



# IRS Issues Notice 2016-42: Proposed Qualified Intermediary Agreement

## Closing the distance

### IRS issues awaited Proposed Qualified Intermediary Agreement

On July 1, 2016, the IRS released [Notice 2016-42 \("Notice"\)](#), providing the Proposed Qualified Intermediary ("QI") Agreement that certain foreign persons may enter into with the IRS to simplify their withholding agent and payor obligations under chapters 3, 4, 61, and section 3406. The Notice and Proposed QI Agreement also provide substantive guidance and operational procedures for implementing the new Qualified Derivative Dealer ("QDD") regime applicable to dividend equivalent payments under section 871(m) as announced in Temporary Regulations §1.871-15T(q) and §1.1441-1T(e)(6) on September 17, 2015. The QDD regime will apply to all dividend equivalent payments received by an electing QI on its principal transactions only and will replace the Qualified Securities Lender regime provided in Notice 2010-46 that applies only to substitute dividend payments received on stock loans, stock repos and substantially similar transactions. The QDD regime will operate solely within the QI Agreement going forward. The Notice and Proposed QI Agreement also accommodate expansion of primary withholding responsibility for substitute interest payments received by QIs acting as principals to the transactions.

*Two appendices for compliance and operational procedures.* Appendix I to the Proposed QI Agreement provides a six-part set of compliance procedures for QIs including special sections exclusively for QDDs (Part V) and QI's that assume withholding on substitute interest payments (Part VI). Appendix II provides audit sampling requirements under a safe harbor and reporting requirements for sampling plans that do not utilize the safe harbor provisions of the Appendix.

*Effective date.* The current QI Agreement (contained in in [Rev. Proc. 2014-39](#)) expires on December 31, 2016. The changes in the Notice, subject to modification, will be finalized in a revenue procedure later this year and will apply to QI Agreements in effect on or after January 1, 2017. The main changes set forth in the Proposed QI Agreement are discussed in detail below.

## Application Eligibility & Process

Certain foreign persons are eligible to enter into a QI Agreement including Foreign Financial Institutions (FFIs), foreign branches of US financial institutions and US clearing organizations, foreign clearing organizations, and certain Nonfinancial Foreign Entities (“NFFEs”). Territory Financial Institutions and Nonparticipating FFIs may not apply to enter into a QI Agreement. Additional eligibility requirements depend on the foreign person’s status, such as compliance with the FFI Agreement for a participating FFI. Certain entities may enter into the QI Agreement for the sole purpose of participating in the QDD regime.

A prospective QI (other than certain NFFEs and foreign central banks of issue) must have submitted a Form 8957 and obtained its chapter 4 status as a Participating FFI, Registered Deemed-Compliant FFI, Registered Deemed-Compliant Model 1 IGA FFI, Direct Reporting NFFE, or Sponsoring Entity of a Direct Reporting NFFE as well as a global intermediary identification number (“GIIN”). To become a QI, a prospective QI must then submit Form 14345, *Application for Qualified Intermediary, Withholding Foreign Partnership, or Withholding Foreign Trust Status*, to establish that adequate resources and procedures exist to comply with the QI Agreement. If the QI application is approved, the IRS will provide an approval notice and QI-EIN.

An existing QI must renew its QI Agreement through the FATCA registration website if it is an FFI, Direct Reporting NFFE, or Sponsoring Entity of a Direct Reporting NFFE. If an existing QI is an NFFE that is not acting as a QI on behalf of its shareholders and is not a Sponsoring Entity, it must renew its QI Agreement by submitting a renewal request to the Foreign Intermediaries Program. If an existing QI also seeks to act as a QDD, it must provide a supplementary statement containing all QDD-related information required by Form 14345. All renewals must take place prior to March 1, 2017.

New QI Agreements will be effective for a period of three years and would become effective if approved, as follows:

- If entered into on or before March 1st, on January 1st of the same year.
- If entered into after March 1st and the applicant has not yet received any reportable payments, on January 1st of the same year.
- If entered into after March 1st and the applicant has received reportable payments, the 1st of the month in which it is approved.

The Notice and Proposed QI Agreement changes the policy of issuing QI Agreements retroactively to the first day of the year regardless of when they are entered into.

*Special rule for NFFEs.* Although an FFI must be located in a country that has IRS approved “Know your Customer” procedures, NFFEs are not required to be located in approved jurisdictions as they cannot rely on documentary evidence.

