be a passport or some other certifications from the person.

NRA Documentation - 8
Who Provides It?

Basic options under final regulations

- ◆ If non-U.S. payee is the *beneficial owner*:
 - Form W-8BEN required from beneficial owner
- ◆ If non-U.S. payee is an *intermediary*:
 - Form W-8IMY from *qualified intermediary* (QI), OR
 - Form W-8BEN or "documentary evidence" from *beneficial owners* holding through NQI, *plus income allocation information* (with transmittal Form W-8IMY from NQI)

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Who provides the documentation under the new rules? Let's look at it from the US financial institution's perspective: They are making a payment to a customer who is a non-US person. If that customer is the beneficial owner of the income, they need to get a Form W-8BEN from him or her. Based on the information on the form, the appropriate withholding rate is applied.

What if that non-US payee is an intermediary; not the beneficial owner of the income? The beneficial owner is somebody behind the intermediary institution. Now it gets a little more complicated:

If that intermediary is what we call a "Qualified Intermediary", it is still a fairly straight forward documentation exercise. The QI fills out a W-8IMY form and provides it back to the US institution.

If the intermediary is a Non-Qualified Intermediary? Now it gets burdensome, because if a Non-QI wants to get the benefit of a reduced withholding rate on US securities, it has to obtain documentation, the W-8BEN or equivalent documentary evidence, from the beneficial owner of the income. Plus they also have to tell the US institution how much income is allocable to that beneficial owner. So there is a beneficial owner documentation disclosure and an income allocation disclosure to the US financial institution.

Options for Intermediaries

Let us now focus on intermediaries. That is where the real problems and challenges are with the new rules.

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What is an intermediary?

- ◆ Intermediary receives income on behalf of beneficial owner
 - For example, private banking, custody, brokerage businesses
- ◆ A partnership (as defined by U.S. law) is not a beneficial owner
 - Treated similar to intermediary
- ◆ A trust may not be a beneficial owner (e.g., simple or grantor trust)

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First of all, what is an intermediary? Basically it is someone who is receiving income on behalf of the beneficial owner: financial institutions, private banks, custodians, any intermediary type business. A partnership, as defined by US rules, is not a beneficial owner it is treated like an intermediary. The IRS is "looking through" the partnership vehicle to who the beneficial owners are, they want to see the partners. Simple trusts or grantor trusts are also treated like an intermediary; they are not the beneficial owners.

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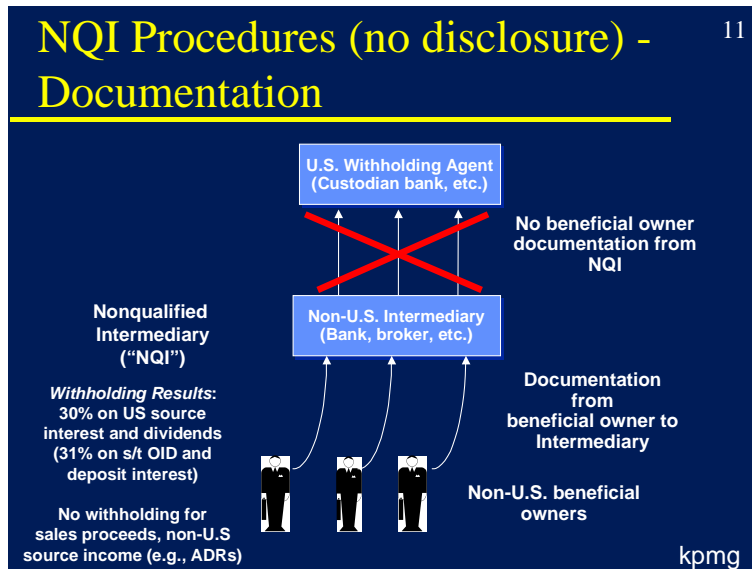
Types of intermediaries

- ◆ Default rule -- intermediary is a "Nonqualified Intermediary" (NQI) if it does not enter into a withholding agreement
- ◆ Intermediary is a "Qualified Intermediary" (QI) if it has a withholding agreement with IRS
- ◆ Similar procedures for partnerships
 - Withholding foreign partnership (WFP) has a withholding agreement
 - Nonwithholding foreign partnership (NWFP) has no agreement with IRS

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There are basically two types of intermediaries under the new rules. The default rule is this: If a non-US intermediary takes no action between now and the end of the year, it is going to be treated as a Non-Qualified Intermediary. To become a Qualified Intermediary you have to take action and enter into a withholding agreement with the IRS. These are your two options.

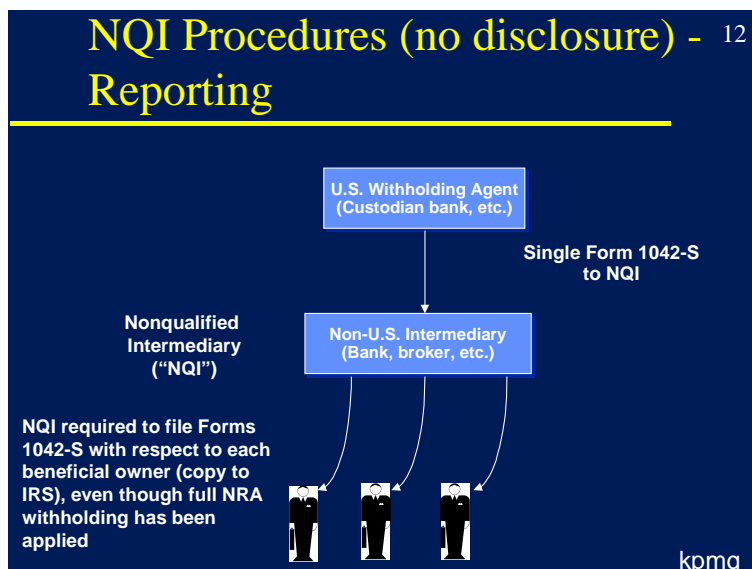
There are similar procedures for partnerships but I do not want to go into too much detail on that.



