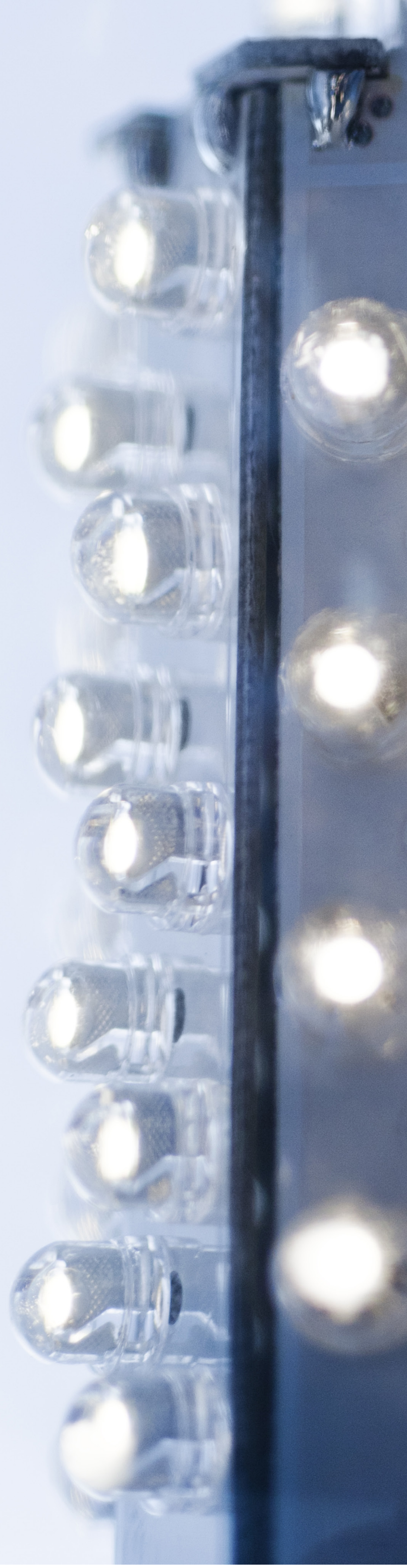
KPMG report: Final qualified intermediary (QI) agreement



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KPMG report: Final qualified intermediary (QI) agreement

The IRS on December 30, 2016, released Rev. Proc. 2017-15, containing a revised final qualified intermediary ("QI") agreement ("Final Agreement") that replaces the current version set forth in Rev. Proc. 2014-39.

While the Final Agreement contains several noteworthy modifications from the Proposed Agreement that was released on July 2, 2016, there are several significant areas of change:

- Updated rules relating to qualified derivatives dealers ("QDDs")
- Changes to certain documentation and due diligence rules
- Additional guidance surrounding the compliance review
- Certain reporting relief

Specific highlights and discussion of the modifications contained in the Final Agreement are described in the following order:

I. Updated QDD regime
II. Significant changes to certain due diligence rules
III. More onerous requirements relating to certain treaty claims
IV. Updated information relating to compliance review, including waivers
V. Modifications to the joint account reporting and review rules

Read **Rev. Proc. 2017-15** [PDF 581 KB]

I. Updated QDD regime

The Final Agreement contained significant changes relating to the QDD regime, including an expansion of the types of entities that are eligible to act as QDDs, certain transitional relief for 2017, new rules for calculating the QDD tax liability, as well as withholding and reporting updates.

Pending guidance

The preamble to the Final Agreement provides that the Section 871(m) regulations are expected to be issued in January 2017.

Eligibility for QDD status

The Final Agreement expanded the category of entities eligible to qualify for QDD status to include bank holding companies that are subject to regulatory supervision as bank holding companies by the government of the jurisdiction in which they are organized or operate, and entities wholly-owned by bank holding companies. The Final Agreement also clarified that QDD status must be determined on branch-by-branch basis, similar to QI eligibility, such that each branch of the QI must separately qualify and apply for QDD status in order to be treated as a QDD.

Acting as a QDD

The Proposed QI Agreement required a QI that acts as a QDD to act as a QDD for all payments made as a principal with respect to a section 871(m) transaction and received as a principal with respect to a section 871(m) transaction and underlying securities. While the Final Agreement retains this requirement, it removed the requirement that a QDD acting as an intermediary with respect to a securities lending transaction or sale-repurchase transaction that is a potential section 871(m) transaction be treated as a principal and thus, a QDD. Therefore, if a QDD is functioning as an intermediary with respect to a securities lending or sale-repurchase transaction, it may continue to apply the QI and NQI rules, as appropriate, rather than the QDD rules.

