

## **New proposed qualified intermediary and qualified derivatives dealer requirements: Insights from the IRS**

The Dbriefs Federal Tax series

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# Agenda

Introduction

Key features of new QI agreement

Details of the QI agreement

Key features of QDD

Details on the QDD regime

Q&A

# Introduction

# Deloitte presenters

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# Polling question #1

What type of Industry are you in?

- Banking
- Broker/Dealer
- Custodial
- Derivative Dealer
- Non-Financial Services
- Don't Know/Not Applicable

# Highlights of the new QI agreement

# Notice 2016-42 – Proposed Qualified Intermediary Agreement (QI)

## Key Points – Non-QDD

- Effective Date
- Certification of Internal Controls
- Periodic Review
- Waivers
- Consolidated Compliance Group
- Renewal of Agreement
- Limitation on Benefits

## Polling question #2

How familiar are you with the Qualified Intermediary Regime?

- Very Familiar, We have QIs in our organization
- Very Familiar but we don't have any QIs
- Somewhat Familiar
- Not at all Familiar
- Don't Know/Not Applicable



# Details of the QI agreement

# Notice 2016-42 – Proposed Qualified Intermediary Agreement Certification of Internal Controls

## **Certification of Internal Controls**

- Initial Certification period - ends on third full calendar year that QI agreement is in effect
- Subsequent certifications - every three calendar years the QI agreement is in effect
- Due Date - July 1 of the calendar year following the certification period
- Certify to internal controls relating to QI compliance and FATCA requirements with respect to accounts acting as a QI

## **Two types of certifications**

- Effective Internal Controls
- Qualified Certification

## **Effective Certification of Internal Controls** – the Reporting Officer (RO) must certify:

- QI has established a compliance program meeting requirements of the QI agreement and it was in effect during certification period and remains in effect at time of the certification
- Based on information known by RO, the QI maintains effective internal controls over its documentation, withholding, and reporting obligations under the Agreement, applicable FATCA requirements for accounts acting as a QI, and QDD requirements
- No material failures were identified, or if any material failures, corrected by date of the certification
- Any underwithholding or failure to report has been corrected by the date of the certification

# Notice 2016-42 – Proposed Qualified Intermediary Agreement Certification of Internal Controls

## **Qualified Certification of Internal Controls –**

- Required where RO identified an event of default or material failure not corrected by date of the certification. The RO must certify:
  - That appropriate actions will be taken to prevent reoccurrence
  - The QI will pay any tax due and file (or amend) the appropriate return
  - The RO will respond to any notice of default (if applicable) or provide to the IRS any requested description of the material failure and a written plan to correct such failure
- Material failures found in 10.03(D) of the proposed QI agreement
- Events of Default found in 11.06 of the proposed QI agreement

***The RO may rely on any reasonable procedure, process, or review to make certification of internal controls - must be documented.***

# Notice 2016-42 – Proposed Qualified Intermediary Agreement

## Periodic Review

### **Periodic Review (absent waiver)**

- At time of the periodic certification of internal controls, QI must also provide factual information (as set forth in Appendix I of the Agreement)
- The basis for the factual information is the periodic review of the QI accounts.
- Testing of accounts relating to QI's compliance with documentation, withholding, reporting, and other obligations under the QI agreement including its QDD tax liability, and FATCA compliance with regards to accounts for which its acting as a QI.
- Review required for only one calendar year in the 3 year certification period
- QI may choose year, except for QDD, who must use 2017 for initial certification period
- Sampling is permitted where more than 50 sample units in the sample population
  - QI accounts, QDD accounts, and accounts receiving substitute interest payments for which QI assumed responsibility are separate sample populations
  - Sampling Safe Harbor methodology provided in Appendix II of the Agreement
  - If underwithholding discovered (without regard to remediation or curing after selection of sample units), must project over stratum of similar sampling units then subtract cured underwithholding.
  - QI must report and pay tax, and notify IRS Financial Intermediaries Unit