## Beneficial Owner’s Claim for Treaty Benefits

Treasury and the IRS are expected to modify the chapter 3 regulations to require withholding agents to collect certain information and certifications regarding a beneficial owner’s claim for treaty benefits. In line with this, Form W-8BEN-E released in April 2016 was revised to include beneficial owner certifications relating to the Limitation on Benefits (“LOB”) provision of an applicable treaty. Similarly, Form 1042-S was revised to include a line to report the corresponding LOB code.

As such, the Proposed QI Agreement requires a QI to collect LOB information from entities in order to support the account holder’s treaty claim (i.e., revised Form W-8BEN-E or documentary evidence and a treaty statement). A QI that uses documentary evidence to document an entity account holder claiming a reduced rate of withholding under an income tax treaty must collect a separate statement from the claimant including the more detailed LOB information. The timeframes for collecting this information depend on the account’s status:

- If the QI opens an account or obtains documentation for an entity account holder on or after January 1, 2017, the QI must collect the new LOB information.

- If the account is a pre-existing account that was documented with documentary evidence, the QI must collect LOB information prior to January 1, 2019 (unless there is a change in circumstances requiring the QI to obtain corrected information before this date).
- If the account is a pre-existing account that was documented with a Form W-8, the form may be relied upon until its normal expiration period (unless there is a change in circumstances requiring the QI to obtain corrected information before this date).

## **Standard of Knowledge**

Under the Proposed QI Agreement, QIs are subject to an actual knowledge standard with respect to LOB claims. In addition, with respect to validation of treaty claims, a QI has reason to know that a treaty claim is unreliable or incorrect if the account holder (both individuals and entities) claims benefits under a treaty that does not exist or is not in force and is, thus, not included on the online list of income tax treaties maintained by the IRS. Application of this rule depends on the account's status:

- For pre-existing accounts for which the QI already holds valid documentation, this rule generally only applies upon a change in circumstances.
- For pre-existing entity accounts, the rule also applies when a QI obtains the required written LOB statement.
- For all new accounts, the rule applies upon account opening.

As written, the new reason to know standard would not appear to apply to pre-existing accounts that were documented with a Form W-8BEN-E unless there was a change in circumstances.

The chapter 3 regulations will be amended to apply both standards of knowledge for LOB claims.

## **Compliance Procedures**

### **Certification of Internal Controls**

A QI's responsible officer ("RO") must undertake a periodic review and make a periodic certification of internal controls. Responding to concerns raised about the impact of the compliance review procedures contained in the 2014 Agreement on the QI, the Proposed QI Agreement allows an RO to rely on reasonable procedures, processes, or reviews in addition to the results of the periodic review in order to make such certifications of compliance. Accordingly, the RO can decide whether to use an external or internal reviewer and what the scope of the engagement should be. In making the certification, the RO must document what he or she has relied upon and retain such documentation for the same period of time for which the compliance review report and certifications must be retained (i.e., as long as the QI Agreement is in effect).

#### *Timing*

A QI must make the certification on or before July 1 of the calendar year following the certification period. The initial certification period is the period ending on the third full calendar year that the 2014 QI Agreement and any superseding revenue procedure were in effect. Thus, a QI with a QI Agreement with an effective date of June 30, 2014 must treat the initial certification period as ending on December 31, 2017 and will be required to make a certification on or before July 1, 2018 (pursuant to the requirements of the QI Agreement in effect after December 31, 2016). A QI that had a QI Agreement under old Rev. Proc. 2000-12 in effect prior to June 30, 2014 with an audit cycle that would have extended past such date, is not required to complete an audit under the previous QI Agreement.

### **Periodic Review**

In addition to making the certification of internal controls, a QI must also report certain factual information regarding its documentation, withholding, reporting, and QDD tax liability (if applicable) obligations under the QI Agreement. Some of this information is gathered through testing of accounts and transactions as part of a periodic review. The IRS clarified that the periodic review does not need to satisfy the standards of a financial audit or other attestation engagement by replacing the term "auditor" with "reviewer" and specifying that the RO can arrange for the review to be conducted by an internal or external reviewer so long as there is sufficient independence to objectively conduct the review, meaning that a reviewer, whether external or internal cannot review their own work. Moreover, in order to

provide QIs with flexibility in the review, the IRS will not publish a step-by-step audit plan and will instead expect each QI to create a step-by-step plan to satisfy the review objectives.

### *Sampling Methodology*

Responding to requests for a safe harbor method for determining a sample of accounts for the periodic review, the Proposed QI Agreement provides a stratified statistical sampling methodology. A QI with 50 or more accounts must review at least 50 accounts and may use a sample to test accounts while a QI with fewer than 50 accounts must review all accounts and may not use a sample. Although the review is not required to include statistical sampling procedures for testing transactions, the reviewer must record its sampling methodology and be able to reconstruct the sample.

