Final qualified intermediary agreement includes qualified derivatives dealer provisions

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In brief

The Internal Revenue Service (IRS) on December 30, 2016 issued Rev. Proc. 2017-15 setting forth the final qualified intermediary (QI) withholding agreement (2017 QI Agreement). Non-US entities and certain foreign branches of US entities may enter into the 2017 QI Agreement with the IRS to simplify their obligations as withholding agents under Chapters 3 and 4 (Foreign Account Tax Compliance Act or FATCA) of the Internal Revenue Code (Code) and as payers under Chapter 61 and Section 3406 of the Code for amounts paid to their account holders. The 2017 QI Agreement has an effective date of January 1, 2017. QIs with expired agreements must renew their agreements before March 31, 2017 to have a new QI agreement with a retroactive effective date of January 1, 2017. See our *Insight: IRS releases final qualified intermediary agreement* for general information regarding the 2017 QI Agreement.

The 2017 QI Agreement allows certain non-US derivatives dealers and securities lenders that are QIs to enter into an agreement with the IRS to act as qualified derivative dealers (QDDs) with respect to transactions that give rise to payments with respect to Code Section 871(m) transactions and substitute interest. The QDD regime addresses the problem of cascading or over-withholding on certain derivatives and securities lending transactions by providing that no withholding tax is required on certain payments made to a QDD when it is acting as a principal.

Rev. Proc. 2017-15 follows Notice 2016-42, which was issued in July 2016 and set forth a proposed QI agreement (2016 Proposed QI Agreement) that contained provisions setting out terms and requirements for QDDs. The IRS requested and received many stakeholder comments on the 2016 Proposed QI Agreement. The 2017 QI Agreement (including the QDD provisions) responds to certain of those comments, and implements the guidance set forth in Notice 2016-76 which delayed many of the provisions related to Code Section 871(m). See our *Insight: IRS notice provides relief under Section 871(m) regulations and qualified derivatives dealer regime* for more information on Notice 2016-76.

Provisions of the 2017 QI Agreement also reflect anticipated updates made by the government modifying certain provisions of the Section 871(m) regulations. The IRS has indicated that revised final Section 871(m) regulations are expected to be published as early as January 2017.

A number of major changes in the 2017 QI Agreement relate to QDDs. For example, the 2017 QI Agreement:

- *expands the type of entity that can act as a QDD to include bank holding companies and their subsidiaries,*
- *re-defines the Section 871(m) amount used in computing the QDD tax liability to incorporate a 'net delta' concept,*
- *provides that, during 2017, a QDD will not be liable for tax on the receipt of actual/deemed dividends or dividend equivalent amounts that it receives in its capacity as an equity derivatives dealer,*
- *contains provisions for the extension of the qualified securities lender (QSL) regime through 2017, and*
- *requires a QDD to prepare a detailed reconciliation schedule with respect to its Section 871(m)-related operations.*

Observation: *While the guidance provided in the 2016 Proposed QI Agreement and the 2017 QI Agreement is helpful, there remain many open issues for QDDs that must be addressed in future Section 871(m) regulations. The government has deferred addressing some of the most difficult aspects of QDD status until 2018.*

In detail

Background of the QDD regime

The QDD regime was originally announced in September 2015 when the US Department of the Treasury (Treasury) and the IRS issued final and temporary regulations under Code Sections 871(m), 1441, 1461, and 1473 (collectively, the Section 871(m) regulations) to address the treatment of dividend equivalents from US sources. Treasury and the IRS 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 Section 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.

Good faith standard for QDDs

Notice 2016-76, released on December 2, 2016, provides guidance for complying with the Section 871(m) regulations in 2017 and 2018 and how the IRS intends to administer the regulations during that period. Notice 2016-76 made calendar year 2017 a phase-in year for QDDs, providing that the IRS, in enforcing and administering the QDD rules, will take into account the extent to which a QDD makes a good faith effort to comply with the Section 871(m) regulations and the relevant provisions of the QI agreement. This good-faith provision also is included in the 2017 QI Agreement.

Eligible entities

The 2016 Proposed QI Agreement provided that a QI seeking to be a QDD must be an eligible entity. In response to comments requesting clarification of the application of the QDD rules to branches, the 2017 QI Agreement provides that the home office and each branch of a QI applying for QDD status must meet the eligible entity requirements and be approved separately for QDD status. The 2017 QI Agreement also provides that each branch approved as a QDD will be treated as a separate QDD and must apply the QDD provisions as if it were a separate entity.

