

Qualified Intermediary or Bust?

By Susan C. Morse

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Recently Deutsche Post ex-CEO Klaus Zumwinkl, billionaire Igor Olenicoff, and a UBS banker smuggling diamonds in a toothpaste tube generated headlines regarding the problem of incomplete residence taxation of income paid to out-of-country bank accounts. Mundane withholding forms and laboriously developed and perfected computer systems can provide the solution. The Obama administration's recent proposals concerning the qualified intermediary and nonqualified intermediary (NQI) systems attempt to translate popular outrage over wealthy Americans' hidden offshore account income into a concrete systems proposal for addressing the problem.

Room for International Cooperation

A QI is a non-U.S. financial institution that enters into an agreement with the IRS to fulfill information gathering and reporting responsibilities and submit to audits of its compliance with that agreement. An NQI does not enter into such an agreement. At first glance, it appears that the administration's proposals seek to define the QI system as the exclusive avenue for banks that wish to hold U.S. securities for their clients. In other words, the proposed statutes appear to use burdensome presumptions for NQI accounts to drive non-U.S. financial institutions, regardless of size or the relative importance of U.S. customer base, into QI status.¹

However, the administration proposals would provide some wiggle room by permitting administrative exceptions to adverse NQI presumptions — for example, for “payments that the Treasury Department concludes present a low risk of tax evasion.”² Any final legislation should retain that provision allowing for the exercise of administrative discretion, in large part because it would allow the IRS and Treasury to pursue the goal of infor-

mation reporting through bilateral or multilateral efforts that may not exactly correspond to the QI regime.

Existing QI and NQI Rules

The 2000 QI and NQI regulations³ address the situation when U.S.-source reportable payments flow from the United States to an account at a non-U.S. financial institution. In that situation, more than one large intermediary typically stands between the holder of a non-U.S. account and the U.S.-source reportable payments that may flow into that offshore account. For example, if assets in an account at a non-U.S. bank are debt or equity instruments issued by U.S. corporations, there are one or more potential withholding agents in the United States, such as the issuing corporation and the global custodian that may hold the securities.⁴ Of course, U.S. taxpayers (although generally not non-U.S. persons) must also pay U.S. income tax on income resulting from investments in non-U.S. securities and other assets, but the 2000 regs did not focus on this pattern.

The 2000 regs generally charge the non-U.S. firm closest to the client (and therefore to the client's information) with information gathering responsibility. If that non-U.S. firm is a QI, it usually may assume withholding responsibility or shift that responsibility (presumably for an additional charge) to a U.S. withholding agent.⁵ If QIs pass information to U.S. withholding agents, they may do so on a pooled basis, stating that a certain amount of a dividend payment is subject to a reduced 15 percent withholding rate, for example. That avoids disclosing client identities and provides a confidentiality advantage, because clients may not want to reveal their identities to governments and because QIs presumably prefer not to share their client lists with the other financial institutions in the payment chain as a condition to obtaining U.S. withholding tax relief.⁶

³E.g., reg. section 1.1441-0 et seq.

⁴Cf. OECD, “Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors,” at 7-8 (Jan. 12, 2009) [hereinafter OECD report] (providing chart of possible intermediaries).

⁵See Rev. Proc. 2000-12, 2000-1 C.B. 387, section 4, sections 3.02 and 3.06, Doc 2000-1307, 2000 TNT 6-7 (permitting opting out of withholding responsibility for reportable amounts).

⁶See Susan C. Morse and Stephen E. Shay, “Qualified Intermediary Status: A New U.S. Withholding Role for Foreign Financial Institutions Under Final U.S. Withholding Regulations,” 27 *Tax Mg't Int'l J.* 331, 339 (1998) (noting confidentiality advantages of QI status).

¹See, e.g., Kristen Parillo, “Obama's QI Proposals Would Impose Significant Burdens on Foreign Banks, Practitioners Say,” *Tax Notes*, May 11, 2009, p. 679, Doc 2009-10238, or 2009 TNT 86-7.

²Treasury Department, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (May 2009), Doc 2009-10664, 2009 TNT 89-44 [hereinafter 2010 green book], at 43, 45; *Id.* at 51, 52 (anticipating “regulatory authority to provide additional exceptions” to Report of Foreign Bank and Financial Accounts (FBAR) reporting presumptions).