Let us first look at Non-QIs: Let us say we are dealing with a non-US intermediary and it decides for one reason or another to just ignore the fact that these rules are going into effect beginning of next year. It says "I understand the issue about QIs, but I am not signing any agreements with the IRS." What happens in this situation?

At the very top of the chain we have a withholding agent in the United States such as a US custodian bank, a US broker/dealer, i.e. a US financial institution that is receiving income on securities on behalf of a customer. The customer is a non-US intermediary (a non-US bank, non-US broker/dealer) and that intermediary is in turn receiving income on behalf of their customers who are the beneficial owners.

The non-US intermediary does get documentation from its customers, but it does not disclose anything to the US custodian. So what happens in that situation? The withholding results are shown in the picture on the left hand side. You are going to see 30% of withholding on US source interest and dividends, 31 % on short-term Original Issue Discount and deposit interest and generally no withholding for gross sales proceeds and no withholding on non-US source income. To the extent that the beneficial owners are currently enjoying 0% withholding on treasury bonds, in this situation, the withholding rate is going to be 30%. Now, this is half the story, this is the withholding result based on the non-disclosure of the beneficial owner by a Non-Qualified Intermediary.



There is also a reporting angle here. Remember the Form 1042-S that I was mentioning before? The US custodian i.e. the withholding agent will file with the IRS a 1042-S reporting of the US source income paid to that Non-QI, but it does not know who the beneficial owners are. So it just says on the 1042-S "We do not know who the owners of

the income are." Now the IRS expects that Non-QI now to file 1042-S forms for all those beneficial owners, even though full withholding of 30 % was applied!

NQI Noncompliance -- What are the Implications?

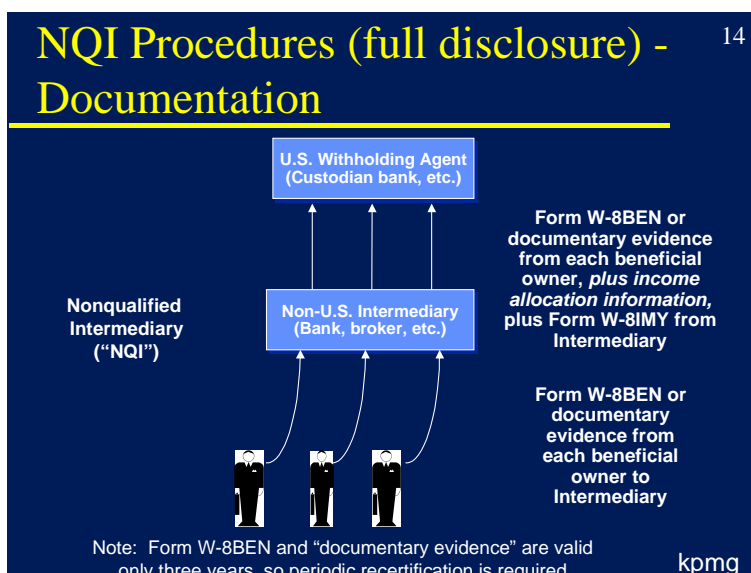
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- ◆ Failing to disclose beneficial owner information generally results in 30 percent withholding on interest and dividends (not sales)
- ◆ If no disclosure, failing to file Forms 1042-S could also result in penalty of up to 20% of interest and dividends
 - Penalty could be enforced via levy notice sent to U.S. withholding agent
- ◆ If NQI does not comply, and its affiliate is a QI, the IRS may refuse to renew QI agreement

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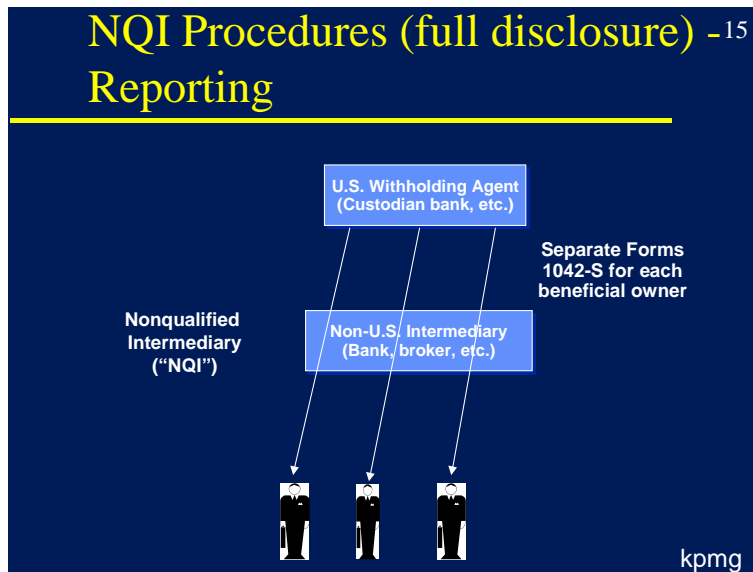
At that point you - the Non-QI - are probably thinking "What if I do not do it? The IRS can not invade my country and force me to file these forms!" Right, a Non-QI can not be forced to disclose its customers to the US custodian. It will then suffer the full withholding rate - generally 30%. But additionally, if it fails to do the 1042-S reporting the IRS is going to assess penalties. Those can be up to 20% of the amount that should be reported. So you are looking at 30% withholding and an additional 20% penalty that can apply on an income strain. How is the IRS going to enforce a penalty against you, located outside the US? The IRS will be trying to go where your money is. Your money is with your US custodian. They will try to enforce the penalties that way.

