

Proposed Audit Guidance for External Auditors of Qualified Intermediaries

Notice 2001-66

This notice requests comments on the attached proposed audit guidelines for qualified intermediaries (QI). QI's are a key component of the withholding and reporting regulations that became effective on January 1, 2001 (T.D. 8734, 1997-2 C.B. 109 and T.D. 8881, 2000-23 I.R.B. 1158).

I. BACKGROUND

Generally, a QI is a non-U.S. financial institution that has entered into a contractual agreement with the Internal Revenue Service (IRS). Under the agreement, the QI generally agrees to report annually certain aggregate information concerning the beneficial owners of U.S. source payments and to make any necessary tax payments to the IRS. Additionally, the QI agrees to engage an external auditor to verify that it is in compliance with the QI agreement. In return, the QI avoids the expense and burden of forwarding documentation with respect to each beneficial owner to a U.S. withholding agent in order to claim reductions in U.S. withholding tax. The QI also enjoys other significant benefits under the new rules, including the ability to rely on a collective refund procedure for its customers.

The IRS and Treasury have worked closely with the financial community in developing the QI system. The audit guidelines attached to this notice are being issued in proposed form specifically to continue the dialogue with the financial community on how to implement the audit procedures of the QI agreements in a way that minimizes costs to the QIs while preserving the compliance goals of the withholding regulations. The IRS and Treasury recognize that achieving these goals requires that the audit process preserves the cooperative nature and effectiveness of the QI system.

II. THE PROPOSED THREE PART QI AUDIT PROCESS

The guidelines attached to this notice reflect a three part audit process. As de-

scribed further below, whether a particular QI's audit will progress through all three parts generally will depend upon the results of each part. IRS expects that, if a QI demonstrates a satisfactory level of compliance with the QI agreement in the first part of the audit process, the QI will not be required to complete any further parts in the process during that audit cycle.

A. PART 1: Basic Fact Finding

Part 1 consists of basic fact finding. The external auditor performs the tasks detailed in the attached audit guidelines. From these fact finding activities, the auditor will develop a report of numerical results. The attached audit guidelines contain precise directions on what numerical information must be included in the auditor's report. The auditor will send a hard copy of this initial report to the IRS. The IRS intends to develop a standard electronic report form.

If the numerical results of a particular QI's audit demonstrate a high level of compliance with the QI agreement, then it is expected that the IRS generally will notify the QI that its audit is complete and that no additional steps need to be taken. If, however, the numerical results suggest that the QI has experienced some difficulties in meeting its obligations under the agreement, then the IRS will notify the QI that it is proceeding to Part 2 of the audit process.

B. PART 2: Follow Up Fact Finding

In Part 2 of the audit process, the IRS will contact the auditor and ask about certain numerical results in the auditor's report. If additional information is needed, the IRS will direct the auditor to perform additional procedures and to report on the results. The goal of this step of the audit process will be to identify the cause for the numerical results and to determine whether corrective actions are readily discernible.

For example, an audit report may show that the auditor was unable to associate beneficial owner information with a specified percentage of the QI's accounts. By discussing the facts with the auditor, the IRS may be able to determine that the

problem was attributable to deficient account opening procedures in one of the QI's branches. If the IRS is satisfied that the QI had taken corrective steps to ensure that the branch was appropriately opening new accounts, and if the QI has otherwise shown a high level of compliance with the QI agreement, then there would be no need to proceed to Part 3 of the audit process. Under other circumstances, however, the IRS may determine that further work must be done to resolve the issues raised in Part 1 of the audit process.

C. PART 3: Audit Meeting with QI

If the concerns arising from the numerical results reported in Part 1 of the audit process cannot be resolved by directed fact finding in Part 2, then the IRS will propose to meet with the QI to attempt mutually to clarify and resolve those concerns. This part is designed specifically to provide a forum where a productive dialogue between the IRS and the QI can occur. Treasury and the IRS continue to believe that the QI system, which allows the IRS's compliance goals to be met while minimizing the administrative burdens on financial institutions, is a critical component of the withholding regulations. Accordingly, the IRS will seek to develop mutually acceptable solutions to the issues that arise in the course of administering the QI agreements so that it will not become necessary to terminate a QI agreement.

III. Key Concepts for Comment in the Attached Audit Guidelines

The IRS and Treasury invite comments on all sections of both this Notice and the attached proposed audit guidelines. This section is intended to draw attention to particularly important aspects of the audit guidelines that are designed to lessen burdens on financial institutions serving as QIs.

A. Submission of Audit Plans.

Under the proposed audit guidelines, the submission of an audit plan to the IRS prior to performing the audit is not necessary if the external auditor plans to follow the audit guidelines. If, however,

the external auditor plans to modify or deviate from the audit guidelines, then an audit plan should be submitted to the IRS for prior approval. For example, the external auditor may propose to use multistage, cluster, stratification or some other sampling methodology in conducting its audit. In such cases, the external auditor should submit a written audit plan and should identify, and explain the reasons for, any proposed modifications or deviations from the audit guidelines.

B. Discretionary Waivers of External Audit.

The proposed audit guidelines allow QIs to request that the IRS waive the performance of an audit by an external auditor in three cases. In the first case, a QI may request a waiver of the external audit if it has received not more than \$250,000 in reportable payments during the year to be audited. Instead of an external audit in this case, the QI must submit copies of its Forms 1042 and 945, copies of the Forms 1042-S issued to it and filed by it, and copies of its Forms W-8IMY provided to its withholding agents, along with information about the number of its account holders of various classes.

In the second case, a QI may request a waiver of the external audit if it has made reportable payments to no more than 2000 direct and indirect account holders during the year to be audited. Instead of an external audit in this case, the QI must itself perform the audit procedures and report to the IRS in accordance with the audit guidelines. Statistical sampling will not be permitted in this case. The IRS will not agree to waive the external audit for the first audit year of the first term of the QI Agreement in this case. The IRS will not agree to waive the performance of an external audit for a Private Arrangement Intermediary (PAI).

In the third case, a QI may request a waiver of the external audit if it has a substantial and independent internal audit department and its internal audit department has audited the QI's compliance under the QI agreement for each of the three years preceding the year to be audited. Instead of an external audit in this case, the QI's internal audit department must perform the audit and report to the IRS in accordance with the audit guidelines. Statisti-

cal sampling will be permitted in this case.

Whether the IRS will waive the external audit in any case is discretionary. In the second and third cases, the IRS will not waive the external audit for more than one audit year during any one term of the QI agreement.

C. External Auditor's Reliance on Internal Auditors.

The proposed audit guidelines allow the external auditor to use a QI's internal audit staff and internal audit reports to any extent the external auditor chooses. Nevertheless, the external auditor remains personally responsible for the conduct of the audit. The external auditor must disclose in the audit report specifically how and when it has used internal audit staff and reports. Further, the external auditor must certify that the use of the internal audit personnel and reports has not affected the accuracy of the external auditor's report.

D. Projection of Underwithholding.

The QI agreement provides that if statistical sampling has been used and the auditor determines that underwithholding has occurred with respect to the sampled accounts, the IRS will determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts.

Under the proposed audit guidelines, if the auditor uses a sample and has found that underwithholding has occurred with respect to an account in the sample, the auditor must report the underwithholding in the report for step 1 of the audit. In step 2 of the audit, the IRS would direct the external auditor to perform any additional procedures necessary to collect any information required to determine whether it is appropriate to project the underwithholding and any information required to make a projection. The IRS will employ a projection method that is consistent with the sampling methodology used. In step 3 of the audit, the QI may address whether projection is appropriate and may propose a projection using another amount of underwithholding based on a more accurate population, a more accurate projection technique, or an examination of all similar accounts.

IV. Comments.

Written comments must be received by December 12, 2001. Send comments to CC:DOM:CORP:R (NOT-151112-01), Room 5228, Internal Revenue Service, Ben Franklin Station, Washington, DC 20224. Alternatively, comments may be hand delivered between the hours of 8:00 AM and 5:00 PM to: CC:DOM:CORP:R (NOT-151112-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave. NW, Washington, DC.

Contact Information

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

APPENDIX

(PROPOSED) GUIDANCE

FOR EXTERNAL AUDITORS OF QUALIFIED INTERMEDIARIES

Section 4 of Rev. Proc. 2000-12 (2000-4 I.R.B. 387, 388) provides the final text of the Qualified Intermediary Agreement ("QI Agreement") between the Internal Revenue Service ("IRS") and a qualified intermediary ("QI"). Section 10 of the QI Agreement provides external audit procedures. In section 10, the IRS agrees not to conduct an on-site audit of the QI provided the QI engages an external auditor to conduct an audit in accordance with the procedures detailed therein. Under those procedures, the external auditor examines the QI to verify whether it is in compliance with the QI Agreement and makes a report to the IRS. Section 10 of the QI Agreement is reproduced below in bolded text for reference. Following each paragraph of section 10, procedural guidance on audit issues is provided under the heading Audit Guidance numbered to correspond to the QI Agreement. The audit guidance under sections 10.01 to 10.03 includes procedures that a QI may follow to request an IRS audit or a waiver of audit. Section 10.03(A), (B), (C), and (D) describe Part 1 of the audit process. This section in-

cludes the procedures that an external auditor should follow in examining the QI and the information to be included in the external auditor's report to the IRS. Section 10.04 provides guidance on the use of statistical sampling and projection of underwithholding. Section 10.05 provides further guidance on the form, content and submission of the external auditor's report. Section 10.06 provides guidance on Parts 2 and 3 of the audit process. The audit guidance does not amend, modify, or interpret the QI Agreement.

QI Agreement Sec. 10.01. In General. Unless QI requests an IRS audit in lieu of an external audit, the IRS agrees not to conduct an on-site audit of QI, or any PAI with which QI has an agreement, with respect to withholding and reporting obligations covered by this Agreement provided that an external auditor designated in Appendix B of this Agreement conducts an audit of QI, and any PAI, in accordance with this section 10. QI shall permit the external auditor to have access to all relevant records of QI for purposes of performing the external audit, including information regarding specific account holders. QI shall permit the IRS to communicate directly with the external auditor and to review the audit procedures followed by the external auditor. QI represents that there are no legal prohibitions that prevent the external auditor from examining any information relevant to the external audit to be performed under this section 10 and that there are no legal prohibitions that prevent the IRS from communicating directly with the auditor. QI shall permit the IRS to examine the external auditor's work papers and reports. However, the external auditor is not required to divulge the identity of QI's account holders to the IRS.

