
Proposed qualified intermediary agreement includes qualified derivatives dealer provisions

July 8, 2016

In brief

The Internal Revenue Service (IRS) on July 1, 2016 issued [Notice 2016-42](#) (Notice) setting forth proposed changes that will apply to non-US entities that elect to enter into qualified intermediary (QI) agreements with the IRS. QI agreements generally permit foreign persons to simplify their obligations as a withholding agent under Chapters 3 and 4 (Foreign Account Tax Compliance Act or FATCA) of the Internal Revenue Code (IRC or Code) and as a payor under Chapter 61 and Section 3406 of the Code for amounts paid to their account holders. The proposed QI agreement will have an effective date of January 1, 2017.

The Notice also sets out terms and requirements for derivatives dealers and securities lenders that are QIs and plan to act as qualified derivative dealers (QDDs) with respect to transactions that give rise to dividend equivalents from US sources under Section 871(m) of the Code (871(m) transactions) and that give rise to substitute interest. The QDD regime addresses the problem of over- or cascading-withholding on certain derivatives and securities lending transactions by providing that no withholding tax is required on certain payments made to a QDD when the QDD is acting as a principal.

The proposed QI agreement provides that the QI may represent its status as a withholding QI irrespective of whether it is acting as intermediary or principal with respect to securities lending transactions, sale-repurchase transactions and collateral arrangements that give rise to substitute interest payments.

The IRS requests that comments with respect to the proposed QI agreement be submitted by August 31, 2016.

For a more in-depth analysis of the provisions of the proposed agreement and the impact to QIs, see our [*Insight: IRS proposes updated qualified intermediary agreement.*](#)

In detail

QDDs

The QDD regime is a new set of reporting and withholding guidelines tailored to non-US derivatives dealers and securities lenders intended to address the problem of over-

withholding on certain 871(m) transactions. These rules were originally announced in September 2015 when the US Department of the Treasury (Treasury) and the IRS issued regulations under IRC Section 871(m). Treasury and the IRS have determined that the most

comprehensive and efficient way to create the QDD regime was to expand the existing QI regime to accommodate taxpayers acting as financial intermediaries on 871(m) transactions, even when these intermediaries are transacting in a principal capacity.

These transactions include securities lending or sale-repurchase transactions, specified notional principal contracts, and specified equity-linked instruments. The Notice contains provisions that permit a QI that is an 'eligible entity' to act as a QDD, and describes the requirements and obligations that pertain to a QDD.

Absent the QDD regime, over-withholding could occur in the following scenarios:

- Brokers that enter into derivative contracts as principals often receive dividends or dividend equivalents payments and are simultaneously obligated to make offsetting payments to counterparties with respect to transactions that are hedged by the derivatives. Withholding would be duplicative if it were to occur on payments the brokers receive as well as the payments the brokers make on hedges.
- Borrowers of securities are required to pay substitute payments (e.g., substitute dividends in lieu of actual dividends) to lenders with respect to securities they borrow. When there is a series of securities lending transactions on identical securities, withholding tax could be duplicated since each substitute payment in a chain of securities lending transactions could give rise to a withholding tax obligation, resulting in 'cascading' taxation that might, in the aggregate, exceed 30% of the amount of the dividend distribution on the underlying loaned security.

Eligibility for QDD status

The proposed QI agreement provides that the following types of entities are 'eligible entities' and may act as QDDs:

- A dealer in securities that are subject to regulatory supervision as a dealer by a governmental authority in the jurisdiction in which it is organized or operates,
- A bank subject to regulatory supervision as a bank by a governmental authority in the jurisdiction in which it is organized or operates and that issues potential section 871(m) transactions to customers and receives dividends or dividend equivalent payments pursuant to potential 871(m) transactions to hedge those transactions issued to customers, or
- An entity that is wholly-owned by a bank subject to regulatory supervision as a bank by a governmental authority in the jurisdiction in which it is organized or operates and that issues potential 871(m) transactions to customers and receives dividends or dividend equivalent payments pursuant to potential 871(m) transactions.

Observation: *An entity that is wholly owned by a broker dealer, and not by a bank, would therefore be ineligible to act as a QDD. This may impact the ability of a broker-dealer affiliate to issue structured notes referencing US equities. There does not seem to be a real policy reason for excluding these entities from acting as QDDs.*

In addition, non-US branches of US financial institutions also are eligible to act as QDDs. The proposed agreement specifies that if a foreign

branch of a US financial institution meets the requirements of an eligible entity, the foreign branch may enter into a QI agreement to act as a QDD.