What is even more: You may be a Non-QI and you may even willingly pay this intentional disregard penalty of 20%. If your institution has any affiliate that is a QI, the IRS might make life very difficult for that QI. It may not even renew its QI agreement with that affiliate!



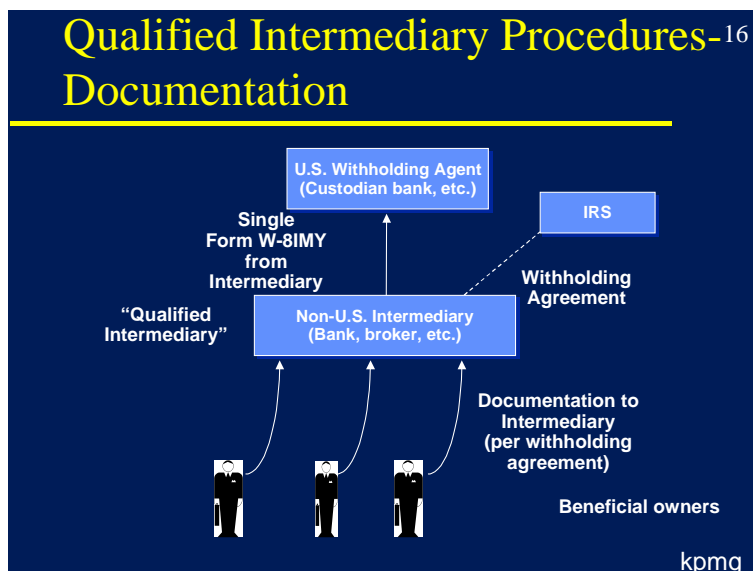
The second option: You have not entered into any agreement with the IRS (i.e. you are still a Non-QI), but you want to get reduced withholding rates for your clients. Now you have to tell your US financial institution who your customers are. In addition, income allocation information is disclosed as well. So your US custodian knows who is getting the income and how much income they are getting. Based on that information they apply whatever withholding rate should apply. The W-8BEN form, the document of evidence, is valid only for 3 years; you have to

refresh it repeatedly. So think about communication, client interaction. What is going to happen if you have to continuously go to them and ask for new W8-BENs. That is on the withholding side.

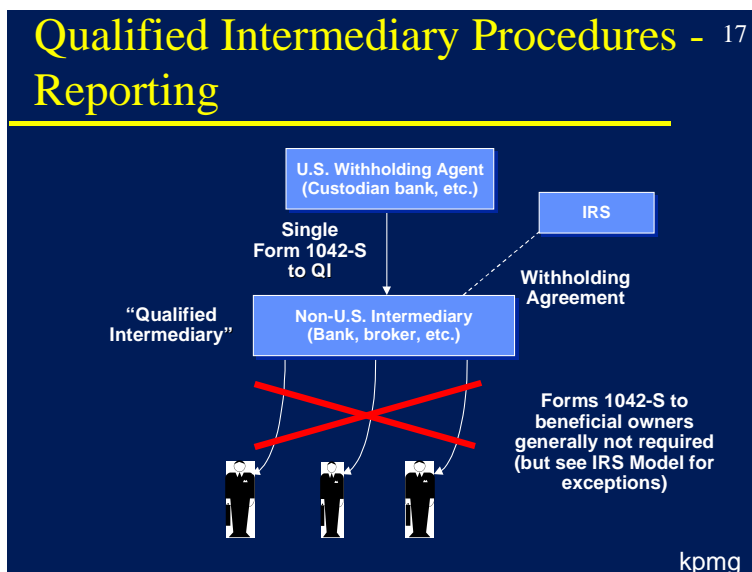


What about the reporting side? The Non-QI has disclosed beneficial owner information to the US custodian. Those beneficial owners now are going to receive 1042-S forms filed directly from the US custodian. The US custodian is reporting the amount of US source interest dividends, the portfolio interest on a US treasury bond - even though there has been no withholding. Remember now what happens next? That 1042-S information is automatically provided via the IRS to the tax administration of every treaty country.

Maybe you think "Non-QI - this is really not a very pleasant option. Very complicated, extraordinarily burdensome. Is the IRS aware of that?" Absolutely, because the IRS does not want a world full of Non-QIs!



This is what the IRS wants the world to look like beginning of next year: They want that intermediary to be a Qualified Intermediary. Procedures for a QI are much more streamlined. The documentation from the beneficial owners stays with the QI. It is not disclosed from the QI to the US withholding agent (assuming all the beneficial owners are non-US persons). There is a catch though: To become a QI you have to have a withholding agreement with the IRS.



What about the reporting side? Remember all the 1042-S reporting that you saw with Non-QIs? There is a Form 1042-S going from the US custodian down to the QI. But when the QI passes the income payments to its customers who are the beneficial owners of the income, no Form 1042-S is sent to those beneficial owners.

QI or NQI? -- A key decision for intermediaries outside the U.S. 18

- ◆ All non-U.S. financial intermediaries with U.S. securities must address QI issue
 - Need to weigh pros and cons of QI or NQI status
- ◆ Issue must be considered for each operation worldwide -- some units may want QI status while others may not
- ◆ Impact on U.S. withholding agents and fees

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It is a major decision for intermediaries around the world whether to be a QI or a Non-QI, and it is affecting everybody. There are varying degrees of understanding of these rules around the world. Some of you in this room are probably very familiar with the QI concept, some of you may be hearing about it for the first time. But it is something that will affect all of you.