Audit Guidance Sec. 10.01:

10.01.1. *IRS Audit.* A QI that is not prohibited by law from disclosing account holder information may request an IRS onsite audit instead of an external audit. To request an IRS audit, the QI must submit a written request to the IRS before March 31 of the year following the specific year to be audited ("audit year").

The QI must send the request to the following address:

Internal Revenue Service
LMSB:FS:QI
290 Broadway
New York, NY 10007-1867
USA

If the IRS agrees to conduct an audit of the QI, the IRS will send the QI a written response within 90 days of the date the IRS received the request. In some cases, the IRS will conduct an audit by correspondence. For instance, in the case of a QI that has made reportable payments to no more than 50 accounts covered by the QI Agreement, the IRS may conduct an audit by correspondence. For purposes of this guidance, "accounts covered by the QI Agreement" are accounts maintained by the QI for its direct account holders (which include intermediaries and flow-through entities) to which the QI has made reportable payments during the audit year from the QI's accounts with withholding agents that the QI has designated as QI accounts.

10.01.2. *External Audit Waiver (\$250,000 Threshold).* A QI may request that the IRS waive the performance of the audit by an external auditor for an audit year if the QI has received reportable payments during that year that do not exceed \$250,000. To calculate the \$250,000 threshold, the QI must aggregate all reportable payments (including payments beneficially owned by the QI) made to its accounts with withholding agents that the QI has designated as QI accounts. The QI must submit its request for a waiver to the IRS in accordance with Audit Guidance 10.01.1 (AG10.01.1).

The QI should include in its request:

- (a) Copies (for the audit year) of its Forms 1042 and 945, the Forms 1042-S issued to it, the Forms 1042-S and 1099 issued by it, and the Forms W-8IMY (including summaries of withholding statements) provided by it to its withholding agents;
- (b) A reconciliation of the Forms 1042-S issued to the QI and the Forms 1042-S issued by the QI; and
- (c) A statement made under penalties of perjury by a person named as a responsible party for performance in the

QI's application for a QI Agreement ("responsible party") that:

1. States

- (i) The number of the QI's direct account holders during the audit year;
 - (ii) The number of the QI's indirect account holders during the audit year; and
 - (iii) Within each category, the number of account holders that were U.S. exempt recipients, U.S. non-exempt recipients, intermediaries, flow-through entities, and undocumented account holders;
- (2) States the total amount of any underwithholding or collective refund for the audit year;
 - (3) States that no event of default under section 11 of the QI Agreement has occurred during the audit year;
 - (4) States that the QI does not refer account holders to an affiliated entity with the effect of circumventing the \$250,000 threshold; and
 - (5) Certifies that the QI was in compliance with the QI Agreement during the audit year.

The IRS may contact the QI to request additional information. If the IRS agrees to waive the performance of the audit for the audit year, the IRS will send the QI a written response within 90 days of the date the IRS received the request. The IRS will not agree to waive the performance of an audit for a Private Arrangement Intermediary ("PAI").

10.01.3. *External Audit Waiver (2000 Account Holder Threshold).* A QI may request that the IRS waive the performance of the audit by an external auditor for an audit year if, during the audit year, the QI has made reportable payments to no more than 2000 direct and indirect account holders covered by the QI Agreement. The QI must submit its request for a waiver to the IRS in accordance with AG 10.01.1. The QI must include in its request a statement, made under penalties of perjury by the responsible party, that states:

- (a) The number of account holders to which the QI has made such payments;

- (b) The aggregate amount of reportable payments (including payments beneficially owned by the QI) made to its accounts with withholding agents that the QI has designated as QI accounts;
- (c) The QI does not refer account holders to an affiliated entity with the effect of circumventing the 2000 account holder threshold; and
- (d) That, in lieu of the external audit, the QI itself will apply the procedures set forth in section 10 of the QI Agreement. In doing so, the QI agrees to examine each account holder and to submit a report to the IRS signed by the responsible party.

The IRS may contact the QI to request additional information. The QI must agree that its performance of the audit will be governed in all respects by section 10 of the QI Agreement as if the persons conducting the audit were the external auditor referred to in that section. The IRS will not permit the use of statistical sampling by the QI. The IRS will not agree to waive the external audit for more than one audit year during any one term of the QI Agreement. If the IRS agrees to waive the performance of the audit for the audit year, the IRS will send the QI a written response within 90 days of the date the IRS receives the request. The IRS will not agree to waive the performance of an audit for a PAI. The IRS will not agree to waive the external audit for the first audit year of the first term of the QI Agreement.

10.01.4. *External Audit Waiver (Annual Internal Audits)*. A QI may request that the IRS waive the performance of the audit by an external auditor for an audit year if the QI maintains a substantial and independent internal audit staff, and the QI's internal auditors have conducted an audit of the QI's compliance with the QI Agreement each year for the three years preceding the audit year. The QI must submit its request for a waiver to the IRS in accordance with AG 10.01.1. The QI must include in its request a statement, made under penalties of perjury by the responsible party, that states:

- (a) The number of direct account holders and the number of indirect account holders to which the QI has made such payments;

- (b) The aggregate amount of reportable payments (including payments beneficially owned by the QI) made to its accounts with withholding agents that the QI has designated as QI accounts;
- (c) How the internal audit staff is organized, including position descriptions, the number of individuals in each position, the names of the individual or individuals with overall responsibility for internal audit, the routine functions of the internal auditors within the QI, and the persons to whom the internal auditors report;
- (d) In brief summaries, the procedures performed, the findings, and the conclusions or recommendations of each annual audit of the QI's compliance with the QI Agreement conducted by the QI's internal auditors in each of the three years preceding the audit year; and
- (e) That, in lieu of the external audit, the QI itself will apply the procedures set forth in section 10 of the QI Agreement to those accounts.

The IRS may contact the QI to request additional information. The QI must agree that its performance of the audit will be governed in all respects by section 10 of the QI Agreement as if the persons conducting the audit were the external auditor referred to in that section. The IRS will not agree to waive the external audit for more than one audit year during any one term of the QI Agreement. If the IRS agrees to waive the performance of the audit for the audit year, the IRS will send the QI a written response within 90 days of the date the IRS receives the request. The IRS will not agree to waive the performance of an audit for a PAI.

QI Agreement Sec. 10.02. Designation of External Auditor. **QI's external auditor must be one of the auditors listed in Appendix B of this Agreement, unless QI and the IRS agree, prior to the audit, to substitute another auditor. QI shall not propose an external auditor unless it has a reasonable belief that the auditor is subject to laws, regulations, or rules that impose sanctions for failure to exercise its independence and to perform the audit competently. The IRS has the right to reject a proposed external auditor, or to revoke its acceptance of an external auditor, if the IRS,**

in its sole discretion, reasonably believes that the auditor is not independent or cannot perform an effective audit under this Agreement.

Audit Guidance Sec. 10.02:

10.02.1. *Auditor Approval.* To obtain assurance that an external auditor will be acceptable to the IRS, the QI or the external auditor may submit a written request explaining the qualifications of the external auditor to the IRS at any time. The QI or the external auditor should send the request to the address provided in AG 10.01.1. The IRS will send the QI or the external auditor a written response within 90 days of the date the IRS receives the request.

10.02.2. *Auditor Independence.* A QI and its external auditor must disclose to the IRS any circumstances that compromise or reasonably appear to compromise the external auditor's independence or ability to perform an effective audit. To make a disclosure, the QI or the external auditor must submit a written statement explaining the circumstances and any steps taken to address them as soon as such circumstances are discovered. The disclosure must be sent to the address provided in AG 10.01.1. If the IRS determines that the external auditor is not acceptable, it will send the QI and the external auditor a written notice to that effect within 90 days of the date the IRS receives the disclosure.

QI Agreement Sec. 10.03. Timing and Scope of External Audits. **QI shall have the external auditor conduct an audit of the second full calendar year and the fifth full calendar year that this Agreement is in effect, subject to section 10.06 of this Agreement. The external auditor shall verify whether QI is in compliance with this Agreement by conducting an audit that meets the requirements of this section 10.03. The external auditor shall verify whether QI is in compliance with its QI agreement by providing a report to the IRS. The report must be received by the IRS, at the address set forth in section 12.06 of this Agreement, no later than June 30 of the year following the year being audited. The IRS may, however, upon request by the external auditor, extend the due date of the audit report**

upon good cause. The report must disclose that the external auditor has, at a minimum, performed the following checks listed in this paragraph 10.03, and set forth how each of those checks was performed and the results of the checks. QI's (or a PAI's) external auditor is encouraged to contact the IRS at the address set forth in section 12.06 of this Agreement and submit an audit plan (which includes, if relevant, the extent to which the external auditor proposes to rely on QI's internal audit procedures) prior to performing the audit so that the audit may be conducted in the most efficient and least costly manner possible.

Audit Guidance Sec. 10.03:

10.03.1. *Specifications of Audit Report.* For guidance on the form and contents of the external auditor's report, submitting the report to the IRS, the due date of the report and extensions of the due date, see AG 10.05.

10.03.2. *Submission of Audit Plan.* Submission of an audit plan to the IRS prior to performing the audit is not necessary unless the external auditor plans to modify or deviate from the procedures described in AG 10.03 and 10.04. In such circumstances, the external auditor should submit a written plan, identifying and explaining the reasons for any planned modifications or deviations from those procedures, prior to performing the audit. The external auditor should submit the audit plan to the address provided in AG 10.01.1. The IRS will send the external auditor a written response within 90 days of the date the IRS receives the audit plan.