Strengthening QIs' Obligations

The QI and NQI rules contain a clear explanation of the underlying premise that the account holder, not a nominee or agent, is the beneficial owner, although foreign corporations are respected as non-U.S. persons.⁷ The rules focus on non-U.S. holders of non-U.S. accounts and the related interest in protecting source-based taxation, but they also anticipate U.S. holders of non-U.S. accounts and the related concern of protecting residence-based taxation. For example, the QI agreement offered by the IRS requires a QI to disclose the identity of, and amounts received by, U.S. individuals and other nonexempt U.S. account holders.⁸

The obligation under the QI agreement to disclose U.S. clients is not watertight. In particular, the agreement sets out a procedure for banks to follow to reconcile their local bank secrecy laws with their obligation to disclose U.S. clients to the IRS. That process has an option that does not include client disclosure — the QI may exclude U.S. securities or other assets that generate U.S.-source reportable payments from the U.S. client's account.⁹ That leaves QIs with the attractive customer-relations strategy of encouraging disclosure-averse U.S. clients to divest assets that generate U.S. reportable payments, such as U.S. Treasury bonds, and replace them with other assets, such as other governments' low-risk debt. Court documents show that UBS followed this strategy.¹⁰

One provision in the administration's recent proposals attempts to close that loophole by requiring that QIs identify all of their account holders that are U.S. per-

⁷See reg. section 1.1441-1(c)(6)(1) (defining beneficial owner). The John Doe summons in the UBS case attempts to encompass situations when taxpayers established foreign sham corporations and claimed they were eligible to provide foreign-person Form W-8 certifications. Instead of referring to beneficial ownership "under U.S. tax principles," as the regulation does, the summons describes the section 7609(f) John Doe class as any U.S. taxpayer with "signature or other authority . . . with respect to any financial accounts," except for taxpayers who had supplied UBS with Forms W-9 and been subject to Form 1099 reporting. Memorandum in Support of Ex Parte Petition For Leave to Serve John Doe Summons at 5, *In re Tax Liabilities of John Does* (S.D. Fla. No. 08-21864) (June 30, 2008), *Doc 2008-14509*, 2008 TNT 128-21.

⁸See Rev. Proc. 2000-12, *supra* note 5, sections 6.01, 6.03 (requiring a QI to provide enough information to permit withholding agents to report and withhold on payments to each nonexempt U.S. account holder, assuming that the QI does not itself assume Form 1099 reporting responsibility for those accounts).

⁹Other options include obtaining a Form W-9 or authority to disclose from the account holder. See Rev. Proc. 2000-12, *supra* note 5, at section 6.04.

¹⁰See UBS, "Qualified Intermediary System: U.S. Withholding Tax on Dividends and Interest Income From U.S. Securities" 1 (Oct. 2004) ("A QI has to ensure that *US Persons* . . . either declare themselves to the US tax authorities . . . or are no longer permitted to invest in US securities"), available at declaration of Daniel Reeves, *United States v. UBS AG* (S.D. Fla. No. 09-20423), Exhibit 10, at 1, *Doc 2009-15457*, 2009 TNT 129-24. See also Joann M. Weiner, "Disqualifying UBS From the QI Regime," *Tax Notes*, Dec. 8, 2008, p. 1097 at 1099, *Doc 2008-24550*, or 2008 TNT 237-8 (describing UBS exploitation of this exception).

sons.¹¹ Unlike the disclosure provision in the QI agreement, this requirement would apply to accounts in which U.S. persons hold only non-U.S. securities. Another modification would require QIs themselves to report payments to U.S. account holders on Form 1099, instead of permitting them to leave that task to a U.S. withholding agent.¹² This change would place the obligation for reporting more securely in the internal processes and computing systems of the gatekeeper closest to the client, as commentators have recommended.¹³ Another proposal would give Treasury regulatory authority to require affiliates of a QI to also act as QIs.¹⁴

Pushing Banks Out of NQI Status

Besides increasing the responsibilities of QIs, the administration proposals would try to "encourage [NQIs] to become QIs"¹⁵ by making the NQI alternative unappealing under default withholding rules applicable to returns on U.S. portfolio holdings. Under current law, an NQI is supposed to forward detailed client information to U.S. withholding agents or face withholding on client accounts under applicable presumptions. The regulations also require an NQI to disclose to a U.S. withholding agent any situation in which the NQI has actual knowledge that a client is a U.S. nonexempt recipient.¹⁶

However, those NQI disclosure requirements lack teeth. A failure to report the U.S. or non-U.S. status of a client results in the presumption that a payment is made to an "unknown, undocumented foreign payee," which in turn requires withholding at a rate of 30 percent on payments of interest and dividends but does not require withholding on payments of gross proceeds.¹⁷ Also, the United States has limited ability to ferret out situations in which U.S. account holders may provide false non-U.S. documentation to NQIs because NQIs (unlike QIs) do not agree to any audit or other U.S. oversight.¹⁸

¹¹2010 green book, *supra* note 2, at 42.

