

means the greater of (A) the area median gross income for the area in which the residence is located or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) provides for an upward adjustment of the income limitations in certain high housing cost areas. Under § 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under § 143(f)(5)(D) by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applicable housing price ratio is the new housing price ratio (new housing average purchase price for the area divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued and nonissued bond amounts elected after December 31, 1988.

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on January 7, 1998, and may be obtained by calling the HUD reference service at 1-800-245-2691, or, in the Washington, D.C., area, at 301-251-5154. The Internal Revenue Service annually publishes only the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on September 6, 1994, in Rev. Proc. 94-55, 1994-2 C.B. 716.

SECTION 3. APPLICATION

.01 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use \$45,300 as the median gross income for the United States. See section 2.06 of this revenue procedure.

.02 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use the area median gross income figures released by HUD on January 7, 1998. See section 2.06 of this revenue procedure.

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 97-26, 1997-17 I.R.B. 17, is obsolete except as provided in section 5.02 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86-124, 1986-2 C.B. 27. Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86-124 to the general approach taken in this revenue procedure.

SECTION 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in section 3 of this revenue procedure for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on January 7, 1998, the date HUD released the income figures, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

.02 Notwithstanding section 5.01 of this revenue procedure, issuers may continue to rely on the United States and area median gross income figures specified in Rev. Proc. 97-26 with respect to bonds originally sold and nonissued bond amounts elected not later than May 13, 1998, if the commitments or purchases described in section 5.01 are made not later than July 13, 1998.

DRAFTING INFORMATION

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SECTION 1. PURPOSE AND SCOPE

.01 *Purpose.* This revenue procedure gives guidance for entering into a withholding agreement with the Internal Revenue Service (IRS) to be treated as a Qualified Intermediary (QI) under §1.1441-1(e)(5) of the Income Tax Regulations. It describes the application procedures for becoming a QI and the terms that the IRS will ordinarily require in a QI withholding agreement. The objective of a QI withholding agreement is to simplify withholding and reporting obligations with respect to payments of income (including interest, dividends, royalties, and gross proceeds) made to an account holder through one or more foreign intermediaries.

.02 *Scope.* This revenue procedure applies to persons described in §1.1441-1(e)(5)(ii)(A) and (B)—foreign financial institutions, foreign clearing organizations, and foreign branches of U.S. financial institutions and U.S. clearing organizations. It does not apply to foreign corporations seeking to become a QI to present claims of benefits under an income tax treaty on behalf of shareholders. See §§1.1441-1(e)(5)(ii)(C) and 1.1441-6(b)(4)(ii)(B). It does not apply to a foreign partnership seeking to qualify as a withholding foreign partnership. See §1.1441-5(c)(2)(ii). It also does not apply to other persons that the IRS may accept to be qualified intermediaries as authorized under §1.1441-1(e)(5)(ii)(D). A person that is not within the scope of this revenue procedure but may seek QI

status under §1.1441-1(e)(5)(ii)(C) or (D), or §1.1441-5(c)(2)(ii) should contact the Office of the Assistant Commissioner (International) at the address or telephone number in section 4.01 of this revenue procedure.

SECTION 2. BACKGROUND

.01 *Withholding and reporting on payments to foreign persons.* Under sections 1441 and 1442 of the Internal Revenue Code (Code), a person that makes a payment of U.S. source interest, dividends, royalties, and certain other types of income to a foreign person must generally deduct and withhold 30 percent from the payment. A lower rate of withholding may apply under the Code (e.g., section 1443), the regulations, or an income tax treaty. Generally, a payor of these types of income must also report the payments on Form 1042-S. See §1.1461-1(c).

Under sections 6042, 6045, 6049, and 6050N of the Code (the Form 1099 reporting provisions), payors of dividends, gross proceeds, interest, and royalties must report the payments on Form 1099 unless an exception applies. If a payor must report a payment on Form 1099, it must obtain a Form W-9 from the payee. If the payor does not receive the Form W-9, it must backup withhold at a 31-percent rate under section 3406 of the Code. One exception to the Form 1099 reporting provisions applies if the payee is a foreign person. A payor can treat a person as foreign if the payor can reliably associate the payment with documentation that establishes that the person is a foreign beneficial owner of the income or a foreign payee. See §§1.6042-3(b)(1)-(iii), 1.6045-1(g)(1)(i), 1.6049-5(b)(12), and 1.6050N-1(c)(1)(i). Moreover, a payor does not have to backup withhold on payments to foreign beneficial owners or foreign payees because backup withholding applies only to amounts that the payor must report on Form 1099.

.02 *Proof of foreign status.* The regulations under section 1441 and the Form 1099 reporting provisions of the Code prescribe the manner in which a beneficial owner or payee certifies to a payor that it is a foreign or U.S. person and, if foreign, whether a reduced rate of withholding applies. For proof of foreign status, a payor or a withholding agent may rely on a Form W-8 or on documentary

evidence for payments made outside the United States to an offshore account or, in the case of broker proceeds, a sale effected outside the United States.