10.03.3. *Use of Internal Audit.* The external auditor is required to perform the audit itself. The external auditor may use the QI's internal audit personnel and internal audit reports to any extent the external auditor chooses to do so. In that case, the external auditor remains responsible for the conduct of the audit as if the external auditor had personally performed the audit. In its report to the IRS, the external auditor must disclose specifically when and how it has used the QI's internal audit personnel and reports in conducting the audit and must certify that the use of the internal audit personnel and re-

ports has not affected the accuracy of the external auditor's report.

10.03.4. *Use of Copies.* In conducting the audit, the external auditor may use copies of any account records or written materials provided by the QI. Nevertheless, the QI must permit the external auditor to have access to the complete and unaltered account holder records in the original, if the external auditor deems it necessary to examine originals.

QI Agreement 10.03(A). Documentation. The external auditor must—
(1) Verify that QI has training materials, manuals, and directives that instruct the appropriate QI employees how to request, collect, review, and maintain documentation in accordance with this Agreement;

Audit Guidance 10.03(A)(1):

10.03(A)(1).1. *Review of Documentation Training.* The external auditor must:

Step 1: Identify the QI's employees that are responsible for opening and maintaining customer accounts.

Step 2: Collect any written training materials, manuals, and directives used by those employees.

Step 3: Inspect the written training materials, manuals, and directives to determine whether they contain instructions specific to accounts covered by the QI Agreement on how to request, collect, review, and maintain documentation.

10.03(A)(1).2. *Documentation Training Report.* The external auditor must specifically report:

Report 1: Whether the QI has written training materials, manuals, and directives that contain instructions specific to accounts covered by the QI Agreement on how to request, collect, review, and maintain customer documentation.

QI Agreement Sec. 10.03(A)(2). Review QI's account opening procedures and interview QI's employees, to determine if appropriate documentation is requested from account holders and, if obtained, that it is reviewed and maintained in accordance with this Agreement;

Audit Guidelines 10.03(A)(2)

10.03(A)(2).1. *Review of Account Opening Procedures.* The external auditor must:

Step 1: Identify the QI employees responsible for opening and maintaining customer accounts and select representative employees for interview.

Step 2: Ask the selected employees how accounts covered by the QI Agreement are opened, what documentation is requested, how the documentation is obtained, and how the documentation is reviewed and maintained.

10.03(A)(2).2. *Account Opening Procedures Report.* The external auditor must specifically report:

Report 1: The number of employees interviewed.

Report 2: The number of employee responses that indicate that Forms W-8 and documents listed in the Attachment to the QI Agreement are not routinely requested, reviewed, cross checked against other account information, or maintained in accordance with section 5.12 of the QI Agreement.

QI Agreement Sec. 10.03(A)(3). Verify that QI follows procedures designed to inform account holders that claim a reduced rate of withholding under an income tax treaty about any applicable limitation on benefits procedures;

Audit Guidance 10.03(A)(3):

10.03(A)(3).1. *Review Limitation on Benefits (LOB) Procedure.* The external auditor must:

Step 1: Ask the QI employees selected for interview under AG 10.03(A)(2) Step 1 how account holders that are not individuals claim a reduced rate of withholding under an income tax treaty.

10.03(A)(3).2. *LOB Procedure Report.* The external auditor must specifically report:

Report 1: The number of employee responses that indicate that such customers are not informed about any applicable limitation on benefits provisions.

QI Agreement 10.03(A)(4). Review QI's accounts, using a valid sample of accounts for which treaty benefits are claimed, to ensure that QI is obtaining the treaty statements required by section 5.03(B);

Audit Guidance 10.03(A)(4):

10.03(A)(4).1. *Review of Treaty Statements.* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or select a valid sample of such accounts in accordance with AG 10.04.

Step 2: From the accounts identified or selected in Step 1, segregate the accounts for which treaty benefits are claimed.

Step 3: From the accounts for which treaty benefits are claimed, segregate the accounts for which documentary evidence has been obtained.

Step 4: From the accounts for which documentary evidence has been obtained, segregate those accounts held by account holders that are not individuals or governments.

Step 5: For the accounts segregated in Step 4, inspect each account holder's documentation to determine whether it contains a valid treaty statement described in section 5.03(B) of the QI Agreement. A valid treaty statement must be signed by the beneficial owner. A treaty statement may be incorporated into another document that is signed by the beneficial owner.

Step 6: For the accounts segregated in Step 4, identify:

- (a) All accounts covered by the QI Agreement held by intermediaries or flow through entities for which recipient specific re-

porting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement.

- (b) The number in Step 6(a) that are intermediaries.
- (c) The number in Step 6(a) that are flow through entities
- (d) The number of indirect account holders holding through intermediaries that are direct account holders; and
- (e) The number of indirect account holders holding through each flow through entity that is a direct account holder.

Step 7: (a) For purposes of Step 7 and the following sections, the external auditor must identify the indirect account holders for which recipient specific reporting is required or select a valid sample of such account holders in accordance with AG 10.04. From the indirect account holders identified or selected, segregate the indirect account holders for which treaty benefits are claimed.

- (b) From the indirect account holders segregated in (a), segregate the indirect account holders for which documentary evidence has been obtained.
- (c) From the indirect account holders segregated in (b), segregate indirect account holders that are not individuals or governments.
- (d) For the indirect account holders segregated in (c), inspect each indirect account holder's documentation to determine whether it contains a valid treaty statement described in section 5.03(B) of the QI Agreement.

10.03(A)(4).2. *Treaty Statements Report.* The external auditor must specifically report:

Report 1: The number of accounts determined under each of Steps 1, 2, 3, and 4.

Report 2: The number of accounts segregated in Step 4 that do not contain a valid treaty statement

described in section 5.03(B) of the QI Agreement.

Report 3: The number of indirect account holders determined under Step 6(a) through (e).

Report 4: The number of indirect account holders identified, selected (if sampling is used), and segregated under Step 7 (a) through (c).

Report 5: The number of indirect account holders whose documentation does not contain a valid treaty statement described in section 5.03(B) of the QI Agreement.

QI Agreement Sec. 10.03(A)(5). Review information, using a valid sample, contained in account holder files to determine if the documentation validity standards of section 5.10 of this Agreement are being met. For example, the external auditor must verify that changes in account holder information (e.g., a change of address to a U.S. address or change of account holder status from foreign to U.S.) are being conveyed to QI's withholding agent, or, if QI assumes primary NRA withholding responsibility or primary Form 1099 reporting and backup withholding responsibility, that QI is applying the appropriate withholding rate;

Audit Guidance 10.03(A)(5):

10.03(A)(5).1. *Review of Documentation Validity (Foreign Persons and U.S. Exempt Recipients).* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or use the same sample selected in AG 10.03(A)(4).1 Step 1.

Step 2: Sort those accounts according to whether they contain the following types of documentation:

- (a) Form W-8BEN;
- (b) Form W-8EXP;
- (c) Form W-8ECI;
- (d) Form W-8IMY;
- (e) Form W-9;
- (f) Documentary Evidence; and
- (g) no documentation.

Step 3: FORM W-8BEN:

(a) For accounts documented with a Form W-8BEN, inspect Part I of the Form W-8BEN. Determine that the following lines are completed and consistent with each other:

- (i) Line 1 (name of individual or organization that is the beneficial owner);
- (ii) Line 2 (country of incorporation or organization), for non-individuals;
- (iii) Line 3 (type of beneficial owner);
- (iv) Line 4 (permanent residence address, including country) A permanent residence address cannot be a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution); and
- (v) Signature and date.

(A) Determine that December 31 of the audit year was within three full calendar years following the year of signature; and

(B) Determine that the certifications attested under penalties of perjury have not been modified.

(b) For a Form W-8BEN for which the beneficial owner has claimed treaty benefits, inspect Part II of the Form W-8BEN. Determine that the following lines are completed and consistent with each other and with Part I of the Form:

- (i) Line 9a (residence certification, including name of country); and
- (ii) Line 9c (section 894 and LOB certification), but only for non-individuals.

Step 4: FORM W-8EXP. For accounts documented with Form W-8EXP, inspect Form W-8EXP. Determine that the following lines are completed and consistent with each other:

- (a) Line 1 (name of organization);

(b) Line 2 (country of incorporation or organization);

(c) Line 3 (type of entity);

(d) Line 4 (permanent residence address, including country), A permanent residence address cannot be a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution);

(e) Either:

- (i) Line 9a and 9b or 9c; or
- (ii) Line 10 (and organization is designated by executive order under 22 U.S.C. 288 through 288(f)); or

(iii) Line 11; or

(iv) Line 12a (including date) or 12b (including attached opinion from U.S. counsel), and, for section 501(c)(3) organizations, Line 12c (including affidavit) or 12d, and Line 6; or

(v) Line 13; and

(f) Signature and date.

(i) Determine that the certifications attested under penalties of perjury have not been modified.

Step 5: FORM W-8ECI. For accounts documented with Form W-8ECI, inspect the Form W-8ECI. Determine that the following lines are completed and consistent with each other:

(a) Line 1 (name of organization);

(b) Line 2 (country of incorporation or organization);

(c) Line 3 (type of entity);

(d) Line 4 (permanent residence address, including country). A permanent residence address cannot be a P.O. Box, in-care-of address, or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution);

(e) Line 5 (business address in the United States);

(f) Line 6 (U.S. taxpayer identification number);

(g) Line 9 (list of items of income that are effectively connected with the conduct of a trade or

business in the United States); and

(h) Signature and date.

(i) Determine that December 31 of the audit year was within three full calendar years following the year of signature; and

(ii) Determine that the certifications attested under penalties of perjury have not been modified.

Step 6: FORM W-8IMY. For accounts documented with Form W-8IMY, inspect the Form W-8IMY. Determine that the following lines are completed and consistent with each other:

(a) Line 1 (name of individual or organization);

(b) Line 2 (country of incorporation or organization), for non-individuals;

(c) Line 3 (type of entity);

(d) Line 4 (permanent residence address, including country). A permanent residence address cannot be a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution).

(e) Either:

(i) Line 9a and Line 6 (QI-EIN);

(ii) Line 10a;

(iii) Line 11 and Line 6 (EIN), and Line 12 or Line 13;

(iv) Line 14 and Line 6; or

(v) Line 15 (and, if line 3 (nonwithholding foreign grantor trust) is checked, Line 6 (EIN)); and

(f) Signature and date.

