Client Alert

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IRS Releases Proposed New QI Agreement to Be Effective January 1, 2017

Some changes are coming for financial institutions that have an agreement with the US Internal Revenue Service ("IRS") to serve as a qualified intermediary ("QI") in respect of certain withholdable payments, which are generally US source income. On July 1, 2016, the IRS proposed the terms of the new Qualified Intermediary agreement ("QIA") in its Notice 2016-42.

The IRS has requested comments to the proposed new QIA by August 31, 2016. Once finalized, the new QIA will be effective with respect to all QIs on or after January 1, 2017, following the expiration of the current QIA at the end of 2016. The new QIA will expire with respect to QIs at the end of the third full calendar year it is in effect.

1. What Is the QI Regime?

The QI regime permits non-US financial institutions (usually banks) and non-US branches of US financial institutions to comply with less burdensome documentation, reporting and withholding tax obligations in meeting their US (Chapter 3) withholding tax and reporting requirements on withholdable payments. The QI regime was implemented by the IRS in order to ease these obligations of non-US intermediaries, as well as to facilitate and increase compliance with withholding of US tax on payments of US-source income to non-US persons.

To qualify for treatment as a QI, an entity must enter into a QIA with the IRS, in which the entity agrees to applicable procedures governing due diligence, withholding and reporting procedures. QI procedures have been coordinated with FATCA obligations of non-US financial institutions since the implementation of FATCA in 2014. The QIA currently in effect pursuant to Rev. Proc. 2014-39 will expire on December 31, 2016, and is to be replaced by the proposed new QIA.

2. What Is New?

The proposed new QIA contains a number of expected changes from the 2014 QIA, particularly with respect to additional provisions permitting a QI that is an eligible entity to act as a qualified derivatives dealer ("QDD"). Further areas of change include procedures for periodic review and certifications of compliance, the joint account or agency option for certain partnerships or trusts and treaty claims issues. The following commentary summarizes the more significant changes and additions contained in the proposed new QIA.

A. Qualified Derivatives Dealers (QDD)

The most significant addition to the QIA is the new framework for QIs to act as QDDs. The QDD regime is designed to replace the Qualified Securities Lender ("QSL") regime previously adopted in Notice 2010-46 and incorporated into the existing QIA. The IRS released final and temporary regulations in September 2015 under section 871(m) of the Internal Revenue Code regarding the treatment of "dividend equivalent" payments as US source dividends for purposes of Chapter 3, FATCA and other US Internal Revenue Code sections. As a result of these regulations, dividend equivalent payments are amounts subject to withholding for purposes of Chapter 3 and withholdable payments for purposes of FATCA. A withholding agent is generally required to deduct and withhold tax of 30% on such dividend equivalent payments unless an exception from withholding or a lower rate of withholding applies.

The new QIA will permit a QI that is an eligible entity to act as a QDD. A withholding agent will not be required to withhold on certain payments made to the QDD, if the QDD provides a valid withholding certificate to the withholding agent, when the QDD is acting as a principal and not as an intermediary (for example, when the QI acts as a custodian of a structured note with a payment referencing a dividend of a domestic corporation). Treatment of a QI as a QDD has the principal benefit of eliminating withholding on payments made to QDDs in hedging transactions, although withholding would be required on the resulting payment made by the QDD. This should prevent cascading withholding in qualifying transactions.

Qualifying payments are those payments related to so-called section 871(m) transactions and payments with respect to underlying securities. The QI may treat such payments in the same manner as it would other withholdable payments or reportable amounts it receives. The QI may therefore choose to act as a QI (and choose whether or not to assume primary withholding responsibility) or it may choose instead to act as a nonqualified intermediary ("NQI") for such payments.

To qualify as a QDD, an entity must enter into a QIA and be an eligible entity. An eligible entity includes a dealer in securities, a bank, and an entity wholly-owned by a bank, in each case where such dealer in securities or bank is subject to regulatory supervision as such by a governmental authority in the jurisdiction in which it is organized or operates. A non-US branch of a US financial institution that meets the requirements of an eligible entity may also enter into a QIA to act as a QDD.

A QI acting as a QDD must assume specified reporting and withholding responsibilities. A QDD must assume primary Chapter 3 and FATCA withholding responsibility and primary Form 1099 reporting and section 3406 backup withholding responsibility for all payments made with respect to potential section 871(m) transactions as a principal or with respect to a potential section 871(m) transaction that is not a dividend equivalent payment but is an amount subject to Chapter 3 or FATCA withholding or a reportable payment.

A QDD must also report specific payee (rather than pooled) reporting on Form 1042-S for payments to other QDDs to which the QDD makes a payment of an amount subject to Chapter 3 withholding and report on separate Forms 1042-S the amount of qualifying dividend equivalent offsetting payments made to a United States person and of effectively connected income. In addition, a QDD will be required to provide specific information upon request to the IRS about US non-exempt recipients that receive qualifying dividend equivalent offsetting payments.

The requirements and obligations applicable to a QDD will become effective when the QDD enters into its QIA following finalization of the new QIA, on or after January 1, 2017.

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B. Periodic Review and Certifications of Compliance

The 2014 QIA already replaced the previous external audit requirement with an internal compliance and review program. Concerns were raised since the introduction of the 2014 QIA regarding the administration of the compliance review procedures, including potential compliance program costs, allocation of resources to conduct the periodic review in the last year of the certification period, and the lack of detailed standards with respect to the periodic review. The QI's responsible officer ("RO") will still be required to make the periodic certification of internal controls but may rely on other processes or reviews, including hiring an external reviewer, although the RO must document what was relied upon in making the certification.

