taxnotes® international

Volume 83, Number 9 ■ August 29, 2016

The Impact of the Proposed U.S. QI Agreement

by Denise Hintzke and Kelly Cruze

Reprinted from *Tax Notes Int'l*, August 29, 2016, p. 789

PRACTITIONERS' CORNER

The Impact of the Proposed U.S. QI Agreement

by Denise Hintzke and Kelly Cruze


Denise Hintzke


Kelly Cruze

Denise Hintzke is a managing director with Deloitte Tax LLP in New York. She is the global tax leader of Deloitte's foreign account tax compliance initiative and a member of the global information reporting practice. Kelly Cruze is a senior consultant with Deloitte Tax in New York and is part of the global information and reporting practice.

The authors would like to thank Paul Epstein and Anthony Martirano for their contributions to this article.

On July 1 the IRS released Notice 2016-42, which proposed changes to the qualified intermediary agreement that some foreign intermediaries may enter into to simplify their compliance with U.S. reporting and withholding requirements. The authors highlight some key changes in the agreement, including the compliance reviews and the new qualified derivative dealer rules.

The IRS recently released Notice 2016-42, 2016-29 IRB 67, containing a new proposed qualified intermediary agreement. As with past agreements, the new version simplifies the withholding and reporting obligations imposed on foreign entities that decide to sign up as QIs. It also provides substantive guidance and operational procedures for implementing the new qualified derivative dealer (QDD) regime applicable to dividend equivalent payments under section 871(m).[1]

QIs should note the changes to existing QI agreements, including enhanced due diligence on claims for treaty benefits, detailed compliance procedures, and the new QDD requirements.

Application and Renewal

Current QI agreements expire December 31.[2] The changes in the proposed QI agreement are expected to be finalized in a revenue procedure later this year and will apply to QI agreements in effect on or after January 1, 2017. Existing QIs will need to renew their QI agreements on or before March 31, 2017.

Notice 2016-42 announced a new policy regarding the retroactive application of QI agreements. Agreements are generally issued with retroactive effect to the first day of the year regardless of when they are entered into. Under the proposed rules, new agreements will be effective for three years and will become effective:

---

[1] *See* 26 C.F.R. 1.871-15T(q) and 1.1441-1T(e)(6).

[2] *See* Rev. Proc. 2014-39, 2014-29 IRB 150.

- on January 1 if entered into on or before March 31;
- on January 1 if entered into after March 31 and the applicant did not receive any reportable payments before application; or
- on the first of the month in which the application is approved if entered into after March 31 and the applicant received reportable payments before application.

Eligibility of Prospective QIs

Foreign financial institutions, foreign clearing organizations, foreign branches of U.S. financial institutions and U.S. clearing organizations, and some nonfinancial foreign entities (NFFEs) may apply for QI status. They should analyze any additional eligibility requirements based on their classification, such as compliance with the Foreign Account Tax Compliance Act.[3] Under FATCA, territory financial institutions and nonparticipating FFIs cannot apply to enter into a QI agreement. Not all QIs will be eligible to participate in the QDD regime, and some entities can enter into the QI agreement for the sole purpose of being a QDD.

Before applying for QI status, a prospective QI (other than some NFFEs and foreign central banks of issue) must submit a Form 8957, ''Foreign Account Tax Compliance Act (FATCA) Registration,'' and obtain both a global intermediary identification number and chapter 4 status as a participating FFI, registered deemed-compliant FFI, registered deemed-compliant Model 1 intergovernmental agreement FFI, direct reporting NFFE, or sponsoring entity of a direct reporting NFFE.

The 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 IRS approves the QI application, it will provide an approval notice and a QI employer identification number.

Renewal of Existing QI Agreements

Existing QIs must renew their QI agreements before March 31, 2017. An existing QI that is an FFI, a direct reporting NFFE, or a sponsoring entity of a direct reporting NFFE must renew its QI agreement through the FATCA registration website. If a 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 agreement by submitting a renewal request to the Foreign Intermediaries program. If an existing QI seeks to act as a QDD under the proposed QI agreement, it must provide a supplementary statement containing all QDD-related information required by Form 14345.