(i) Determine that the certifications attested under penalties of perjury have not been modified.

Step 7: FORM W-9. For accounts documented with Form W-9, inspect the Form W-9. Determine that the following lines are completed and consistent with each other:

(a) Name;

(b) U.S. taxpayer identification number;

- (c) Part II (For U.S. payees exempt from backup withholding); and
- (d) Signature and date.
 - (i) Determine that the certifications attested under penalties of perjury have not been modified.

Step 8: DOCUMENTARY EVIDENCE.

For accounts documented with documentary evidence, inspect the documentary evidence. Determine:

- (a) Whether the documentary evidence is one of the types listed in the applicable Attachment to the QI Agreement,
- (b) Whether it appears to be in proper form when compared to documents of the same type listed in the Attachment,
- (c) Whether it:
 - (i) Supports the account holder's foreign status and, for an account holder that claims treaty benefits, supports the account holder's residence in the treaty country, or
 - (ii) Supports the account holder's status as a U.S. exempt recipient.
- (d) In the case of an international organization, whether the organization is designated by executive order under 22 U.S.C. 288 through 288(f).
- (e) In the case of a foreign government or foreign central bank of issue, whether the documentary evidence supports the account holder's status as such.

Step 9: For each account determined to be documented under Steps 3 through 8, examine the account opening statement, any other account documents or memoranda and any correspondence associated with the account (for purposes of this section, "the account holder's file"). Determine:

- (a) Whether the identifying information in the documentation matches the identifying information in the account holder's file (taking into account any updated information that links the identifying information in

the documentation to the identifying information in the account holder's file),

- (b) Whether, in the case of an account documented with documentary evidence, the documentary evidence and the account holder's file contains only: an address at a financial institution, including a hold mail instruction (except when the financial institution is the beneficial owner), an in-care-of address, or a P.O. Box, and if so, whether the QI has satisfied the additional requirements of section 5.10(B)(2)(i) of the QI Agreement.
- (c) Whether the documentation or the account holder's file shows a U.S. mailing or residence address for the account holder or standing instructions to pay from the account to a U.S. address or to an account maintained in the United States, and if so, whether:
 - (i) The account holder is a U.S. person, or
 - (ii) In the case of documentary evidence, the QI has satisfied the additional requirements of section 5.10(B)(2)(i), (ii), and (iii) of the QI Agreement or, in the case of Forms W-8, the QI has satisfied the additional requirements of section 1.1441-7(b)(5) of the regulations.
- (d) For accounts where the beneficial owner has claimed treaty benefits, whether the documentation or the account holder's file shows a residence address or mailing address, or a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail instruction (except when the financial institution is the beneficial owner), that is not in the applicable treaty country, or standing instructions to pay from the account to an address outside the treaty country or to an account maintained outside the treaty country, and if so, whether:

- (i) In the case of documentary evidence, the QI has satisfied the additional requirements of section 5.10(B)(3) of the QI Agreement; or
- (ii) In the case of Forms W-8, the QI has satisfied the additional requirements of section 1.1441-7(b)(6) of the regulations.

- (e) Include in the category of accounts with no documentation (AG 10.03(A)(5).1 Step 2(g)) all accounts:
 - (i) That are not documented with Forms W-8BEN, W-8EXP, W-8IMY, W-8ECI, W-9 or documentary evidence that is listed in the applicable Attachment to the QI Agreement, and
 - (ii) That are documented with Forms W-8 or documentary evidence that is inadequate after applying the additional requirements of AG 10.03(A)(5).1 Step 9(b)-(d).

Step 10: (a) Identify all indirect account holders for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement, or use the same sample of indirect account holders selected under AG 10.03(A)(4).1 Step 7.

- (b) From those indirect account holders, segregate the indirect account holders that are not U.S. non-exempt recipients.
- (c) Inspect the documentation for each indirect account holder segregated in Step 10(b) to determine whether the documentation validity standards of section 5.03(C) of the QI Agreement are satisfied by performing the procedures under AG 10.03(A)(5) with the following modifications:
 - (i) Part II of the Form W-8BEN is not complete unless line 9b and line 6 are completed, except in the case of a claim of treaty benefits for income from a marketable security.
 - (ii) Documentary evidence establishing entitlement to

treaty benefits must be documentary evidence described in section 5.03(A)(3) of the QI Agreement. Also, except in the case of income from a marketable security, a TIN is required.

- (iii) Documentary evidence for purposes other than establishing entitlement to treaty benefits must be documentary evidence described in Treas. Reg. 1.1441-1(c)(17).

Step 11: For indirect account holders, the external auditor must apply Steps 1 through 9.

10.03(A)(5).2. *Documentation Validity Report (Foreign Persons and U.S. Exempt Recipients)*. The external auditor must specifically report:

Report 1: The number of accounts identified or selected under Step 1.

Report 2: The number of accounts segregated under Step 2.

Report 3: The number of Forms W-8BEN inspected under Step 3(a) and the number of Forms W-8BEN that did not satisfy the criteria under that section.

Report 4: The number of Forms W-8BEN inspected under Step 3(b) and the number of Forms W-8BEN that did not satisfy the criteria under that section.

Report 5: The number of Forms W-8EXP inspected under Step 4 and the number of Forms W-8EXP that did not satisfy the criteria under that section.

Report 6: The number of Forms W-8ECI inspected under Step 5 and the number of Forms W-8ECI that did not satisfy the criteria under that section.

Report 7: The number of Forms W-8IMY inspected under Step 6 and the number of Forms W-8IMY that did not satisfy the criteria under that section.

Report 8: The number of Forms W-9 inspected under Step 7 and the

number of Forms W-9 that did not satisfy the criteria under that section.

Report 9: The number of accounts:

- (a) Documented with documentary evidence inspected under Step 8;
- (b) Reviewed under Step 8 that did not satisfy criteria (a) or (b) of that section;
- (c) Reviewed under Step 8 that satisfy the criteria of either section (c)(i) or (ii);
- (d) Reviewed under Step 8 that did not satisfy the criteria of either (c)(i) or (ii); and
- (e) Described in each of (d) and (e) of Step 8 and the number of accounts that did not satisfy the criteria of (d) and (e) of Step 8.

Report 10: The number of accounts:

- (a) That did not satisfy the criteria of Step 9(a);
- (b) Described in Step 9(b) and the number of accounts that did not satisfy the additional criteria of that step;
- (c) Described in Step 9(c), the number of accounts described in (c)(i) of that step, and the number of accounts that did not satisfy (c)(ii) of that step; and
- (d) Described in Step 9(d) and the number of accounts that did not satisfy the criteria of (d)(i) or (ii) of that step.

Report 11: The number of accounts described in each of (i) and (ii) of Step 9(e).

Report 12: For indirect account holders, the external auditor must separately complete Report 1 through 11.

QI Agreement Sec. 10.03(A)(6). Review accounts, using a valid sample of U.S. non-exempt recipient account holders, to determine if QI is obtaining Forms W-9 from those customers whose identity is not prohibited by law from disclosure, and that QI is transmitting those forms to a withholding agent to the extent QI does not assume primary Form 1099 reporting and backup withholding responsibility with respect to

reportable amounts and, if applicable, designated broker proceeds;

Audit Guidance 10.03(A)(6):

10.03(A)(6).1. *Review of Documentation Validity (Disclosed U.S. Non-exempt Recipients)* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or select a valid sample of such accounts in accordance with AG 10.04.

Step 2: From those accounts, segregate the accounts of those U.S. non-exempt recipients whose identity is not prohibited by law from disclosure, including the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary Form 1099 and backup withholding responsibility. From the accounts segregated in Step 2, segregate the accounts of U.S. non-exempt recipients for which the QI has not assumed primary Form 1099 reporting and backup withholding responsibility.

Step 4: From the accounts segregated in Step 3, segregate the accounts documented with Form W-9 and determine that each Form W-9 satisfies the criteria of AG 10.03(A)(5).1 Step 7.

Step 5: From the accounts segregated in Step 3, segregate the accounts that are not documented with Form W-9 and the accounts for which the Forms W-9 did not satisfy the criteria of AG 10.03(A)(5).1 Step 7.

Step 6: Obtain the withholding statements associated with QI's Forms W-8IMY.

Step 7: For each Form W-9 that satisfies the criteria of AG 10.03(A)(5).1 Step 7, match the name and TIN on the Form W-9 to the name and TIN on the withholding statement.

Step 8: For each account segregated in Step 5, match the name, and (if provided) address, and TIN of the U.S. non-exempt recipient to the name, address, and TIN on the withholding statement.

- Step 9: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement.
- (b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.
- (c) Segregate the indirect account holders that are U.S. non-exempt recipients.
- (d) Apply Steps 2 through 8.

10.03(A)(6).2. *Documentation Validity (U.S. Non-exempt Recipients) Report.* The external auditor must specifically report:

Report 1: The number of accounts segregated under each of Steps 1, 2, 3, 4, and 5.

Report 2: The number of accounts that did not satisfy the criteria of Steps 7 and 8.

Report 3: For indirect account holders, the external auditor must report:

- (a) The number of indirect account holders identified and segregated under Step 9;
- (b) The number of indirect account holders identified and segregated under Steps 2 through 5; and
- (c) The number of indirect account holders that did not satisfy the criteria of Steps 7 and 8.

QI Agreement Sec. 10.03(A)(7). Review accounts, using a valid sample of U.S. non-exempt recipient account holders whose identity and account information is prohibited by law, including by contract, from disclosure, to verify that—

(i) Such accounts exist in only rare and unusual circumstances (and detailing in the audit report the nature of such circumstances); and

(ii) The procedures of section 6.04 have been, and are being, followed.

Audit Guidance 10.03(A)(7):

10.03(A)(7).1. *Account Review of U.S. Non-exempt Recipients (Disclosure Prohibited).* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the same sample selected for AG 10.03(A)(6).

Step 2: From those accounts, segregate the accounts of those U.S. non-exempt recipients whose identity is prohibited by law from disclosure, excluding the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: From the accounts segregated in Step 2, segregate the accounts opened by U.S. non-exempt recipients on or after January 1, 2001.