The scope of this is amazing: You may have to address this QI / Non-QI issue simply because you have a customer who wants to invest in a US security. That is all that has to happen! Once you receive this US security for the account of your customer, the IRS is going to say "If you want US securities you are going to have to play by our rules."

The issue has to be considered for all of your operations worldwide. For those of you who are representing banks and your bank operates in several jurisdictions, you have to think about every jurisdiction. To what extent are we acting as an intermediary? Do we need to be a QI in that jurisdiction? This is an enormous issue. You also have to consider what is going to happen to your relationship with your US custodian.

The US custodian is no disinterested party here. If you decide to be a Non-QI and you send a couple of thousands W-8BEN forms from your beneficial owners to your US custodian, and you give them all the allocation information so that they can do the reduced withholding and all the reporting, it is a lot more work for them. Do you think your custodian wants to do that for free? I do not think so. So you have to consider the impact both on your customers and on your service providers in the US.

Model QI agreement

At this point I want to talk about the model QI agreement. Let us say that you have reviewed your options. You are an intermediary. You understand the implications of being a Non-QI. You have clients that want to have US securities. They want to have reduced withholding, but you do not want to bother them with W-8BEN forms. You do not want to have your clients subject to income reporting: You opt for the QI route.

You have to have an agreement with the Internal Revenue Service. And the IRS wants a world full of QIs, because quite frankly, the new rules will not work in a world full of Non-QIs.

Background to the final model QI Agreement (QIA) 19

- ◆ Single model agreement helps eliminate one-on-one negotiations; standardizes terms for all QIs
- ◆ Final QIA resulted from negotiations between IRS and several countries
- ◆ With the QIA issued (Rev. Proc. 2000-12), each intermediary must now decide if the terms are acceptable

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What is this agreement with the IRS like? Is it a straight forward, easy to understand document? It is not. We love complexity in the United States, we really love it with tax rules and I think we love it the most with reporting withholding compliance, particularly when it affects institutions outside the United States...

Normally when you think of making an agreement, you think of sitting down with your counterpart and you negotiate the terms and you decide by mutual agreement what is going to happen. Is that what happens with the IRS? No way. There is a model agreement, it is one agreement for the whole world. You want to be a QI? Here is the agreement, no negotiations. It is a take it or leave it proposition.

The IRS did go through a significant amount of discussions with financial institutions around the world to develop the terms of the withholding agreement. This time last year I was very skeptical whether the QI program would survive at all, because the terms of the proposed model agreement were difficult to understand and impossible to do. Now it is difficult to understand and almost impossible to do, but I think more people can do it now than could have last year.

Countries where the QIA is available

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- ◆ The QIA is NOT available to intermediary operations in all countries
 - Prerequisite: the IRS must receive a description of "know-your-customer" (KYC) rules for that country
 - IRS has an 18-point KYC questionnaire
- ◆ What if a country has no acceptable KYC procedures?
 - Branch operations whose head office has acceptable KYC rules may still be a QI
 - Otherwise, QI status not available

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Where is the QI agreement available? Is it for intermediary operations around the world? Not quite. There is a prerequisite: A jurisdiction has to have "Know Your Customer" (KYC) rules based on money laundering legislation. Those rules have to be acceptable to the IRS. Without that they just do not feel comfortable extending the privileges of being a QI. The IRS developed an 18-point questionnaire on KYC. So, intermediaries wishing to become QI need to obtain the KYC questionnaire, complete it for their jurisdiction, send it in to the IRS and receive the IRS's blessing.

What if you are in a country that does not have KYC procedures acceptable to the IRS? Well, a subsidiary operation could not be a QI. For branches it would be possible still to become a QI if their head office has acceptable KYC procedures. The KYC documentation standard within a particular country will serve as an attachment to the model agreement, because, as a QI, generally you are going to start with locally accepted KYC documentation as the type of documentation to obtain from your customers. So, that is the only variation with the model agreement: Country by country there is going to be a different KYC attachment.

Let us look at an outline of the general requirements to the model agreement: documentation disclosure, withholding reporting, external audit, and some default provisions.

Outline of the QI Agreement

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- ◆ Customer documentation
- ◆ Disclosure requirements
- ◆ Withholding requirements
- ◆ Reporting requirements
- ◆ External audit
- ◆ Default/termination/renewal

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Documentation

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QIA Requirements: Documentation

- ◆ Documentation received under QI's local "know your customer" (KYC) rules *may* suffice
 - IRS must approve
- ◆ Documentation from beneficial owner required
 - QI may treat account holder -- **including collective investment vehicles** -- as beneficial owner (unless QI has actual knowledge to the contrary)
 - QI must assume certain account holders are intermediaries (banks, brokers, etc.)

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As I just mentioned - the starting point is the acceptable KYC documentation in your jurisdiction. If you are dealing with individual customers passports are acceptable KYC documentation. They will be acceptable as part of the QI agreement. If you have passport copies you are okay, you do not have to go out and get Form W-8BENs from customers as long as their passports show they are non-US persons.

You do need to get documentation from the beneficial owner of the income. Beneficial ownership here is based on US tax principles, it is not based on money laundering principles. When an income payment is made, you have to look at who is believed to be subject to any potential tax on that income. You can assume that your customer is the beneficial owner of the income unless you have knowledge of the contrary.