¹²*Id.*

¹³See, e.g., "House Ways & Means Comm. Hearing on Issues Involving Bank Secrecy Practices and Wealthy American Taxpayers," statement of Stephen E. Shay, Ropes & Gray, Boston at 11 (Mar. 31, 2009) (recommending assigning the task of information reporting to U.S. persons to QIs).

¹⁴See 2010 green book, *supra* note 2, at 42.

¹⁵"Shulman Describes IRS International Enforcement Priorities at OECD Conference" (June 4, 2009), *Doc 2009-12458*, 2009 TNT 104-36 [hereafter Shulman OECD remarks].

¹⁶See reg. section 1.1441-1(e)(3)(iv).

¹⁷See reg. section 1.1441-1(b)(3)(v)(B) (requiring 30 percent withholding); reg. section 1.6049-5(d)(3)(ii) (providing that withholding on gross proceeds is not required for payment to a non-U.S. intermediary unless the payer has actual knowledge that a nonexempt U.S. person is the beneficial owner of the payment).

¹⁸Some administration releases have used accusatory language when describing NQIs. That seems imprudent if the goal is to persuade NQIs to join the U.S. compliance effort. See, e.g., White House, Office of the Press Secretary, "Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas" (May 4, 2009), *Doc 2009-10037*, 2009 TNT 84-44. ("Under this proposal, the assumption will be that these institutions are facilitating tax evasion, and the

(Footnote continued on next page.)

Several administration proposals would attempt to make the NQI option unappealing, at least for accounts whose assets include U.S. securities. One proposal would subject all payments to NQIs to a default 30 percent withholding on U.S.-source interest, dividends, and other fixed or determinable annual or periodic income, regardless of self-certification. Non-U.S. persons erroneously subjected to withholding could claim a refund.¹⁹

Another proposal would require 20 percent withholding on broker proceeds when paid to an NQI in a jurisdiction lacking “a comprehensive [U.S.] income tax treaty that includes a satisfactory exchange of information program.”²⁰ It’s unclear whether satisfactory would mean automatic, and in a usable electronic format. Hopefully it would, although that meaning of satisfactory would go beyond the OECD model.²¹ Finally, a pair of proposals would establish an evidentiary presumption that an account held at an NQI requires the filing of a Report of Foreign Bank and Financial Accounts (FBAR) and that the failure to file an FBAR is willful, and therefore subject to significant civil and criminal penalties, if the account balance at an NQI exceeds \$200,000 at any point in the year.²²

Automatic Information Sharing Outside QI System

Even if the proposed NQI presumptions reflect a correct judgment that the NQI system as it now exists simply does not work, it may still be possible to repurpose the NQI model with the help of cooperative information exchange efforts outside the QI system. The proposals leave room for a possible third choice, one that might be based on bilateral or multilateral reporting agreements rather than the U.S. QI system. Treasury and the IRS have consistently engaged in such bilateral and multilateral discussions in the past, although the result-

burden of proof will be shifted to these institutions and their account-holders to prove they are not sheltering income from U.S. taxation.”)

¹⁹See 2010 green book, *supra* note 2, at 43.

²⁰*Id.* at 44. One question is whether the same requirement would apply to partnerships that do not elect to be withholding foreign partnerships. This point is important for disclosure-sensitive foreign investors in investment partnerships. Cf. Stephen E. Shay and Elaine B. Murphy, “Notice 2002-41 Guidance for Withholding Foreign Partnerships,” 31 *Tax Mg’t Int’l J.* 560, 562 n. 25 (2002) (noting that gross proceeds returns and associated withholding may have particular importance for some foreign partnerships).