The 2017 QI Agreement expands the definition of eligible entity to include (1) a bank holding company subject to regulatory supervision as a bank holding company by the governmental authority in the jurisdiction in which it is organized or operates and (2) an entity that is wholly-owned (directly or indirectly) by such a bank holding company. To qualify as a QDD, a bank holding company or wholly-owned subsidiary of a bank holding company must satisfy the other eligible entity requirements. The 2017 QI Agreement also provides the IRS with flexibility in accepting other types of entities as QDDs.

QDD tax liability

The role of the dealer

Dealers in Section 871(m) transactions establish trading books in which they take actual and synthetic long and short positions over US equities. Those trading books are managed so that the dealer can quantify the risk over any particular equity by calculating the net exposure, or delta, with respect to a particular equity. Dealers do not necessarily match individual long and short positions with each other. The IRS appreciated the fact that dealers do not necessarily hedge on a linear basis, so the original QDD concept allowed dealers to net dividends received against dividends paid with respect to a particular underlying security and to calculate a 'Section 871(m) amount' based on such net dividend amount.

In addition to the dealer's net long position, the IRS wanted to ensure that QDDs remained liable for dividends, deemed dividends, and dividend equivalent amounts received in a capacity other than as dealer (for example, as proprietary trader), and other types of US source payments (such as interest) associated with Section 871(m) transactions.

Computation of the QDD tax liability under the 2017 QI Agreement

The 2017 QI Agreement provides that the QDD tax liability is the sum of:

1. the Section 881(a) tax liability for the QDD's 'Section 871(m) amount' on each dividend on each underlying US security (i.e., the net delta calculation) *less* (but not below zero) the amount of tax paid by the QDD on actual dividends received in its capacity as an equity derivatives dealer in respect of that dividend,

2. the QDD's tax liability for dividend equivalent payments received by the QDD in its non-equity derivatives dealer capacity, and

3. the QDD's tax liability for any payments, such as dividends or interest, received as a QDD with respect to potential Section 871(m) transactions that are not dividend or dividend equivalent payments to the extent the full liability was not satisfied with withholding.

The 2017 QI Agreement modifies the QDD tax liability to correspond with changes announced in Notice 2016-76 to change the Section 871(m) amount and to require withholding, beginning in 2018, on dividends (including deemed dividends) paid to a QDD. Specifically, the 2017 QI Agreement revises the Section 871(m) amount to reflect the net delta exposure computation and permit a QDD to reduce the tax liability on its Section 871(m) amount by taking into account withholding taxes paid on that same dividend as described below. The QDD tax liability is separate and cannot be used to reduce the QDD's obligation to withhold on deemed dividends and dividend equivalent amounts paid to its counterparties.

While the Section 871(m) amount computation was modified to permit offsets for withholding taxes paid on that same dividend, the QDD remains liable for tax on any dividends received, without offset or credit forward, to address concerns raised by the expansion of offsets in the Section 871(m) calculation. The 2017 QI Agreement also is revised to reflect that QDDs are subject to withholding on all US source fixed or determinable, annual or periodical payments made to a QDD with respect to potential Section 871(m) transactions or underlying securities, other than dividend equivalents, to the extent the full liability was not otherwise satisfied by withholding.

Observation: *When Notice 2016-76 was released in December 2016, there was concern by potential QDDs that their inability to credit tax withheld on actual and deemed dividends paid to them against withholding they were required to levy on Section 871(m) transactions would result in cascading withholding. Treasury and IRS officials appeared to be giving different messages about the availability of a credit forward procedure to avoid cascading withholding. It is apparent that these concerns have not yet been resolved. The 2017 QI Agreement defers withholding on actual and deemed dividends for one year and solicits comments on ways to avoid cascading withholding. The use of a net delta approach, which would allow a QDD to offset positions subject to withholding against positions not subject to withholding (for example, low delta options), apparently has created concern that the calculation of the QDD's Section 871(m) amount could be leveraged to avoid withholding.*

The 2017 QI Agreement provides that, for calendar year 2017, QDDs will not be subject to withholding tax on dividends (including deemed dividends) they receive in their capacity as equity derivatives dealers. This transitional rule is intended to provide QDDs the requisite time to implement the processes necessary to comply with the revised Section 871(m) amount computation. However, QDDs will be subject to withholding on dividends (including deemed dividends) received on or after January 1, 2018.