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QIA Requirements: Documentation

- ◆ *Representations confirming treaty benefits* required from customers other than individuals and governments
 - Beneficial owner meets any Limitation on Benefits (LOB) requirements, and "derives" the income within the meaning of section 894.
 - QI must have procedures to inform customers of LOB requirements.
 - Two year-phase in:
 - » For accounts opened before 1 January 2001, statement not required until 1 January 2003.

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But if you have an account holder that is a bank, broker, or some other intermediary, you have to assume that they are not the beneficial owner of the income. You need to get additional representations from non-individuals who want to get treaty benefits. They have to certify that they meet limitations on benefit requirements, that they derive their income within the meaning of the IRS code section 894. It is somewhat complicated but you do have an additional standard to comply with.

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QIA Requirements: Documentation

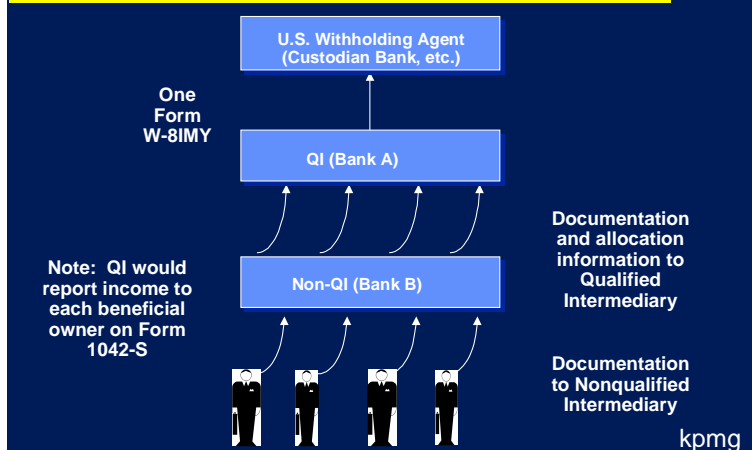
- ◆ *No special renewal requirements* -- instead, follow KYC renewal procedures (if any)
- ◆ *"Due diligence"* review of documentation
 - Detailed guidance in the QIA -- for example:
 - » Person claiming non-U.S. status may not have U.S. mailing or residence address
 - » For post-2000 accounts, customer cannot have only a financial institution address, in-care-of address, or P.O. Box
 - » "Bad" documentation may be "cured" with additional documentation/explanation

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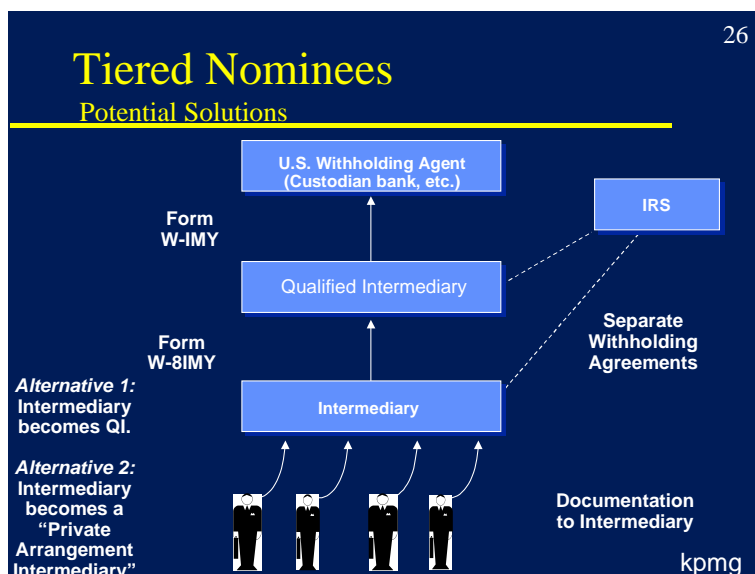
There is no special renewal requirements for KYC. So if you have that passport copy for an individual it is valid indefinitely - unlike a W-8BEN form which is valid only for 3 years. However you do have what the IRS calls due diligence requirements. If you have a passport that says "German citizen and German resident" but the customer wants you to mail all payments into the United States that may be an indication that he is a US person and not really a German resident. The due diligence standard requires you to verify that the documentation you have can be relied on.

QIA Requirements: Documentation 25

Tiered Nominee Issue



Up to now the requirements are straight forward: you have a US custodian, a non-US intermediary, a beneficial owner. What happens if we have a series of intermediaries? Surely the IRS does not expect all intermediaries in that chain to become QIs? Well, think again. The IRS wants to look through all the non-US intermediaries until they get to the beneficial owner of the income.



So if you yourself are a non-US intermediary and you look at who your customer is and your customer is another bank or another broker and they are an intermediary, you have got the same issue. If you are Bank A and a QI, and you have a client, Bank B that is a Non-QI, if you are going to give them reduced withholding, you have to obtain beneficial owner documentation. It is the same drill that we had earlier for Non-QIs. The potential solution is for that intermediary at the bottom to become a QI, i.e. they sign a separate agreement with the IRS. Another option is a "private arrangement" between the intermediary and the QI whereby the intermediary agrees to follow that QI's agreement with the IRS. Essentially it is going to be acting just like a QI.

Disclosure issues

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Elements of a Withholding Agreement -- Disclosure

- ◆ *Potential disclosure of U.S. customers* (other than "exempt recipients" like corporations)
 - Disclosure if U.S. customer receives U.S. source income (assuming QI is non-U.S.)
 - » If U.S. customer receives **ONLY non-U.S. source income**, disclosure not required!
 - U.S. withholding agent generally would file Forms 1099 and backup withhold at 31% (unless QI does)
 - Disclosure relates only to securities producing U.S. source income -- information on non-U.S. securities is irrelevant

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Typically, if your beneficial owner is a non-US person you do not have to disclose their identity at all. But remember that the first objective the IRS has, is to flush out all US individuals who are investing in US securities. So what if your customer is a US individual and is investing in US securities?