Step 4: Obtain a letter from the responsible party explaining why the accounts in section 10.07(A)(7).1 Step 2 exist and how the procedures of section 6.04 of the QI Agreement have been and are being applied.

10.03(A)(7).2. *Account Review of U.S. Non-exempt Recipients (Disclosure Prohibited) Report.* The external auditor must specifically:

Report 1: Report the number of accounts segregated under Steps 1, 2, and 3; and

Report 2: Include a copy of the letter obtained under Step 4.

QI Agreement Sec. 10.03(A)(8). Review QI's agreements with its PAIs to ensure that the obligations imposed on the PAIs are identical to the obligations imposed on QI under this Agreement, except as otherwise provided in section 4.02.

Audit Guidance 10.03(A)(8):

10.03(A)(8).1. *Review PAI Obligations.* The external auditor must:

Step 1: Obtain copies of the QI Agreement and all PAI agreements.

Step 2: Inspect each PAI agreement to determine whether:

- (a) The PAI agreement covers all offices of the PAI located in a country listed in Appendix A of the QI Agreement;
- (b) The PAI agreement provides that the QI include all reportable payments made by the PAI in the QI's Forms 945 and 1099 and 1042 and 1042-S;
- (c) The PAI agreement requires the PAI to provide the QI with all information necessary for the QI to meet its obligations under the QI Agreement;
- (d) There are not any provisions limiting the PAI's liability for underwithholding or reporting due to the PAI's failure to perform its obligations under the PAI agreement;
- (e) The PAI agreement requires the PAI to disclose U.S. non-exempt recipients to the same extent as the QI Agreement;
- (f) The PAI agreement permits the PAI to assume primary withholding responsibility or primary Form 1099 reporting and backup withholding responsibility;
- (g) The PAI is subject to audit procedures that are identical to those applicable to the QI under the QI Agreement and that the PAI's designated auditor is listed in Appendix B of the QI Agreement or has been approved by the IRS for that PAI; and
- (h) The PAI is subject to all other obligations of the QI under the QI Agreement.

Step 3: Obtain a copy of the notice identifying each PAI filed by the QI with the IRS described in section 4.01(B) of the QI Agreement and determine that the date of filing for each notice precedes the date of the first payment received by the PAI from the QI pursuant to the PAI agreement.

Step 4: Obtain a copy of the PAI's W-8IMY provided to the QI and determine that it satisfies the criteria of AG 10.03(A)(5).1 Step 6.

10.03(A)(8).2. *PAI Obligations Report.* The external auditor must specifically report:

Report 1: The number of PAI agreements;

Report 2: The number of PAI agreements that did not satisfy the criteria of each of Step 2(a) through (h); and

Report 3: The number of PAI agreements that did not satisfy the criteria of Step 3.

Report 4: The number of Forms W-8IMY obtained in Step 4 and the number of Forms W-8IMY that did not satisfy the criteria of Step 6.

QI Agreement Sec. 10.03(A)(9). State in its external audit report if the auditor is aware that QI is in material violation or is under investigation for violation of any of the know-your-customer rules, practices, or procedures applicable to the offices audited.

Audit Guidance 10.03(A)(9):

10.03(A)(9).1. *Knowledge of KYC Investigations.* The external auditor must:

Step 1: Obtain a letter signed by the responsible party and by the QI's legal counsel stating whether either is aware that the QI is in material violation or is under investigation for violation of any of the know-your-customer rules, practices, or procedures applicable to all branches of the QI located in countries named in the Attachments to the QI Agreement.

10.03(A)(9).2. *KYC Investigations Report.* The external auditor must specifically report:

Report 1: Whether, based on the information in the letter described in Step 1 and on its own information, the external auditor is aware of any such material violations or investigations and, if so, identify them.

Report 2: The external auditor must attach to its report:

(a) A copy of the letter described in Step 1.

QI Agreement Sec. 10.03(A)(10). State in its external audit report if the auditor is aware that QI removes U.S. non-exempt recipients from accounts covered by this Agreement for the purpose of circumventing the Form 1099 reporting and backup withholding provisions of this Agreement.

Audit Guidance 10.03(A)(10):

10.03(A)(10).1. *Review for Removal of U.S. Non-exempt Recipients.* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the sample selected in AG 10.03(A)(6).1 Step 1.

Step 2: Inspect account closing records to determine whether the account was closed during the audit year.

Step 3: Inspect account transfer records to determine whether any assets have been transferred to another account held by the same account holder during the audit year.

10.03(A)(10).2. *Removal of U.S. Non-exempt Recipients Report.* The external auditor must specifically report:

Report 1: The number of accounts covered by the QI Agreement held by U.S. non-exempt recipients that were closed during the audit year.

Report 2: Whether the external auditor is aware of any accounts with the QI not covered by the QI Agreement held by the same U.S. non-exempt recipients that were opened during the audit year, and if so, the number of such accounts.

Report 3: Whether the external auditor is aware of any transfers of assets from an account covered by the QI Agreement held by a U.S. non-exempt recipient to another account with the QI not covered by the QI Agreement held by the same U.S. non-exempt re-

ipient, and if so, the number of accounts to which such transfers were made.

Report 4: Whether the external auditor is aware that the QI removes U.S. non-exempt recipients from accounts covered by the QI Agreement for the purpose of circumventing the Form 1099 reporting and backup withholding provisions of the QI Agreement.

QI Agreement Sec. 10.03(B)(1). Withholding Rate Pools. The external auditor must—

(1) Verify that QI has training materials, manuals, and directives that instruct the appropriate QI employees how to determine withholding rate pools based on documentation and the presumption rules;

Audit Guidance 10.03(B)(1):

10.03(B)(1).1. *Review of Withholding Rate Pool Training Materials.* The external auditor must:

Step 1: Identify the QI's employees that are responsible for determining withholding rate pools.

Step 2: Collect any written training materials, manuals, and directives used by those employees.

Step 3: Inspect the written training materials, manuals, and directives to determine whether they contain specific instructions on how to determine withholding rate pools based on documentation and the presumption rules.

10.03(B)(1).2. *Withholding Rate Pool Training Materials Report.* The external auditor must specifically report:

Report 1: Whether the QI has written training materials, manuals, and directives that contain specific instructions on how to determine withholding rate pools based on documentation and the presumption rules.

QI Agreement Sec. 10.03(B)(2). Inter-view employees responsible for determining withholding rate pools to ascertain if they are adequately trained to

determine those pools and that they follow adequate procedures for determining those pools;

Audit Guidance 10.03(B)(2):

10.03(B)(2).1. *Review of Personnel Training (Withholding Rate Pool).* The external auditor must:

Step 1: Identify the QI's employees that are responsible for determining withholding rate pools and select representative employees for interview.

Step 2: Ask the selected employees whether they have received any formal or informal training on determining withholding rate pools and if so, ask the selected employees to describe the training, when it occurred, and how much time was devoted to it.

Step 3: Ask the selected employees how an account is assigned to withholding rate pools.

10.03(B)(2).2. *Personnel Training (Withholding Rate Pool) Report.* The external auditor must report:

Report 1: The number of employees interviewed.

Report 2: The number of employee responses that indicate that the employee has not received training on how to determine withholding rate pools.

Report 3: The number of employee responses that indicate that accounts are assigned to withholding rate pools without routinely referring to documentation, presumptions, the type of income earned, and the withholding rate applied.

QI Agreement Sec. 10.03(B)(3). Review QI's procedures for preparing the withholding statements associated with QI's Forms W-8IMY and verify that the withholding statements provided to withholding agents convey complete and correct information on a timely basis;

Audit Guidance 10.03(B)(3):

10.03(B)(3).1. *Review of Withholding Statements.* The external auditor must:

Step 1: Identify the QI's employees that are responsible for preparing withholding statements and providing them to withholding agents, and select representative employees for interview.

Step 2: Ask the selected employees how withholding statements are prepared and provided to withholding agents.

Step 3: Obtain copies of the withholding statements provided to withholding agents and records of payments from the withholding agents to the QI.

Step 4: Inspect the withholding statements to determine whether they are consistent with the payment records.

Step 5: Inspect the withholding statements to determine whether the withholding statement information was updated and provided to the withholding agent before the withholding agent made payments.

10.03(B)(3).2. *Withholding Statement Report.* The external auditor must report:

Report 1: The number of employees interviewed.

Report 2: The number of employee responses that indicate that withholding statement information was not routinely reviewed, updated and provided to the withholding agent before the withholding agent made payments.

Report 3: The number of payments with respect to which the withholding statements were inconsistent.

Report 4: The number of payments with respect to which the withholding statement information was not updated or provided to the withholding agent before payment.

QI Agreement Sec. 10.03(B)(4). Perform test checks, using a valid sample of account holders assigned to each withholding rate pool, and cross check that assignment against the documen-

tation provided by, or presumption rules that apply to, the account holder, the type of income earned, and the withholding rate applied;

Audit Guidance:

10.03(B)(4).1. *Review Withholding Rate Pool Classification.* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(4).1 Step 1.

Step 2: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary NRA withholding responsibility. For accounts covered by the QI Agreement for which the QI has not assumed such responsibility, the external auditor must perform the procedures described below.

Step 3: Obtain:

(a) The account statements and records that show the investment and the type of income earned and the amounts of withholding; and

(b) The account records that show how the QI has classified the type of income and withholding rate for purposes of its withholding rate pools.

Step 4: (a) Based on the records described in Step 3(a), classify the accounts according to the type of income paid to each account. An account to which more than one type of income has been paid must be placed into multiple income classifications.

(b) Based on the documentation for the account (after the determinations under AG 10.03(A)(4) and (5) have been made) and applicable presumptions under section 5.13 of the QI Agreement, determine the withholding rate and further classify the accounts within an income classification according to withholding rate. An account

within an income classification to which more than one withholding rate has been applied must be placed into multiple withholding rate classifications.

Step 5: Determine whether the classifications under Step 4(a) and (b) match the QI's classifications in the account records described in Step 3(b).

Step 6: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;

(b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.