KPMG observation

This is a welcome change as the prior requirement under the Proposed QI Agreement would have required a QI to assume primary withholding in circumstances where the QI previously may have been passing up withholding instructions to an upstream withholding agent. Under the revised rule, QIs will not be required to develop withholding systems when they are acting as intermediaries in securities lending transactions and sale-repurchase transactions.

Withholding on QDDs and transitional withholding relief for 2017

Under the revised withholding rules provided in the Final Agreement, QDDs will be subject to withholding on all US source FDAP payments made to a QDD with respect to an underlying security other than dividend equivalent payments. This is an expansion of the withholding rule provided in Notice 2016-76 which stated only that QDDs would be subject to withholding on actual dividends (including deemed dividends).

However, the Final Agreement provides a transitional period for 2017 under which QDDs will not be subject to withholding on actual dividends (including deemed dividends) but will remain subject to withholding on other U.S. source FDAP income on underlying securities (other than dividends and dividend equivalent payments) during this period.

The Final Agreement also provides for the extension of the Qualified Securities Lender (QSL) regime set forth in Notice 2010-46 throughout 2017, as reflected in Notice 2016-76 and, accordingly, has added back provisions to the QI Agreement relevant to QSLs.

KPMG observation

This 2017 transitional rule provides temporary relief from cascading withholding for QDDs that hold physical shares offshore and would have been subject to withholding on actual dividends while potentially also being required to withhold on outgoing dividend equivalent payments made with respect to the same security. While the cascading withholding problem would still exist in 2018 when withholding begins on actual dividends paid to QDDs, the preamble to the revenue procedure provides that Treasury and IRS will consider comments on how to reduce cascading withholding for payments starting in 2018. Therefore, while withholding on actual dividends has been temporarily delayed, it is important that dealers that hold physical securities offshore provide comments to Treasury and the IRS indicating the need for permanent relief from cascading withholding and suggesting alternate approaches.

The Final Agreement does not provide guidance regarding the form a QDD should provide when receiving payments of actual dividends, or other payments, that are eligible for treaty relief. Since the Form W-8BEN-E is the only form that accommodates a treaty claim, the QDD should presumably provide a Form W-8BEN-E when receiving actual dividends in lieu of a Form W-8IMY. However, the Final Agreement only discusses the option for a QDD to provide a Form W-8IMY and does not address the circumstance of a QDD receiving a payment eligible for treaty relief. In addition to the uncertainty regarding the proper form that should be completed, managing multiple forms for potential section 871(m) transactions also provides an additional level of complexity for QDDs and their upstream withholding agents.

Calculation of QDD tax liability

Under the revised rules set forth in the Final Agreement, a QDD's QDD tax liability is equal to the sum of the following:

- The QDD's tax liability under section 881 for its section 871(m) amount for each dividend on each underlying security reduced (but not below zero) by the amount of tax paid by the QDD on dividends received with respect to that underlying security on that same dividend in its capacity as an equity derivatives dealer,

- The QDD's liability under section 881 for dividend equivalent payments received by the QDD in its non-equity derivatives dealer capacity, and

- The QDD's liability under section 881 for any payments (such as dividends or interest) received as a QDD with respect to potential 871(m) transactions or underlying securities that are not dividend equivalent payments to the extent the full liability was not satisfied by withholding at source.

The Final Agreement provides, however, that a QDD will not be liable for tax under section 881(a)(1) on actual dividends received on physical shares and dividend equivalent payments that the QDD receives in its equity derivatives dealer capacity during 2017. This exception does not apply to payments received by QDD in its proprietary capacity.

1. *871(m) amount*

   As previewed in Notice 2016-76, the Final Agreement adopts the net delta approach for determining a QDD's 871(m) amount. Under the net delta approach, the QDD's section 871(m) amount will be determined for each dividend on each underlying security by multiplying the QDD's net delta exposure to the underlying security (measured in number of shares) by the applicable dividend amount per share.