A QI is required to report certain factual information regarding its documentation, withholding, reporting, and other obligations, and, in the case of a QI that is acting as a QDD, certain information related to the determination of its QDD tax liability. The IRS wishes to allow QIs to have more flexibility in this process and does not intend to publish a step-by-step audit plan as was previously done. A QI is, however, expected to create a step-by-step plan to satisfy the objectives for the review contained in the new QIA and to provide the required factual information.

The new QIA requires that a QI with 50 or more accounts must review at least 50 accounts as part of the periodic review. If a QI has fewer than 50 accounts, it must review all of its accounts and is not allowed to use the sampling procedures contained in the new QIA. The new QIA also references a reviewer, rather than an auditor, to clarify that the periodic review is not subject to the standards of a financial audit or similar procedure. The RO may also arrange for the review to be conducted by either an external or an internal reviewer. In either case, the reviewer must have sufficient independence to objectively conduct the review.

Under limited circumstances, a QI not acting as a QDD may apply for and obtain a waiver of the periodic review requirement and instead provide specified factual information along with its periodic certification. The QI may also now choose the year in which the periodic review is to be conducted. This review is no longer required to be conducted in the last year of the certification period.

A QI that is a foreign financial institution ("FFI") for FATCA purposes is required to comply with the FATCA requirements applicable to its status as a participating FFI, registered deemed-compliant FFI, or registered deemed-compliant Model 1 IGA FFI.

A QI that is a non-financial foreign entity ("NFFE") under FATCA acting on behalf of its shareholders is required to comply with the requirements of a direct reporting NFFE, meaning it must register for FATCA purposes and, if required, conduct FATCA reporting.

The RO may rely on other personnel with oversight or responsibility for the QI's FATCA requirements in making its FATCA-related certifications. The QI's periodic review requirements relating to its FATCA compliance are limited to those accounts for which it is acting as a QI.

The new QIA continues to apply the option for a QI to be a member of a consolidated compliance program under the supervision of a compliance QI, subject to the approval of the IRS. In order to establish such a consolidated compliance program, the RO of the compliance QI should consult the Financial Intermediaries Team as specified in the new QIA to determine if the proposed consolidated compliance program is acceptable. A QI that is part of

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an approved consolidated compliance program will be required to provide factual information for each QI member of the group separately but will be permitted to certify internal controls for the entire consolidated compliance group.

C. Limited FFIs and Limited Branches

Limited FFI and limited branch status will no longer be available, in accordance with updated FATCA regulations.

D. Substitute Interest

A QI will be permitted to assume primary Chapter 3 and FATCA withholding responsibility and primary Form 1099 reporting and backup withholding responsibility for payments of interest and substitute interest received in connection with a sale-repurchase or similar agreement, a securities lending transaction, or collateral held in connection with its activities as a securities dealer. This change was incorporated in response to comments that payments of substitute interest should be covered, in addition to substitute dividend payments, based on incorporation of the old QSL regime into the new QDD regime.

This treatment will allow a QI to provide a Form W-8IMY to a withholding agent certifying that the QI is a QI assuming primary withholding responsibility without requiring the QI to distinguish between payments of interest and substitute interest received by the QI as a principal or as an intermediary. A QI assuming primary withholding responsibility for such payments of interest and substitute interest must assume primary withholding responsibility for all such payments.

E. Partnerships or Trusts Applying the Joint Account or Agency Options

The new QIA will allow a QI to apply the joint account or agency option to partnerships or trusts that are covered as accounts that are excluded from the definition of financial accounts under FATCA. A QI can also apply the joint account or agency option to partnerships or trusts that are owner-documented FFIs with respect to the QI.

F. Treaty Claims and Limitation on Benefits

The new QIA is modified to be consistent with the new Form W-8BEN-E and Form 1042-S reporting requirements for substantiation of a claim of treaty benefits under an applicable limitation on benefits provision. A QI using documentary evidence to document an entity account holder claiming a reduced rate of withholding under an income tax treaty must collect information regarding limitation on benefits on the treaty statement provided by the account holder. A QI will be required to collect this limitation on benefits information when opening an account or obtaining documentation for an entity account holder on or after January 1, 2017. There will be a two-year transition period for the collection of the limitation on benefits information for pre-existing entity accounts that were documented with documentary evidence, unless a change in circumstances requires corrected information sooner. Forms W-8 used to document accounts may be relied upon until their normal expiration period, also unless a change in circumstances requires corrected information sooner.

An actual knowledge standard will apply to a QI with respect to limitation on benefits claims. A QI will also be considered to have reason to know that a claim for treaty benefits 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

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included on the IRS list of tax treaties currently in force. This reason-to-know standard will also apply to pre-existing accounts (accounts for which valid documentation is held prior to January 1, 2017) upon a change in circumstances or when a written limitation on benefits statement is obtained. For all new accounts, the reason-to-know rule will apply upon account opening.

3. What Is Next?

Current and prospective QIs should carefully review the terms of the proposed new QIA and begin now to take steps to adjust their compliance review and reporting procedures in light with the new requirements. QIs that receive payments of substitute dividends in 871(m) transactions should consider qualification as a QDD to prevent the application of cascading withholding based on the new QDD terms. All QIs and prospective QIs should take steps to synchronize their FATCA compliance to the new QI requirements and should begin implementing procedures for the new documentation requirements for treaty limitation on benefits claims.

This alert was prepared by Gregory Walsh (Zurich) and Lyubomir Georgiev (Zurich).