

Part III

Administrative, Procedural, and Miscellaneous

Guidance on Implementation of Withholding and Reporting Regulations

Notice 2001-43

This Notice provides guidance on the implementation of the withholding and reporting regulations (T.D. 8734, 1997-2 C.B. 109, and T.D. 8881, 2000-23 I.R.B. 1158). Specifically, this Notice:

- (1) provides a temporary alternative procedure for withholding and reporting on payments made to certain nonqualified intermediaries (NQIs) and foreign trusts, which is available only for payments made to NQIs or foreign trusts on or after January 1, 2001, and before January 1, 2002;
- (2) clarifies and corrects sections 1.1441-6(b)(1) and 301.6114-1 of the regulations, which require disclosure of certain treaty based return positions;
- (3) adds a new alternative convention for converting payments in foreign currency into U.S. dollars to those listed in section 1.1441-3(e)(2);
- (4) modifies section III. A. 1. of Notice 2001-4, 2001-2 I.R.B. 267, to permit an applicant for a qualified intermediary agreement that has been issued a QI-EIN to represent that it is a qualified intermediary (QI) until the IRS revokes its QI-EIN and to permit an applicant that has been issued a QI-EIN before January 1, 2002, to apply all of the provisions of the QI agreement beginning January 1, 2001;
- (5) clarifies section III. C. of Notice 2001-4, which provides documentation and reporting relief for simple and grantor trusts; and
- (6) modifies Announcement 2000-48, 2000-23 I.R.B. 1243, to permit a branch of a QI to act as a qualified intermediary under the QI's home country know-your-customer (KYC) rules if the branch is located in a country for which KYC rules have been submitted to IRS for approval.

1. Transitional relief for certain nonqualified intermediaries and foreign trusts.

In October 1997, Treasury and the IRS issued T.D. 8734, 1997-2 C.B. 109 (modified by T.D. 8881, 2000-20 I.R.B. 1158), which provided comprehensive regulations under chapter 3 (sections 1441-1445) and subpart G of subchapter A of chapter 61 (sections 6041-6050S) of the Internal Revenue Code. These regulations,

which became effective on January 1, 2001, were developed after years of discussion with the U.S. and foreign financial services industry regarding how to improve compliance with the U.S. withholding rules without unduly impeding foreign investments in the United States or burdening financial institutions.

A key component of the new rules is the introduction of the qualified intermediary (QI) concept. In basic terms, a QI is a foreign financial institution that enters into an agreement with the IRS to verify the beneficial ownership of payments of U.S. source income for purposes of determining whether any reductions in the statutory 30 percent U.S. withholding tax rate under sections 871 and 881 are appropriate. To make this determination, a QI generally may rely on the documentation that it collects under the bank regulatory rules requiring it to establish the identity and residency of its account holders (know your customer (KYC) rules). The QI is required to transmit pooled information (but generally not the identity of its non-U.S. customers) to the U.S. withholding agent to enable the withholding agent to determine the correct amount of tax to withhold on payments made to the QI's customers. The QI is also required to report certain pooled information to the IRS, as specified in the regulations. By allowing QIs to transmit information on a pooled basis, the regulations reduce the QI's compliance burden (by minimizing the amount of information that is required to be reported to the IRS) and protect the QI's customer base (by minimizing the amount of information that must be reported to the U.S. withholding agent, who will often be a competitor of the QI).

Sections 1.1441-1(e)(3)(iii) and (iv) of the regulations require a nonqualified intermediary (NQI) to supply the U.S. withholding agent or a QI with customer-specific documentation, rather than pooled information, to establish that its customers qualify for a reduction in the statutory 30 percent withholding rate.