(c) Segregate the indirect account holders that are not U.S. non-exempt recipients.

(d) Apply Steps 2 through 5 to those indirect account holders.

10.03(B)(4).2. *Withholding Rate Pool Classification Report*. The external auditor must specifically report:

Report 1: The number of accounts identified or selected as a sample in Step 1.

Report 2: The number of accounts in Report 1 classified under Step 4(a) and (b).

Report 3: The number of accounts in Report 1 for which the QI's classifications do not match the account records under Step 5.

Report 4: For indirect account holders,

(a) The number of indirect account holders under Step 6(a) through (c); and

(b) The number of indirect account holders under Step 4(a) and (b) and Step 5.

QI Agreement Sec. 10.03(B)(5). Perform test checks, using a valid sample of accounts of U.S. non-exempt recipients, to verify that appropriate withholding rate pools are established for U.S. non-exempt recipients; and

Audit Guidance 10.03(B)(5):

10.03(B)(5).1. *Review of Withholding Rate Pool Classification (U.S. Non-exempt Recipients)*. The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(6).1 Step 1.

Step 2: From those accounts, segregate the accounts of those U.S. non-exempt recipients whose identity is not prohibited by law from disclosure, including the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary Form 1099 and backup withholding responsibility. From the accounts segregated in Step 2, segregate the accounts of U.S. non-exempt recipients for which the QI has not assumed primary Form 1099 reporting and backup withholding responsibility.

Step 4: Obtain:

(a) The account statements and records that show the investment and the type of income earned and the amounts backup withheld (if any); and

(b) The withholding statements associated with the Forms W-8IMY.

Step 5: Based on the records described in Step 4(a), classify the pools within each account according to the type of reportable payment made to each account. The external auditor must apply this Step 5 and Step 6 whether or not the QI is using the alternative procedure contained in section 6.03(B) of the QI Agreement.

Step 6: Determine whether the classifications and amounts of income and amounts backup withheld (if any) under Step 5 match classifications and amounts in the with-

holding statements described in Step 4(b).

Step 7: For indirect account holders:

(a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;

(b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.

(c) From the indirect account holders identified or selected in (b), segregate the indirect account holders that are U.S. non-exempt recipients.

(d) Apply Steps 2 through 6 to the indirect account holders segregated in (c).

10.03(B)(5).2. *Withholding Rate Pool Classification (U.S. Non-exempt Recipient) Report*. The external auditor must specifically report:

Report 1: The number of accounts segregated under Steps 1, 2, and 3.

Report 2: The number of accounts for which the classifications and amounts do not match the classifications and amounts in the QI's withholding statements.

Report 3: For indirect account holders,

(a) The number of indirect account holders under Step 7(a) through (c);

(b) The number of indirect account holders under Step 2; and

(c) The number of indirect account holders for which the classifications and amounts do not match the classifications and amounts in the QI's withholding statements.

QI Agreement Sec. 10.03(B)(6). Verify, if QI is using the alternative procedure for U.S. non-exempt recipients contained in section 6.03(B) of this Agreement, that QI is providing sufficient and timely information to withholding agents that allocates reportable payments to U.S. non-exempt recipients.

Audit Guidance 10.03(B)(6):

10.03(B)(6).1. *Review of Alternative Procedure.* The external auditor must:

Step 1: Inspect the withholding statements associated with the Forms W-8IMY to determine whether the allocation information for each account was provided to the withholding agent no later than January 15 of the year following the year of payment.

10.03(B)(6).2. *Alternative Procedure Report.* The external auditor must specifically report:

Report 1: The number of accounts for which allocation information was not provided to the withholding agent by January 15 of the year following the year of payment.

QI Agreement Sec. 10.03(C)(1). Withholding Responsibilities. The external auditor must—

(1) To the extent QI has assumed primary NRA withholding responsibility, perform test checks, using a valid sample of foreign account holders, to verify that QI is withholding the proper amounts;

Audit Guidance 10.03(C)(1):

10.03(C)(1).1. *Review of Withholding (NRA Withholding Assumed).* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(4).1 Step 1.

Step 2: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary NRA withholding responsibility. For accounts covered by the QI Agreement for which the QI has assumed such responsibility, the external auditor must perform the procedures described below.

Step 3: Obtain the account statements and records that show the investment

and the type of income earned and the amounts of withholding.

Step 4: (a) Based on the records described in Step 3, classify the accounts according to the type of income paid to each account. An account to which more than one type of income has been paid must be placed into multiple income classifications.

(b) Based on the documentation for the account (after the determinations under AG 10.03(A)(4) and (5) have been made), determine the withholding rate and further classify the accounts within an income classification according to withholding rate. An account within an income classification to which more than one withholding rate has been applied must be placed into multiple withholding rate classifications.

Step 5: For each account, determine the amount (if any) by which the amount of withholding based on the classifications under Step 4(a) and Step 4(b) exceeds the amount withheld by the QI.

Step 6: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;

(b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.

(c) From the indirect account holders identified or selected in (c), segregate the indirect account holders that are not U.S. non-exempt recipients.

(d) Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary NRA withholding. For accounts covered by the QI Agreement for which the QI has assumed such responsibility, the external auditor must perform the procedures described below.

(e) Complete Steps 4(a) through (c) and Step 5.

10.03(C)(1).2. *Withholding (NRA Withholding Assumed) Report.* The external auditor must report:

Report 1: The amount of underwithholding for each account examined within each withholding rate classification in Step 1.

Report 2: The amount of underwithholding for each indirect account holder examined within each withholding rate classification.

QI Agreement 10.03(C)(2). To the extent QI has not assumed primary NRA withholding responsibility, verify that QI has fulfilled its responsibilities under section 3.02 of this Agreement;

Audit Guidance 10.03(C)(2):

10.03(C)(2).1. *Review of Responsibilities under Section 3.02.* The external auditor must:

Step 1: For each account required to be reported under AG 10.03(B)(4).2 Report 3 and each indirect account holder required to be reported under AG 10.03(B)(4).2 Report 4(b), determine the amount (if any) by which the amount of withholding based on the classifications under AG 10.03(B)(4).1 Step 4(a) and Step 4(b) exceeds the amount withheld.

10.03(C)(2).2. *Responsibilities under Section 3.02 Report.* The external auditor must report:

Report 1: The amount of underwithholding for each account and each indirect account holder within each withholding classification.

QI Agreement 10.03(C)(3). To the extent QI has assumed primary Form 1099 reporting and backup withholding responsibility, perform test checks using a valid sample of U.S. non-exempt recipient account holders to verify that QI backup withheld when required;

Audit Guidance 10.03(C)(3):

10.03(C)(3).1. *Review of Backup Withholding (Responsibilities Assumed)*. The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(6).1 Step 1.

Step 2: From the accounts identified or selected in Step 1, segregate the accounts of those U.S. non-exempt recipients whose identity is not prohibited by law from disclosure, including the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary Form 1099 and backup withholding responsibility. From the accounts segregated in Step 2, segregate the accounts of U.S. non-exempt recipients for which the QI has assumed primary Form 1099 reporting and backup withholding responsibility.

Step 4: Obtain the account statements and records that show the investment and the type of income earned and the amounts backup withheld (if any).

Step 5: Based on the records described in AG 10.03(A)(6).1, determine whether account holder's file contains the account holder's TIN.

Step 6: If the account holder's file does not contain the account holder's TIN, determine whether the QI imposed backup withholding on reportable payments at the correct rate.

Step 7: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;
(b) Identify the indirect account holders holding through those accounts, or use the same sam-

ple selected under AG 10.03(A)(4).1 Step 7;

(c) From the indirect account holders in (b), segregate the indirect account holders that are U.S. non-exempt recipients.

(d) Apply Steps 2 through 6 to those indirect account holders.

10.03(B)(5).2. *Backup Withholding Report (Responsibilities Assumed)*. The external auditor must specifically report:

Report 1: The amount of underwithholding for each account and each indirect account holder that does not contain the account holder's TIN.

QI Agreement Sec. 10.03(C)(4). To the extent QI has not assumed primary Form 1099 reporting and backup withholding responsibility, perform test checks using a valid sample of U.S. non-exempt account holders to verify that QI has fulfilled its backup withholding responsibilities under sections 3.04, 3.05, and 3.06 of this Agreement;

Audit Guidance 10.03(C)(4):

10.03(C)(4).1. *Backup Withholding Review (Responsibilities Not Assumed)*. The external auditor must:

Step 1: For each account required to be reported under AG 10.03(B)(5).2 Report 2 and each indirect account holder required to be reported under AG 10.03(B)(5).2 Report 3(c), determine whether backup withholding was imposed at the correct amount.

10.03(C)(4).2. *Backup Withholding Report (Responsibilities Not Assumed)* The external auditor must report:

Report 1: The amount of underwithholding for each account and each indirect account holder for which backup withholding is required.

QI Agreement Sec. 10.03(C)(5). Review the accounts of U.S. non-exempt recipient account holders whose identity is prohibited by law, including by contract, from disclosure and verify that QI or another payor is backup withholding on reportable payments made to such account holders;

Audit Guidance 10.03(C)(5):

10.03(C)(5).1. *Review of Backup Withholding on Reportable Payments (Disclosure Prohibited)*. The external auditor must:

Step 1: For each account required to be reported under AG 10.03(A)(7).2 Report 2, determine whether backup withholding was imposed at the correct amount.

10.03(C)(5).2. *Backup Withholding on Reportable Payments (Disclosure Prohibited) Report*. The external auditor must report:

Report 1: The amount of underwithholding for each account for which backup withholding is required.

QI Agreement Sec. 10.03(C)(6). Review a valid sample of accounts of U.S. non-exempt recipient account holders and determine if assets that generate or could generate reportable payments are held in an account of any U.S. non-exempt recipient account holders whose identity is prohibited by law, including by contract, from disclosure, and ascertain the reason why such assets have not been disposed of or the account holder disclosed;

Audit Guidance 10.03(C)(6):

10.03(C)(6).1. *Review of Assets Held by U.S. Non-exempt Recipients (Disclosure Prohibited)*. The external auditor must:

Step 1: For each account required to be reported under AG 10.03(A)(7).2 Report 2, obtain a letter from the responsible party explaining the reason why assets that generate or could generate reportable payments have not been disposed of or the account holder disclosed.