Observation: *Under the proposed QI agreement, an entity that is resident in a jurisdiction that does not have an IRS approved know your customer (KYC) attachment cannot be a QDD because it is not eligible for QI status. Similarly, an entity that is not the type of entity that is eligible for QI status cannot become a QDD.*

Application for QDD status

In order for a QI to act as a QDD, the information relating to QDDs must be included in its QI agreement application which is currently being revised by the IRS (Form 14345, *Application for Qualified Intermediary, Withholding Foreign Partnership, or Withholding Foreign Trust Status*). An existing QI that wants to renew its QI agreement and act as a QDD going forward will be required to add a statement to the renewal request that contains all information required on Form 14345 relating to a QDD, but will not have to provide a new Form 14345.

Types of payments subject to QDD status

The Notice provides that a QI may act as a QDD only for payments with respect to certain transactions:

- *Payments made or received as principal:* A QI can act as a QDD only for payments with respect to potential 871(m) transactions or underlying securities that it receives with respect to potential 871(m) transactions that it makes as a principal (not as intermediary), whether or not the payments are received or made in its dealer capacity.

Example: When a QI acts as a custodian of a structured note with a payment referencing a dividend of a US corporation, it is receiving the payment as an intermediary and cannot act as a QDD for this payment. The QI may, but is not required to, act as a QI for those payments and can choose whether or not to assume primary withholding responsibility or it may act as a nonqualified intermediary (NQI) for such payments.

- A QI cannot be a QDD for income effectively connected to a US trade or business (ECI): To the extent that a payment received by a QI as principal is treated as income effectively connected with QI's trade or business in the United States, then the QI is not allowed to act as a QDD for such payment.

Securities lending

The proposed QI agreement contains two provisions that are relevant to securities lenders - one for potential 871(m) transactions (i.e., involving substitute dividends) and another for other securities (i.e., for substitute interest).

871(m) transactions / substitute dividends

The QDD regime is intended to replace the qualified securities lender (QSL) regime described in IRS Notice 2010-46 which applies to substitute dividends. The proposed QI agreement will require a QI to act as a QDD for all securities lending and sale-repurchase transactions the QDD enters into that are 871(m) transactions. Securities lending and sale-repurchase transactions are 871(m) transactions deemed to be entered into by the QI as a principal and therefore are within the scope of the QDD regime.

Until the QDD regime is implemented, the QSL rules will continue to apply for substitute dividend payments made pursuant to a securities lending or a sale-repurchase transaction.

Observation: Under the QSL regime, stock lenders are required to comply with the terms of Notice 2010-46 in order to avoid duplicative withholding tax, and they merely need to certify their status as a qualified securities lender to a withholding agent in order to avoid or minimize withholding tax. Under the proposed QI agreement, stock lenders will need to enter into a QI agreement to obtain the same level of withholding tax relief. A QI agreement carries many more compliance obligations than the former status of qualified securities lender. For example, a QI needs to appoint a responsible officer and adhere to other compliance provisions contained in the QI agreement.

Substitute interest

A QI may assume primary withholding responsibility for payments of US source substitute interest received in connection with a sale-repurchase or similar agreement, a securities lending transaction, or collateral that it holds in connection with its activities as a dealer. If a QI does assume primary withholding responsibility for payments of substitute interest, it must assume primary withholding responsibility with respect to all such payments. With respect to substitute interest received in connection with the aforementioned transactions, a QI may represent its status as a withholding QI on a Form W-8IMY regardless of whether it acts as an intermediary or as a principal with respect to these payments.

Observation: Under this new provision in the proposed QI agreement, lenders of securities that receive substitute interest will be

permitted to receive that interest free of withholding regardless of whether they are acting as principal, agent, or intermediary.

Reporting and withholding responsibilities of a QDD

A QDD's reporting and withholding responsibilities under the proposed QI agreement primarily mirror those of other QIs, with a few important differences. Specifically, the Notice provides that QDDs must:

- Assume primary Chapter 3 and 4 withholding responsibility and primary Form 1099 reporting and backup withholding responsibility for all payments made with respect to potential 871(m) transactions as a principal. QDDs withhold on the dividend payment date for the applicable dividend.
- Assume primary Chapters 3 and 4 withholding responsibility and primary Form 1099 reporting and backup withholding responsibility for all payments with respect to potential 871(m) transactions that are not dividend equivalent payments, but that are amounts subject to Chapter 3 or 4 withholding or that are reportable payments.
- Report specific payee (rather than pooled) information on IRS Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, for payments to other QDDs to which the QDD makes a payment of an amount subject to chapter 3 withholding. This includes reporting on separate Forms 1042-S the amount of qualifying dividend equivalent offsetting payments that represent:

1. the aggregate amount of payments made to a US person that would be dividend equivalent payments if made to a person who was not a US person, and
 2. the aggregate amount of payments of effectively connected income.
- Upon request, provide specific information (such as, name, address, and US taxpayer identification number) to the IRS about US non-exempt recipients that receive qualifying dividend equivalent offsetting payments. To facilitate this reporting, the proposed QI agreement requires QDD's to obtain a waiver from each US non-exempt recipient that has any limitation on providing the information requested to the IRS. If the QDD does not obtain a waiver or collect and maintain such information about a US non-exempt recipient, any payment made to that US non-exempt recipient will not be treated as a qualifying dividend equivalent offsetting payment. The QDD also will be required to report these payments in a pool on a separate Form 1042-S.