In addition, a payor or withholding agent may rely on a QI's certifications (as described in §1.1441-1(e)(3)(ii) and section 5.02 of this revenue procedure) to determine whether a beneficial owner or payee is foreign, and to determine the applicable rate of withholding and the appropriate type of reporting. The QI provides its certifications on a Form W-8. By furnishing its own Form W-8 to a payor or withholding agent, a QI may, for example, act on behalf of its foreign account holders to claim a reduction of the 30-percent withholding rate without having to document or identify to the withholding agent each foreign account holder individually.

SECTION 3. DEFINITIONS

For purposes of this revenue procedure, the terms listed below are defined as follows.

.01 A "QI" is an eligible person as described in §1.1441-1(e)(5)(ii)(A) or (B) (and paragraph .10 of this section) that enters into a withholding agreement (described in section 5 of this revenue procedure) with the IRS. A person acting in its capacity as a QI does not act as an agent of the IRS, nor does it have the authority to hold itself out as an agent of the IRS.

.02 A "QI-Form W-8" means a withholding certificate described in §1.1441-1(e)(3)(ii).

.03 An "account holder" means any person that has an account with a QI. It includes a person that is the beneficial owner of the account or a person that holds the account as an intermediary (e.g., custodian, nominee or agent).

.04 An "exempt recipient" means, for interest, dividends, and royalties, a person described in §1.6049-4(c)(1)(ii). For broker proceeds, it is a person described in §1.6045-1(c)(3)(i)(B) or in §1.6045-2(b)(2)(i).

.05 A "non-exempt recipient" or "non-exempt payee" means a person that is not an exempt recipient under the definition in paragraph .04 of this section.

.06 Any reference to "chapter 3 of the Code" means sections 1441, 1442, and 1443 of the Code, and shall not include references to sections 1445 and 1446 of

the Code, unless specifically indicated otherwise.

.07 Any reference to "chapter 61 of the Code" means sections 6041, 6041A, 6042, 6044, 6045, 6049, and 6050N of the Code.

.08 A "reportable amount" means an amount subject to withholding under chapter 3 of the Code (within the meaning of §1.1441-2(a)), U.S. source deposit interest (including original issue discount) described in section 871(i)(2)(A) of the Code, and U.S. source interest or original issue discount on short-term obligations described in section 871(g)(1)(B) of the Code. The term does not include payments on deposits with banks and other financial institutions that remain on deposit for two weeks or less. It also does not include amounts of original issue discount arising from a sale and repurchase transaction completed within a period of two weeks or less, or amounts described in §1.6049-5(b)(7), (10), or (11) (relating to certain obligations issued in bearer form). See §1.1441-1(e)(3)(vi).

.09 A "withholding agent" has the same meaning as set forth in §1.1441-7(a) and includes a payor, as defined in §1.6049-4(a)(2). As used in this revenue procedure, the term generally refers to the person making a payment to a QI.

.10 An "eligible person" means, as described in §1.1441-1(e)(5)(ii)(A) or (B), any foreign financial institution, foreign clearing organization, or foreign branch of a U.S. financial institution or U.S. clearing organization.

.11 A "branch" includes an office.

.12 A "financial institution" means a person described in §1.165-12(c)(1)(iv) (not including a person providing pension or other similar benefits or a regulated investment company or other mutual fund, unless otherwise indicated).

.13 A "clearing organization" means a person described in §1.163-5(c)(2)(i)-(D)(8).

.14 "Class of assets" and "withholding pool," have the meanings given to the terms in section 5.02(4)(c) of this revenue procedure.

.15 Any reference to "payments to a QI or an account holder" includes crediting an amount to the account of the QI or account holder.

.16 An "acceptance agent" is a person, as described in §301.6109-1(d)(3)(iv)(B),

that is authorized to assist persons in obtaining individual taxpayer identification numbers or employer identification numbers from the IRS. See Rev. Proc. 96-52, 1996-2 C.B. 372.

SECTION 4. APPLICATION FOR QI STATUS AND WITHHOLDING AGREEMENT

.01 *Where to Apply and Pre-submission Conferences.* To apply for QI status and a withholding agreement, an eligible person must submit a written request to:

Assistant Commissioner (International), CP:IN:OO:WT 950 L'Enfant Plaza South, SW
Washington DC 20024
FAX: (202) 874-1797

An eligible person may request one or more pre-submission conferences by contacting the Office of the Assistant Commissioner (International) at (202) 874-1800 (not a toll-free number).

.02 *Content of Application.* The application must establish to the satisfaction of the IRS that the applicant has adequate resources and procedures to comply with the terms of a withholding agreement. An application must include the information specified in this section 4.02, and any additional information and documentation requested by the IRS.

(1) A statement that the applicant is an eligible person and that it requests a QI withholding agreement with the IRS.

(2) The applicant's name, address, and employer identification number (EIN), if any.

(3) The country in which the applicant was created or organized and a description of the applicant's business.