# Notice 2016-42 – Proposed Qualified Intermediary Agreement Periodic Review and Waiver

## **Periodic Review (absent waiver)**

- Periodic Review may be performed by either an internal or external reviewer
- Must be independent, e.g., cannot be reviewing own work
- Must provide a written report to RO of the results of the periodic review (forms basis of factual information)
- Must report results of initial review before any curing has taken place

## **Waiver of Periodic Review**

- Not available to a QI acting as a QDD or to NFFE
- Cannot be part of a consolidated compliance program
- Cannot have received reportable amounts that exceeded \$5 million for each calendar year covered by certification period
- Timely filed Forms 1042, 1042-S, 945, 1099, and 8966 for each calendar year covered by certification period
- QI made all required periodic certifications and reviews required by QI agreement and FATCA status, if applicable
- Waiver is requested at time periodic certification of internal control is made and must be approved by IRS. If denied, 6 months to complete the periodic review.

# Notice 2016-42 – Proposed Qualified Intermediary Agreement Consolidated Compliance Program

## **Consolidated Compliance Program**

- Two or more QIs may establish a consolidated compliance program
- Must be members of a group of entities under common ownership
- Operate under a uniform compliance program
- Share practices, procedures and systems subject to uniform monitoring and control
- Subject to a consolidated periodic review that includes a review of internal controls and testing of transactions with respect to each QI in the consolidate program
- If using stat sample, must provide a copy of plan to IRS for approval.
- Each QI must appoint a Compliance QI who can make a certification of internal controls for entire group but must provide factual information for each QI member of the group
- Must be approved by the IRS

# Notice 2016-42 – Proposed Qualified Intermediary Agreement Periodic Review By IRS

## **Periodic Review By IRS**

Based on certifications of internal control and disclosure of failures, the information reported on Forms 945, 1042, 1042-S, 1099 and 8966 filed with IRS during the certification period, or otherwise at the IRS's discretion for compliance purposes, the IRS may:

- Preemptively request remediation or conduct of a limited review before prescribed time, if IRS identifies a presence of factors indicating systemic or significant compliance failures
- Request a copy of the periodic review report
  - Must be provided within 30 days of request
- Conduct a correspondence review
- Require QI to engage an external reviewer to perform additional review procedures
  - Due within 120 days

# Notice 2016-42 – Proposed Qualified Intermediary Agreement Expiration and Renewals

## **Expiration and Renewals**

- Current QI agreement will expire on December 31, 2016
- Existing QIs will be required to renew their March 31, 2017 to be effective as of January 1, 2017
- Use FATCA registration website except for NFFE
- A prospective QI that applies for QI status prior to March 31 of a calendar year, will have a QI agreement with an effective date of January 1 of that year.
- If a prospective QI applies for QI status after March 31 of a calendar year and has not received a reportable payment prior to the date it applies for QI status, will have a QI agreement with an effective date of January 1 of that year.
- If a prospective QI applies for QI status after March 31 and has received a reportable payment prior to the date it applies, if approved, its QI agreement will have an effective date of the first of the month in which its QI application is approved and the prospective QI is issued a QI-EIN.



# Notice 2016-42 – Proposed Qualified Intermediary Agreement Substitute Interest on Debt Securities and Limitation on Benefits

## **Substitute Interest**

- QI may assume primary withholding responsibility for U.S. source FDAP payments of interest and substitute interest it receives in connection with a:
  - Sale-repurchase or similar agreement
  - Securities Lending Transaction, or
  - Collateral held in connection with its activities as a dealer in securities
- Can be acting as a principal or intermediary

## **Limitation on Benefits**

- QI using documentary evidence for entity account holder claiming a reduced rate of withholding must collect LOB information on the treaty statement.
- Applies January 1, 2017 for new accounts or those for which documentation is being obtained.
- Pre-existing entity accounts documented with documentary evidence - two-year transition period (unless there is a change in circumstances that requires the QI to obtain corrected information)
- Pre-existing entity accounts documented with Forms W-8 - forms may be relied up on until their normal expiration period (unless there is a change in circumstances that requires QI to obtain corrected information)

