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Proposed Changes to the Qualified Intermediary (QI) Agreement

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A U.S. withholding agent generally includes any person that pays an amount subject to withholding to a foreign person. If the foreign person receives the payment as an intermediary on behalf of one or more beneficial owners of the income, the obligations of both the U.S. withholding agent and the intermediary vary based on intermediary's status under chapter three of the I.R.C. A nonqualified intermediary (NQI) is an intermediary that has not entered into any agreement with the IRS, and NQIs generally do not have any obligations other than passing up information regarding the persons for whom they receive payments so that upstream withholding agents can withhold and report as required. A qualified intermediary (QI) is an intermediary that has entered into a QI agreement, as described in Reg. §1.1441-1(e)(5)[1] and §1.1441-1(e)(6), under which the QI assumes certain withholding and reporting obligations that would otherwise generally fall on upstream withholding agents.

BRIEF OVERVIEW OF PROPOSED CHANGES TO QI AGREEMENT

On May 3, Treasury and the IRS released an advanced copy of Notice 2022-23 (Notice), setting forth the proposed changes to the QI agreement. The proposed changes will permit a QI to act in that capacity when receiving certain amounts from a publicly traded partnership (PTP) that are subject to withholding under §1446(a) and §1446(f).

In general, the QI agreement allows certain non-U.S. intermediaries to enter into an agreement with the IRS to simplify certain of their obligations as a withholding agent under chapters 3 and 4 of the Code and as a payor under chapter 61 and §3406 for amounts paid to their account holders. The QI agreement currently in effect, as provided in Rev. Proc. 2017-15, expires on December 31, 2022. That agreement specifically excludes §1446 from the definition of chapter 3. This means that, currently, a QI is not permitted to act in that capacity when it receives income from a PTP distribution that is effectively connected to the PTP's U.S. trade or business (ECI) on behalf of a non-U.S. account holder.

Significant to this, many QIs invest into PTPs on behalf of their non-U.S. account holders. Moreover, since the effective date of the current QI Agreement, there have been statutory and regulatory changes to the partnership rules relating to non-U.S. holders. In December 2017, §864(c)(8) and §1446(f) were added to the Code. Section 864(c)(8) generally provides that, for a non-U.S. interest holder, gain or loss on the sale or exchange of an interest in a partnership engaged in a trade or business within the United States is treated as effectively connected gain or loss to the extent provided in that section. Section 1446(f)(1) provides that if any portion of the gain on any disposition of an interest in a partnership would be treated under §864(c)(8) as effectively connected with the conduct of a trade or business within the United States, then the transferee of the interest must withhold a tax equal to 10% of the amount realized on the disposition. Since the time of enactment, impacted stakeholders have worked with the IRS to incorporate the new §1446(f) withholding rules into the QI Agreement. The Notice outlines the intended modifications to the

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

QI Agreement for QIs effecting a transfer of an interest in a PTP or receiving a PTP distribution on behalf of an account holder.

Pursuant to the proposed changes, QIs are permitted three options as it relates to its §1446(a) and §1446(f) responsibilities: (1) Assume withholding responsibilities (Withholding QI); (2) Don't assume withholding responsibilities and provide pooled withholding instructions to the upstream custodian (Nonwithholding QI); or (3) Don't assume withholding responsibilities but fully disclose owner information to the upstream custodian (disclosing QI). The first two options are the norm under the current QI regime. The third option, fully disclosing non-U.S. owner information, is a new concept for the QI regime.

The reporting requirements generally follow the withholding obligations but there are also certain options available as it relates to the §6031 reporting requirements (the so-called nominee rules). Below are the documentation, withholding, and reporting requirements for each of the three options.

QI THAT ASSUMES WITHHOLDING FOR §1446(A) AND §1446(F) (WITHHOLDING QI)

Documentation for Non-U.S. Beneficial Owners of PTP Interests

Similar to the normal QI documentation rules, a QI (other than a disclosing QI, discussed below) generally may document a non-U.S. beneficial owner account holder with a withholding certificate (e.g., Form W-8BEN/BEN-E) or documentary evidence for purposes of §1446(a) and §1446(f). Because of the §6031 nominee reporting obligations and the non-U.S. investor's U.S. tax return filing requirement, however, the QI must have the non-U.S. beneficial owner's U.S. taxpayer identification number (TIN). Note that where a non-U.S. beneficial owner is claiming an exemption from withholding under an income tax treaty or pursuant to §501(c), a withholding certificate (i.e., IRS Forms W-8BEN/BEN-E for a treaty claim or Form W-8EXP for a claim under §501(c)) is the only permissible type of documentation. The normal rules apply for documenting another intermediary or flow through entity.