(4) A list of the applicant's officers and directors and a list of the employees who are responsible parties for performance under the agreement.

(5) A list of the branches that the agreement will cover and their location.

(6) An explanation and sample of the account opening agreements and other documents used to open and maintain the accounts at each location covered by the agreement.

(7) The type of account holders (e.g., U.S., foreign, treaty benefit claimant, or intermediary), the approximate number of account holders within each type, and the estimated value of U.S. investments that the QI-Form W-8 will cover.

(8) An explanation of the applicant's "know-your-customer" practices and procedures (under its local money-laundering laws) for opening accounts, and identifying and communicating with customers at each location covered by the agreement. The explanation should include whether local law mandates the "know-your-customer" procedures and the manner in which local authorities verify compliance. The applicant should also describe the governmental or other supervisory authorities that regulate the "know-your-customer" procedures, and the sanctions that apply under local law for failing to comply with the procedures. The applicant must include supporting documentation.

(9) A list of assets in the United States from which amounts owed to the IRS can be collected, if necessary.

(10) A completed Form SS-4 (Application for Employer Identification Number) to apply for a QI Employer Identification Number (QI-EIN) to be used solely for QI reporting and filing purposes. An applicant must apply for a QI-EIN even if it already has another EIN.

(11) A proposed QI withholding agreement drafted in accordance with section 5 of this revenue procedure.

SECTION 5. QI WITHHOLDING AGREEMENT

.01 *Scope of the agreement.* An agreement may not cover U.S. branches of an eligible person. An eligible person is not required to include all of its foreign branches in the agreement. The IRS may require, however, that an eligible person agree to include certain of its branches to insure the disclosure of certain U.S. account holders. See §1.1441-1(e)(5)(iii) and section 5.02(3), below. In appropriate cases, an eligible person may request that the agreement cover its related non-U.S. affiliates or unrelated account holders that act as nominees, custodians, or agents of beneficial owners. If the IRS grants the request, each related non-U.S. affiliate or unrelated account holder must agree to be a signatory to the agreement.

.02 *Terms and procedures regarding intermediary withholding certificate.* (1) *Submission of QI-Form W-8.* The agreement must specify that a QI will furnish its QI-Form W-8, with its QI-EIN, to withholding agents for reportable amounts in lieu of furnishing a Form W-8

or Form W-9 from each of its account holders to such withholding agents.

(2) *Designation of primary withholding responsibility.* A QI is a withholding agent under chapter 3 of the Code and a payor under chapter 61 and section 3406 of the Code for reportable amounts that it pays to its account holders. Generally, a withholding agent that makes a payment to the QI, however, will be responsible for actually withholding under chapter 3 and section 3406 of the Code. Thus, if the withholding agent has withheld and reported on the reportable amounts paid to the QI, the QI is not required to withhold except to the extent required to correct any under-withholding. See §1.1441-1(b)(6). The QI may, however, agree in its withholding agreement to assume primary withholding responsibility for payments to foreign account holders. See §1.1441-1(e)(5)(iv). Generally, the IRS will not allow a QI to assume primary withholding or reporting responsibility for payments to U.S. persons unless the QI is a foreign branch of a U.S. financial institution, or the QI has a branch in the United States and establishes that its U.S. branch can adequately comply with the provisions under chapter 61 and section 3406 of the Code.

(3) *Disclosure of identity of beneficial owner or payee by QI.* Except as otherwise provided in this subparagraph (3), a QI is not required to disclose the identity of its account holders covered by a QI-Form W-8 to a withholding agent. Further, the documentation given by an account holder to a QI supporting the account holder's claim of foreign status and, if applicable, entitlement to a reduced rate of withholding does not need to be attached to the QI-Form W-8. The QI must, however, furnish a Form W-9 (or an acceptable substitute form) for each of its account holders (or those of another intermediary or of a foreign partnership) that is a U.S. payee that is not an exempt recipient. The identity of U.S. payees who are exempt recipients is not required to be disclosed to the withholding agent. If the QI does not hold a Form W-9 for a non-exempt U.S. payee, it must furnish to the withholding agent any information the QI has regarding the payee's name, address, and taxpayer identifying number. The requirement to disclose the identity of non-exempt U.S. payees will apply despite local bank secrecy laws.

(4) *Information to withholding agent.* (a) *In general.* A QI must agree to identify the classes of assets covered by the QI-Form W-8 by following §1.1441-1(e)(5)(v) and subparagraph (4)(c) of this section. In addition, the QI must state the rate of withholding for each class.

(b) *Application of presumptions.* To identify the relevant classes of assets, a QI may determine the status of its, or another intermediary's, account holders by following the presumptions in §§1.1441-1(b)(3), 1.1441-5(d) and (e), and 1.6049-5(d)(2) through (d)(5).