The NQI does this by attaching appropriate documentation and a withholding statement identifying customers and allocating payments among them to an intermediary certificate that it forwards to the U.S. withholding agent or QI. To ensure the proper withholding and reporting of a payment, the U.S. withholding agent or QI must receive this intermediary certificate before it makes a payment of a reportable amount (as defined in section 1.1441-1(e)(3)(vi)) to the NQI. Finally, unless its withholding agent has done so, the NQI must report payment information to the IRS on Forms 1042 and 1042-S and must send the foreign income recipient a corresponding Form 1042-S. In the same way, foreign simple trusts and foreign grantor trusts are required to forward to the U.S. withholding agent or QI a flow-through withholding certificate with attached documentation and a withholding statement identifying beneficiaries and grantors and to report payment information to the IRS.

Treasury and the IRS understand that, despite significant efforts by U.S. withholding agents and QIs to establish automated systems to process information received from NQIs and foreign trusts for withholding and reporting purposes, in some cases these systems are not yet fully operational. Treasury and the IRS have been

advised, however, that the automated systems in those cases will be fully operational before the end of 2001. Accordingly, Treasury and the IRS believe that limited relief is warranted to ensure a smooth transition into the new withholding procedures. Treasury and the IRS emphasize, however, that the NQI and foreign trust documentation and reporting rules in the regulations are central to the appropriate administration of the U.S. withholding regulations, and U.S. withholding agents and QIs are expected to complete the development of automated systems that will ensure compliance with these rules.

To achieve a smoother transition period for withholding agents that make payments to NQIs and foreign trusts, the IRS will permit a withholding agent and NQI or foreign trust to apply the alternative procedures of section 1.1441-1(e)(3)(iv)(D) of the regulations as modified below for calendar year 2001, provided the withholding agent and NQI or foreign trust comply with all the conditions set forth below. This modified alternative procedure may not be used by flow-through entities or U.S. branches described in section 1.1441-1(e)(3)(iv)(D)(g) of the regulations. (See sections III. C. and IV. of Notice 2001-4, 2001-2 I.R.B. 267 for certain other relief provisions relating to trusts and partnerships.) A withholding agent may use this modified alternative procedure only for payments made to NQIs and to foreign simple or grantor trusts. This modified alternative procedure may not be used by a withholding agent if the withholding agent would be responsible for filing fewer than 250 Forms 1042-S for calendar year 2001 without using this modified alternative procedure. This modified alternative procedure may not be used for payments to U.S. nonexempt recipients.

An NQI or foreign trust and its withholding agent that comply with the conditions set forth below may rely on this Notice for payments made on or after January 1, 2001, and before January 1, 2002: (1) to permit pooled basis reporting on Form 1042-S instead of the payee specific reporting otherwise required under the alternative procedure of section 1.1441-1(e)(3)(iv)(D); and (2) to permit the NQI or foreign trust to provide the withholding agent with a withholding statement containing the beneficial owner information required under sections 1.1441-1(e)(3)(iv)(C)(1) and (D)(2) after a payment is made but no later than January 31, 2002.

In order to qualify for this transitional relief, the following conditions must be met:

(1) The withholding agent submits a notification no later than January 31, 2002, that it is using the temporary alternative procedure under this Notice. Notifications should be sent to:

Internal Revenue Service
Pre-Filing Services LM:PFT:PF
New Mint Building, 3rd Floor
1111 Constitution Avenue, NW
Washington, DC 20224

(2) The withholding agent includes the following in its notification under penalties of perjury:

(a) a statement listing the NQIs and foreign trusts that are participating with the withholding agent in using the temporary alternative procedure under this Notice;

(b) a statement (i) that during 2001 the withholding agent was engaged in the building and implementation of computerized information systems for transfer and processing of withholding statement information between the withholding agent and the NQI or foreign trust and for Form 1042-S reporting to the IRS, and (ii) that they were relying on completion of those systems for purposes of complying with section 1.1441-1(e)(3)(iii) and (iv) of the regulations;

(c) a representation that the withholding agent has exercised its best efforts to complete those systems;

(d) a statement that those systems are not capable of complying with the requirements of section 1.1441-1(e)(3)(iii) and (iv) regarding timely provision of withholding statement information by the NQI or foreign trust and Form 1042-S reporting by the withholding agent for calendar year 2001;

(e) a statement of the number of Forms 1042-S that the withholding agent would be responsible for filing for calendar year 2001 if it were not using this modified alternative procedure; and

(f) a representation that the systems will be capable of complying with those withholding statement and Form 1042-S reporting requirements for calendar year 2002.