# Key features of QDD

# Qualified Derivatives Dealers (QDD)

## Key Features of QDD Regime

- Implements principles of Qualified Securities Lender regime adopted in Notice 2010-46 and adopts QDD regime and principles announced in Final and Temporary Regulations issued in September 2015 for certain dealer but not other transactions subject to tax under section 871(m).
- Applies to all Dividends and Dividend Equivalent Amounts (“DEA”) received **only**
  - For principal transactions
  - Entered into in securities dealer capacity
  - By defined eligible entities
  - Acting as a Qualified Intermediary that applies for QDD treatment in the QI Agreement
- QDD agrees to act as primary withholding agent for Chapters 3 and 4
  - QDD Tax Liability for principal tax owed on newly defined section 871(m) amount
  - Withholding liability for payments made on section 871(m) and potential section 871(m) transactions and
  - Backup withholding and 1099 reporting for payments made to U.S. persons

# Qualified Derivatives Dealers

## Eligible Entities for QDD regime

- Foreign Broker-Dealers that are subject to regulatory supervision in the foreign location where dealer operations are conducted
- Foreign Banks transacting in dealer capacity
- Affiliates of foreign banks
- Foreign branches of U.S. regulated banks
- Note: Custodians and Clearing Houses, currently eligible for QSL status are not eligible for QDD status

# Qualified Derivatives Dealers

## Eligible and Ineligible Transactions

### Eligible Transactions: QDD Regime

- Stock Lending and Sale Repurchase Transactions and similar transactions entered into in dealer capacity
- Potential section 871(m) transactions entered into in dealer capacity
- Offsetting potential section 871(m) transactions that may give rise to DEA payments
- Offsetting transactions that would give rise to potential DEA payments but for the fact they are made to a U.S. person or are effectively connected income (ECI) with a foreign person's US trade or business (USTB)

### Ineligible Transactions: Non-QDDs

- Stock Lending and Sale Repurchase Transactions entered into in investment or proprietary trading capacity
- Notice 2010-46 phase-outs: All potential section 871(m) dealer transactions entered into by a non-QI
  - Current QSL transactions by non-QIs must transition to QI regime to become QDD or become ineligible
  - Non-QSL principal transactions that use the "Credit Forward" regime will cascade gross basis tax as of January 1, 2017
- All potential section 871(m) transactions entered into in dealer capacity by a non-QI/non-QDD
- ECI amounts with a USTB **even if received in dealer capacity by electing QDD**

## Polling question #3

Will the new QDD regime requirements disqualify any of your section 871(m) transactions from withholding exemption as of January 1, 2017?

- 1) No. We enter into eligible transactions and can comply with the new requirements by January 1, 2017
- 2) Yes. We need more than six months to comply with the new requirements
- 3) Yes. We transact equity derivatives for our own account and are ineligible under the new regime
- 4) Yes. We transact we currently use the current credit forward regime that is being phased out as of January 1, 2017
- 5) Yes. We have a combination of Answers 2, 3 and 4
- 6) Don't Know/Not Applicable

# Details on the QDD regime

# Qualified Derivatives Dealers

## QDD Dealer Capacity Requirements

- Potential section 871(m) transactions must be entered into in Dealer capacity
- Dealer status is defined under Section 475(c)(1)
- Transactions recorded in a dealer book are presumed entered into in dealer capacity
- Consistency rule: QDD must act as a QDD for all payments from potential section 871(m) transactions and underlying securities it receives as principal and all payments it makes with respect to potential 871(m) transactions
- Observations:
  - Dealer eligibility is broader for QDD eligible transactions than for Subpart F and proposed global dealing “Regular Dealer in Securities” treatment
  - Aggregation treatment for transactions in dealer capacity does not appear harmonious with discrete transactional offsetting treatment determinations described in Temp. Reg. §1.871-15(q)(2) Example 2