The general rule is that you have to disclose that customer. You have to disclose them to the US custodian and they would do Form 1099 reporting and backup withholding if required. If they only receive non-US income though you are not to worry about disclosure. If that person wants to stay in US securities you have a problem but if they are just holding non-US securities, generally you do not have to worry about any disclosure issue.

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Elements of a Withholding Agreement -- Disclosure

- ◆ *Special procedures for U.S. customers if disclosure is prohibited by law or contract*
 - QI permitted NOT to disclose U.S. individuals
 - » Accounts opened before 1 Jan 2001: QI must request authority to disclose, authority to sell U.S. securities, or request the account holder to disclose himself by mandating QI to forward a W-9 to the U.S. withholding agent. QI must make request twice per year.
 - » Slightly different procedures for accounts opened on or after 1 January 2001. Generally, QI may not allow U.S. customer to own U.S. securities on undisclosed basis.
 - » With rare exception, no undisclosed US (with US securities) allowed by end of 2002 (or QI is in default).

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What happens to operations where the local jurisdiction has banking secrecy or some kind of confidentiality rules and if you disclose that US person you could be going to jail? The QI agreement - after much haggling with the IRS - allows for at least some transition period so that existing customers, who are US persons unwilling to be disclosed, can continue to hold US securities, but they are subject to 31% backup withholding on interest, dividends and gross sales proceeds. This is really going to get their attention... So you may want to get these people out of US securities now in order to avoid that pain.

What the IRS essentially wants by the end of a 2-year transition period is no US person holding US securities on an undisclosed basis. For new accounts opening in the beginning next year you should take care of that problem at the time the account is opened - assuming that you still want to have customers who are US persons.

Payments beneficially owned by non US persons

Taxes are going to be required to be withheld on dividends, almost always. What is the proper rate and how is it applied? There are two options:

QI with primary withholding responsibility.

You as the QI may assume the responsibility to do all non resident alien (NRA) withholding. This will be easy for your US custodian as it will allow them to just pay you 100% of the source income, all the dividends, all the interest goes to you. You now need to do the withholding and you have to deposit it generally on a weekly basis with the IRS.

QI without primary withholding responsibility

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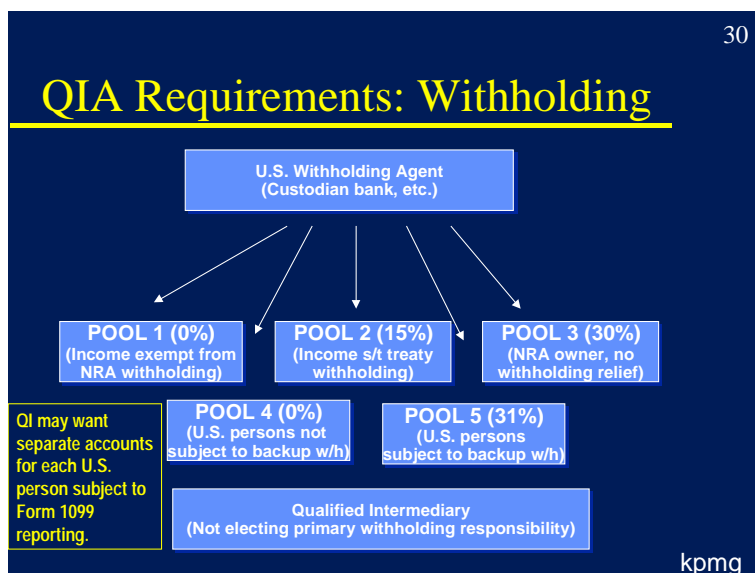
Elements of a Withholding Agreement -- Withholding

- ◆ *QI may assume primary NRA withholding responsibility.* If so, QI is responsible for withholding and depositing all NRA withholding taxes.
- ◆ *If QI does not assume primary NRA withholding responsibility,* QI provides withholding information to withholding agent.
 - QI must establish “withholding rate pools”
 - Operational implications (segregated accounts vs. payment-by-payment withholding information)

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Alternatively you to have to tell the US custodian what withholding to deduct. You establish what the IRS calls withholding rate pools. One pool combines all holdings subject to the same rate of withholding tax. Generally you set those pools up in the form of segregated accounts, so that your US custodian or the upstream custodian from you knows what withholding rate will apply to each pool.

The next picture shows one way to do it: Pools 1, 2, and 3 owned by non-US persons are subject to different withholding rates. If you have a high volume of transactions, having segregated accounts like this might not be that easy from a clearing and settlements standpoint. But you have very clear withholding results for income payments to those segregated accounts.



It does not have to be segregated accounts though, you could also segregate on a payment by payment basis in an omnibus account. In that case, you would have to tell your US custodian how much of each income payment is subject to what withholding rate.

If that solution does not appeal to you either, then you need to assume withholding responsibility. If you are assuming withholding responsibility you need just one account with your US custodian. It is a 0% withholding account because you are receiving everything and you segregate internally as described above.



There are some reporting requirements for a QI: You have to file Forms 1042 and 1042-S. There was an initial requirement from the IRS for a QI to report how much income was received and distributed to customers on a country-by-country basis. This is a very sensitive issue and a very burdensome requirement. After much debate the

IRS decided to back off temporarily on country-by-country reporting. The current status is that, if you enter into a QI agreement with the IRS before the end of this year, you do not have to do country-by-country reporting at least for the term of that agreement, which is 6 years. For agreement renewals or first time agreements entered into next year they still reserve the right to require it.

