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Legal Update
July 5, 2016

Bits & Pieces: IRS Notice 2016-42 Offers First Glimpse of Qualified Derivatives Dealer Rules

By Mark Leeds[1]

When my sister and I were very young, one year our parents bought an elegant makeup vanity for my sister as a Chanukah gift. The vanity set was much more elaborate than the typical gifts either she or I received. As a result, my parents gave my sister the mirror on one night, the brush set on the second night, the vanity itself on the third and so on. For my sister, the wait for the entire ensemble was excruciating. This childhood memory bears a striking resemblance to the doling out of the rules for Qualified Derivatives Dealers ("QDDs") by the US Internal Revenue Service ("IRS"). We were introduced to the QDD concept by regulations issued in September 2015.[2] On July 1, 2016, in Notice 2016-42, the IRS issued an initial set of implementation rules, but the regime is still far from complete. Like my sister, we anxiously await the entire ensemble rules necessary to fulfill QDD obligations. Until that happens, though, this article summarizes what we now know about non-US financial institutions that desire to elect to be QDDs. Other changes to the qualified intermediary ("QI") rules effected by Notice 2016-42 are not discussed herein.

Background

Section 871(m) of the Internal Revenue Code of 1986 (as amended, the "Code") treats "dividend equivalents" paid to non-US persons[3] as though they were actual dividends. "Dividend equivalents" include amounts paid or credited in respect of dividends in (i) securities lending and sale-repurchase transactions, (ii) specified notional principal contracts (swaps) and (iii) certain equity-linked instruments.[4] Accordingly, if a non-US person would have been subject to a withholding tax if he or she received a dividend on a share of a US stock, the payment of a dividend equivalent to that non-US person is subject to the same level of withholding tax.[5] The Code provides for a 30 percent withholding tax, although this rate may be reduced by the terms of an income tax treaty.

The fact that a dividend equivalent can be subject to US withholding tax in the same manner as an actual dividend can give rise to a phenomenon known as "cascading withholding taxes." To illustrate, assume that non-US person "A" owns a share of US stock. "A" loans the stock to non-US person "B." As is typical in securities lending transactions, B must make payments equal to all dividends paid on the stock during the term of the transaction to A. B holds the stock over the dividend record date. The stock issuer withholds 30 percent of the dividend that it pays to B. If B is then required to withhold 30 percent of the amount of the dividend equivalent that it pays to A, there will have been multiple levels of withholding tax imposed on the same dividend. Congress provided the IRS with the authority to address this overwithholding when it added Code § 871(m) to the tax law.[6]

When Code § 871(m) was enacted, the IRS promulgated rules for addressing overwithholding in securities lending and sale-repurchase transactions.[7] These rules were referred to as the "Qualified Securities Lender" ("QSL") rules. No guidance was issued addressing how to cure overwithholding in specified notional principal contract or equity-linked instrument transactions. The situation to date, however, has not been dire because only a very limited class of equity swaps is currently subject to dividend equivalent withholding. Withholding on dividend equivalents paid on equity-linked instruments ("ELIs") and all equity swaps only will be required for transactions opened in 2017. Thus, with the clock ticking, guidance is now needed.

Requirements for Financial Institutions to Be Treated as QDDs

As noted above, the concept of a QDD was introduced by the IRS in a September 2015 regulation package. Specifically, temporary regulations provide that dividend equivalent payments to a QDD will not be subject to US withholding taxes when received by the QDD in its capacity as a dealer.[8] The temporary regulations limit the entities that could be QDDs to (A) dealers in securities, (B) banks and (C) companies wholly owned by a bank that (1) issue potential section 871(m) transactions to customers and (2) receive dividends with respect to stock, or dividend equivalent payments, on holdings that hedge potential section 871(m) transactions that they issue.[9]

Notice 2016-42 § 2.01(B) expands the list of qualifying entities by providing that non-US branches of US financial institutions may elect to be treated as QDDs. Conversely, when a non-US financial institution is acting through its US branch, it will not be able to act as a QDD. It is worth noting it has always been true that when a non-US person acts through a US branch, it is not subject to US federal income tax withholding on FDAP income, including dividends and dividend equivalents. Accordingly, financial institutions seeking to avoid application of the QDD rules and still avoid cascading withholding can use their US branches for affected transactions.