   The QDD's net delta exposure will be determined by taking the aggregate number of shares to which the QDD has exposure in the underlying security as a result of holding positions in the underlying security with values that move in the same direction as the underlying security minus the aggregate number of shares to which the QDD has exposure as a result of positions in the underlying security with values that move in the opposite direction from the value in the underlying security. In other words, the QDD's net delta exposure will be determined by totaling the QDD's long positions in the underlying security and subtracting out the QDD's short positions in the underlying security. However, the net delta exposure will not take into account any positions that are held by the QDD in a proprietary capacity or any positions treated as effectively connected with the QDD's conduct of a trade or business in the United States.

2. *Timing of QDD tax liability*

   The Final Agreement removed the requirement that a QDD pay its QDD tax liability based on the timing that would have been required for those underlying dividend payments and, instead, permits a QDD to determine its QDD tax liability due at the time the payments are treated as received under the Code and applicable regulations.

KPMG observation

The Final Agreement makes substantial changes to the calculation of the QDD's QDD tax liability from the approach taken in the Proposed QI Agreement. While the net delta approach to determining the QDD's section 871(m) amount reflects changes requested by the industry, the imposition of withholding on QDDs, which raises the possibility for cascading withholding, is concerning. The request for additional comments provides some hope that further revisions will alleviate the cascading withholding prior to 2018. In addition, the transitional relief in 2017 from calculating the QDD tax liability during

2017 provides QDDs necessary time to absorb and prepare for the QDD tax liability calculations.

QDD withholding and reporting

The Final Agreement retains a QDD's obligation to withhold on dividend equivalent payments it makes to non-U.S. payees but also adds a requirement that a QDD must notify each payee in writing that it will withhold on the dividend payment date before the time for determining the payee's first dividend equivalent payment.

The Final Agreement provides that a withholding agent that acts as both an intermediary and as a QDD must file separate Forms 1042-S to report payments made by the withholding agent when acting in each capacity. In addition, each branch acting as a QDD must file a separate Form 1042-S for payments made as a QDD.

The Final Agreement removed the requirement that the QDD's QDD tax liability be reported on Form 1042 and instead left the discretion to the IRS to determine the appropriate form for reporting of the QDD's tax liability. As a QDD is not required to calculate its QDD tax liability for 2017, the Final Agreement reserved on the specific form for reporting a QDD's QDD tax liability until future guidance is issued later in 2017.

II. Significant change to the due diligence rules for withholding certificates

Section 5.10(B) of the original QI Agreement (Rev. Proc. 2000-12), the 2014 version of the QI Agreement, as well as the Proposed QI Agreement all contained similar rules relating to when a QI had reason to know that it could not rely on a withholding certificate of non-U.S. status from a direct account holder. As it related to conflicts with information contained in the QI's account file, those prior rules clearly delineated that a QI only had "reason to know" that a withholding certificate of non-U.S. status was not reliable if the conflicting information contained in the account file was that of the account holder. That is, the QI was deemed to have reason to know that a claim of non-U.S. status was invalid where it had information relating to the account **holder** that conflicted with the claims being made on the account holder's withholding certificate.

The Final Agreement removes the prior due diligence language and replaces it with a cross reference to the due diligence rules set forth in the Treasury Regulations. Those rules, however, are not identical to the prior versions of the QI Agreement.

Specifically, the due diligence rules set forth in the regulations now require the QI to identify, and cure, any conflicts contained in the account file in general and not just those conflicts that relate to the account holder's information when the account holder has provided the QI with a withholding certificate certifying non-U.S. status.

KPMG observation

The due diligence requirements in the prior agreements, relating to conflicts with account holder information only, as opposed to any information contained in the QI's account files, had been intentional and something that had been negotiated between the IRS and the prospective QI community. Specifically, prospective QIs had maintained that it was overly burdensome for them to cure account file conflicts when it was clear from the information they maintained that the potential conflicts related to persons other than the QI's direct account holders (e.g., fund managers, attorneys, accountants, etc). Given the fact that this change was not contained in the Proposed QI Agreement (with time for comment), coupled with the fact that there is no grandfathering or transition relief, it is possible that this change was not intentional. Regardless, without modification to the Final Agreement, a significant number of QI accounts could be considered undocumented and subject to withholding on the effective date of the new agreement.