10.03(C)(6).2. *Assets Held by U.S. Non-exempt Recipients (Disclosure Prohibited) Report*. The external auditor must:

Report 1: Include a copy of the letter obtained in Step 1 with its report.

QI Agreement Sec. 10.03(C)(7). Verify that amounts withheld were timely deposited in accordance with section 3.08 of this Agreement.

Audit Guidance 10.03(C)(7):

10.03(C)(7).1. *Review of Timely Deposits.* The external auditor must:

Step 1: Obtain the QI's records of payments covered by the QI Agreement, the QI's Form 1042 and the QI's records of tax deposits.

Step 2: Determine that the payment dates timely correspond with the deposit dates for any required deposits.

10.03(C)(7).2. *Timely Deposits Report.* The external auditor must report:

Report 1: Any payment dates that do not timely correspond with deposit dates.

QI Agreement Sec. 10.03(D)(1). Return Filing and Information Reporting. The external auditor must—

(1) Obtain copies of original and amended Forms 1042 and Forms 945, and any schedules, statements, or attachments required to be filed with those forms, and determine whether the amounts of income, taxes, and other information reported on those forms are accurate by—

(i) Reviewing work papers;

(ii) Reviewing Forms W-8IMY, together with the associated withholding statements, that QI has provided to withholding agents;

(iii) Reviewing copies of Forms 1042-S that withholding agents have provided QI;

(iv) Reviewing account statements from withholding agents;

(v) Reviewing correspondence between QI and withholding agents; and

(vi) Interviewing personnel responsible for preparing the Forms 1042 and 945 and the work papers used to prepare those forms.

Audit Guidance 10.03(D)(1):

10.03(D)(1).1. *Review of Forms 1042 and 945.* The external auditor must:

Step 1: Obtain copies of:

- a. The QI's Forms W-8IMY and associated withholding statements, Forms 1042 and 945,

and the Forms 1042-S issued to the QI and the Forms 1042-S filed by the QI (for PAI's, obtain the reporting pool information provided to its QI); and

- b. The copies of the QI's records of payments from withholding agents and of payments to the QI's reporting pools, other QI's and withholding foreign partnerships and trusts, other recipients for which recipient specific reporting is required under section 8.02 of the QI Agreement, U.S. non-exempt recipients, and U.S. exempt recipients as a class.

Step 2: Reconcile the amounts reported paid to the QI on the Forms 1042-S issued to the QI, the amounts reported paid by the QI on the Forms 1042-S filed by the QI, the amounts shown paid by the QI to U.S. non-exempt recipients on its withholding statements and in the QI's records of payments, and the amounts shown paid by the QI to U.S. exempt recipients as a class in the QI's records of payments, and the amounts reported on the QI's Forms 1042 and 945.

10.03(D)(1).2. *Forms 1042 and 945 Report.* The external auditor must report:

- Report 1: (a) The aggregate amount reported paid to the QI on the Forms 1042-S issued to the QI;
- (b) The aggregate amount reported paid by the QI on Forms 1042-S to each reporting pool;
 - (c) The aggregate amount reported paid by the QI on Forms 1042-S to other QI's as a class;
 - (d) The aggregate amount reported paid by the QI on Forms 1042-S to indirect account holders;
 - (e) The aggregate amount shown paid by the QI to U.S. non-exempt recipients as a class;
 - (f) The aggregate amount shown paid by the QI to U.S. exempt recipients as a class;

(g) The total amounts withheld by the QI; and

(h) The total amounts withheld by others.

Report 2: The aggregate amount of any adjustments under section 9 of the QI agreement incorporated in each amount in Report 1.

Report 3: The aggregate amount of any other adjustments that were incorporated in the amounts reported under Report 1 in performing the reconciliation under Step 2.

Report 4: Attach a copy of the QI's Form 1042.

QI Agreement Sec. 10.03(D)(2). Obtain copies of original and corrected Forms 1042-S and Forms 1099 together with the work papers used to prepare those forms and determine whether the amounts reported on those forms are accurate by—

(i) Reviewing the Forms 1042-S received from withholding agents;

(ii) Reviewing the Forms W-8IMY, and the associated withholding statements, that QI has provided withholding agents;

(iii) Reviewing a valid sample of account statements issued by QI to account holders; and

(iv) Interviewing QI's personnel responsible for preparing the Forms 1042-S and, if applicable, Forms 1099, and the work papers used to prepare those forms.

Audit Guidance 10.03(D)(2):

10.03(D)(2).1. *Review of Forms 1042-S and 1099.* The external auditor must:

Step 1: Obtain copies of:

- (a) The QI's records of payments from withholding agents and the QI's records of payments to the QI's reporting pools and to any other QIs (or PAIs) contained in the sample selected for AG 10.03(A)(4), and
- (b) The Forms 1042-S filed by the QI for each reporting pool and any such QIs.

Step 2: Match the QI's records of payments to the amounts reported for each reporting pool and any QI's described in Step 1(a) on the QI's Forms 1042-S.

Step 3: Identify:

- (a) All accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement; and
- (b) The indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.

Step 4: Obtain copies of:

- (a) The Forms 1042-S and Forms 1099 filed by the QI for each indirect account holder;
- (b) The Forms W-8IMY and associated withholding statements applicable to each indirect account holder;
- (c) The QI's records of payments to each indirect account holder; and
- (d) The documentation for each indirect account holder.

Step 5: Match the QI's records of payments to the amounts reported for each indirect account holder on the QI's Forms 1042-S and 1099.

Step 6: (a) In the case of a QI that assumed primary Form 1099 and backup withholding responsibility, identify all accounts covered by the QI Agreement that are held by U.S. non-exempt recipients, or use the same sample as in AG 10.03(A)(6).1 Step 1.
(b) Match the QI's records of payments to the amounts reported on each Form 1099 filed by the QI.

10.03(D)(2).2. *Forms 1042-S and 1099 Report.* The external auditor must report:

Report 1: For each pool or QI for which the amounts paid and the amounts reported do not match, the amounts of income reported on each Form 1042-S under

Step 2, and the amounts paid to each pool or QI.

Report 2: The number of:

- (a) Nonqualified intermediaries and flow through entities that are direct account holders under Step 3(a);
- (b) Indirect account holders under Step 3(b);

Report 3: The number of indirect account holders for which the payments made do not match the payments reported on Forms 1042-S and on Forms 1099, and for those account holders the amounts reported on each form and the amounts paid to each indirect account holder.

Report 4: The number of non-exempt recipients for which the payments made do not match the payments reported on Forms 1099, and for those accounts the amounts reported on each form and the amounts paid to each non-exempt recipient.

QI Agreement Sec. 10.03(D)(3). Thoroughly review the statements attached to amended Forms 1042 filed to claim a refund, ascertain their veracity, and determine the causes of any overwithholding reported and ensure QI did not issue Forms 1042-S to persons whom it included as part of its collective credit or refund.

Audit Guidance 10.03(D)(3):

10.03(D)(3).1. *Review of Refunds.* The external auditor must:

Step 1: Obtain:

- (a) The QI's amended Form 1042 (including the attached statements), the Forms 1042-S filed by the QI, and the Forms 1042-S issued to the QI;
- (b) The QI's records of payments from withholding agents and the QI's records of payments to the QI's reporting pools; and
- (c) The QI's records of payments to the account holders who received a refund of overwithholding from the QI.

Step 2: Inspect the QI's records of payments to determine whether overwithholding occurred and the amount of the overwithholding.

Step 3: Match the amount of income, withholding, and overwithholding with the QI's Form 1042.

Step 4: Identify the reporting pool or pools to which the overwithholding is attributable and the amount of overwithholding attributable to each pool.

Step 5: Identify the account holders who received a refund of the overwithholding from the QI.

Step 6: Identify all Forms 1042-S filed by the QI on a recipient specific basis.

Step 7: Match the account holders identified under Step 5 with the Forms 1042-S identified under Step 6.

10.03(D)(3).2. *Refund Report.* The external auditor must report:

Report 1: The total amount of overwithholding under Step 2.

Report 2: The amounts of overwithholding by each pool under Step 4.

Report 3: The number of account holders identified under Step 5.

Report 4: The number of account holders that do not match with Forms 1042-S under Step 7.

QI Agreement Sec. 10.03(D)(4). Determine, in the case of collective credits or refunds, that QI repaid the appropriate account holders prior to requesting a collective refund or credit.

Audit Guidance 10.03(D)(4):

10.03(D)(4).1. *Review of Account Holder Repayment Prior to Refund.* The external auditor must:

Step 1: Obtain:

- (a) The QI's amended Form 1042 (including attached statements); and
- (b) The QI's records of payments to the account holders who received a refund of overwithholding from the QI.

Step 2: Inspect the QI's Form 1042 and records of payments to determine that the dates of payments of overwithholding made to each account holder were prior to the date of filing the Form 1042.

10.03(D)(4).2. *Account Holder Repayment Prior to Refund Report:* The external auditor must report:

Report 1: The amount of overwithholding paid to each account holder that occurred after the date of filing the Form 1042.

QI Agreement Sec. 10.03(E). Change in Circumstances. The external auditor must verify that in the course of the audit it has not discovered any significant change in circumstances, as described in section 11.03(A), (D), or (E) of this Agreement.

Audit Guidance 10.03(E):

10.03(E).1. *Review of Change in Circumstance.* The external auditor must:

Step 1: Obtain a letter signed by the responsible party and by the QI's legal counsel stating:

- (a) Whether there has been an acquisition of all, or substantially all, of the QI's assets in any transaction in which the QI is not the surviving legal entity;
- (b) Any material changes in the know-your-customer rules and procedures set forth in the Attachments to the QI Agreement; and
- (c) Any significant changes in the QI's business practices that affect the QI's ability to meet its obligations under the QI Agreement.

10.03(E).2. *Change in Circumstance Report.* The external auditor must report a change in circumstances by:

Report 1: Attaching a copy of the letter under Step 1.