Validating Beneficial Owner Treaty Claims

The U.S. Treasury and the IRS have announced that they expect to modify the chapter 3 regulations to require withholding agents to collect and validate specific information and certifications regarding a beneficial owner's claim for treaty benefits. In line with that, they released an updated Form W-8BEN-E in April that includes more substantial beneficial owner certifications regarding the limitation on benefits provision. Similarly, they revised Form 1042-S to include a line to report the applicable LOB code. The proposed QI agreement requires a QI to collect and validate LOB information from entity account holders to support their treaty claims. That will require organizations to implement enhanced processes for those claims.

A QI that chooses to use documentary evidence instead of a Form W-8BEN-E, ''Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities),'' 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 that includes the more detailed LOB information. The time frames for collecting that information depend on the account's status:

- the QI must collect the new LOB information if it opens an account or obtains documentation for an entity account holder on or after January 1, 2017;
- for a preexisting account with documentary evidence, the QI must collect LOB information before January 1, 2019, unless there is a change in circumstances requiring it to obtain corrected information before that; or
- for a preexisting account documented with a Form W-8, the form may be relied on until its normal expiration period unless there is a change in circumstances requiring the QI to obtain corrected information before that.

Under the proposed agreement, QIs are subject to an actual knowledge standard regarding LOB claims, meaning that if they know the party is not entitled to reduced withholding under the treaty, they cannot grant one. Further, for validation of treaty claims, a QI will be treated as having a reason to know that a claim is unreliable or incorrect if the account holder claims benefits under a treaty that does not exist or is not in force and thus is not on the IRS's online list of income tax treaties. Application of that rule depends on the account's status:

- for preexisting accounts for which the QI already holds a valid Form W-8BEN-E, the rule generally applies only on a change in circumstances;
- for preexisting entity accounts with documentary evidence, the rule applies when a QI obtains the required written LOB statement; or
- for all new accounts, the rule applies on account opening.

[3]Although an FFI must be located in a country that has IRS-approved ''know-your-customer'' procedures, NFFEs are not subject to the same requirement because they cannot rely on documentary evidence.

The new reason-to-know standard does not apply to preexisting accounts that were documented with a Form W-8BEN-E unless there is a change in circumstances, which implies that there was previously no responsibility to determine whether an account holder claiming benefits under a tax treaty was actually in a treaty country. That is likely an oversight.

Under the new requirements, a QI's existing form validation processes will require heightened procedures for treaty claim purposes. The chapter 3 regulations will be amended to apply both standards of knowledge for LOB claims.

Clarification of Compliance Procedures

Certification of Internal Controls

As part of a QI's internal compliance and review program, a responsible officer must establish a compliance program and make a periodic certification of the sufficiency of internal controls. The current QI agreement has raised concerns regarding the implementation of that type of compliance program, including costs, resource requirements, and the unavailability of detailed standards for performance.

Addressing those concerns, the proposed QI agreement allows the responsible officer to rely on reasonable procedures, processes, or assessments in addition to the results of a periodic review to make his certifications of compliance. It grants the officer greater flexibility to decide whether to use an internal or external reviewer and dictate the scope of the engagement. That flexibility allows the responsible officer to control costs and resources. The rules require the officer to document what he relied on to make the certification and retain that documentation for the same period as the compliance review report and certifications — that is, as long as the QI agreement is in effect.

The responsible officer 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 procedures were in effect. Thus, a QI with an agreement with an effective date of July 1, 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 (under the requirements of the QI agreement in effect after December 31, 2016). A QI that had an agreement under Rev. Proc. 2000-12, 2000-4 IRB 1, in effect before June 30, 2014, with an audit cycle that would have extended past that date is not required to complete an audit under its previous QI agreement.

In addition to making the certification of internal controls, a QI must report specific information regarding its documentation, withholding, reporting, and QDD tax liability (if applicable) obligations under the QI agreement. Some of that information is gathered through testing of accounts and transactions as part of a periodic review.

The IRS has 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 responsible officer can arrange for the review to be conducted by an internal or external reviewer with sufficient independence to objectively conduct the review — that is, a reviewer cannot review her own work. Consistent with the flexibility it has allowed for certifying internal controls, the IRS does not intend to publish a step-by-step audit plan. Instead, each QI will be expected to create its own step-by-step plan to satisfy the review objectives in the QI agreement.