Further, it is important to address the significance of this change more generally. The due diligence rules set forth in the Final Agreement simply cross reference numerous regulations (which themselves cross reference numerous other regulations) in lieu of the comprehensive set of rules contained in the prior agreements. From a QIs perspective, this is a costly and unnecessary change. Compliance with U.S. tax rules for non-U.S. financial institutions is sufficiently challenging. Given that the drafting style of U.S. tax regulations is uncommon for most QIs, the change will require additional resources as well as updates to existing processes. It further requires ongoing monitoring for any changes within the various rules that are now incorporated by cross reference.

III. Changes to treaty claims

Similar to the Proposed QI Agreement, the Final Agreement requires a QI that utilizes the alternative documentation rules for treaty claims by entity account holders (i.e., documentary evidence listed in the KYC Attachment and a treaty statement) to obtain additional information relating to how the entity meets the appropriate limitation on benefits (LOB) provision in the particular treaty. Unlike the Proposed QI Agreement, however, the Final Agreement does not appear to require the LOB information to be contained in the treaty statement itself. Rather, the Final Agreement merely provides that the QI is required to collect and report such information.[1]

[1] Given the new validity period for a treaty statement collected by a QI, this is likely a drafting error. Specifically, the preamble provides that the LOB certifications must be included "on" the treaty statement (compared with Section 5.03(B) which provides the QI must collect such information but does not specifically require that the information be contained on the statement itself.).

The reference to reporting in this section seems misplaced and, presumably, directed towards payments to indirect account holders only as the QI will pool report payments made to its direct account holders. Similar to the Proposed QI Agreement, a QI must obtain this new LOB information for preexisting entity accounts for which it uses this alternative documentation rule by 1/1/2019.

The significant change as it relates to the treaty statement is the new validity period. Under the prior QI Agreements, including the Proposed QI Agreement, a treaty statement obtained from an entity account holder was valid indefinitely, absent a change in circumstance. Pursuant to the Final Agreement, a treaty statement now has a three year limited validity period. This is a fundamental shift in the documentation rules for QIs.

KPMG observation

As with the due diligence rules, above, the alternative documentation provisions set forth in the original QI Agreement were heavily negotiated and considered one of the benefits of QI status. Specifically, in exchange for the burdens associated with some of the QI requirements, industry groups and the IRS negotiated certain accommodations to encourage foreign financial institutions to enter into QI Agreements. One of those benefits was the ability to incorporate certain AML/KYC processes into the documentation requirements of a QI. While the IRS agreed with this, in general, it eliminated the ability to rely on certain local AML/KYC documents by way of the KYC Attachments (that delineated the IRS approved AML/KYC documents for a particular country) as well as imposed the requirement for treaty statements for entity account holders. Notwithstanding those modifications to the local requirements, the IRS had agreed that the validity period for such documents would remain on par with local AML/KYC rules. Given this history, and similar to the due diligence changes outlined above, it was unexpected to see these new validity limitations without a comment period for impacted QIs.

We note, further, that the Final QI Agreement retains, by cross reference to the due diligence regulations mentioned above, the unusual due diligence rule relating to reason to know that a treaty claim is not valid if the beneficial owner is claiming a treaty benefit under a treaty that does not exist. As indicated previously, we are not aware of situations where a QI granted treaty benefits under a treaty that was non-existent or not in force. Instead, the general practice has been to verify the existence of both the treaty and the particular article claimed and to only accept the documentation to establish non-U.S. status when the treaty claim related to a treaty that was not in existence or not in force.

Finally, while the imposition of an actual knowledge standard to the LOB provision indicates that a lesser due diligence applies than would otherwise apply to the treaty claim in general, and would seem to suggest that the QI is not required to research whether the LOB provision claimed is one that is relevant to the particular treaty under which the claim is made, this distinction remains unclear under the final guidance.

IV. Updated guidance for compliance review

The Final Agreement contains several significant updates as they relate to the compliance review provisions, including: new review rules for the 2017 QDD activities, changes to the safe harbor sampling numbers, postponement for timing of the Responsible Officer (RO) certification for QIs that choose year three of the certification period as the review year, as well as miscellaneous modifications/clarifications to the compliance provisions in general.