The temporary regulations specified four requirements that an eligible non-US financial institution must meet in order to be treated as a QDD:

A. Furnish to a withholding agent a QI withholding certificate to the payer stating that it is a QDD with respect to the applicable dividends and dividend equivalent payments;[10]
B. Agree to assume the primary withholding and reporting responsibilities on all dividends and dividend equivalents that it receives and makes in its dealer capacity for regular tax, FATCA and backup withholding tax purposes;
C. Agree to remain liable for tax on any dividend or dividend equivalent it receives in its dealer capacity to the extent that the offsetting dividend equivalent payment on an underlying security the QDD is contractually obligated to make is less than the dividend and dividend equivalent amount the QDD received; and
D. Comply with the compliance review procedures applicable to a QI that acts as a QDD under a QI agreement.

It is worth noting two very significant differences between the QSL rules and the QDD rules. First, QSLs were not required to be QIs, but QDDs must be QIs. QSLs could simply declare themselves to be QSLs and then agree to follow certain specified procedures. This difference is important because the QI regime is quite burdensome, requires the execution of an agreement with the IRS and imposes extensive audit requirements on participating non-US financial institutions. Second, there is no credit-forward credit for upstream withholding taxes, which was available under Notice 2010-46.

The temporary regulations provided that the withholding tax exemption for QDDs would not be applicable when the QDD was acting in a proprietary capacity.[11]

Notice 2016-42

Notice 2016-42 addresses issues faced by QIs for purposes of regular withholding tax, the Foreign Account Tax Compliance Act ("FATCA") and backup withholding taxes. The QDD provisions of the notice constitute a very small amount of the overall guidance on QIs contained in the notice. Accordingly, the IRS took a very different approach in Notice 2016-42 than it did with Notice 2010-46. Notice 2010-46 provided extensive guidance solely on the rules applicable to QSLs. Notice 2016-42 folds in certain due diligence and reporting responsibilities of QDDs into an existing framework.

Furthermore, Notice 2016-42 states that when the QDD rules are finalized, the QSL regime will be repealed and the only avenue available for avoiding cascading withholding taxes will be the QDD rules.[12]

AGENCY LENDING AND CUSTODIAL ARRANGEMENTS ARE NOT COVERED

Many non-US banks act as agent lenders. In an agency lending transaction, the non-US bank will lend out stocks and securities of its clients to third parties. This allows the clients and the financial institutions to earn fees for lending their stocks and securities. Sometimes, the non-US bank will disclose the identity of the clients to the borrowers. In most cases, however, the non-US bank does not disclose the names of its clients to the securities borrowers.

Notice 2016-42 § 2.01(A) begins by explicitly providing that when a QDD provides a withholding certificate to a withholding agent stating the QDD is acting as a principal, the withholding agent will not be required to withhold on the payment of dividends or dividend equivalents to the QDD. Section 1.01 of the draft QI Agreement (included in Notice 2016-42) drives home the point that QDD status will not be a ground to avoid withholding when the QDD is acting as an agency lender: "A QI may not act as a QDD when it receives or makes payments as an intermediary." Accordingly, when a QDD is acting as an agency lender, it will not be able to take advantage of its QDD status to provide the stock borrower with an avenue to avoid withholding on the dividend equivalent payment made to the QDD as agent for the true stock lender. The agency lender, however, may rely on the normal QI rules to assume the withholding responsibility.

Notice 2016 § 2.01(B) further provides that a QDD may not use its QDD status to avoid US withholding taxes when it is acting as a custodian of a structured note. For example, a non-US bank may hold a structured note for a non-US client in the name of the QDD pursuant to a non-disclosed custody arrangement. In this case, the QDD may not avoid withholding on the structured note, and thereby assume US withholding tax responsibilities itself, by virtue of its QDD status. If the QDD is a withholding QI, however, it may rely on that status to assume the withholding obligation directly.

