group of 20 hospitals that were selected for examination based on compensation amounts, and (3) although the compensation appears to be high, most of the amounts were upheld as established pursuant to the rebuttable presumption standard. Lois Lerner, in a press briefing issued on February 12, 2009, specifically addressed the compensation issue and the results of the Hospital Compliance Project and stated that the Service needs to closely examine the quality of comparability data used to establish reasonableness (specifically whether compensation amounts paid by for-profit organizations should be allowed) and the impact of the initial contract exception on compensation paid by hospitals.

Conclusion

While discussing the possibility of a trend in executive compensation of nonprofit hospitals moving toward the high end of the spectrum, the Service's TE/GE Commissioner, Steven T. Miller, stated (in an interview with the American Health Lawyers Association): "When the river rises, all boats rise. There's a question as to whether that was the intention of the rebuttable presumption concept." It appears that the issue of reasonable compensation will be a focus of the Service for the present time. Every tax-exempt organization should review its compensation policy to determine whether the policy appropriately incorporates the three-prong test set forth in Regulation section 53.4958-6, and sets forth standards that exceed the minimum for compensation data comparison. Hospitals should be on notice that the Service is looking carefully at compensation arrangements and consider whether past practices will continue to satisfy the rebuttable presumption standard. ■

Qualified Intermediary Program Reform

By Kathryn Morrison Sneade*

Last year, the qualified intermediary ("QI") program, which essentially allows foreign financial institutions to act as U.S. withholding agents by entering into an agreement with the Service and promising to abide by various terms, came under widespread scrutiny as a result of reported abuses of the program by the foreign banks UBS and LGT. As a result, proposals for reforming the program have been presented by the Service, the Senate Permanent Subcommittee on Investigation ("PSI"), and, most recently, the Obama administration. Many of these reforms would impose significant burdens on QIs, which will affect foreign financial institutions' ability and desire to participate in the QI program. However, the Obama administration's proposed reforms would also have serious negative consequences for non-QIs, leaving foreign financial institutions with a difficult choice.

Overview of the Program

The QI program was established in 2000 to encourage compliance with the U.S. withholding requirements of Code section 1441 and the corresponding Treasury regulations and to enhance reporting on U.S. persons' foreign account activity. Under the program, foreign financial institutions that have signed a QI agreement agree to take primary responsibility for withholding tax from payments to foreign persons and may also agree to take on primary Form 1099 responsibility for certain payments to U.S. persons. QIs must obtain a Form W-9 (indicating that the client is a U.S. person), Form W-8BEN (indicating that the client is a non-U.S. person who beneficially owns an account held in the name of an intermediary), or other appropriate documentation from each client that buys or sells U.S. securities through an account for which the foreign financial institution is a designated QI participant. All QIs are required to have "know-your-customer" ("KYC") procedures in place for collecting documentation regarding account holders' identities, and therefore, they are thought to be in a better position to accurately determine the residency and nationality of the account holders than other U.S. withholding agents.

As an incentive for financial institutions to join the program, QIs are not required to disclose the identities of non-U.S. account holders in the reporting and withholding process. Instead of filing an individual Form 1042S (used to report foreign persons' U.S. source income subject to withholding) for each non-U.S. client filing a W-8BEN form, QIs may pool the "reportable amounts" of U.S. source income paid to all non-U.S. accounts in the QI program and file a single Form 1042 for each category of U.S. source income paid to those accounts, remitting withheld taxes to the Service on an aggregate basis. In contrast, a QI that has taken on primary Form 1099 responsibility must file an annual Form 1099 with the Service for each U.S. client receiving "reportable payments" of U.S. source income in a QI-designated account. UBS and LGT reportedly helped many U.S. clients with U.S. securities avoid disclosure by helping them to establish foreign entities to hold the securities in a new account. The banks would then accept W-8BENs from the new accounts and treat them as accounts held by non-U.S. entities,

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although the banks were aware that the beneficial owners of the accounts were U.S. persons. It is a matter of debate whether such actions actually violated the banks' QI agreements, but lawmakers' perception of the banks' actions as abusive has given rise to a number of reform proposals.