(3) The withholding agent and NQI or foreign trust comply with all applicable requirements of section 1.1441-1(e)(3)(iv)(D) of regulations, except as modified by conditions (4), (5) and (6).

(4) The NQI or foreign trust provides the withholding agent with withholding rate pool information prior to the payment of a reportable amount in accordance with section 1.1441-1(e)(3)(iv)(D)(2) of the regulations. The NQI or foreign trust must also provide appropriate documentation with respect to its customers to the withholding agent prior to the payment being made. The NQI or foreign trust need not, however, provide the withholding statement information identifying and classifying foreign persons as required by sections 1.1441-1(e)(3)(iv)(C)(1) and (D)(2) and assigning each listed foreign person to a withholding rate pool as required by section 1.1441-1(e)(3)(iv)(D)(2) prior to payment. The NQI or foreign trust is required to provide that withholding statement information to the withholding agent no later than January 31, 2002. The NQI or foreign trust must provide the withholding agent with withholding statement

information allocating the income in each withholding rate pool to each payee within the pool no later than January 31, 2002, as required under sections 1.1441-1(e)(3)(iv)(C)(2) and (D)(3) of the regulations.

(5) The withholding agent withholds and timely files Forms 1042-S based on the withholding rate pool information provided by the NQI or foreign trust.

(6) The withholding agent submits a copy of the withholding statement that it receives from the NQI or foreign trust (which must identify each beneficial owner of payments to the NQI or foreign trust and allocate payments among these beneficial owners) for calendar year 2001 to the IRS at the address stated in condition (1) on or before the due date for filing Forms 1042-S for calendar year 2001.

If the NQI or foreign trust fails to provide the withholding statement information required under condition (4) by January 31, 2002, for any withholding rate pool, then the withholding agent may apply the provisions of sections 1.1441-1(e)(3)(iv)(D)(4), (5), (6) and (7). The NQI or foreign trust will be responsible for withholding, filing Form 1042 and filing Forms 1042-S for each beneficial owner for which it has received payments.

The IRS will accept the pooled basis reporting and withholding statements filed under this temporary procedure in lieu of the payee specific reporting otherwise required of an NQI or foreign trust and its withholding agent only if the NQI or foreign trust and its withholding agent satisfy all of the conditions set forth above. The withholding agent and NQI or foreign trust must retain all records, documentation and other evidence relevant to the above conditions for the same retention period as would be required for information relevant to an audit of Form 1042-S for calendar year 2001.

In determining on audit whether a withholding agent has exercised its best efforts to complete building and implementing their information systems, the IRS will take into account all the facts and circumstances including the efforts and performance of similarly situated withholding agents.

2. Disclosing treaty based return positions.

Section 1.1441-6(b)(1) of the regulations provides that withholding under sections 1441, 1442 and 1443 on a payment to a foreign person is eligible for reduction under the terms of an income tax treaty only to the extent that the payment is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner, and all other requirements for benefits under the treaty are satisfied. It provides further that if the beneficial owner is a person related to the withholding agent within the meaning of section 482, the beneficial owner's withholding certificate must contain a representation that the beneficial owner will file the statement required under section 301.6114-1(d) if applicable. This requirement applies only to amounts of income subject to withholding received during the calendar year that exceed \$500,000 in the aggregate.