The proposed QI agreement provides a stratified statistical sampling method to be used for the periodic review. According to that method, a QI with at least 50 accounts may use a sample to test accounts as long as a minimum of 50 accounts are reviewed. A QI with fewer than 50 accounts must review all accounts and may not use a sample. Although the review does not have to include a memorandum outlining the statistical sampling procedures used for testing transactions, the reviewer must record its sampling method and be able to reconstruct the sample.

Finally, the proposed agreement allows QIs to choose which year in the certification period they will use for the periodic review. However, if the QI is also acting as a QDD, it must use 2017 as the periodic review year for its initial certification period.

In some circumstances, QIs may apply for a waiver of the periodic review requirement. Even if the waiver is granted, the intermediaries must still provide some factual information with the periodic certification. To be eligible for a waiver, the QI must:

- not act as a QDD;
- not be part of a consolidated compliance program;
- not receive reportable amounts in excess of $5 million for each calendar year covered by the certification period;
- have timely filed forms 1042, 1042-S, 945, 1099, and 8966 for all calendar years covered by the certification period;
- 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 under FATCA; and
- have made a certification of effective internal controls.

The QI must request the waiver when the responsible officer makes its periodic certification of internal controls and reapply for each certification period. 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.

QDD Regime

The proposed QI agreement includes implementing provisions allowing some QIs to act as QDDs. The QDD regime will apply to all qualifying dividend equivalent payments received and made by the electing QI on its principal transactions entered into in dealer capacity only and will replace the qualified securities lender (QSL) regime[4] 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, and Treasury has said it intends to modify the section 871(m) regulations in accordance with the provisions of the proposed QI agreement. The effective date will be January 1, 2017, and the QSL regime will no longer apply as of that date. Accordingly, eligible stock lenders that have elected QSL status outside the QI regime under Notice 2010-46 will no longer be eligible for withholding and tax exemptions on substitute dividends payments received and made as principal unless they enter into QI agreements.

Further, the credit-forward regime in Notice 2010-46 for non-QSL stock lenders will be phased out, and foreign-to-foreign transactions outside the QDD regime as of January 1, 2017, might be subject to cascading gross basis and withholding tax.

Eligible Entities and Applicable Transactions

To qualify as a QDD, an entity must be an eligible entity, enter into a QI agreement, and elect QDD status. Eligible entities include:

- government-regulated securities dealers;[5]
- government-regulated banks that issue potential section 871(m) transactions to customers and receive dividends or dividend equivalent payments under those transactions to hedge them; and
- entities wholly owned by an entity described above.

A foreign branch of a U.S. financial institution is an eligible entity if it would fall under one of the above categories if it were a separate foreign entity.

A foreign entity may qualify as a dealer in securities for QDD purposes without qualifying as an eligible dealer in securities for purposes of the subpart F and global securities dealing rules. Therefore, foreign-based securities dealers that transact through dealer functions performed exclusively in one foreign location and only by offering to regularly enter into transactions to buy or sell securities that give rise to dividend equivalent payments can participate in the QDD regime. The rules permitting exemption from withholding under the QDD regime are more permissive than they are for a subpart F exemption[6] and single-enterprise transfer pricing[7] and risk-transfer agreement qualification purposes.[8]

The proposed QI agreement adopts the principles of the QSL regime, which will be phased out for all substitute dividend payments as of January 1, 2017. The QDD provisions exempt from ultimate gross basis tax liability only transactions in which the QI acts as a principal in dealer capacity to its counterparty and transactions that give rise to U.S.-source dividends[9] and potential dividend equivalent payments under section 871(m) or that would give rise to that income if received by a foreign entity instead of a foreign branch of a U.S. financial institution.

Unlike the QSL regime, the QDD regime also applies to all other dividend equivalent payments determined under section 871(m) regarding equity-linked instruments. The QI may not act as a QDD when it receives or makes a payment regarding a potential section 871(m) transaction as an intermediary. For those kinds of payments, the entity may act as either a qualified or a nonqualified intermediary.

Further, amounts paid by the QDD must qualify as potential dividend equivalent payments under section 871(m) or be payments that would so qualify but for the fact that the counterparty is a domestic person or a foreign person who receives the payments as income effectively connected with the conduct of a U.S. trade or business.