Verification, audit

Now we know that the IRS is making agreements with intermediaries who are outside the United States, outside the US jurisdiction and the IRS is deputizing these QIs to follow certain US withholding tax procedures. Is the IRS just going to trust the QIs to follow the terms of that agreement? No! They want to have a way of verifying compliance. The way to do that is generally through an external auditor. The QI would be the one selecting the external auditor. Who pays for the external auditor? Well, that is one of the costs of being a QI.

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QIA Requirements: Audit

- ◆ *Two verification options:* Audit must be performed by either the IRS or an approved external auditor
 - QI may provide IRS with a list of potential external auditors
- ◆ *External audit required for every second and fifth year* of the QI's agreement
- ◆ IRS welcomes proposed audit plan in advance -- may incorporate QI's *internal* audit procedures

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You could do the external audit for instance every 2nd and 5th year of the QI agreement. You can propose an audit plan to the IRS. If you have a very robust internal audit department maybe some of your internal audit procedures could be incorporated as part of your overall QI audit plan. That might reduce the scope and the cost of your external audit. There are detailed external audit procedures in the QI agreement.

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QIA Requirements: Audit

- ◆ Detailed audit procedures provided in QIA
 - Testing of account documentation, reporting, withholding, etc.
- ◆ Potential liability for noncompliance
 - QI is potentially liable to IRS for noncompliance
 - If underwithholding detected from an account sample, total amount due to the IRS will be based on a *projection* of error to other accounts. QI may propose more accurate calculation of underwithholding.

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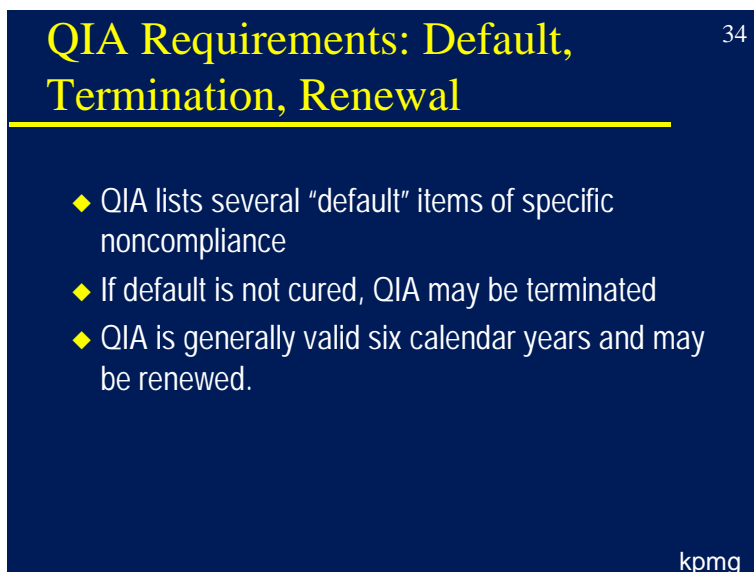
There is detailed testing in terms of seeing that documentation is there, that withholding is done, the reporting is done when required, etc. The IRS does allow for sampling of accounts, so they do not have to look at every single

account you have. What happens if the external auditor finds that the QI made a mistake and that mistake resulted in underwithholding of US taxes?

The IRS is going to expect to be paid the taxes that were due and the QI is going to have to pay the bill. What happens when the error is discovered based on a sample of accounts? Is the bill or the IRS assessment limited to that error on that one account that was identified as having a problem? No. The IRS is going to project that error to all of the accounts in that withholding pool.

So for all similar accounts they are going to assume that the same error applied with the same frequency. That is the starting point. If you want to show the IRS that that is not the right result, you may feel free to do so, but the debate has started. I think this is probably the most controversial part of the QI agreement.

Default



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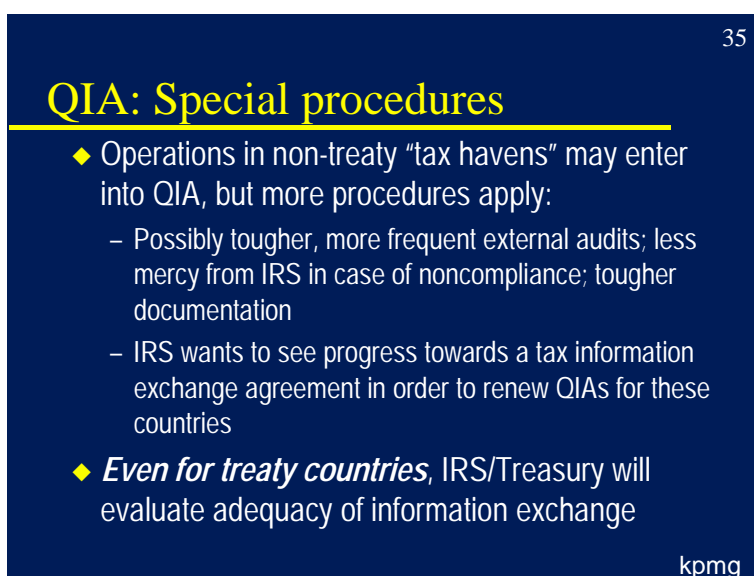
QIA Requirements: Default, Termination, Renewal

- ◆ QIA lists several "default" items of specific noncompliance
- ◆ If default is not cured, QIA may be terminated
- ◆ QIA is generally valid six calendar years and may be renewed.

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There are several ways that you can be in default on this agreement. If you do not do something right, you are in default. The IRS is going to be very reluctant to terminate an agreement though. They are going to give people the chance to fix their problems, because again, it is in the IRS' interest to have a world full of QIs. And again, the QI agreement is generally valid for 6 years and it can be renewed.