STRUCTURED PRODUCTS

Non-US banks are frequent issuers of structured products. Structured products are a form of ELIs. For example, a non-US bank could issue a structured note[13] that references a US stock as follows. If the total return of the stock over a one-year period is 20 percent or less, the holder of the structured note receives a 20 percent return. If the total return of the referenced stock increases by more than 20 percent during the one-year period, the holder still receives only a 20 percent return. If the total return of the stock during the one-year period is negative, the holder receives the negative return (sometimes after the application of a floor). The non-US bank will typically purchase shares of the referenced stock to hedge its payment obligations on the structured note.

Assume that the non-US bank issued the structured note described above to a US person (referred to as a "U.S. non-exempt recipient" in Notice 2016-42).[14] If the non-US bank suffered US withholding tax on dividends paid on any stock held as a hedge of its obligations under the structured note, it would be uneconomical for the non-US bank to issue the note because the US holder would not accept that its return should be reduced by the withholding tax imposed on the issuer. If the non-US bank issuer in this example was a QDD, however, it would be able to receive dividends on its hedge shares without the imposition of US federal income tax, provided that it meets certain requirements. In order to avoid withholding on the hedge shares or derivative hedge, the QDD must obtain a waiver from the US non-exempt recipient allowing the QDD to disclose the name, taxpayer identification number and other information regarding the US non-exempt recipient to the IRS.[15]

The QDD rules contain a technical fix that ultimately may have significant FATCA implications. The QDD rules recognize that many derivatives and structured product transactions do not result in the long party to such transactions having an "account" with the originating financial institution.[16] This means that no FATCA due diligence or reporting would be required with respect to such relationships. Similarly, a QI has due diligence obligations with respect to its accounts. The draft QI Agreement addresses this technical issue by providing that an "account" includes a relationship under which a QDD makes a dividend equivalent payment to another person.[17] The due diligence requirements applicable to such accounts are limited to obtaining necessary information on the account holder. The QDD must obtain US tax information on US payees and appropriate tax documentation from non-US payees.[18]

PROPRIETARY TRANSACTIONS

From a practical perspective, one of the most difficult directives of the 2015 regulations was the admonition that principal transactions were ineligible to be treated as QDD transactions. The difficulty lies in execution. A QDD could enter into multiple transactions with the same counterparty (after having provided a US single tax form) and the counterparty paying the dividends or dividend equivalents to the QDD would not have the systems capability to determine which transactions were client transactions (to be governed by QDD status) and which transactions were proprietary transactions (on which the counterparty would be required to withhold). The good news is that the QDD rules contained in Notice 2016-42 provide that proprietary transactions can be treated as QDD transactions for withholding tax purposes.[19] Notice 2016-42 states that the temporary regulations will be amended to reflect this change in approach.

In order to implement the withholding tax relief, Notice 2016-42 creates a concept referred to as the "QDD tax liability."[20] The QDD tax liability is equal to the sum of its tax liability (determined at the applicable withholding rate) on (i) the "section 871(m) amount," (ii) dividends and dividend equivalents received in proprietary transactions and (iii) other US-source FDAP (withholdable) income received in connection with a potential section 871(m) transaction. This newly developed regime ensures that a QDD "remains liable for tax on any dividends and dividend equivalents it receives … to the extent the QDD is not contractually obligated to make offsetting payments."[21] The QDD tax liability must be reported on a Form 1120-F and not on a Form 1042.[22]

The section 871(m) amount excludes dividends and dividend equivalents received by the QDD in proprietary transactions.[23] In general, a QDD will differentiate between dealer (QDD) transactions and proprietary (non-QDD) transactions by a "books and records" segregation. In other words, positions held in a proprietary trading book cannot be treated as part of the section 871(m) amount. This could result in overwithholding for banks employing a macro hedging technique. Thus, the section 871(m) amount is the excess of dividends and dividend equivalents received in dealer transactions over "qualifying dividend equivalent offsetting payments."[24] Qualifying dividend equivalent offsetting payments are equal to the sum of dividend equivalents paid to non-US persons and dividend equivalents paid to US persons that would have been subject to withholding taxes if paid to a non-US person. As described above, payments made to US persons may be deducted only if the QDD has obtained a waiver from the payee allowing the QDD to disclose its information to the IRS.[25]