# Qualified Derivatives Dealers

## "871(m) Amount": Definition and Computation of dealer amounts

- A Component of a QDD's total "QDD Tax Liability"
- Applies only to Dividends and Dividend Equivalent Amounts received in dealer capacity that is not ECI with a USTB of the QDD
- "Section 871(m) Amount" - QI Agreement definition: Section 2.79 –
  - Sum of following amounts received in dealer capacity
    - Dividends on underlying securities from potential section 871(m) transactions, and
    - Dividend equivalent amounts received

In excess of

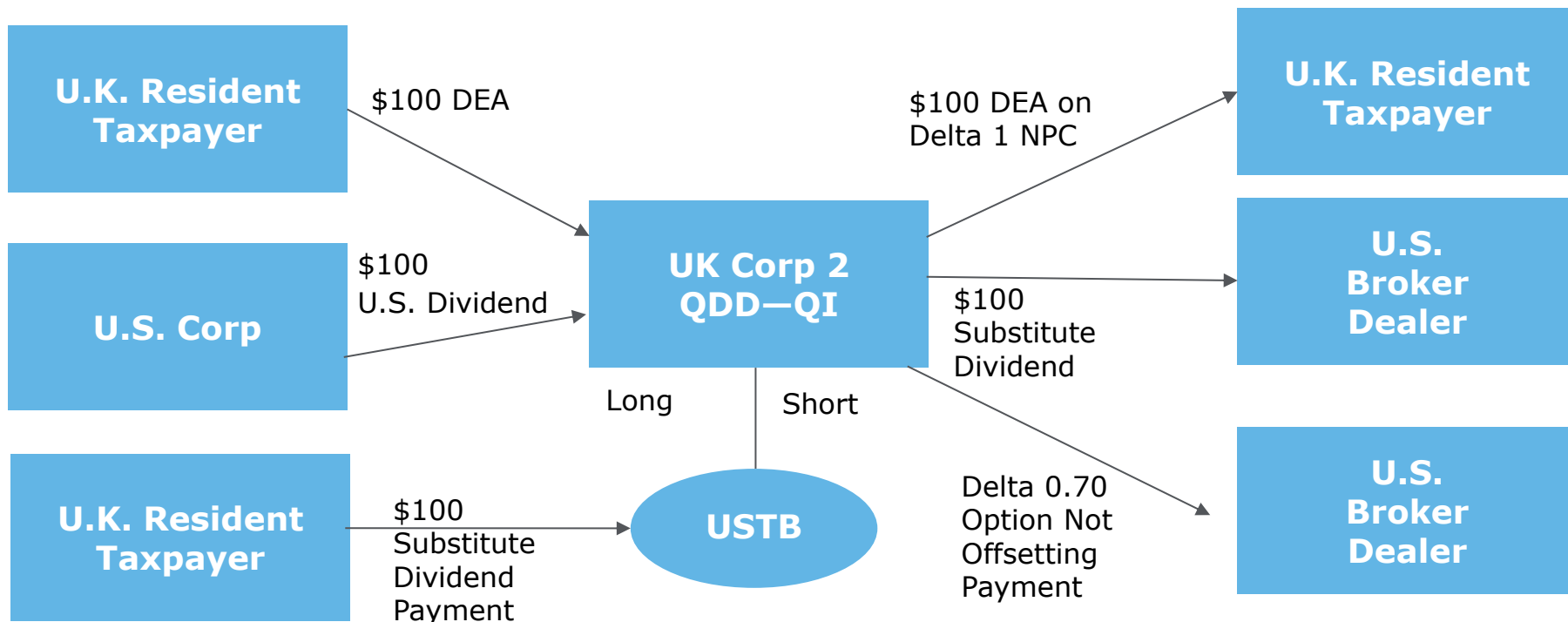
- Sum of the following amounts made or which QDD is contractually obligated to make with respect to same dividend in QDD's dealer capacity
  - Dividend equivalent payments
  - Qualifying dividend equivalent amounts made or obligated to make