2017 QDD activities

In line with the QDD changes outlines above, the Final Agreement provides a phase in year for QDD compliance. Specifically, pursuant to the Final Agreement, the QDD's reviewer is not required to review the QI's 2017 QDD activities nor is the QI required to make a certification to the IRS that it has adequate internal controls relating to its 2017 QDD activities. Instead, the QI must make a certification that it has made a good faith effort to comply with the QDD requirements of the Final Agreement. In this, the IRS will consider the QDD compliant during 2017 to the extent it makes a good faith effort, even if full compliance is not achieved. Pursuant to these new requirements, the QI does not submit this requisite good faith certification to the IRS but, instead, retains it in its file (along with any supporting information) until December 31, 2022.

Changes / clarifications relating to review requirements

While the rationale is not abundantly clear, the Final Agreement provides that statistical sampling will only be permitted where a particular stratum contains more than 60 accounts (as opposed to 50 accounts under the Proposed Agreement and the prior Agreed Upon Procedure (AUP) set forth in Rev. Proc. 2002-55). Further, similar to the prior AUP, the Final Agreement provides that a spot check can now be used for the withholding review. The Final Agreement also clarifies (further) that, for FATCA testing, the population of accounts is that used for general QI testing (U.S. account holders that receive a reportable payment and non-U.S. account holders that receive a reportable amount). Finally, the Final Agreement makes clear (by reference to the local reporting schema) that the FATCA review is not limited to the filing of paper Forms 8966.

KPMG observation

The ability to review a limited number of accounts for purposes of the withholding review, as well as the reiteration that the population of accounts to review for FATCA purposes are the same as for general QI testing, is welcome and will help keep review costs more manageable. The review of the FATCA reporting may be challenging in certain countries, however, because generally there are no recipient or paper copies of those reports. Presumably, a review of the workpapers for the particular account, coupled with a review of the confirmation of the QI's filing to the local regulators, will suffice.

Postponement for timing of the responsible officer (RO) certification for QIs that choose the third review year

The Proposed QI Agreement permitted a QI to choose any one of the three years in the certification period as the review year for purposes of account testing. Regardless of the review year chosen, however, the Responsible Officer certification was required to be submitted on or before July 1st of the year following the close of the three year certification period. Because part of the certification relates to the proper filing of tax returns (which generally would not have been filed by the certification date for a QI with a year three review year), commentators requested an extension of the certification date.

As an accommodation, the Final Agreement was modified to permit a QI that has chooses year three as the review year to submit the certification to the IRS on or before December 31st of the year following the close of the three year certification period. All other QIs must adhere to the original certificate date.

Removal of mandatory extrapolation of underwithholding

Pursuant to the Proposed QI Agreement, any underwithholding discovered during the review was automatically subject to extrapolation when the QI's reviewer used statistical sampling methodologies. Historically, extrapolation was only required when a particular number of accounts were undocumented and, even then, the QI had the opportunity to rebut the IRS's projection figure.

After considering the comments made by many, the Final Agreement has removed the automatic extrapolation requirement. Instead, under the new rules, the QI must pay any underwithholding that is discovered during the course of review and report to the IRS's Financial Intermediaries Program details relating to the underwithholding, including, among other items, the amount of underwithholding prior to curing. The IRS will then determine whether projection is warranted.

RO certifications required after termination

The Final Agreement contains a new provision that requires a QI that has terminated its QI Agreement to nevertheless make the required compliance certifications in respect of the period between the most recent certification and the termination date.

KPMG observation

Because the agreement will no longer be in effect at the time this new certification requirement becomes due, it remains unclear how the IRS will handle enforcement.

Waiver opportunity for small QIs

As with the Proposed QI Agreement, the Final Agreement provides a possible waiver of the periodic review requirement for QIs that do not have reportable amounts that exceed $5 million in each year covered by the certification period. Similar to the prior waivers, the QI must submit an application that, among other information, requires the QI to disclose detailed account information, including the number of accounts that have valid documentation and those that have no (or invalid) documentation. To this latter point, the preamble to the Final Agreement makes clear that a compliance review is not required as part of the information gathering. The QI also must certify that it timely filed Forms 1042, 1042-S, 945, 1099, and 8966 (or local law equivalent) for all calendar years covered by the certification period. It is important to note that QIs that: (1) are NFFEs; (2) are part of a consolidated compliance program; or (3) act as QDDs cannot request a review waiver. Finally, notwithstanding the IRS accepting an application for a waiver from the compliance review, the QI's RO is still required to make the certification regarding adequate internal controls.