(c) *Class of assets and withholding pool.* (i) *Definition.* Generally, a class of assets is a group of assets that produces the same type of income (e.g., interest or dividends), is subject to the same rate of withholding, and is associated with the same type of payee or beneficial owner (e.g., foreign, U.S., or undocumented (i.e., a payee for whom the QI holds no or unreliable documentation)). Notwithstanding the general rule that a class of asset should produce the same type of income, a QI-Form W-8 may state that all assets held in a particular account are within a single class of assets if all the income from the assets in such account is subject to the same rate of withholding and the same type of information reporting. See, for example, subparagraph (4)(c)(ii)(C) of this section. The QI withholding agreement must require the QI to identify classes of assets on a country-by-country basis. The income from each class of assets is a separate "withholding pool." See section 5.07(3) for more information on withholding pools.

(ii) *Application.* (A) *Foreign payees.* Assets that are associated with foreign payees, that produce a specific type of income, and are subject to a particular withholding rate are a class of assets. Thus, there may be numerous classes of assets for the same type of income paid to foreign payees because of different withholding rates under the Code or an applicable treaty.

(B) *U.S. payees.* Assets associated with each U.S. payee that is a non-exempt recipient are a separate class. Assets associated with all U.S. payees that are exempt recipients are a single separate class.

(C) *Undocumented payees.* Assets associated with undocumented payees con-

stitute a separate class. A QI paying reportable amounts (other than U.S. source bank deposit interest or short-term OID) must presume that undocumented payees of those amounts are foreign unless the QI has actual knowledge that the payee is a U.S. non-exempt recipient. For reportable amounts that are bank deposit interest from a U.S. branch of a U.S. bank or similar financial institution or short-term original issue discount, the QI must presume that the undocumented payee is a U.S. non-exempt recipient.

(D) *QI assuming primary withholding responsibility.* Assets for which a QI assumes primary withholding responsibility are a separate class. The QI does not have to identify separate classes of assets within that class if the assumption of withholding responsibility makes such a disclosure unnecessary. The QI withholding agreement may, however, require a QI to identify the assets with respect to which it assumes primary withholding responsibility on a country-by-country basis.

(iii) *Example.* (A) *Facts.* A QI ("QI1") has foreign account holders. The QI1 also has account holders that are U.S. non-exempt recipients. Another account holder is a QI ("QI2") that has assumed primary withholding responsibility. Finally, QI1 has some account holders for whom it does not have the required documentation. QI1 has not assumed primary withholding responsibility for any assets.

All account holders earn U.S. source interest that would qualify as portfolio interest if they gave the documentation required by §1.871-14(c)(2). They also earn U.S. source dividends. Some of the foreign account holders can benefit from a 15-percent reduced withholding rate under a tax treaty on dividend income while others cannot.

(B) *Analysis.* QI1 has the following classes of U.S. source assets and withholding pools:

(1) assets producing interest earned by foreign account holders claiming the portfolio interest exemption at source (a withholding pool of interest - zero rate);

(2) assets producing dividend income earned by foreign account holders claiming the 15-percent reduced rate at source under an income tax treaty (a withholding pool of dividends - 15% rate);

(3) assets producing dividend income earned by foreign account holders resid-

ing in a non-treaty country (a withholding pool of dividends - 30% rate);

(4) assets producing interest income earned by each U.S. account holder (a withholding pool per account holder of interest reportable on a Form 1099 - zero rate);

(5) assets producing dividends earned by each U.S. account holder (a withholding pool per account holder for dividends reportable on a Form 1099 - zero rate);

(6) assets producing dividends and interest income earned by account holders for whom the QI1 does not hold all of the required documentation as specified under the agreement (a withholding pool for undocumented payees - 30% rate (presumed foreign)—Note: QI1 could divide this class of assets into one for dividends and another for interest income); and

(7) assets producing dividends and interest payable to QI2 for its foreign account holders (a withholding pool for which QI2 assumes withholding).

.03 *Documentation requirements.* (1) *In general.* The agreement must contain provisions covering the type of documentation a QI will obtain from its account holders. Generally, the QI must agree to the same documentation requirements that apply to withholding agents under chapters 3 and 61 of the Code. The QI may use any substitute form for a Form W-8 or Form W-9 that is acceptable to the IRS. The QI may include a substitute form in an account opening form. If a QI relies on documentary evidence in place of a Form W-8, the agreement must specify the type of documentary evidence upon which the QI may rely.

(2) *Documentary evidence from beneficial owners.* Beneficial owner documentary evidence is acceptable if the QI complies with the provisions of §1.6049-5(c)(1). Generally, a QI will be permitted to rely on the "know-your-customer" procedures (as submitted for review pursuant to section 4.02(8) of this revenue procedure) if such procedures are acceptable to the IRS.