# Qualified Derivatives Dealers

## “QDD Tax Liability” – Section 3.09 of QI Agreement

- QDD must withhold the Sum of the following amounts
  - The Section 871(m) amount (i.e. net dealer capacity dividends and DEAs received)
  - Dividends received that are not on underlying securities in potential section 871(m) transactions and DEAs received on section 871(m) transactions in non-dealer capacity, and
  - Payments such as interest on potential section 871(m) transactions that are not dividends or dividend equivalents (e.g. contingent interest subject to section 871(m))
- Foreign Branch QDD of a U.S. bank does not have a QDD Tax liability
- Elaborate QI Compliance Procedures must be undertaken pursuant to Section 10.02(A)(5) of QI Agreement in connection with QDD Tax liability determinations

# Qualified Derivatives Dealers — Section 871(m) Amount



## §871(m) Amount: Alt. 1

- \$200 Received (\$100 is ECI and ineligible)
- \$200 Offsetting Paid

## UK Corp 2 Results

- **§871(m) Amount = \$0**
- QDD w/h on \$100 to UK

## §871(m) Amount: Alt 2

- \$200 Received
- \$100 Substitute Div. Paid allocates to ECI
- \$100 Offsetting Payment

## UK Corp 2 Results

- **§871(m) Amount = \$100**
- QDD w/h on Subs Div. Paid to UK = \$100 or \$0

## §871(m) Amount: Alt 3

- \$200 Received
- \$33 DEA and \$33 Subs. Div. paid pro-rata Alloc ECI
- \$133 Offsetting Payment

## UK1 §881 Results

- **§871(m) Amount = \$67**
- QDD w/h on \$67 to UK

# Qualified Derivatives Dealers

## QDD Documentation and Reporting Requirements

- QDD must provide new Form W-8IMY identifying its QDD status to persons with whom it enters into potential 871(m) transactions only as principal.
- QDD must collect withholding statements on Forms W-8 or W-9 or collect conduct foreign know-your-customer documentation procedures for each of its “account holders”
  - defined as persons the QDD transacts potential section 871(m) transactions with or who hold potential section 871(m) transactions with a QI/QDD)
- 1042S separate reporting required for-
  - DEAs to other QDDs
  - Offsetting payments made to US persons and as ECI to other foreign persons
  - Pooled reporting permitted to foreign non-QDDs
  - Segregated 1042S reporting for
    - QDD tax liability
    - Qualified Offsetting DEA payments to US persons and to ECI recipients
- QDD may not enter into simplified joint account documentation, reporting, and withholding agreement procedures with nonwithholding partnerships and trusts that are available to QIs generally for other payments.

# Qualified Derivatives Dealers

## QDD – Separate QI Compliance Requirements

- **Section 10.01** requires QDD to have established policies and procedures for computation of 871(m) Tax liability, tax reporting and other reporting required by the QI agreement
- Waiver of Internal Review Procedures are restricted for QDD activities
- **Section 10.02** - QI Responsible Officer must ensure QDD has appropriate systems to identify and compute all aspects of section 871(m) and potential section 871(m) transactions including (but not limited to) systems that
  - Calculate delta (where required) for potential section 871(m) transactions,
  - Perform substantial equivalence test for complex transactions,
  - Calculated DEA and qualifying DEA offsetting payments,
  - Determine the QDD Tax liability, and
  - Establish the timing for the payments received and made as a QDD in accordance with section 6302 tax payment requirements

## Polling question #4

Do you plan to expand Equity Linked Note (ELI) transacting as principal under the QI/QDD regime?

- No. We only act as QI in custody for derivative transactions
- No. We intend to maintain ECI status on potential section 871(m) transactions
- No. We do not transact equity derivatives as a dealer
- Yes. We are a foreign equity derivatives dealer
- Don't Know/Not Applicable

# Q&A

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