KPMG observation

While the preamble makes clear that a review is not required to apply for a waiver, the application continues to require the QI to report the number of validly documented and undocumented accounts. It is unclear how this is possible without a 100% review of account documentation. Further, it remain unclear why a QI that is an NFFE cannot qualify for a waiver when all other requirements have been satisfied. Finally, notwithstanding the stated limitation, it is anticipated that smaller QIs that are part of a consolidated compliance program will be allowed to request a review "exclusion" in accordance with the IRS's historical administrative practice.

V. Modifications to joint account procedure reporting and review

The joint account procedure was implemented as an accommodation for QIs operating in countries that have local law prohibitions from the recipient specific reporting requirements for indirect account holders. Pursuant to the procedure, as originally drafted, the QI could treat the underlying owners of partnerships or trusts availing themselves to these alternative rules as joint account holders when certain requirements were satisfied. The requirements included imposing the highest rate of withholding for any one owner but, more importantly, the procedure provided a QI with the ability to include the payments to these underlying owners in with its direct account reporting pools.

The Proposed QI Agreement had modified the reporting rule by requiring the QI to create a separate Form 1042-S pool for each partnership or trust and also required the name of the partnership or trust to be included on each such form. Commentators pointed out that, for the same reasons a QI could not disclose the underlying owners to the IRS, it similarly could not disclose the names of the partnership and trusts.

In response to these comments, the Final Agreement eliminates the requirement for a separate reporting pool for each partnership or trust and, instead, reverts back to the original rule. Further, the rule in the Proposed QI Agreement that required the QI to name each partnership or trust with the information submitted by its RO as part of the certification process has also been eliminated.

Finally, the Final Agreement also modified the review requirements for these types of account holders. Instead of requiring a separate stratum for all partnerships and trust availing themselves to the joint account provision, the QI is directed to place the partnership or trust into its Direct Non-US stratum but does not include the underlying owners into the Indirect stratum. Instead, the underlying owner review is required only when the partnership or trust is selected for review.

KPMG observation

The reporting and disclosure modifications will be a welcome change for any QI that was using these alternative rules.

VI. Term of agreement and renewal instructions

Following industry comments, the effective date of the Final Agreement is back to the original six year term. Further, as stated in the Proposed Agreement, the effective date for the Final Agreement will hinge on certain facts relating to the time of application/renewal and whether the QI has received reportable payments prior to the submission of an application/renewal.

Specifically, if a prospective QI submits it application prior to March 31st, the agreement will be in effect as of January 1st of that year. In addition, if the application is submitted after March 31st but the prospective QI has not received any reportable payments prior to that date, its agreement will also have an effective date of January 1st of that year.

If, however, the submission date is after March 31st and the prospective QI has received a reportable payment prior to the submission date, its agreement will be effective as of the first day of the month in which the QI application is approved and the QI-EIN issued. For example, a prospective QI that submits an application on May 10, 2017, and has received a reportable payment prior to that time, will have QI status beginning on the first day of the month in which the IRS approves the QI application and assigns the QI-EIN.

For a seamless transition, an existing QI must submit its request for renewal prior to March 31, 2017. In doing so, the new agreement will have an effective date of January 1, 2017. (See IRS Publication 5262 for details on the new QI Application and Account Management System.)

KPMG observation

Because information reporting is based on the calendar year, the early cutoff is likely to cause reporting difficulties for QIs that attain such status on a date other than January 1st. Specifically, these QIs will need to have dual reporting processes in place for that initial year—reporting as a nonqualified intermediary from January 1st of that year, and QI reporting from the date of QI status through the end of the year. While significant industry comments on this point were made, the stricter effective date timelines remain.

Contact us

For more information, contact a tax professional with KPMG's Washington National Tax practice:

—about U.S. withholding agent, QI or QDD questions

Laurie Hatten-Boyd
T: +1 206 913 4489
E: lhattenboyd@kpmg.com

Danielle Nishida
T: +1 212 954 2774
E: daniellenishida@kpmg.com

Mark Naretti
T: +1 212 872 7896
E: marknaretti@kpmg.com

—about section 871(m)

Mark Price
T: +1 202 533 4364
E: mhprice@kpmg.com

Dan Mayo
T: +1 973 315 2658
E: dmayo@kpmg.com

kpmg.com/socialmedia

kpmg.com/app

Download on the App Store