(3) *Documentation supporting claim of reduced rate.* A QI may not reduce the rate of withholding, or instruct a withholding agent to reduce the rate, unless it can associate the payment with valid documentation described in the section 1441 regulations or in the QI withholding agreement. If an account holder is not an

individual, the QI must obtain a certification that the account holder meets the Limitations on Benefits article contained in any treaty the account holder invokes. See §1.1441-6(c)(5). If an account holder, other than an individual, is acting for its own account, the QI must also obtain a representation that the account holder is not a partnership for U.S. tax purposes. If the account holder is a partnership for U.S. tax purposes, then the QI must obtain a Form W-9 as described in §1.1441-1(d)(2) (if the partnership is a domestic partnership) or a Form W-8 as described in §1.1441-5(c) (if the partnership is a foreign partnership). In addition, if an account holder, other than an individual, claims the benefit of a reduced rate of withholding under a tax treaty, the QI must obtain the representations set forth in §§1.1441-6(b)(4)(i) and 1.894-1T(d).

(4) *Documentation from intermediaries.* When the QI receives a payment of a reportable amount for an account holder that is an intermediary (e.g., nominee, custodian, or agent), the QI must obtain beneficial owner documentation in the following manner:

(a) *Intermediary that is not a QI.* If the intermediary is not a QI, then the intermediary must give the QI a Form W-8 according to §1.1441-1(e)(3)(iii), including a statement described in §1.1441-1(e)(3)(iv) regarding the allocation of payments. A QI that receives a non-QI intermediary Form W-8 may either give the non-QI intermediary Form W-8, with all the accompanying documentation, to the withholding agent or may use the non-QI intermediary Form W-8 as the basis for the certifications that the QI includes in its own QI-Form W-8 regarding the status of, and entitlement to benefits by, the non-QI intermediary's account holders.

(b) *Intermediary that is a QI.* If the intermediary is a QI (i.e., a second tier QI), the second tier QI must give the first tier QI a QI-Form W-8. The first tier QI may give the second tier QI's QI-Form W-8, and accompanying documentation, to the withholding agent. Alternatively, the first tier QI may use the second tier's QI-Form W-8 as the basis for the certifications that the first tier QI includes in its own QI-Form W-8 regarding the status of, and entitlement to benefits by, the second tier QI's account holders. If the first tier QI relies on the second tier QI's QI-

Form W-8 to certify to the withholding agent the withholding status of the second tier QI's account holders, then the first tier QI must agree to allocate the assets associated with the second tier QI's QI-Form W-8 to the classes that the first tier QI has established for its own account holders as if the account holders of the second tier QI were the first tier QI's own account holders.

(c) *Assumption of primary withholding responsibility.* If a QI has assumed primary withholding responsibility, it must generally assume that responsibility for all other intermediaries, whether or not they are QIs, that are before it in the chain of payment. If a second tier QI has agreed to assume primary withholding responsibility, then a first tier QI that has also assumed primary withholding responsibility does not have to withhold on income paid to the second tier QI. If the second tier QI has assumed primary withholding responsibility but the first tier QI has not, the first tier QI must agree to identify for the withholding agent those assets associated with the second tier QI's QI-Form W-8 and on which there should be no withholding (other than under section 3406 of the Code, if applicable). See example under paragraph .02(4)(c)(iii), above.

(5) *Standards of reliability and due diligence.* A QI must agree to follow the due diligence obligations of §1.1441-7(b)(2)(ii). The reliability of any documentation will be evaluated by the type of information contained in the documents, the procedures under which the documents are issued, and the ease with which the documents could be falsified.

(6) *Renewal of documentation.* Unless specified otherwise in the agreement, a QI must agree to follow the provisions of §1.1441-1(e)(4)(ii) regarding the renewal of the Forms W-8 and documentary evidence provided by its account holders.

.04 *Assistance regarding taxpayer identification numbers.* (1) *Acceptance agents.* A QI may agree to act as an acceptance agent, including a certifying acceptance agent, for purposes of section 6109 of the Code and the regulations thereunder. See Rev. Proc. 96-52, 1996-2 C.B. 372, for the duties and obligations of an acceptance agent.

(2) *TIN certifications.* A QI may agree to assist its account holders in complying

with the requirements for a certified TIN under §1.1441-6(b). Only account holders claiming a reduced rate under an income tax treaty for certain payments (e.g., income from non-publicly traded securities) are required to obtain a certified TIN. See §1.1441-6(b)(1) and (2)(i).

.05 *Recordkeeping obligations.* The agreement must provide that the QI will maintain a record of the documentation obtained and reviewed under the agreement. The QI must maintain the documentation for any account holder for a period of three years after its validity expires. The documentation must also be available for inspection by the IRS or, if applicable, an approved external auditor.

.06 *Withholding obligations.* (1) *QI assumes primary withholding responsibility.* A QI that assumes primary withholding responsibility must agree to withhold any amount due under section 1441, 1442, or 1443 of the Code in accordance with §1.1441-1(b)(1) and §1.1443-1(b). If applicable, the QI must also agree to withhold any amount due under section 3406 of the Code. In addition, the QI must agree to deposit the withheld amounts following §1.1461-1(a) and all other relevant deposit obligations. Under the agreement, the IRS may agree to special deposit procedures to facilitate remittances from a foreign country.