Section 301.6114-1(a) of the regulations provides that if a taxpayer takes a

return position that a tax treaty overrules or modifies any provision of the Internal Revenue Code and thereby effects a reduction of any tax at any time, the taxpayer shall disclose such return position on a statement attached to the return. If a tax return would not otherwise be required to be filed, a return must nevertheless be filed to make this disclosure. For this purpose, the taxpayer's taxable year is deemed to be the calendar year, unless the taxpayer has established or timely chooses to establish a different taxable year. The taxpayer must make the disclosure statement on a fully completed Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) attached to the return.

Section 301.6114-1(b) provides that reporting is required unless it is expressly waived, and it further provides a nonexclusive list of particular positions for which reporting is required. Among the positions listed are those described in section 301.6114-1(b)(4)(ii)(C) or (D).

Paragraph (b)(4)(ii)(C) requires a taxpayer to report a position taken under a treaty that contains a limitation on benefits provision if: (1) the treaty exempts from tax or reduces the rate of tax on income subject to withholding; (2) the income is received by a foreign person other than an individual or State that is the beneficial owner of the income and the foreign person is related to the person obligated to pay the income within the meaning of sections 267(b) and 707(b)(5); (3) the income exceeds \$500,000; and (4) the foreign person meets the requirements of the limitation on benefits provision. Paragraph (b)(4)(ii)(D) requires reporting a position taken under a treaty that imposes any other conditions for the entitlement to treaty benefits if the position is that such conditions are met.

Section 301.6114-1(c) lists positions for which reporting is expressly waived. Paragraph (c)(1)(i) waives reporting for the position that a treaty has reduced the rate of withholding tax otherwise applicable to a particular type of income subject to withholding to the extent that the income is beneficially owned by an individual or a State. Paragraph (c)(2) waives reporting by an individual who receives payments or income items during the taxable year that do not exceed \$10,000 in the aggregate.

Taxpayers have requested guidance on the scope of the reporting required under section 301.6114-1(b) in the case of treaty claims for exemption or reduced rates of tax on income subject to withholding made by foreign persons that are not individuals or States. Taxpayers have expressed concerns that:

- (1) Because paragraph (c)(1)(i) of that section waives reporting only for individuals and States, it is unclear whether taxpayers that are not individuals or States and that are not required to report under paragraph (b)(4)(ii)(C) are required nevertheless to disclose treaty based return positions described in paragraph (b)(4)(ii) under the general rule of paragraph (b).
- (2) Because paragraph (c)(2) waives reporting only for individuals who receive less than

the threshold amount, taxpayers that are not individuals must report under paragraph (b)(4)(ii)(D) even when they have received de minimis amounts of income subject to withholding.

(3) Because the representation under section 1.1441-6(b)(1) is required when the beneficial owner is related to the withholding agent within the meaning of section 482 and the filing under section 301.6114-1(b)(4)(ii)(C) is required when the beneficial owner is related to the person obligated to pay the income within the meaning of sections 267(b) and 707(b), it is unclear how the representation requirement coordinates with the filing requirement.

(4) Because section 1.1441-6(b)(1) states that the filing requirement applies only to amounts received during the calendar year that exceed \$500,000 in the aggregate and section 301.6114-1(b)(1) permits a taxpayer to adopt a taxable year for filing different from the calendar year, it is unclear how a fiscal year taxpayer is to report those amounts.

To address these concerns, Treasury and the IRS intend to amend sections 1.1441-6(b)(1) and 301.6114-1 of the regulations, as described below, effective January 1, 2001.

(1) Treasury and the IRS intend to amend section 301.6114-1(c) to provide that reporting is waived for taxpayers that are taking a treaty based return position described in section 301.6114-1(b)(4)(ii), unless those taxpayers are described in paragraph (b)(4)(ii)(A) and (B), or (C) or (D).

(2) Treasury and the IRS intend to amend section 301.6114-1(c) to waive reporting under section 301.6114-1(b)(4)(ii)(D) for taxpayers that are not individuals or States and that receive amounts of income subject to withholding that do not exceed \$10,000 in the aggregate.