Withholding

The Notice's proposed changes to section three of the QI Agreement will allow a QI to assume primary withholding responsibilities for withholding under §1446(a) on a payment-by-payment basis. It is important to note, however, that if a QI assumes withholding responsibility for any portion of a PTP distribution, it must assume the responsibility for the entire distribution (including amounts subject to withholding under chapters 3 and 4, even if the QI does not normally assume such responsibilities). In this regard, similar to the current QI regime, a withholding QI will receive the payment free of withholding and will apply the withholding itself based on the tax documentation it has on file for the beneficial owner. Note that a withholding QI does not need to assume withholding responsibilities for payments to another QI that has assumed withholding responsibilities with respect to §1446 (or to a withholding foreign partnership or withholding foreign trust for the portion of the distribution relating to amounts subject to withholding under chapters 3 and 4 only).

For purposes of §1446(a), a withholding QI that acts as a nominee with respect to a PTP distribution generally will impose withholding (generally 21% for non-U.S. corporate beneficial owners and 37% for all other non-U.S. owners) based on the amount designated in the PTP's qualified notice. As it relates to a distribution and the 10% §1446(f) withholding, a withholding QI's withholding responsibilities is limited to distributions in excess of the PTP's cumulative net income. Again, this amount, if any, will be set forth in the PTP's qualified notice. If the QI does not receive a qualified notice for a distribution (or the qualified notice does not specify the amount subject to withholding), the QI is required to withhold at the maximum rates under the normal §1446(a) rules.

As indicated above, a QI that §1446(f) withholding responsibilities must withhold on the payment except for any amount allocable to another QI that has elected to assume the same withholding responsibilities on the amount realized. While the normal rules apply for Forms W-8IMY from an intermediary or flow through entity, similar to the regulations, the withholding QI may not reduce the rate of withholding under §1446(f) to payments to a nonqualified intermediary (NQI). Thus, even where proper underlying owner documentation is provided, and that documentation supports a lower rate of withholding, the full 10% withholding on the amount realized must be imposed. Conversely, the QI may withhold on the modified amount realized for payments to a nonwithholding foreign partnership when proper documentation is provided (i.e., apply the 10% withholding only on the amounts allocable to persons that would be subject to the withholding had they owned the PTP interest directly). It is important to note that, for purposes of §1446(a) and §1446(f), a withholding foreign partnership is treated the same as a nonwithholding foreign partnership.

Finally, a QI that is a U.S. payor and chooses to assume these withholding responsibilities must also assume the responsibility for Form 1099 reporting and

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backup withholding on any portion of the amount realized allocable to a U.S. nonexempt recipient. In other words, the exception to pass that responsibility to the upstream broker will not apply for the amount realized from the sale of the PTP interest for a withholding QI.

Form 1042-S Reporting

Also similar to the current QI rules for chapters 3 and 4, a withholding QI is permitted to pool report the PTP distributions and amounts realized subject to withholding under §1446(a) and §1446(f) and paid to its direct non-U.S. beneficial owner account holders on Forms 1042-S. That said, the Form 1042-S Instructions provide that the name of the PTP must be included on that form as the payor. This means the QI must issue its pooled Forms 1042-S broken down by each specific PTP into which the QI invests on behalf of its non-U.S. account holders. In addition, the QI is required to issue a recipient-specific Form 1042-S to any non-U.S. account holder upon request.

For payments to foreign partnerships that are the QI's direct account holder, the Form 1042-S should be issued directly to the partnership (unless the §4.06 agency rule, discussed below, applies). If the account holder is a grantor trust, the Form 1042-S must be issued to the grantor (again, unless the §4.06 agency rule applies). Finally, for payments of an amount realized subject to §1446(f) withholding paid to an account holder that is an NQI, the Form 1042-S should be issued to ''Unknown Recipient.'' Note, however, that there is an option to report directly to the NQI's underlying owners if, among other requirements, the QI agrees to the recipient-specific reporting (including Form 1099-B, if required) and the NQI has provided all of the requisite documentation, including the §6031 nominee reporting information (and an agency appointment with respect to QI transferring that information to the PTP).