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. Therefore, a QDD may receive payments that are presumptively in dealer capacity and free of withholding, but the QDD remains subject to tax if those transactions are held for dealer or investment purposes and not in dealer capacity.

Section 871(m) Amount and QDD Tax Liability

A QDD (other than a foreign branch of a U.S. financial institution) must also determine and pay its own QDD tax liability, which is the sum of the QDD's liability under sections 871(a) and 881 for:

[4]*See* Notice 2010-46, 2010-24 IRB 757.

[5]26 U.S.C. 475(c)(1) defines dealer.

[6]*See* U.S. Treas. reg. section 1.954-2(a)(4)(iv) for the definition of the term ''regular dealer.''

[7]*See* prop. reg. section 1.863-3(h)(3).

[8]*See* prop. reg. section 1.482-8(a)(2)(iii) for the global securities dealing definition of regular dealer in securities. The risk transfer agreement rules that require the counterparty participation of a global dealing participant are in prop. reg. section 1.475(g)-2.

[9]Substitute dividend payments defined in 26 C.F.R. 1.861-3(a)(6) are characterized as dividends under 26 C.F.R. 1.871-7(a)(6) and 1.881-2(b)(2).

- its newly defined section 871(m) amounts;
- its dividends that are not on underlying securities associated with potential section 871(m) transactions and its dividend equivalent payments received as a QDD in its non-dealer capacity; and
- any other U.S.-source fixed or determinable annual or periodic payments received as a QDD regarding 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.

The QDD's section 871(m) amount is the excess of its dividend and dividend equivalent payments received in its dealer capacity over the sum of the dividend equivalent payments made in its dealer capacity and the dividend equivalent payments the QDD is contractually obligated to make acting as a QDD in its 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 U.S. nonexempt person or are effectively connected income to a foreign person.

In determining the section 871(m) amount, gross dividends regarding 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 U.S.-source dividends, while the QSL regime does not. However, offsetting dividend equivalent payments made by the QDD in its dealer capacity remain subject to withholding if the foreign counterparty is subject to gross basis tax as a documented or undocumented foreign beneficial owner.

Qualified offsetting transactions do not include transactions whose payments and obligations are allocable to ECI of the QDD. Amounts paid or obligated to be made to U.S. persons and to ECI of foreign persons are qualified offsetting payments if they are not allocable to ECI of the QDD and they stem from transactions that have a delta of at least 0.8 on the transaction issuance date. Amounts paid or obligated to be made for transactions that have a delta of less than 0.8 on the transaction issue date are not qualified offsetting transactions and do not decrease the section 871(m) amount, which in turn increases the QDD tax liability for a particular stock's dividend payment period.

Impact of QSL Phaseout

Because the QSL regime will be phased out for substitute dividend payments as of January 1, 2017, an entity that elected QSL treatment outside the QI regime and is exempt from U.S. withholding on U.S.-source substitute dividend payments regarding stock lending and stock sale repurchase transactions will be able to continue with that exempt treatment only if it is entitled to elect, and does elect, QDD status under the QI program.

Moreover, the credit-forward regime used by entities that did not elect the QSL regime is being phased out for substitute dividend payments after December 31. Accordingly, U.S.-source substitute dividend payments that are not paid to an eligible QDD after December 31 will be subject to potential cascading of U.S. gross basis tax if payments are made in a chain of transactions to foreign persons. The credit-forward regime could be restored when the temporary regulations are finalized, but that relief has not been provided for in the proposed QI agreement. Non-QSLs may continue to use the credit-forward regime until the proposed QI agreement becomes effective.

QDD 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 regarding 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.

Other Section 871(m) Considerations

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

The proposed QI agreement also requires an eligible electing QDD to act as a QDD for all securities lending and sale-repurchase transactions that are section 871(m) transactions in addition to acting as a QDD for payments for other potential section 871(m) transactions and underlying securities as a principal. All such transactions that a QI enters into will be deemed 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 — that is, that are not presumed entered into in its dealer capacity — must be segregated and not taken into account in determining the section 871(m) amount even if subject to dividend equivalent treatment under section 871(m).

The rules also permit a QDD to elect to include substitute interest payments that are not within the scope of section 871(m) to be treated in the same manner as section 871(m) transactions within the QDD regime. ◆