The 2017 QI Agreement also retains provisions in the 2016 Proposed QI Agreement and Notice 2016-76 that make QDDs liable for tax on dividends and dividend equivalents that they receive in any capacity other than an equity derivatives dealer, including those received in 2017.

In addition, the 2017 QI Agreement provides that QDDs, in their capacity as equity derivatives dealers or otherwise, are responsible for withholding on dividend equivalents paid to non-US persons on Section 871(m) transactions. As with the 2016 Proposed QI Agreement, a QDD is required to withhold on the dividend payment date for the actual dividend under Chapter 3 and not the dividend equivalent payment date as defined in the Section 871(m) regulations.

Observation: *It remains to be seen whether the use of the payment date for withholding on the underlying dividend will be applicable only for QDDs or will be changed for withholding agents generally once the revised final regulations are released.*

Computation of Section 871(m) amount

The 2016 Proposed QI Agreement described the Section 871(m) amount as the excess of (1) dividends on underlying securities associated with potential Section 871(m) transactions and dividend equivalent payments that a QDD receives in its dealer capacity over (2) dividend equivalent payments and qualifying dividend equivalent offsetting payments that a QDD makes with respect to the same dividend in its dealer capacity.

The 2017 QI Agreement requires that the computation of the QDD's Section 871(m) amount is to be determined using the net delta approach beginning in 2018. The net delta approach keys off whether a dealer has a net positive delta position in an underlying security on the relevant dividend date with respect to positions the QDD holds in its capacity as an equity derivatives dealer. A dealer's net delta exposure to an underlying security is measured in respect of each dividend for each underlying security on the date that is the earlier of the record date or close of the day before the ex-dividend date for the underlying security. For each applicable dividend, the net delta is the amount (measured in number of shares) by which (1) the aggregate number of shares in the underlying security that the QDD has exposure to as a result of long positions exceeds (2) the aggregate number of shares of the underlying security that the QDD has exposure to as a result of short positions. QDDs generally should use the net delta computed for non-tax business purposes to the extent it is consistent with this definition, modified as necessary to comply with the applicable requirements.

Observation: *The preamble to the 2017 QI Agreement states that the net delta computation will become relevant only in 2018. The application of the net delta standard potentially may lead to different results than the net delta that a QDD calculates for business purposes. For example, net delta keys off positions in 'underlying securities,' which may not include qualified indices, while no such distinctions typically would be made when calculating delta for general business purposes. QDDs should carefully consider whether any such disconnects may be present.*

Payment of QDD tax liability

The 2016 Proposed QI Agreement provided that a QDD was required to pay its QDD tax liability according to the time and manner prescribed for remitting federal tax withheld under Chapters 3 and 4. The 2017 QI Agreement changes this requirement to provide that QDD tax liability should be paid according to the general rules regarding the time and manner for paying income tax liability. Under the 2017 QI agreement, QDDs generally will need to make quarterly estimated payments of their QDD tax liability.

QDD withholding and reporting of payments

A QDD must assume primary Chapter 3 and Chapter 4 withholding responsibility for all payments it makes as a QDD. The amount subject to withholding is not reduced by any taxes paid by the QDD, including any tax paid as part of its QDD tax liability. A QI can elect whether or not to assume primary Chapter 3 and FATCA withholding responsibility for payments for which it is not required to act as a QDD. While the 2016 Proposed QI Agreement already contained a rule that allowed a QI to elect whether or not to assume primary withholding responsibility for payments for which it was not required to act as a QDD, the 2017 QI Agreement clarifies that a QI that is not acting as a QDD may elect whether to assume primary withholding responsibility for payments that are not related to its QDD activities.

The 2016 Proposed QI Agreement provided that there would be no withholding or reporting on Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, on payments made to a QDD with respect to potential Section 871(m) transactions and underlying securities, other than reporting for dividends and substitute dividends. Comments requested that the exclusion be limited to dividends and dividend equivalents. As a result of the 2017 QI Agreement's changes to the Section 871(m) amount, all payments (other than dividend equivalent payments) made to a QDD with respect to underlying securities will be subject to withholding and reporting if the payments would be subject to withholding and reporting to a non-QDD. However, a QDD will be subject to withholding on dividends (included deemed dividends) beginning with those payments received on or after January 1, 2018.