(2) *QI that does not assume primary withholding responsibility.* A QI that does not assume primary withholding responsibility nevertheless must agree to withhold if it knows that an amount should have been withheld from the payment and the full amount was not withheld. The QI must also agree to comply with withholding and deposit procedures in the same manner as described in paragraph .06(1) of this section for amounts that it withholds.

.07 *Reporting obligations.* (1) *In general.* The regulations under section 1461 of the Code require a QI to make returns on a Form 1042 and to provide information to the IRS and beneficial owners or payees on a Form 1042-S on a calendar year basis under the provisions of §1.1461-1(b), subject to the following modifications to which the IRS may agree.

(2) *Form 1042 reporting.* Generally, every QI shall file an annual Form 1042 and the form must include the following additional information:

(a) A schedule providing information on reportable amounts of income subject to withholding under chapter 3 of the Code that the QI received during the calendar year. The schedule should list the name, address, and EIN of each withholding agent from whom the reportable amounts were received and the income type and rate of withholding;

(b) Information regarding overpayments or balances due, adjustments under §1.1461-2 and an explanation for the over- or underwithholding;

(c) A statement regarding the audit conducted by the QI's internal auditors under the audit guidelines specified in the agreement (i.e., that the QI is complying with the agreement in all material respects or a description of the irregularities uncovered by the internal auditors and the actions undertaken to correct such irregularities); and

(d) A statement that an approved external auditor conducted an audit, when required, with a copy of the report of audit findings (see paragraph .09 of this section regarding verification procedures).

(3) *Form 1042-S reporting.* The agreement may waive the obligation for a QI to report beneficial owner information to the IRS on Forms 1042-S in appropriate cases. In place of beneficial owner information, the IRS may require the QI to report by country and withholding pools. An appropriate case may exist if beneficial owner information is otherwise available to the IRS, for example, pursuant to treaty exchange of information provisions, or the IRS decides that access to beneficial owner information is not necessary for compliance. Similarly, reporting by withholding pools may be sufficient for compliance purposes if the QI has agreed to adequate verification procedures as described in paragraph .09 of this section. The QI may provide the information on a Form 1042-S, as modified by the IRS to adapt to the withholding pool reporting requirements, on magnetic media, by electronic means, or on any form to which the IRS and the QI agree. The information must include the number of account holders in each pool. The type of withholding pool subdivisions the IRS may require for the payment of reportable amounts under chapter 3 of the Code (within the meaning of §1.1441-2(a)) includes the following:

(a) Type of income;

(b) Withholding rate;

(c) Country of residence of account holder; and

(d) Type of recipients (e.g., undocumented payees, U.S. payees).

(4) *Furnishing a Form 1042-S to the beneficial owner or payee.* The agreement may modify or waive the obligation under §1.1461-1(c)(1)(i) that the QI furnish a statement to a beneficial owner or payee on a Form 1042-S and provide for alternative reporting procedures.

(5) *Reports related to claims of a reduced rate under a tax treaty.* The QI must agree to give the IRS, on request or on an annual basis, the names and addresses of its account holders that received a reduced rate of withholding under a tax treaty and that have certified that they meet the Limitation on Benefits provision and that they derive, within the meaning of §1.894-1T(d), the income receiving the benefit. The QI must also agree to disclose the names and addresses of account holders of any non-QI intermediary that has given the QI a Form W-8 or other documentation if the account holders have certified that they meet the Limitation on Benefits provision of a treaty and derive the income receiving the benefit. Generally, the IRS will agree to limit disclosure to account holders that receive more than an agreed upon amount (not less than \$100,000) of treaty-benefited income in their QI account.

.08 *Adjustments for under- and overwithholding, refund procedures, and underwithholding determined after the filing of Form 1042.* (1) *Adjustments.* If a QI has not assumed primary withholding responsibility, it must agree that it will provide sufficient information to a withholding agent so that the withholding agent can make the adjustments for over- and under-withholding described in §1.1461-2(a) and (b). If a QI has assumed primary withholding responsibility, it may make the adjustments itself in the manner described under §1.1461-2(a) and (b).

(2) *Refunds.* A QI withholding agreement may allow any net amount of overwithholding for a calendar year on a QI's account holders which remains outstanding after the due date for filing the QI's Form 1042 (not including extensions) to be refunded to the QI for its account holders (under procedures as the IRS may pre-

scribe) if an adjustment under §1.1461-2(a) cannot be made.

(3) *Underwithholding determined after filing a QI's Form 1042.* A QI, including a QI that does not assume primary withholding responsibility, must agree to file an amended Form 1042 to report any underwithheld tax which is determined after the filing of the QI's Form 1042 for the calendar year in which the tax was underwithheld. In addition, the QI must agree to pay the tax due (including interest and penalties). This includes, but is not limited to, instances where the underwithholding is determined as a result of an audit by the QI's internal or external auditors.