### *Waiver*

In certain circumstances, QIs may apply for a waiver of the periodic review requirement but if granted will still be required to provide some factual information along with the periodic certification. To be eligible to apply for a waiver, (1) the QI must not also act as a QDD, (2) the QI must not be part of a consolidated compliance program, (3) for each calendar year covered by the certification period, reportable amounts received by the QI must not exceed \$5 million, (4) the QI must have timely filed Forms 1042, 1042-S, 945, 1099, and 8966 for all calendar years covered by the certification period, and (5) the QI must have made all periodic certifications and reviews under sections 10.02 and 10.03 of the Proposed QI Agreement as well as any certifications required pursuant to FATCA, and (6) the QI must have made its certification of effective internal controls.

A QI must apply for a waiver for each certification period for which the waiver is requested and must request the waiver at the time the RO makes the periodic certification of internal controls. If the IRS does not approve the waiver, the QI will receive a six-month extension from the date of denial to complete its periodic review.

### *Timing*

Responding to comments regarding difficulties with conducting the periodic review during the last year of the certification period (e.g., resource constraints due to all QIs conducting periodic reviews at the same time), the Proposed QI Agreement allows QIs to choose which year in the certification period to select for the periodic review. However, if a QI is also acting as QDD, it must use 2017 for its periodic review for the initial certification period.

## **Qualified Derivatives Dealer (“QDD”)**

The Proposed QI Agreement includes new implementing provisions announced in Temporary and Proposed regulations issued in September 2015 allowing certain QIs to act as QDDs subject to specific requirements and obligations. A separate Tax Alert providing more detail on the QDD provisions will be issued to supplement the brief overview, below.

### **Requirements and Scope**

The QDD provisions apply only to an eligible entity that elects QDD status, and only with respect to transactions in which the QI acts in a dealer capacity as a principal to its counterparty and the transactions give rise to US source dividends and potential dividend equivalent payments under section 871(m) or would give rise to such income if received by a foreign entity instead of a foreign branch of a US financial institution. In addition, amounts paid by a QDD must be potential dividend equivalent payments under section 871(m) or would be potential dividend equivalent payments but for the fact the counterparty is a domestic person or a foreign person who receives the payments as effectively connected income with a trade or business within the United States. Transactions entered into for proprietary trading or investment purposes do not qualify for the QDD regime. However, transactions recorded in a dealer book are presumed to be entered into in dealer capacity for purposes of the QDD rules.

*Eligible entity.* To qualify as a QDD, an entity must be an “eligible entity” and enter into a QI Agreement. Eligible entities include certain (1) government-regulated securities dealers, (2) government-regulated banks that issue potential section 871(m) transactions to customers and receive dividends or dividend equivalent payments pursuant to such transactions to hedge those transactions issued to customers, and (3) entities wholly-owned by an entity

described under (2). A foreign branch of a US financial institution is an eligible entity if it would fall under one of the above categories if it were a foreign separate entity. The definition of dealer is determined under section 475(c)(1).

*Observation.* The foreign entity may qualify as an eligible dealer in securities for QDD purposes without qualifying as an eligible regular dealer in securities for purposes of the Subpart F and global securities dealing rules. The rules permitting exemption from withholding are more permissive than they are for Subpart F exemption and single-enterprise transfer pricing and risk-transfer agreement qualification purposes.

For all such eligible entities, as announced in Temporary and Proposed Regs. §1.871-15(p) and 1.1441-1(e)(6) and its preamble, the Proposed QI Agreement adopts the principles of the Qualified Securities Lender ("QSL") regime provided in Notice 2010-46 with respect to all US source dividends received as beneficial owner and all dividend equivalent payments received as principal counterparty under section 871(m) or which would be dividend equivalent payments received but for the fact they are received by a foreign branch of a US financial institution. All persons who elected QSL treatment pursuant to Notice 2010-46 outside the QI regime and who currently obtain exemption from US withholding on US source substitute dividend payments with respect to stock lending and stock sale repurchase transactions defined in Treas. Regs §1.861-3(a)(6), will only be able to continue such exempt treatment as an electing QDD and only within the QI program. The QSL program for persons acting outside the QI regime is being phased out for all substitute dividend payments as of January 1, 2017.