Section 6031 (Nominee) Reporting

In general, §6031 requires a nominee that holds a partnership interest on behalf of another person to provide the partnership certain information about itself as well as the person for whom it holds the interest. This information allows the partnership to issue the requisite Schedule K-1 to the actual owner of the interest so that the interest holder has the information needed to file a tax return. Where the nominee does not provide this information, it is required to provide certain information to the person for whom it acts (e.g., partnership income, gain, loss, deductions, etc.). Pursuant to the Notice, the term nominee includes a QI that assumes withholding responsibilities for a PTP distribution. For purposes of the §6031 reporting, the Notice allows the withholding QI to provide the PTP (or its agent) with the information set forth in Reg. §1.6031(c)-1T(a) so that the Schedule K-1 reporting can be issued by the PTP directly to the partner(s) for whom the withholding QI acts. Conversely, the withholding QI can choose to not provide such information and, instead, provide the information set forth in Reg. §1.6031(c)-1T(h) directly to the partner.

QI THAT DOESN'T ASSUME WITHHOLDING AND PASSES UP POOLED WITHHOLDING INFORMATION (NONWITHHOLDING QI)

Documentation for Non-U.S. Beneficial Owners of PTP Interests

The documentation requirements for non-U.S. beneficial owners investing in PTPs through a nonwithholding QI are identical to those outlined above for the withholding QI.

Withholding

The proposed changes permit a nonwithholding QI to provide pooled withholding instructions to its upstream custodian with respect to amounts covered by §1446(a) and §1446(f). Similar to the current QI regime, the QI that adopts this approach will provide the upstream withholding agent pooled withholding information on the withholding statement that is associated with its Form W-8IMY. With respect to broker proceeds from the sale of PTP interests owned by U.S. nonexempt recipients, the QI must separately elect to assume (or not assume) the Form 1099 reporting and backup withholding on the Form W-8IMY it provides to its upstream broker. In line with the normal nonwithholding QI rules, the nonwithholding QI will have a residual withholding obligation when it knows that the proper withholding was not imposed (regardless of whether it was the cause of the underwithholding).

Form 1042-S Reporting

The Form 1042-S reporting for the nonwithholding QI are identical to those outlined above for withholding QIs.

Section 6031 Nominee Reporting

Similar to the rules for Form 1042-S reporting, the Notice provides that the nonwithholding QI has the

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same options with respect to §6031 reporting as a withholding QI. That is, the QI can either pass up the required information so that the PTP (or its agent) can issue the Schedule K-1 directly to the partner(s) for whom the QI acts or the QI can report the partner's allocable share of the information on the Schedule K-1 that it receives to the partner(s) itself. (Given this, it is unclear why the definition of a nominee only includes a QI that has assumed withholding responsibilities on PTP distributions).

Analysis

Non-U.S. persons that invest in PTPs that distribute ECI, including gains on transfers subject to withholding under §864(c)(8), are required to file a U.S. tax return. For this reason, a U.S. TIN must be associated with the beneficial owner tax documentation (see documentation requirements above). That said, the QI Agreement continues to allow pooled reporting absent a request by the account holder for a recipient-specific form (which, seemingly, the interest holder will need in order to claim the credit for the withholding). It is helpful that the proposed changes limit the QI's requirement to issue the recipient-specific forms to situations where the non-U.S. account holder has a U.S. TIN (or indicates in writing that it has applied for one) and the request is made within three full calendar years from the year the QI made the reportable payment.

Unfortunately, however, the Notice does not contain any guidance as to what the QI is required to do in terms of amending the Form 1042-S reporting pool in which the payment was originally reported. It is anticipated that the request for recipient-specific Forms 1042-S will be made frequently and throughout the stated three-year period. It will be impractical for the QI to amend its pooled Form 1042-S every time a recipient-specific Form 1042-S request is made. Instead, an annual amendment requirement or, better yet, an internal record reconciliation that could be reviewed by the QI's external/internal reviewer prior to a responsible officer compliance certification would be a welcomed accommodation.

More importantly, as it relates to the U.S. TIN requirement, the proposed rules are silent regarding what happens if the account holder does not have the TIN. Section 1446 would simply require the application of the presumption rules for withholding. Significant to this, the IRS currently receives and processes Schedules K-1 without partner TINs[2] Presumably, the same rules will apply here (though see potential concerns outlined below for disclosing QIs).