.09 *Verification procedures.* (1) *In general.* Unless the QI agreement allows for verification by an external auditor, a QI must agree to make records and account information specified in the QI withholding agreement available to the IRS for audit, and must agree to procedures for carrying out an audit of those records and information. The IRS must be able to verify that the QI has adequate systems and control procedures in effect to comply with the agreement. In addition, the IRS may require specific procedures to allow it to verify compliance with the QI withholding agreement for specific accounts.

(2) *Verification of specific account information.* If a QI is not subject to audit under the approved external auditor procedure, described in paragraph .10(3) of this section, then the QI withholding agreement will contain procedures for IRS audits of account information. Generally, a QI that complies with the filing requirements on Forms 1042 and 1042-S (or otherwise makes account holder information available to the IRS) may be exempted from IRS audits or be subject to abbreviated IRS audits. If a QI has agreed to certify tax residence to the IRS under §1.1441-6(c)(2)(iii) based upon documentation the QI has obtained and reviewed, it must also agree to give the documentation to the IRS upon written request in the manner agreed. To conduct periodic compliance checks, the IRS may rely on sampling techniques to assure reliability of the examination without undue disruption to the QI. The agreement will specify the manner in which IRS compliance checks will take place. In appropriate cases, assistance may be

obtained from the tax authorities of the countries where the QI activities are located.

(3) *Approved external auditors.* If, given local enforcement of know-your-customer procedures and local oversight and controls over the QI and its external auditors, the IRS determines it is appropriate, the following procedures will generally apply under the agreement.

(a) The QI must establish that it has implemented adequate internal procedures and accounting systems to comply with the QI withholding agreement and to verify its compliance with those procedures. Internal auditors must review those procedures and accounting systems on an annual basis as a regular part of their audit program. Their conclusions must be included in their annual audit report. A statement certifying that the annual review has taken place and the results of that review (including a notation of all irregularities observed and actions taken to address those irregularities) must be attached to the QI's annual Form 1042 filed with the IRS.

(b) Verification must also be performed by external auditors. The QI must agree to an external auditor's review after the first year of operation as a QI. Thereafter, the frequency and scope of compliance checks by external auditors will occur only at the request of the IRS, generally based upon a review of the QI's Form 1042 or indicators that the QI may have compliance problems (e.g., large refund requests, large pool of undocumented payees). The scope of review by external auditors may be limited based on the scope of annual internal audits. In order for the external auditors to perform their audit effectively, the QI must agree to allow external auditors to have access to all of its relevant records for purposes of performing the audits.

(c) The external auditor must be approved by the IRS and designated in the QI withholding agreement. Subsequent changes of external auditors must also be approved by the IRS. To be approved, an auditor must be subject to regulatory supervision under the laws of the country or countries in which the QI's activities under the agreement are expected to occur. The external auditor's procedures must require it to verify that the QI complies with the terms of the agreement and

to report non-compliance findings under the agreement.

(d) Upon completion of the audit, the external auditors must issue a report of audit findings (or incorporate their audit findings as a separate part of a larger audit report) and provide the report to the IRS in English (and using U.S. dollars). The report must explain the scope and objectives of the audit, state the methodology used, and certify that the audit was conducted in accordance with applicable laws and regulatory requirements. The report must express the auditor's opinion on the QI's compliance with the terms of the agreement. The QI and the approved external auditor must agree to allow the IRS to communicate with the external auditors and review their workpapers, if necessary. If the external auditor's report identifies compliance issues or if, based on a review of the external auditor's report, the IRS determines that further checks are necessary, then the IRS may request that the external auditor perform additional audit procedures.

(4) *Special rules for foreign branches of U.S. financial institutions.* Generally, a QI that is a foreign branch of a U.S. financial institution will be subject to the same IRS audit procedures that apply to any U.S. taxpayer.

.10 *Guarantee of payment.* To insure collection of payments for underwithheld amounts, the agreement may require a guarantee to be furnished by the QI to the IRS. The guarantee may include a letter of credit, bond, or other surety in an amount to which the QI and the IRS agree. The amount of the bond or letter of credit must be commensurate with the approximate risk of underwithholding. Factors to be considered in this regard include the amount of U.S. investments made through the QI, the number of beneficial owners making U.S. investments, the type of investment and the characteristics of the beneficial owners, and the degree of reporting by the QI to the IRS. Generally, a QI that has substantial assets in the United States will be considered to have adequately guaranteed its withholding obligations.

.11 *Approval and Execution.* An agreement must be signed by the authorized representative of the QI and by the IRS. The Assistant Commissioner (International) will sign on behalf of the IRS upon

approval by the Associate Chief Counsel (International). To the extent an agreement covers a QI's related non-U.S. affiliate or unrelated account holder, that affiliate or account holder must be a signatory to the agreement.

.12 *Expiration, Termination and Default.* (1) *Term and events of termination.* The period of the agreement will be between three and six years. The agreement may be renewed for further periods as specified in paragraph .13 of this section. Either the IRS or the QI may terminate the agreement prior to its term by delivering a 30-day notice of termination to the other party. The IRS will not give notice of termination until thirty days after it has delivered a notice of default to the QI. The IRS may deliver a notice of default at any time after an event of default under the agreement has occurred or after a significant change in the circumstances of the QI has occurred such as a merger, changes in the business or operations of the QI, or bankruptcy.