²¹A “satisfactory” exchange of information provision should require automatic provision of information — in contrast, for example, to the OECD model information sharing agreement, which requires information sharing on request. See, e.g., Lee A. Sheppard, “Don’t Ask, Don’t Tell, Part 4: Ineffectual Information Sharing,” *Tax Notes*, Mar. 23, 2009, p. 1411, *Doc 2009-6201*, or 2009 *TNT* 54-7 (noting also that governments should develop systems to effectively use automatically shared information).

²²See 2010 green book, *supra* note 2, at 51, 52; see also Fred Feingold, “Further Guidance Needed on Who Must Report Foreign Accounts,” *Tax Notes*, May 25, 2009, p. 1023, *Doc 2009-9113*, or 2009 *TNT* 98-11 (arguing that the FBAR proposal goes too far, because ignorance of reporting requirements, and not willful intent to evade tax, may cause failure to comply with FBAR filing).

ing arrangements have not yet produced effective, automatic information exchange.²³

Effective global information reporting might or might not necessarily follow the QI model, even though IRS Commissioner Douglas Shulman has said that “the enhanced QI system proposed by the President is a good starting point eventually for a multilateral QI system.”²⁴ A January 2009 OECD report detailed three possible approaches to structuring a cross-border information exchange arrangement. First, a financial institution or other intermediary might report directly to the countries where each of its customers is resident, consistent with the approach of the QI proposals discussed here, and those countries would also report to the countries where payments are sourced. Second, an intermediary might report to the country where it is located or regulated, and that country’s tax authorities would then transmit the information to countries where customers are resident, consistent with the approach of the European Union Savings Directive in its requirements for interest reporting. Third, an intermediary could report information to the country where payments (for example, interest and dividends) are sourced, consistent with the approach of the existing QI rules as applied to non-U.S. account holders, and the source country would pass information on to the residence country as appropriate.²⁵

There are advantages and disadvantages to each of those structures, but any of them — or perhaps a combination — could support a working information exchange program. As the OECD report acknowledges, the development of a multilateral agreement on uniform computerized reporting protocols presents a central challenge in any case. Those protocols may not take the form of IRS forms W-9 and W-8BEN and other forms in the W-8 family, and they may be inconsistent with the know-your-customer rules approved for QI use by the IRS.²⁶ It is important that Treasury and the IRS retain the ability to participate in the broader effort to construct a global information sharing system without being confined to the particulars of the QI rules.

Even short of multilateral agreement on a global information sharing system, non-QI bilateral information

²³See William L. Burke, “Tax Information Reporting and Compliance in the Cross-Border Context,” 27 *Va. Tax Rev.* 399, 427-431 (2007) (noting development of increased cross-border information exchange and coordinated audits); Kenneth R. Petrini et al., “Inter-Governmental Cooperation and Information Sharing — Where Are We Now?” 85 *Taxes* 43, 46-47 (2007) (noting that although governments may have routine or automatic information exchanges, specific requests make up the most significant part of cross-border exchanges and estimating the annual number of outbound requests at between 100 and 500 and the number of inbound requests at 1,500 or less).

²⁴Shulman OECD remarks, *supra* note 15.

²⁵See OECD report, *supra* note 4, at 16-19.

²⁶*Id.* at 20-21; see also Morse and Shay, “Qualified Intermediary Status, Act II: Notice 99-8 and the Role of a Qualified Intermediary,” 28 *Tax Mg’t Int’l J.* 259, 262-265 (1999) (outlining rules permitting QI reliance on local know-your-customer rules).

sharing efforts might sometimes give the IRS and Treasury enough confidence that non-U.S. financial institutions automatically share adequate information with the U.S. tax authorities. For example, perhaps local European banks with small numbers of U.S. clients could satisfy the U.S. need to know about the existence of those clients by building on the banks' existing savings-directive-based internal systems. Treaty information-exchange provisions expanded to require automatic exchange of information might also provide sufficient assurance. Other governments might be amenable to building on treaty relationships to accomplish the goal of automatic information exchange²⁷ — and the cooperation of foreign governments could provide other benefits for the United States, including possible assistance in enforcing the obligations of QIs or other information sharing institutions.²⁸ An information-on-request provision like that in the OECD model and the recently initialed protocol to the Switzerland-U.S. treaty is not enough,²⁹ but the QI regime is not the only way to accomplish the goal of automatic information exchange.