Another significant compliance issue will occur when an NQI or nonwithholding foreign partnership passes up a comprehensive documentation package (including tax documentation for U.S. nonexempt recipients and withholding statements containing gain allocations for those persons). Specifically, when this occurs, the relief from Form 1099-B reporting on the sales proceeds from the sale of a PTP interest provided under Reg. §1.6049-4(d)(3) will no longer apply. This is because the QI will now have actual knowledge that an underlying owner is a U.S. nonexempt recipient AND actual knowledge of the amount allocable to such person(s).

A final observation relates to the reporting for U.S. owners of NQI account holders where the QI has agreed to report at the beneficial owner level. Because the §1446(f) 10% withholding on the amount realized is mandatory, even on the amounts allocable to the underlying U.S. owners, it is unclear how the QI should report to ensure that these owners can get a credit for the amounts withheld. Currently, the Form 1042-S instructions provide that the forms should be not issued to U.S. persons. Further, reporting the 10% withholding on a Form 1099-B would not be appropriate because the amount withheld has been deposited into the 1042 account of the withholding agent (whether that person is the QI or its upstream custodian) as opposed to the 945 account associated with a Form 1099. Presumably, guidance on this issue will be forthcoming.

QI THAT DOESN'T ASSUME WITHHOLDING AND PASSES UP FULL ACCOUNT HOLDER DOCUMENTATION (DISCLOSING QI)

Finally, the proposed changes also contain the anticipated new category of a ''disclosing QI.'' A disclosing QI does not assume withholding responsibilities under §1446(a) and §1446(f) and, instead, passes up underlying owner documentation, along with a withholding statement including recipient-specific ownership information as well as income/gain allocations. The disclosing QI must also pass up the requisite §6031 nominee statement containing sufficient information for the PTP (or its agent) to issue the Schedule K-1 to the beneficial owners of the PTP interests. When these procedures are properly executed, the disclosing QI should not have any reporting obligations as it relates to the PTP distributions or transfers.

Documentation Requirements for the Disclosing QI

The proposed guidance provides that withholding certificates are the only permissible form of documen-

[2] *See* IRM 3.0.101.14.17.2 (01-01-2018), which provides IRS personnel with processing instructions where the TIN is missing on the Schedule K-1.

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tation for accounts holders of a disclosing QI. In addition, the proposed rules cross reference the §1446 rules for purposes of form validity for a disclosing QI. Specific to this, the §1446 rules make clear that a valid form (regardless of type) must include a U.S. TIN. This requirement appears to be an ''all or nothing'' concept. In other words, as currently drafted, it appears that a QI could not act as a disclosing QI unless it has Forms W-8 with U.S. TINs for all account holders for whom it receives a PTP distribution or payment of an amount realized subject to withholding under §1446(a) or §1446(f).

Withholding and Form 1042-S Reporting Obligations

A disclosing QI would only have withholding and reporting obligations if it knew that the upstream custodian, broker, or PTP did not withhold and/or report correctly.

Section 6031 Nominee Reporting

As indicated above, for purposes of §6031 reporting, the Notice requires the disclosing QI to provide the PTP, its agent, or the QI's upstream nominee with the information set forth in Reg. §1.6031(c)-1T(a) so that the Schedule K-1 reporting can be issued directly to the partner(s) for whom the disclosing QI is acting. Where the QI provides the statement to its nominee, it must either appoint that nominee as its agent or obtain a representation from the nominee that it is acting as an agent of the PTP with respect to the statement.

Analysis

The ''all or nothing'' approach seems unnecessarily inflexible without an apparent need. Many non-U.S. investors in PTPs do not have U.S. TINs and, to date, the IRS has not pushed that issue notwithstanding the fact that it receives Schedules K-1 without TINs. For a non-U.S. individual, the application process for an Individual Taxpayer Identification Number (ITIN) is currently exceeding one year in many instances.