Some special procedures



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QIA: Special procedures

- ◆ Operations in non-treaty "tax havens" may enter into QIA, but more procedures apply:
 - Possibly tougher, more frequent external audits; less mercy from IRS in case of noncompliance; tougher documentation
 - IRS wants to see progress towards a tax information exchange agreement in order to renew QIAs for these countries
- ◆ ***Even for treaty countries***, IRS/Treasury will evaluate adequacy of information exchange

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If you have an operation in a non-treaty country but the IRS decides it is a tax haven because it has banking secrecy rules, some additional procedures are going to apply to those QIs. They will be subject to tougher external audit, tougher IRS enforcement in case of noncompliance and tougher documentation rules.

At one point the IRS was considering not even allowing these non-treaty countries to participate in the QI program, but the IRS scaled that back. But the IRS wants to see progress in these countries towards a tax information exchange agreement before the first wave of QI agreements expire after six years. Otherwise renewal of the agreement may be uncertain.

Even for treaty countries the IRS and the US Treasury are going to produce a kind of report card and assess whether the current information exchange procedures with those countries are adequate. If they are found inadequate then the Treasury Department is threatening not to renew agreements.

QI Application procedures

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QIA Application procedures

- ◆ If intermediary wants QIA, it must submit an application to IRS. QI application includes:
 - Sample of account forms
 - List describing types of account holders (e.g., U.S., non-U.S., treaty resident, intermediary), number of account holders, and approximate value of U.S. investments covered by QIA
 - General description of U.S. assets, approximate value (separate for proprietary and custodial)
 - Responsible person identified
 - External auditor list

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Once a jurisdiction is eligible to become QI for its domestic operation, by having adequate KYC rules, then it is up to each bank, each intermediary in that jurisdiction to become a QI. They have to submit an application to the IRS, tell the IRS some basic information about who they are, the amount of investments in the US, what kind of clients they have etc.. If satisfied, the IRS then sends back the model agreement for signature and you are set.

Implications

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Implications

- ◆ New withholding rules will increase cost of investing in U.S. securities
 - IRS and Treasury realize that demand for U.S. securities could be affected
- ◆ Failing to address the business and operational impact of these rules could create significant problems
- ◆ For multinational operations, scope of the QI problem could be significant
- ◆ Application by other countries?

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The costs of investing in US securities are clearly going up for intermediary operations. Is this not going to affect the US market? Is the US Treasury going to dampen the demand for its own bonds when something like 40% of all US Treasury Bonds are held by non-US investors? Well the thinking is that if financial institutions are so willing and so eager to offer US securities to their customers, that those institutions will be willing to swallow the additional administrative costs of being a QI.

For those of you acting as intermediaries, if you fail to address the business and operational impacts of these rules, you can have some serious issues and some serious problems beginning next year. You get increased withholding, potential IRS penalties, it will be just a very different environment. If you are a multinational operation you also have to worry about where you are operating and where you need to be a QI.

My remarks were all about the United States, but what are other countries doing? They are watching to see how successful the IRS is going to be. In fact, Ireland already has passed similar legislation. They call it QI agreements, QIs and the whole thing... We could end up seeing the same development in other countries as well.

Questions from the Floor

Q: What if we sent in our application in December only? When would we get the approval from the IRS?

A: The way that the IRS has set this up is that everything should be in a rubber stamp process. You get the approval as long as you seem to be a normal financial institution and no strange issues come to the surface. The IRS will send the agreement to you, you sign it and you are done. In theory it should not take long for the IRS to process it. In reality I am not sure what is going to happen. I would recommend handing in before December.

Q: How is the Know Your Customer rule going to be evaluated?

A: Well you respond to the 18 point questionnaire and the IRS is in the process of reviewing the replies right now. They have approved the KYC procedures for all 13 countries that have submitted them so far. But it is a matter of replying to the questionnaire and providing the IRS with copies of the underlying legislation and guidance notes. Typically it is a local bankers association that will provide the KYC information to the IRS. If the association does not act, individual banks could get together and send in the information, or even one bank could do it directly. In practice that has not happened yet. In a couple of situations the government has actually been the one submitting the information to the IRS.

Q: What are the pros and cons for a non US QI to become a QI with withholding responsibility?

A: Pros are that you just have to have one account with your US custodian. That allows you to have very streamlined procedures, because you are not going to have segregated accounts and you receive all of the proceeds on just that one account. Operationally that is a desirable solution.

Further, you get all of the income the moment it is payable (assuming no operational delays on the side of your US paying agent). You need to do the appropriate withholding and then you have to remit the tax to the IRS, basically every week. The point is that you are having a period of time when you are holding that tax money. You can earn income on it. So that could actually help finance your development cost of becoming a QI.

The cons are that you need to develop new functionalities allowing you to do all the withholding and to remit the tax to the IRS. The more you have to do, the more chances you have of doing something wrong and then suffering the wrath of the IRS. If you make deposits late or fail to make deposits, you become liable. If you assume the responsibility make sure you get it right!

Q: What if my clients invest in derivatives instead of US securities directly?

A: Such as equity swaps and the like? Even though the equity swap may be based on US equities, it is not a US source income if the issuer of the new instrument is not a US person. If it is not US source income you do not have to worry about it. So there are ways to minimize or mitigate the impact of these rules. But the question that you have to keep asking yourself is this: Are my customers going to be willing to get into these derivatives instead of having the real US security? If your customer wants to invest in Cisco or Microsoft shares or any other specific security, then you have no way but to consider the QI issue.