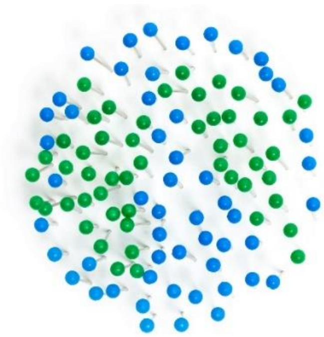

IRS Issued Notice 2018-05: Transition Rules on QSL Regime Extended

On December 22, 2017, the IRS released Notice 2018-05 under which withholding agents may apply transition rules of Notice 2010-46, Part III, (Transition Rules) for U.S. source substitute dividend payments made in 2018 and 2019 pursuant to a securities lending or stock sale repurchase agreement. Final regulations covering the U.S. source treatment of substitute dividends were issued in 1997 in T.D. 8735, 62 FR 53498-53502, Oct. 14, 1997 and remain in force under section 871(m). Notice 97-66, 1997-2 C.B. 328 which suspended the 1997 final regulations was obsoleted in Notice 2010-46, Section 1.B., and reinstated the final 1997 regulations for the U.S. source and dividend characterization of substitute dividend payments made on or after September 14, 2010. The applicable rules for U.S. source and dividend characterization treatment of substitute dividend payments are in Treas. Reg. §1.861-3(a)(6), §1.871-7(b)(2) and §1.881-2(b)(2).

In Notice 2010-46, the Department of Treasury (Treasury) and the IRS announced the Qualified Securities Lender (QSL) regime covering the treatment of substitute dividend payments in securities lending and stock sale repurchase transactions and permitted withholding agents to rely on the Transition Rules for implementation of relief from cascading withholding on U.S. source substitute dividend payments until guidance was developed that would include documentation and substantiation of withholding. Generally, the Transition Rules provide that the maximum aggregate U.S. gross-basis tax due, if any, with respect to a series of securities lending transactions and any related U.S. source substitute dividend payment is the amount determined by the tax rate paid by the foreign taxpayer (other than in the case of a QSL that is obligated to make an offsetting substitute dividend payment) bearing the highest rate of U.S. gross-basis tax in the series. Accordingly, the aggregate U.S. gross-basis taxes paid in such transactions generally should not exceed the 30 percent statutory rate applicable to U.S.-source dividends paid to foreign persons. Notice 2010-46 also provides a proposed framework permitting taxpayers to credit forward prior withholding made in a chain of substitute dividends paid pursuant to the same chain or series of securities loans or stock sale repurchase agreements. The credit forward regime is not carried forward in any of the regulations issued pursuant to section 871(m) or in the QDD agreement. Foreign taxpayers eligible for the QSL and credit forward regimes in Notice 2010-46 were more broadly described than in final regulations under section 871(m). A QSL could be a bank, custodian, broker-dealer or clearing organization that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized, is regularly engaged in a trade or business that includes borrowing of securities of domestic corporations, and, is merely subject to audit by the IRS under section 7602, and observes annual certification compliance on a form (to be prescribed by the IRS – which was never issued). Final regulations provide relief from cascading of gross basis tax liability only with respect to payments made to and from a QDD. Foreign withholding agents that make substitute dividend payments outside of the QDD regime are subject to cascading of the gross basis tax amount under the final regulations.

On September 18, 2015, temporary regulations containing rules for qualified derivatives dealers (QDD) were released with the intent that the final QDD regulations would supplant the proposed regulatory framework described in Notice

2010-46 and would obsolete the QDD regime. In Notice 2016-42 (dated July 1, 2016), which contained the proposed qualified intermediary agreement (QI Agreement), Treasury and the IRS reiterated the intent to replace the proposed regulatory framework and QSL regime described in Notice 2010-46 with the related provisions covering securities lending transactions in the QDD regime. Revenue Procedure 2017-15, released on January 17, 2017, set forth the final QI Agreement and stated that taxpayers could continue to rely on Notice 2010-46 including the QSL regime during calendar year 2017.

As part of transition relief, Notice 2016-76 of December 2, 2016, provided that taxpayers may continue to rely on Notice 2010-46 during 2017, and that Notice 2010-46 would be obsoleted as of January 1, 2018. On January 24, 2017, final regulations containing rules for QDDs were published (2017 Final Regulations) which obsoleted Notice 2010-46 as of January 1, 2018. Market participants responded to 2017 Final Regulations with comments providing that securities lending transactions do not pose a high risk for withholding tax avoidance and that the QSL regime provided by Notice 2010-46 should be extended for a longer transitional period. As a result, Treasury Department and the IRS issued Notice 2018-05 providing that, notwithstanding the preamble to the 2017 Final Regulations, withholding agents may continue to apply the Transition Rules but only for payments made in calendar years 2018 and 2019 while Treasury considers whether additional guidance is appropriate. Accordingly, foreign withholding agents outside of the QDD regime may continue to observe the Transition Rules in Part III of Notice 2010-46 for 2018 and 2019. Unless additional guidance is issued, after 2019 the only withholding relief for substitute dividend payments will be for such payments made to or from a QDD.

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