Processing delays are also common for a non-U.S. entity applying for an Employer Identification Number (EIN). Given this, at a minimum, there should be some type of transition relief. More problematic, however, is the burden this is placing on a QI that would like to disclose owner information where possible even though the QI may have some forms without the requisite TIN. It is not clear why the QI cannot avail itself of this option and, instead, must implement additional compliance processes notwithstanding the fact that it may already have segregated accounts upstream for these account holders for purposes of §1446. As indicated above, the IRS currently receives Schedules K-1 without TINs, and regardless as to who issues the reporting under these facts (the QI, upstream custodian, broker, or PTP), the information will be identical–that is, regardless of who reports, there will be no TIN. Therefore, there does not appear to be a compliance objective achieved by placing the reporting burden on the QI rather than the upstream withholding agent when certain account holders have not provided TINs.

Over and Underwithholding

The Notice makes clear that a QI is not able to utilize the collective refund procedures for any withholding imposed under §1446(a) or §1446(f). This is because the non-US interest holder is required to file a U.S. tax return to report the PTP's ECI. If the QI overwithholds or underwithholds, the proposed rules provide that the normal rules relating to chapters 3 and 4 will apply.

Joint/Agency Account Options

The joint account option was implemented as an accommodation to QIs operating in jurisdictions where local law prohibited recipient-specific reporting on payments to certain indirect account holders (e.g., non-U.S. partners in a non-U.S. partnership). That said, the option has never been applicable to the extent any indirect account holder was a U.S. person. Given this, and the purpose of withholding and reporting pursuant to §1446(a) and §1446(f), Treasury and the IRS concluded that any modification to those rules for purposes of §1446(a) or §1446(f) would not be appropriate.

Private Arrangement Intermediaries (PAI)

The Notice provides that a QI that has an agreement with a PAI may apply the disclosing QI rules with respect to any payments subject to §1446(a) or §1446(f). This means that the PAI must provide the QI with all of the documentation and information that a disclosing QI must provide and the PAI's QI must withhold and report accordingly. In addition, the modified §4 provides that the QI must follow the rules in §8.07 to satisfy the §6031 nominee reporting obligations (and that the PAI must provide the QI with the necessary information for it to meet those requirements).

Analysis

The PAI rules were incorporated into the original 2001 QI Agreement as an accommodation to very

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small intermediaries (e.g., cooperatives) that had very little U.S. investment on behalf of its account holders and where the compliance burdens of the QI agreement were cost prohibitive. In essence, the rules permit a PAI to "piggyback" off of the QI's agreement without having to enter into a QI Agreement with the IRS directly and without having to provide the QI for whom it acts as a PAI with its account holder documentation. Subsequent to the original PAI provisions, modifications were made that eliminated a PAI's ability to request a waiver from the otherwise mandatory QI audit (now QI review). Because of this, nearly all PAIs ended their PAI relationships with the QIs and entered into QI Agreements themselves. (Further modifications later reinstated the potential review waiver to the extent the QI for whom it acted as a PAI met the requirements to request a waiver (i.e., it was compliant and its reportable amount thresholds (including those allocable to any of its PAIs) were under the stated thresholds). The subsequent agreements limited the type of entity that can become a PAI to certified deemed compliant FFIs. Consequently, the number of overall PAIs has remained very low and, given these limitations, the proposed changes are likely to have little, if any, consequence.

Aside from the PAI rules discussed above, another option for "piggybacking" off a QI's Agreement has been the agency rules for certain partnerships and trusts that are direct account holders of the QI. These rules were modeled after the PAI rules applicable to intermediaries. The Notice provides that the agency rules will be available to a foreign partnership (other than a PTP) or grantor trust. The rules are not applicable to a foreign simple trust because such a trust is not permitted to provide underlying beneficiary information for purposes of §1446(a) or §1446(f). In both instances, the partnership or trust must provide the QI with a U.S. TIN. As with PAIs, discussed above, subsequent limitations to the types of entities that may utilize these rules, as well as other modifications to the specific requirements, the number of partnerships and trusts currently utilizing these rules are limited.

REMINDERS AND OBSERVATIONS

The Notice was officially issued May 16, 2022. Treasury and the IRS anticipate that the proposed changes outlined in the Notice will be included in a revenue procedure containing the final QI Agreement, pending further modifications based on comments received. The effective date of the new QI Agreement will be January 1, 2023, (the same day the rules for the transfers of interests in PTPs will go into effect). Given this tight timeline, impacted entities are likely to need additional transition relief. To that end, Treasury and the IRS solicited written comments to the Notice through May 31, 2022. Due to limited in-office personnel, Treasury and the IRS strongly encourage those persons submitting comments to do so electronically: www.regulations.gov (search "IRS-2022-0010" to find the Notice).

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