REPORTING AND WITHHOLDING RESPONSIBILITIES

A QDD, acting as such, is fully responsible for withholding and reporting all dividend equivalent, and other FDAP, payments that it makes to non-US persons.[26] Pooled information reporting may not be used. Reporting to non-US payees is to be made on the standard Form 1042-S. Qualifying dividend offsetting payments must be separately reported.[27]

All QIs must appoint a responsible officer to ensure that the QI procedures are properly implemented.[28] The QDD's responsible officer must ensure that the QDD "has appropriate systems in place to make necessary determinations and calculations to identify section 871(m) transactions, potential section 871(m) transactions, underlying securities associated with potential section 871(m) transactions" and other information necessary to ensure the proper crediting and withholding of US tax.[29]

The effective date rules for QI audits may be problematic for many non-US financial institutions. A non-US financial institution that desires to become a QI to take advantage of the QDD rules must satisfy extensive compliance procedures beginning in 2017.[30] In other words, non-US financial institutions that desire to become QDDs must have processes in place to capture relevant tax and reporting information before January 1, 2017. Exceptions are provided for entities that are already QIs and have QI agreements in place that extend into 2017.

Concluding Observations

The most welcome rule contained in Notice 2016-42 is the new ability of QDDs to include their proprietary transactions within their QDD activities. This change will alleviate many systems challenges posed to implementing the QDD rules. While the QI rules contained in Notice 2016-42 contain many welcome clarifications, many changes remain unanswered, including the ability of a QDD to rely on information about delta, the timing of correlation testing and responsibilities under the substantial equivalent test (sometimes referred to as the "SET"). It is hoped that the IRS will complete the ensemble with enough time to allow affected market participants to implement the complete suite.

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Endnotes

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[2] T.D. 9734 (September 18, 2015).

[3] Throughout this article, references to non-US persons mean non-US persons who have not received the payment of a dividend equivalent in connection with the conduct of a trade or business in the United States.

[4] See Treas. Reg. § 1.871-15(a)(4).

[5] Treas. Reg. § 1.1441-1(b)(4)(xxi).

[6] See Code § 871(m)(6).

[7] Notice 2010-46, 2010-25 I.R.B. 757. For a detailed analysis of Notice 2010-46, please see my prior article, Leeds, *When the Other Shoe Falls: IRS Notice 2010-46 Restricts the Application of Notice 97-66 in Advance of the Effective Date of Code § 871(l),*published in the Practising Law Institute Corporate Tax Practice Series (October 2010).

[8] Temp. Treas. Reg. § 1.871-15(q)(1).

[9] Temp. Treas. Reg. § 1.1441-1(e)(6)(ii).

[10] See Proposed draft QI Agreement § 5.07(D).

[11] Temp. Treas. Reg. § 1.871-15(q)(1).

[12] Notice 2016-42 § 2.01(F).

[13] Although the financial product described in the text is referred to as a "structured note," it is unlikely that this financial product would be treated as indebtedness for federal income tax purposes.

[14] US non-exempt recipients include both US persons and US branches of non-US persons.

[15] Notice 2016-42 § 2.01(C).

[16] Notice 2016-42 § 2.01(E).

[17] Draft QI Agreement § 2.01(E).

[18] Draft QI Agreement § 8.03(C).

[19] Notice 2016-42 § 2.01(B).

[20] Notice 2016-42 § 2.01(D); proposed draft QI Agreement § 2.67.

[21] *Id.*; Draft QI Agreement § 3.09.

[22] *Id.*

[23] *Id.*; Draft QI Agreement § 2.79.

[24] See Draft QI Agreement § 2.70(A).

[25] Draft QI Agreement § 2.70(B).

[26] Notice 2016-42 § 2.01(C).

[27] Draft QI Agreement § 2.70.

[28] Draft QI Agreement § 10.02.

[29] Draft QI Agreement § 10.02(A)(5).

[30] Notice 2016-42 § 2.02(D).