QI Agreement Sec. 10.04. Use of Statistical Sampling. If the external auditor is required to make a determination based on a valid sample of accounts, it shall use a statistical sampling whenever an examination of all of accounts within a particular class of accounts would be prohibitive in terms of time and expense. If it is reasonable to examine all accounts in connection with a particular issue, statistical sampling techniques shall not be used. If statistical sampling techniques are required, the external auditor must determine a sample size that provides a 95 percent confidence level. If statistical sampling has been used and the auditor determines that underwithholding has occurred with respect to the sampled accounts, the IRS will determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts. For this purpose, QI agrees to provide the IRS with the information (e.g., number of accounts and amounts) required to project the underwithholding. QI shall either report and pay, in accordance with section 9.06 of this Agreement, the underwithheld tax determined under the IRS projection or propose another amount of underwithholding based on a more accurate population, a more accurate projection technique, or an examination of all similar accounts. If the IRS does not agree with the amount proposed by QI, the IRS shall assess a tax

by making a return under section 6020 of the Code.

Audit Guidance 10.04:

10.04.1. *When to Use Statistical Sampling.* The external auditor is permitted to select three statistical samples for use in performing the procedures in AG 10.03. These are the samples permitted to be selected in:

- (a) AG 10.03(A)(4).1 Step 1 (a sample of all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients);
- (b) AG 10.03(A)(6).1 Step 1 (a sample of all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients); and
- (c) AG 10.03(A)(4).1 Step 7 (a sample of the indirect account holders for which recipient specific reporting is required).

The external auditor may always elect to conduct a 100 percent review instead of selecting a statistical sample. The statistical sampling methodology used in these guidelines cannot be used for any other tax purpose.

10.04.2. *Sample Size.* The external auditor is permitted to select a sample only if there are more than 50 accounts from which to select a sample in 10.04.1(a) or (b) or more than 50 indirect account holders from which to select a sample in 10.04.1(c).

10.04.3. *Sample Formula.* The external auditor must determine the sample size by using the following formula:

$$\text{Sample Size} = \frac{\frac{t^2 P Q}{d^2}}{1 + \frac{1}{N} \left(\frac{t^2 P Q}{d^2} - 1 \right)}$$

where $t=1.96$ (confidence coefficient at 95 percent two sided)

$P=5$ percent (error rate)

$Q=1-P$

$d=2$ percent (precision level)

N =total population

The sample size will not exceed 456 (as determined by the formula above) or 50 percent of the population, whichever is smaller. In no event may the sample size be lower than 50.

10.04.4. *Number Generator.* The external auditor must select the sample by using a random number generator.

10.04.5. *Records of Sampling Methodology.* The external auditor is required to record its statistical sampling procedures and to maintain the ability to reconstruct the sample.

10.04.6. *Alternative Sampling Methods.* Multistage, cluster, stratification or other sampling methodology may be used with the consent of the IRS. The sample size may be adjusted to achieve a 5 percent error rate, a 2 percent precision level and a 95 percent two sided confidence level. See AG 10.03.2 (Submission of Audit Plan).

10.04.7. *Projection.* If the external auditor has used a sample and has determined that underwithholding under AG 10.03(C)(1), (2), (3), (4), or (5) has occurred, then the IRS will determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts using a projection method that is consistent with the sampling method used. For example, if a simple unrestricted random sample as provided in these guidelines has been used, then the IRS may determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts as follows:

- (a) Dividing the amount of underwithholding for the sample by the number of accounts (or indirect account holders) in the sample; and
- (b) Multiplying the result in (a) by the total number of accounts in the population.
- (c) If the external auditor has used a sample and has determined

that overwithholding has occurred, the QI may not project the amount of overwithholding in order to claim a refund. For samples of direct account holders, the IRS will offset any underwithholding in the sample against any overwithholding in the sample, provided that the QI enters into a closing agreement (Form 906) that QI will not file a claim for refund for any overwithholding that the external auditor has discovered.

- (d) The IRS will determine whether it is appropriate to project an amount of underwithholding when the facts show that:
 - (i) The amount is the consequence of an identified error; and
 - (ii) The error was not repeated throughout the population over which it would be projected.
- (e) The QI may propose that it is not appropriate to project an amount of underwithholding when the QI shows that:
 - (i) The underwithholding was the consequence of an identified error,
 - (ii) The QI has corrected the error in the sample in which it was discovered,
 - (iii) The QI has corrected the error throughout the population from which the sample was drawn,
 - (iv) The QI has established safeguards to prevent repetition of the error in the future, and
 - (v) As a consequence of the correction, the facts as corrected show that there was actually no underwithholding during the audit year. (Penalties and interest may nevertheless be imposed.)

The QI may also propose an alternative projected underwithholding tax adjustment based on facts and circumstances. See Audit meeting

in AG 10.06 Step 3 for procedures for making such proposals.

Sec. 10.05. External Auditor's Report. Upon completion of the audit of QI and any PAI, the external auditor shall issue a report, or reports, of audit findings directly to the IRS by sending the original report to the IRS at the address set forth in section 12.06 of this Agreement by June 30 following the calendar year being audited, or if that date falls on a Saturday or Sunday, the next U.S. business day. The report must be in writing, in English, and currency amounts must be stated in U.S. dollars. The report must fully describe the scope of the audit, the methodologies (including sampling techniques) used to determine whether QI is in compliance with the provisions of this Agreement, and the result of each such determination. The report must also specifically address each of the items in section 10.03 of this Agreement.

Audit Guidance 10.05:

10.05.1. *Auditor's Report Requirements.* The external auditor's report must:

- (a) List the external auditor's name, address, contact person and contact person's telephone number.
- (b) List the QI's name, address, QI-EIN, responsible party and responsible party's telephone number.
- (c) List each procedure required under these Audit Guidelines in the order listed in the Audit Guidelines with a notation that the procedure was performed.
- (d) Identify the audit year.
- (e) List, under each procedure, the items required to be reported under these Audit Guidelines in the order listed in the Audit Guidelines.
- (f) Include any items required to be attached to the report as Appendix 1. These items should be cross-referenced in the report with footnotes.
- (g) Include any information that requires a narrative response and any other information that the external auditor wishes to include as Appendix 2. These

items should be cross-referenced in the report with footnotes.

- (h) Contain a certification signed by the external auditor that the required procedures have been competently performed and that the information reported is accurate and complete.

10.05.2. *Electronic Report.* The IRS intends to develop a standard electronic report form. For audit reports due after the publication date of that form, the external auditor must also complete that form and send it to the IRS in the manner required by the form.

10.05.3. *Report Due Dates.* The external auditor must send the hard copy audit report to the IRS at the address set forth in section 12.06 of the QI Agreement by June 30 of the year following the audit year. The external auditor and the QI may jointly request an extension of the due date of the report by submitting a request for extension in writing signed by the external auditor and by the QI's responsible party to the IRS at the address in AG 10.01.1 by June 30 of the year following the audit year. The request should state the date to which the extension is requested, explain the reason for the extension and include telephone numbers for the external auditor's contact person and the QI's responsible party. The IRS will send the external auditor and the QI a written response as soon as practicable after receiving the request.

Sec. 10.06. Expanding Scope and Timing of External Audit. Upon review of the external auditor's report, the IRS may request, and QI must permit, the external auditor to perform additional audit procedures, or to expand the external audit to cover some or all of the calendar years for which the period of limitations for assessment of taxes has not expired. In addition, the IRS may

request, and QI agrees to permit, the external auditor to perform an audit for one or more calendar years not scheduled for audit under section 10.03 of this Agreement.

Audit Guidance 10.06:

10.06.1 *IRS Review of Audit Report.* Within 90 days after the IRS receives the external auditor's report, the IRS will review the report and, if the IRS determines that no further action is necessary, then the IRS will send a written notice to the QI and the external auditor informing them of this determination.

10.06.2. *Audit Part 2: IRS Directed Procedures.* The IRS may determine that additional fact finding is necessary. In such cases, the IRS will contact the external auditor and the QI by telephone or in writing within 90 days after the IRS receives the external auditor's report. The IRS will direct the external auditor to perform specific audit procedures and to report in writing the results of those procedures. The IRS directed procedures may include instructing the external auditor to forward to the IRS certain of the external auditor's work papers and reports or instructing the external auditor to perform specific procedures (or perform an audit in accordance with these Audit Guidelines) for the audit year or for years other than the audit year. The IRS will stipulate a due date not more than 90 days from the date of its instructions to the external auditor for the external auditor's report on the results of any IRS directed procedures. The external auditor may request an extension of the due date in accordance with AG 10.05 at any time before the due date. Within 90 days after receiving the external auditor's report on the results of the initial IRS directed procedures, the IRS will contact the external auditor and the QI. If the IRS determines that additional fact finding is necessary, then the IRS may direct the external auditor to perform further addi-

tional procedures under this section until the IRS determines that the facts have been sufficiently developed. If the IRS determines that the audit is complete, the IRS will notify the external auditor and the QI in writing of the completion of the audit and of any actions that it will take as a result of the audit.

10.06.3. *Audit Part 3: Audit Meeting.* At any time after the external auditor has submitted its report on the initial IRS directed procedures and before the IRS notifies the QI and the external auditor of the completion of the audit, either the IRS or the QI may request an audit meeting between the IRS and the QI to accelerate fact finding, and to clarify and resolve concerns. To request and schedule a meeting, the IRS will contact the QI's responsible party by telephone or in writing, and the QI may contact the IRS at the address in AG 10.01 by telephone or in writing. The IRS will meet with the QI within 90 days of the date the IRS receives or makes the request, or at such other time as the IRS and the QI may agree. If the IRS and the QI agree, the employees of the external auditor who are acting in the capacity of external auditors under the QI Agreement may attend the audit meeting in that capacity, and other employees of the same firm may attend in other capacities. The IRS may continue to direct the external auditor to perform specific audit procedures under AG 10.06.2 without regard to whether an audit meeting has been scheduled or held. After the first audit meeting, either the IRS or the QI may request further audit meetings at any time before the IRS notifies the external auditor and the QI of the completion of the audit.