*Phase-out of Credit Forward treatment.* The "credit forward" regime provided in Notice 2010-46 for entities that do not elect the QSL regime is being phased out for substitute dividend payments after December 31, 2016. Accordingly, US source substitute dividend payments that are not paid to an eligible QDD after December 31, 2016 will be subject to potential cascading of US gross basis tax for payments made in a chain of transactions to foreign persons. The credit forward regime could still be restored when the temporary regulations are finalized, but, such relief has not been provided by the Notice. The Notice states that non-QSLs may continue to use the credit forward regime until the Proposed QI Agreement becomes effective.

*QDD regime expands scope of eligible transactions.* In addition to substitute dividend payments defined in Treas. Reg. §1.861-3(a)(6), and characterized as dividends under Treas. Regs §1.871-7(a)(6) and §1.881-2(b)(2), the QDD regime also applies to all other dividend equivalent payments determined under section 871(m) with respect to Equity Linked Instruments ("ELIs") that the QSL regime does not apply to.

*Segregation of principal and intermediary transactions.* A QI acting as a QDD is generally required to act as a QDD for (1) all payments with respect to potential section 871(m) transactions and underlying securities that it receives as a principal and (2) all payments with respect to potential section 871(m) transactions that it makes as a principal. However, a QI may not act as a QDD when it receives or makes a payment with respect to a potential section 871(m) transaction as an intermediary. For such payments, the QI may either act as a QI or a nonqualified intermediary ("NQI").

## **Reporting and Withholding Responsibilities**

A QI acting as a QDD must assume primary responsibility for chapters 3 and 4 withholding, Form 1099 reporting, and section 3406 backup withholding for all payments made with respect to potential section 871(m) transactions as a principal, including payments that are not dividend equivalent payments but are either subject to chapter 3 or 4 withholding or are reportable payments. For Form 1042-S purposes, a QDD must perform specific payee reporting for payments of amounts subject to chapter 3 withholding to other QDDs.

## **QDD Tax Liability**

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 the QDD's liability under sections 871(a) and 881 for (1) its newly defined "section 871(m) amount," (2) its dividends that are not on underlying securities associated with potential section 871(m) transaction and its dividend equivalent payments received as a QDD in its non-dealer capacity, and (3) any other US source FDAP payments received as a QDD with respect to potential section 871(m) transactions or underlying securities that are not dividend or dividend equivalent payments. A QDD must report its QDD tax liability on Form 1042 and make any necessary payments and deposits with respect to such amount.

*Section 871(m) amount.* The QDD's "section 871(m) amount" is the excess of its dividends and dividend equivalent payments received in dealer capacity over the sum of the amount of dividend equivalent payments made in its dealer capacity and the amount of dividend equivalent payments the QDD is contractually obligated to make acting as a QDD in dealer capacity. Offsetting payments also include payments made to persons that would be dividend equivalent payments but for the fact they are paid to a US non-exempt person or that is effectively connected income to a foreign person.

*Observation.* In determining the section 871(m) amount, gross dividends with respect to stocks beneficially owned by a foreign entity acting as QDD are eligible for offset by dividend equivalent payments made by the QDD acting in its dealer capacity. Accordingly, the QDD regime enables gross basis tax and withholding exemption on US source dividends where the current QSL regime does not.

Offsetting dividend equivalent payments made by the QDD in dealer capacity remains subject to withholding to the extent the foreign counterparty is subject to gross basis tax as a documented or undocumented foreign beneficial owner.

### **Account for Section 871(m) Transactions**

The Proposed QI Agreement specifically defines "account" with respect to a QI acting as a QDD to include any potential section 871(m) transactions or underlying securities where the QI receives payments as a principal and any potential section 871(m) transactions where the QI makes payments as a principal. A QI acting as a QDD is not required to document each account. Instead, a QDD is only required to document an account holder of an account to which it makes a reportable payment or qualifying dividend equivalent offsetting payment.

### **Consistent Treatment of All Eligible QDD Transactions**

The Proposed QI Agreement requires an eligible electing QDD to act as QDD for all securities lending and sale-repurchase transactions that are 871(m) transactions in addition to acting as QDD for payments with respect to other potential 871(m) transactions and underlying securities as a principal. All such transactions that a QI enters into will be deemed to be entered into by the QI as a principal and, thus, within the QDD regime, unless they are not entered into in dealer capacity. All non-dealer transactions (i.e. that are not presumed entered into in dealer capacity) must be segregated and not taken into account in determining the section 871(m) amount even if such transactions are subject to dividend equivalent treatment under section 871(m).

### **Coordination with Section 871(m) Regulations**

Treasury and the IRS intend to modify the 871(m) regulations in accordance with the provisions of the Proposed QI Agreement with respect to QDD requirements and withholding agents making payments to QDDs.

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