PSI Recommendations

The PSI's recommendations for strengthening the program, presented in its Staff Report on Tax Haven Banks and U.S. Tax Compliance released in conjunction with its July 17, 2008, hearing, would attempt to address the issue of such abuse by requiring QIs to file a Form 1099 for every U.S. client and for all accounts beneficially owned by U.S. clients. In addition, QIs would be required to use all information obtained through their KYC procedures to identify the beneficial owners of accounts. The PSI also recommended strengthening external audits of QIs by requiring auditors to report evidence of fraudulent or illegal activity, a recommendation that the Government Accountability Office also made in a 2007 report on the QI program to the Senate Finance Committee. Finally, the PSI recommended the termination of QI status for tax haven banks that impede U.S. tax enforcement or fail to disclose accounts held directly or indirectly by U.S. clients. This would be inconsistent with the general approach taken by the Service in the past, which has been to work with QIs to remedy any compliance issues, rather than terminating their QI agreements, since the agreements generally allow the Service to collect taxes that otherwise might not be collected and also encourage investment in the U.S. by foreign account holders, as their identity is protected by the QI's pooled reporting. However, the PSI recommendations are in line with the approach reflected in the Obama administration's proposals, which take a similarly hard line with respect to tax evasion.

Service Proposals

The Service proposed changes to the program in Announcement 2008-98, issued in October 2008, as the first step in a multipronged plan to improve the program. (The Service has announced that it also plans to issue proposed section 1441 regulations to enhance documentation requirements, as well as a separate set of proposed regulations that would allow them to identify "bad actors," such as account holders whose documentation does not match up.) Announcement 2008-98 proposed three major changes to the QI program. First, a QI would be required to immediately inform the Service of any material failure of its internal controls relating to its performance under the QI agreement. Second, external auditors performing audits of QIs' performance would be required to collect additional information relating to the evaluation of the risk of a material failure of internal controls. Procedures for testing certain accounts for characteristics that suggest that a U.S. person has authority over the account would also be added. And finally, external auditors would be required to associate with audits a U.S. auditor who would accept joint responsibility for the performance of procedures under audit guidance.

These proposals have received a largely negative reaction from foreign financial institutions, which have expressed the view that foreign QIs have invested significant resources to ensure high levels of compliance with their obligations and that QI audits thus far have generally reflected satisfactory performance. In their view, the proposals are not necessary to ensure continued compliance by QIs, and the additional costly and time-consuming requirements proposed by the Service unfairly penalize compliant QIs and impose such significant burdens that many QIs may find it necessary to leave the program. For QIs that stay in the program, the significant additional costs of compliance will be passed on to customers, making U.S. investment less attractive.

Furthermore, a number of commentators have expressed the view that the Service should issue any proposed regulations enhancing the documentation requirements under section 1441 before making changes to the QI audit procedures, particularly any changes regarding testing accounts for authority of U.S. persons, as QIs currently have no special obligations with respect to accounts over which a U.S. person has authority.

The Administration's Reform Proposals

On May 4, 2009, the Obama administration presented several proposals for reforming the QI program as part of its plan to overhaul international tax policy. Consistent with the PSI recommendations for strengthened reporting by QIs, the administration's proposal would increase the reporting requirements for QIs. For instance, every QI would be required to file Form 1099s with respect to all "reportable payments" received on behalf of all U.S. account holders. Also, the Treasury Department would be authorized to issue regulations providing that QIs must collect information indicating the beneficial owners of foreign entity account holders and specifically report if the beneficial owner is a U.S. person. Additional reporting requirements would also be imposed on QIs and U.S. financial intermediaries regarding the establishment of or transfer of assets to foreign financial accounts and on QIs and U.S. persons regarding the establishment of offshore entities. Additional reporting requirements for QIs would provide a disincentive for foreign financial institutions to enter into QI agreements, as would regulations providing that a foreign financial institution may qualify as a QI only if all commonly-controlled financial institutions are also QIs. (The Obama administration's proposal would authorize the Treasury Department to issue such regulations.) However, the Obama administration's other proposals regarding the QI regime

would have significant negative consequences for non-QIs.