(3) Treasury and the IRS intend to amend section 1.1441-6(b)(1) to conform the representation requirement to the filing requirement of section 301.6114-1(b)(4)(ii)(C). Thus, section 1.1441-6(b)(1) will require a representation if the taxpayer takes the position under a treaty that contains a limitation on benefits provision that the treaty exempts from tax or reduces the rate of tax on income subject to withholding, the income is received by a foreign person other than an individual or State that is the beneficial owner of the income, the foreign person is related to the person obligated to pay the income within the meaning of sections 267(b) and 707(b), the income exceeds \$500,000 in the aggregate, and the foreign person meets the requirements of the limitation on benefits provision.

(4) Treasury and the IRS intend to amend section 1.1441-6(b)(1) to conform to section 301.6114-1(b)(1) by changing the rule that the filing requirement applies only to amounts received during the calendar year that exceed \$500,000 in the aggregate.

The conformed rule will provide that the filing requirement applies only to income received during the taxpayer's taxable year that exceeds \$500,000 in the aggregate.

A taxpayer that is required to make the disclosure statement on Form 8833 under sections 301.6114-1 (b)(4)(ii)(A) and (B) or (C) or (D) taking into account the modifications described in the Notice will be considered to have timely filed Form 8833 if, in the case of a calendar year taxpayer, the taxpayer files the Form 8833 with its return for its taxable year ending on December 31, 2001, or in the case of a fiscal year taxpayer, the taxpayer files Form 8833 with its return for its first taxable year ending after December 31, 2001.

Taxpayers may rely on the authority of this Notice until the regulations are amended.

3. Converting payments in foreign currency to U.S. dollars.

Section 1.1441-3(e)(2) provides that if an amount subject to tax is paid in a currency other than the U.S. dollar, the amount of withholding under section 1441 shall be determined by applying the applicable rate of withholding to the foreign currency amount and converting the amount withheld into U.S. dollars at the spot rate on the date of payment. A withholding agent that makes regular or frequent payments in foreign currency is permitted to use a month end spot rate or a monthly average spot rate.

Certain withholding agents that make regular and frequent payments in foreign currency have expressed concern that the permitted conversion conventions can expose them to currency risks that would require management by means of hedging transactions. Also, they have expressed concern that permitted conventions can require multiple accounting adjustments when payment amounts in the base currency are adjusted or corrected in the course of processing and settlement. They have suggested that using the spot rate on the day of deposit of the amount of tax withheld would eliminate the currency risks and the need for those accounting adjustments.

In response to those concerns, Treasury and the IRS intend to amend section 1.1441-3(e)(2) to add the suggested alternative conversion convention to the conventions already permitted. Section 1.1441-3(e)(2) will permit a withholding agent that makes regular or frequent payments in foreign currency to convert the amount withheld into U.S. dollars at the spot rate on the day the tax is deposited provided that the deposit is made within seven days of the date of payment. As is the case with the conversion conventions currently in the regulations, taxpayers using this alternative convention must do so consistently for all nondollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner. Taxpayers may rely on the authority of this Notice until the regulations are amended.

4. Representing QI status and applying QI agreement beginning January 1, 2001.

Section III. A. 1. of Notice 2001-4 provides that an applicant that has submitted a QI application before January 1, 2001, may represent on Form W-8IMY that it is a QI without being in possession of a fully executed QI agreement until June 30, 2001. It further provides that an applicant that has submitted a QI application after December 31, 2000, may represent on Form W-8IMY that it is a QI until the end of the sixth full month after the month in which it submits its QI application. Applicants have been issued QI-EINs upon application to permit them to complete Forms W-8IMY. Finally, it provides that a potential QI may apply all of the provisions of the QI agreement beginning January 1, 2001, provided that it submits its application before July 1, 2001.

Taxpayers have requested extension of the time during which an applicant may represent that it is a QI without being in possession of a fully executed QI agreement and extension of the July 1, 2001, application deadline for application of the QI agreement beginning January 1, 2001, in order to allow adequate time for the process of review and execution by both the applicants and the IRS.