Toughening NQI presumptions would provide U.S. tax authorities with a tool that could be used, most obviously, to push NQIs into QI status. But thanks to administrative discretion exceptions, Treasury and the IRS could also use the tool of disadvantageous NQI status more flexibly and creatively, responding to opportunities as systems for automatic tax information sharing develop around the world. Legislation should retain this latitude for administrative discretion, and tax administrators should use it responsibly.

²⁷UBS and its amicus, the Swiss government, have argued that UBS compliance with unilateral U.S. demands for information about clients not already suspected of wrongdoing would violate Swiss law and that treaty information exchange provisions should determine the UBS obligation to disclose. See, e.g., Brief of UBS AG in Opposition to the Petition to Enforce the John Doe Summons, at 23-35, in *United States v. UBS AG*, No. 09-CV-20423 (S.D. Fla. Apr. 30, 2009); Amicus Brief of Government of Switzerland, at 11-15, in *United States v. UBS AG*, No. 09-CV-20423 (S.D. Fla. Apr. 30, 2009).

²⁸The QI program and other information exchange initiatives have expanded the de facto enforcement reach of U.S. tax administration. See Thomas D. Greenaway, "Worldwide Taxation, Worldwide Enforcement," *Tax Notes*, May 4, 2009, p. 561, Doc 2009-7317, or 2009 TNT 84-12. But U.S. court jurisdiction still has limits. For example, the Justice Department in the UBS case pointedly noted that UBS has branch offices in the district where the government filed suit. See Memorandum in Support of Ex Parte Petition For Leave to Serve John Doe Summons, at 1, No. 08-21864 (S.D. Fla. June 30, 2008).

²⁹See Parillo, "U.S., Switzerland Initial Protocol Updating Information Exchange Provisions," *Tax Notes*, June 29, 2009, p. 1504, Doc 2009-14027, or 2009 TNT 117-1; see also Sheppard, *supra* note 21 (explaining insufficiency of OECD information exchange provision); Joann M. Weiner, "Is Switzerland a Tax Haven?" *Tax Notes*, May 11, 2009, p. 669, Doc 2009-9684, or 2009 TNT 89-25 (explaining conflict over bank secrecy or "financial privacy" between Switzerland and other nations).

Judge Sonia Sotomayor's Tax Opinions

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With the Senate about to confirm Judge Sonia Sotomayor as associate justice of the Supreme Court, *Tax Notes* readers may wish for information and analysis regarding her three published opinions on federal taxation, one as a district court judge and two as a court of appeals judge.

Two of the opinions deal with routine matters and will therefore be discussed only briefly. The third opinion, which was reviewed by the Supreme Court, will be discussed at greater length. Although Chief Justice John Roberts, writing for the Supreme Court, affirmed the result in that third opinion, he criticized Judge Sotomayor's reasoning (even though both the solicitor general and Treasury had endorsed it) and offered a different rationale. After a careful reading, I find the rationale of Judge Sotomayor's opinion at least as valid as, and probably preferable to, that of Chief Justice Roberts. I also find his criticism of her rationale logically flawed and therefore unwarranted.

Judge Sotomayor's first tax opinion, *Toker v. United States*,¹ written when she was a district court judge, was affirmed without opinion by the Second Circuit.² The taxpayers in *Toker* deducted losses for 1982, 1983, and 1984 in connection with a car leasing partnership. After receiving a deficiency notice for 1982, they filed a Tax Court petition contesting the deficiency. Two years later, in accordance with a stipulation between the taxpayers and the IRS, the Tax Court affirmed the deficiency, which the taxpayers paid shortly thereafter. After receiving additional deficiency notices for 1983 and 1984, the taxpayers entered into a binding written agreement with the IRS to settle the dispute and pay the deficiencies.

Other participants in the car leasing partnership declined settlement offers from the IRS and contested asserted deficiencies before the Tax Court, where they ultimately prevailed. The taxpayers in *Toker* then filed suit in the district court, arguing that the IRS had agreed to refund their payment of asserted deficiencies if other partners prevailed in litigation of the claimed deductions.

Judge Sotomayor's opinion granted the government's motion for summary judgment. For the 1982 deductions, she found that the district court lacked subject matter jurisdiction under section 6512(a), which provides that a

¹1982 F. Supp. 197 (1997), Doc 97-12312, 97 TNT 86-55.

²133 F.3d 908 (2d Cir. 1997).