

June 2, 2003

MEMORANDUM FOR INDUSTRY DIRECTORS  
DIRECTOR, FIELD SPECIALISTS  
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE

FROM: Paul D. Director, Industry Director  
Financial Services - LMSB

SUBJECT: Industry Directive on Qualified Intermediary Audit Reports  
For Audit Years Before 2005

The purpose of this directive is to provide direction to examiners in the Financial Services Qualified Intermediary Audit Team ("Audit Team") in reviewing Qualified Intermediary (QI) audit reports for audit years before 2005. This LMSB directive is not an official pronouncement of the law or the Service's position and cannot be used, cited or relied upon as such.

The guidelines for external auditors of Qualified Intermediaries are published in Revenue Procedure 2002-55, 2002-35 I.R.B. 435, ("Audit Guidance"). Under Sec. 10.03.5 of the Audit Guidance, an external auditor need not submit an audit plan to the IRS unless it plans to modify or deviate from the audit procedures set forth in the Audit Guidance. The Audit Guidance provides the Audit Team with discretion in determining which situations are appropriate for modification or deviation.

The Audit Guidance further permits an external auditor to provide explanatory footnotes or addenda to the audit report that it submits to the Audit Team. This optional provision offers the external auditor an opportunity to clarify the results it reports. Such information may assist the Audit Team in reviewing the reports. The Audit Team will use information presented in footnotes (including those specifically described below) to evaluate problematic results and to assess whether further factual development is required in Phase 2 as described in the Audit Guidance.

External auditors have repeatedly raised certain questions regarding the presentation of information in their audit reports. To achieve a uniform presentation in the audit report of issues that are of general concern and to eliminate the need for external auditors to submit, and the Audit Team to review, multiple audit plans that address the same issues, the Audit Team should inform external auditors that presentation of information in their audit reports in accordance with the following instructions will not require submission of an audit plan. The following instructions do not limit the discretion of the Audit Team to assess whether further factual development is required in Phase 2.

(1) Partnerships and Trusts Subject to Notice 2001-4.

The Audit Team will allow the external auditor to report, as follows, information regarding partnerships and trusts to which a QI has applied the transition rules of sections III. C. and IV. of Notice 2001-4:

(a) Partnerships:

- i. The audit report contains footnotes documenting the following procedures and the number of partnership account holders to which the procedures were applied.
  - A. All partnership accounts were included in the population for purposes of calculating sample size under Sec. 10.04.2 of the Audit Guidance.
  - B. A partnership account that the QI identified as one to which it applied the transition relief of Notice 2001-4 was either
    1. so identified by the QI before the external auditor drew the sample and the account was excluded from the population by the external auditor for purposes of drawing the sample, or
    2. could not be identified by the QI before the external auditor drew the sample. If the partnership account could not be identified before the sample was drawn, it was skipped by the external auditor when drawn, and another account was drawn in its place. The replacement account was drawn by generating another random number that continues the sequence of previously generated random numbers.
- ii. Notwithstanding the procedures described in (1)(a)i. above, the external auditor applied the Audit Guidance to all U.S. non-exempt recipient partners as indirect account holders.

(b) Simple and Grantor Trusts:

- i. The audit report contains footnotes documenting the following procedures and the number of trust account holders and beneficiaries or owners of such trust account holders to which each procedure was applied.

- A. The QI identified the trust account as one to which it applied the transition relief of Notice 2001-4.
  - B. For purposes of selecting accounts held by direct account holders for the sample, the external auditor treated the trust as a single direct account holder.
  - C. For purposes of performing the procedures under Sec.10.03 of the Audit Guidance, the external auditor treated each beneficiary or owner of the trust as a direct account holder.
- ii. The audit report distinguishes
- A. beneficiaries or owners of a trust that were properly double documented under Notice 2001-4,
  - B. beneficiaries or owners of a trust that were documented with either valid documentation listed in the attachment to the QI Agreement or a valid Form W-8, but not both, and
  - C. beneficiaries or owners for which there was no valid documentation.
- iii. A trust account was selected for spot check when no valid documentation was obtained for one or more owners or beneficiaries of the trust. In such cases, the spot check procedures were applied only to the beneficiaries or owners for which there was no valid documentation, and
- A. if payment allocation information from the trust was available, the spot check was applied in accordance with the allocations, or
  - B. if payment allocation information from the trust was unavailable, all payments made to the trust account were presumed to have been paid to the undocumented beneficiaries or owners.
- iv. If a trust account was selected for spot check at random, under Sec. 10.04.7 of the Audit Guidance, spot check procedures were applied to a single beneficiary or owner, selected at random.

(2) Certain Foreign Estates

The Audit Team will allow the external auditor to report, as follows, information regarding accounts of deceased account holders that contain no documentation for the estate.

- (a) The external auditor reported the account as undocumented.
- (b) The external auditor footnoted instances where
  - a. the account contains correct documentation with respect to the decedent, and
  - b. it received a representation from the QI that
    - i. no person has been authorized to provide documentation for the estate, and
    - ii. either (1) the QI treated the account as undocumented or (2) the QI treated the account as documented based on the documentation of the decedent.
- (c) The external auditor did not select for spot check any account that was so footnoted.

(3) Prior Versions of Forms W-8 and W-9

The Audit Team will allow the external auditor to report information regarding Forms W-9 in accordance with section 10.03(A)(5) of the Audit Guidance without noting whether the form is the most current version. The Audit Team will allow the external auditor to report information regarding Forms W-8 in accordance with section 10.03(A)(5) of the Audit Guidance without noting whether the form is the most current version if the revision date on the form is October 1998 or December 2000.

(4) Sample Size

The Audit Team will allow the external auditor to report, as follows, information regarding how the sample size was determined.

- a. The external auditor footnotes how the sample size was determined and what steps were taken to insure that all accounts subject to the QI Agreement were included in included in the population of accounts from which the sample was drawn.

b. The footnote includes:

- i. the total number of accounts in the population,
- ii. the total number of accounts in the sample,
- iii. the total reportable amounts for the population, and
- iv. the total reportable amounts for the sample, broken down by strata.

**EFFECT ON OTHER GUIDANCE:**

This directive should be applied in the context of published guidance such as Rev. Proc. 2002-55. This directive is not intended to supercede any such guidance or law and must be construed in that context. As in the case with any issue, the QI Team members are encouraged to exercise their professional judgment in developing and resolving factual issues.

**CONTACTS:**

For any questions concerning this LMSB Directive, please contact Thomas Chillemi, Team Manager QI at 212-298-2101. .