Other reforms proposed by the administration are based on a presumption that non-QI foreign financial institutions are facilitating tax evasion. Accordingly, U.S. financial institutions would be required to withhold 20 to 30% of U.S. payments to foreign individuals who use non-QIs. Investors entitled to a lower rate would have to prove their status to obtain refunds. There also would be a rebuttable evidentiary presumption that an account held by a U.S. citizen at a non-QI contains enough funds to require the filing of a Report of Foreign Bank and Financial Accounts ("FBAR"), and any failure to file an FBAR with respect to an account at a non-QI would be considered willful if the account had a balance of greater than $200,000 at any point during the year. In addition, U.S. individuals would also be required to report on their income tax returns most transfers of money or property made to or from non-QI accounts more than 50% owned, actually or constructively, by the individual. Reforms like this would make doing business with non-QIs unattractive for both foreign and U.S. investors.

Conclusion

The Service has indicated that it will announce final changes to the QI agreement and audit procedures "soon," and proposed regulations with respect to withholding are also expected "soon." It is likely to take some time for the PSI and Obama administration proposals to work their way through Congress, but it is clear that major changes are in the pipeline that will affect not only the QI program, but also foreign financial institutions generally. If many of the reform proposals are adopted, foreign financial institutions will be facing a difficult choice between participating in a QI program with increasingly burdensome requirements, some of which arguably push the limits of what the U.S. government can ask foreign financial institutions to do, and dealing with significant restrictions imposed on non-QIs, which would have major negative consequences for the financial institutions' ability to do business and attract customers. Altogether, the reform proposals are likely to advance the goal of preventing tax evasion, but it will be at the cost of alienating foreign investors and foreign financial institutions. ■

News Briefs

Section of Taxation White Papers

The Tax Section has created a series of White Papers that provide clear statements of tax policy issues that are important to the Section, and on which the Section has worked for many years. Some of the issues reflect the Section's policy advocacy positions that have been adopted by the ABA House of Delegates and are now reflected in tax-related ABA policies. Other issues may include information from specific Tax Section policies that have not been adopted by the ABA House of Delegates or its Board of Governors, and are specific only to the Tax Section. We hope that the papers will be useful to policymakers and the public, and will inform debate on these issues going forward. The following White Papers are available on the Section's website at **www.abanet.org/tax/pubpolicy**.

- Statement of Policy Regarding U.S. International Taxation
- Joint Statement on Tax Issues in Health Care Reform
- Statement of Policy Favoring Reform of Federal Civil Tax Penalties
- Statement of Policy Favoring Tax Simplicity, Stability, and Transparency

Important Developments Reports

As a service to its members, the Tax Section features on its website Annual Reports on Important Developments as well as interim updates presented by a number of committees at Section Meetings. These reports are an important work product of the Section's committees and track recent legislative changes, regulations, cases, and rulings, as well as forecast upcoming developments in over 30 substantive areas of the tax law. Reports for 2000-2008 are available. To access the online index, go to: **www.abanet.org/tax/developments**.

Tax Bridge to Practice for Law Students

The ABA Tax Section's Young Lawyers Forum is offering a Tax Bridge to Practice Program at the Section's Joint Fall CLE Meeting with the Trust and Estate Division of the Real Property Section. The event will be held on Thursday afternoon, September 24, 2009, in Chicago and is open to all 2L, 3L and LL.M. students in the area. The program will provide substantive lectures in tax by the best tax professors in the country, along with career advice and a series of practice-focused workshops. For more information, please contact the ABA Tax Section at 202-662-8680.

continued on back page