(2) *Events of default.* Events of default include the determination upon audit or otherwise that the QI has failed to comply with the procedures required by the agreement in a way that (1) causes, or may cause, significant underwithholding, excessive refunds, or an excessive number of undocumented payees, or (2) impedes, or may impede, the disclosure of the identity of persons who are required to be disclosed under the agreement. An event of default also includes the lack of cooperation by the QI or an approved external auditor in connection with an audit of the QI or with inquiries by the IRS related to verifying compliance by the QI. The agreement will define when underwithholding or inadequate reporting is deemed to be significant. A QI will also be in default if it makes material misrepresentations on its Form W-8; it has actual knowledge at the time a payment is made that documentation regarding a significant number of account holders is lacking, incorrect, or unreliable; or it fails to perform any other material duty or obligation required of it under the agreement. The QI may respond to the notice of default by making an offer to cure within thirty days. The IRS will accept or reject the offer to cure, or make a counter-proposal, within ten days.

.13 *Renewal.* A QI may renew a QI withholding agreement by submitting an

application for renewal to the IRS no earlier than one year and no later than six months prior to the expiration of the agreement. In the application for renewal, the QI will update the information it provided in the original application. Before approval of any renewal of the agreement, the IRS will require an audit of the QI.

.14 *Effective date of agreements.* The agreements entered into under §1.1441-1(e)(5) will be effective for all accounts opened on or after the date specified in the agreement. For accounts existing on the effective date of the agreement, the requirements to obtain documentation generally will not apply until the expiration of the one-year period beginning on the agreement's effective date. Until the documentation is obtained for these accounts, the QI generally will be permitted to rely on any documentation or information in an existing account file. In the absence of any documentation or indication, or actual knowledge, the QI will be allowed to presume that an account holder is a foreign person based on the indicia of foreign status described in §1.1441-1(b)(3)(iii)(A). The presumption shall not be effective for purposes of obtaining the benefit of the portfolio interest exemption under section 871(h) or 881(c) of the Code or the benefit of a tax treaty.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective on the date of its publication in the Internal Revenue Bulletin. The IRS may conclude agreements under this revenue procedure at any time after that date, but such agreements will not have effect before the date specified in the agreement.

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1597.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information are contained in sections 4 and 5 of this revenue procedure regarding (1) the application procedures for QI status and withholding agreements, and (2) the provisions of the QI withholding agreement requiring record retention or maintenance, and any communication or contact with the IRS or the account holders. This information will be used to enable the IRS to determine whether to enter into a withholding agreement with the QI applicant and, if accepted, to verify the QI's compliance with the agreement. The collection of information is required to obtain a QI withholding agreement. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 301,393 hours.

The estimated average annual burden is 30 minutes for a QI account holder, and 2,093 hours for a QI, depending on individual circumstances. The estimated number of respondents and/or recordkeepers is 88,504.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 8. FURTHER INFORMATION

For further information regarding this revenue procedure, telephone the Office of Assistant Commissioner (International) at (202) 874-1800 (not a toll-free number).

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Sections 471; 1.471-2.)

Rev. Proc. 98-29

SECTION 1. PURPOSE

This revenue procedure provides guidance for a taxpayer that wants to change to a method of accounting for estimating inventory "shrinkage" in computing ending inventory. "Shrinkage" refers collectively to such items as undetected theft,

breakage, and bookkeeping errors. In addition, section 4 of this revenue procedure provides interim guidance that describes the "retail safe harbor method" for a taxpayer that wants to change to the retail safe harbor method for estimating inventory shrinkage. The procedures for a taxpayer within the scope of this revenue procedure to automatically change to a method of accounting for estimating inventory shrinkage are provided in Rev. Proc. 97-37, 1997-33 I.R.B. 18, as modified by section 5.02 of this revenue procedure. This revenue procedure also requests comments on issues that should be addressed in forthcoming regulations under § 471 regarding proper methods of estimating inventory shrinkage for taxable years ending after August 5, 1997.

SECTION 2. BACKGROUND

.01 Section 471(a) of the Internal Revenue Code provides that whenever, in the opinion of the Secretary, the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories must be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

.02 Section 1.471-2(d) of the Income Tax Regulations provides that when a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith. Physical inventories are used to determine and adjust book inventories for shrinkage.

.03 Section 961 of the Taxpayer Relief Act of 1997 (Act) amended § 471(b) to permit, under certain circumstances, adjustments to ending inventory for estimates of inventory shrinkage. Section 961(b) of the Act provides that, in the case of any taxpayer permitted by § 471(b) to change its method of accounting to a permissible method for any taxable year, the change is treated as made with the consent of the Secretary and the period for taking into account the adjustments under § 481 by reason of such change is four years.