Securities lending and sale-repurchase (repo) transactions

As part of the treatment of 2017 as a transition year, the provisions of Notice 2010-46 applicable to QSLs will remain effective in 2017. The 2017 QI Agreement therefore includes provisions related to QSL only for 2017.

The 2016 Proposed QI Agreement provided that a QI must act as a QDD for any securities lending or repo transaction it enters into that is a Section 871(m) transaction and that, for purposes of the agreement, a QDD is deemed to make and receive payments pursuant to those securities lending and repo transactions as a principal. In response to comments requesting that this provision be revised to permit entities acting as agents of lenders in securities lending or repo transactions to act as intermediaries and not be required to obtain QDD status, the 2017 QI Agreement provides that to the extent a QI determines that it is acting as an intermediary with respect to a securities lending or repo transaction that is a Section 871(m) transaction, it will not be treated as entered into by the QI as a principal.

The 2017 QI Agreement provides that if a QI is acting as a QDD, the QI must act as a QDD for all payments made as a principal with respect to potential Section 871(m) transactions and underlying securities. Therefore, a QI cannot be both a QSL and a QDD, except with respect to a securities lending or repo transaction for which the QI has determined that it is acting as an intermediary.

Observation: *To the extent that an entity is acting solely as a QSL, it can continue to apply Notice 2010-46 in 2017, including whatever credit forward arrangements it has in place to avoid cascading withholding.*

As indicated in the 2016 Proposed QI Agreement, the 2017 QI Agreement also allows QIs to act as such with respect to securities lending and repo transactions over US debt securities as well as equity securities. A QI is allowed to assume primary withholding responsibility under Chapters 3 and 4 and primary Form 1099 reporting and backup withholding irrespective of whether it is a QDD. A QI that assumes such responsibility must do so for all payments of interest and substitute interest on such transactions.

Documentation provided by QDDs to other counterparties

Withholding statements provided by QIs acting as QDDs must specify accounts for which the QDD is receiving payments with respect to:

- potential Section 871(m) transactions or underlying securities as a QDD,
- potential Section 871(m) transactions (and that are not underlying securities) for which withholding is not required, and
- underlying securities for which withholding is required, and, if applicable, identifying the home office or branch that is treated as the owner for US income tax purposes.

Withholding statements provided by QSLs must identify accounts for which it is acting as such.

Observation: *With respect to non-US financial institutions that have complex relationships with other financial institutions, it may be necessary to provide multiple Forms W-8 and to establish a process for identifying the capacity in which each transaction is being executed. While this issue exists currently, the addition of QDD status will add to the complexity.*

Form 1042-S reporting

Consistent with the requirement on Form 1042-S that a withholding agent provide its Chapter 3 status code, the 2017 QI Agreement provides that a QI that also is acting as a QDD is required to file separate Forms 1042-S to report payments made in each capacity by identifying its specific Chapter 3 status code as a QI or QDD. A separate Form 1042-S also is required for each QDD (identified by its home office or branch) when a withholding agent makes a payment to a QDD that is subject to reporting under Chapter 3 or FATCA.

Compliance issues

The 2017 QI Agreement has special compliance provisions for QDDs in addition to the expanded compliance provisions applicable to QIs generally.

A QDD must maintain a reconciliation schedule that tracks the Section 871(m) amount for each dividend for each underlying security. The schedule is required to contain extensive information which would allow the IRS to reconcile the tax paid by the QDD with its implementation of the Section 871(m) requirements.

The QDD also is required to have written policies and procedures sufficient to satisfy the documentation, withholding, reporting, and other obligations of the 2017 QI Agreement, including the satisfaction of its QDD tax liability. In addition, the QDD must ensure that it has systems in place to implement the requirements of Section 871(m). The periodic review report required by QIs generally has special provisions related to QDDs.

The takeaway

Many stakeholders already have begun their Section 871(m) compliance programs. With the issuance of the 2017 Foreign Financial Institution Agreement, eligible QIs should consider whether they should become QDDs. Organizations choosing QDD status must begin to incorporate the 2017 QI Agreement requirements into their 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 that have been operating as QSLs to minimize their US withholding tax obligations should consider entering into a QI agreement and operating as a QDD since the QSL regime is scheduled to be replaced by the QDD regime on January 1, 2018.

Let's talk

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

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