In response, this Notice modifies those provisions of Notice 2001-4. An applicant to which IRS has issued a QI-EIN may represent on Form W-8IMY that it is a QI without being in possession of a fully executed QI agreement until the IRS revokes its QI-EIN. The IRS will revoke an applicant's QI-EIN if the applicant does not execute and return its QI agreement to the IRS within a reasonable time after the IRS has sent the QI agreement to the applicant for signature. An applicant to which the IRS has issued a QI-EIN before January 1, 2002, may apply all of the provisions of the QI agreement beginning January 1, 2001.

5. Documentation and reporting relief for simple and grantor trusts.

The QI agreement generally requires a QI to obtain a Form W-8IMY from a foreign simple or grantor trust together with appropriate documentation from beneficiaries and grantors and requires the QI to file separate Forms 1042-S for each beneficiary or grantor.

Section III. C. of Notice 2001-4, 2001-2 I.R.B. 267, provides documentation and reporting relief for simple and grantor trusts. It permits a QI to treat the beneficiaries or grantors as direct account holders, and thus permits them to be incorporated into the pooled basis reporting permitted for direct account holders rather than requiring separate Forms 1042-S for each of them, provided three criteria are met. (1) The QI must be required, pursuant to the applicable KYC rules, to determine the identity of the beneficiaries or owners of foreign simple or grantor trusts. (2) The QI must obtain the type of documentation set forth in the appropriate KYC attachment to the agreement. (3) The QI must obtain a valid Form W-8BEN from the beneficiary or owner of the trust.

Some QIs have suggested that the scope of criterion (1) may be unclear, because local KYC rules in certain jurisdictions require the QI to determine the identity of the beneficiaries or owners of foreign simple or grantor, but do not require the QI to obtain documentation confirming their identities. These QIs have expressed the

concern that the reporting relief for trusts may be unavailable in such jurisdictions.

This Notice clarifies that criterion (1) is satisfied if the local KYC rules require the QI to determine the identity of trust beneficiaries and grantors, even if those rules do not require the QI to obtain documentation confirming their identities. The QI must nevertheless obtain any documentation necessary to satisfy criterion (2), which is based on the applicable KYC documentation.

6. Branches permitted to apply QI's home country KYC.

Announcement 2000-48, 2000-23 I.R.B. 1243, provides that the IRS generally will not extend the QI system to any country that does not have KYC rules or that has unacceptable KYC rules. The IRS will, however, permit a branch of a financial institution (but not a separate juridical entity affiliated with the financial institution) located in such a country to act as a QI if the branch is part of an entity organized in a country that has acceptable KYC rules and the entity agrees to apply its home country KYC rules to the branch.

Taxpayers have requested that this rule be extended to include branches of QIs in countries for which KYC rules have been submitted to IRS for approval during the time those rules are pending approval.

In response, this Notice modifies Announcement 2000-48. IRS will permit a branch of a financial institution (but not a separate juridical entity affiliated with the financial institution) to act as a QI if the branch is located in a country identified by the IRS as a jurisdiction awaiting approval of KYC rules on the IRS website at www.irs.ustreas.gov, if the branch is part of an entity organized in a country that has acceptable KYC rules and if the entity agrees to apply its home country KYC rules to the branch. The branch will be permitted to act as a QI under this rule only for the period of time during which the jurisdiction in which it is located is identified as awaiting approval. If the IRS approves the KYC rules of the jurisdiction, then the branch must apply the KYC rules of the jurisdiction beginning on the date that an attachment to the QI agreement for the jurisdiction is posted on the IRS website at www.irs.ustreas.gov.

Contact Information

For further information regarding this Notice, contact Carl Cooper or Laurie Hatten-Boyd of the Office of the Associate Chief Counsel (International), Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Mr. Cooper and Ms. Hatten-Boyd may be contacted by telephone at 202-622-3840 (not a toll-free call).