Tax Liability of a QDD

A QDD (other than a foreign branch of a US financial institution) must determine and pay its 'QDD Tax Liability' which is the sum of:

1. The QDD's 'Section 871(m) amount' which is the excess of:

(A) the dividends on underlying securities associated with potential 871(m) transactions and dividend equivalent payments that the QDD receives in its dealer capacity

over

(B) the dividend equivalent payments and the qualifying dividend equivalent offsetting payments that the QDD makes or is contractually obligated to make with respect to the same dividend in its dealer capacity.

Observation: Including a QDD's Section 871(m) amount in its QDD Tax Liability means that a QDD is liable for tax on dividends or dividend equivalents it receives in its capacity as a dealer to the extent that the offsetting dividend equivalent payment on an underlying security the QDD is contractually obligated to make is less than the dividend and dividend equivalent amount that the QDD received.

2. The dividends it receives that are not on underlying securities associated with potential 871(m) transactions and its dividend equivalent payments received as a QDD in its non-dealer capacity.

and

3. Any payments, such as interest, received as a QDD with respect to potential 871(m) transactions or underlying securities that are not dividend or dividend equivalent payments.

Reporting QDD Tax Liability

In addition to determining and paying its QDD Tax Liability, a QDD is required to report on Form 1042 its QDD Tax Liability, and must separately identify each part (as described above) of its QDD Tax Liability on Form 1042.

Observation: Details on reporting the QDD Tax Liability on Form 1042 should be provided on the instructions to the 2017 Form 1042, which has not been issued yet. The additional reconciliation, which must be provided to the IRS upon request, may require modifications to a QDD's recordkeeping systems.

A QDD also must maintain, and make available to the IRS upon request, a reconciliation schedule that tracks across calendar years the Section 871(m) amount for each dividend with respect to each underlying security associated with potential 871(m) transactions or underlying security referenced by a potential 871(m) transaction.

Observation: The proposed QI agreement clarifies that when a foreign branch of a US financial institution acts as a QDD, the branch is not required to determine and pay its QDD Tax Liability. Nor is it required to report a QDD Tax Liability for income relating to potential 871(m) transactions and underlying securities on Form 1042. Instead, the US financial institution must file the appropriate US income tax return (for example, Form 1120, U.S. Corporation Income Tax Return) for the tax year covered by the QI agreement to report and pay its tax liability under Chapter 1 of the Code.

Withholding agent obligations

When a QDD provides a valid withholding certificate (e.g., Form W-8IMY) to a withholding agent, the withholding agent will not be required to withhold on Section 871(m) dividends or dividend equivalent payments or on payments with respect to underlying securities made to the QDD as long as the QDD is acting as a principal (not as an intermediary).

Observation: Note that although no withholding applies to certain transactions with QDDs, withholding agents still are required to report the payment (as discussed above). Additionally, withholding agents may need to enhance existing procedures for collection and review of withholding certificates to ensure that they can process forms that contain a QDD certification.

The takeaway

Many stakeholders already have begun their Section 871(m) compliance programs. With the issuance of the Notice, eligible QIs should consider whether they should become QDDs. Organizations choosing QDD status must begin to incorporate the Notice requirements

into their developing Section 871(m) compliance programs. QIs that choose to become QDDs should focus quickly on the additional reporting and operational burdens resulting from this status and coordinate these additional burdens with existing Section 871(m) workstreams within the organization. Additionally, foreign

securities lenders who have been operating as qualified securities lenders under IRS Notice 2010-46 to minimize their US withholding tax obligations should consider entering into a QI agreement and operating as a QDD since the QSL regime will be replaced by the QDD regime.

Let's talk

For a deeper discussion of how this development might affect your business, please contact:

Dominick Dell' Imperio
(646) 471-2386
dominick.dellimperio@pwc.com

Candace Ewell
(202) 312-7694
candace.b.ewell@pwc.com

Michael Gaffney
(203) 539-3339
mike.gaffney@pwc.com

Erica Gut
(415) 498-8477
erica.gut@pwc.com

Jon Lakritz
(646) 471-2259
jon.w.lakritz@pwc.com

Rob Limerick
(646) 471-7012
robert.limerick@pwc.com

Kerstin Thinnest
(352) 494-8483177
kerstin.thinness@lu.pwc.com

Amandine Horn
(352) 494-8482026
amandine.horn@lu.pwc.com

Camille Perez
(352) 494-8484618
camille.perez@lu.pwc.com

Marie Laffont
(352) 494-8483069
marie.laffont@lu.pwc.com

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