

# Markit | CTI Tax Solutions

Phase out of Qualified Securities Lender status and new Qualified Derivatives

Dealer framework / April 2016

**QSL regime to be replaced by a QI/QDD framework 3**

**What is a QI Agreement? 3**

**Who can become a QI? 4**

**What are the obligations of a QI? 4**

**What tools are available to assist withholding agents  
with their QI/QDD obligations? 6**

**Learn more 6**

## QSL regime to be replaced by a QI/QDD framework

Financial institutions currently relying on Qualified Securities Lender (QSL) status to avoid potentially cascading US withholding taxes on cross-border securities lending and sale and repurchase transactions will soon need to reassess these transactions in light of a changing tax landscape for equity derivatives. Perhaps the most significant impact will be from new US tax regulations issued in September 2015 that will impose US withholding tax on “dividend equivalent” payments arising from a broad swath of equity derivative contracts beginning January 1<sup>st</sup> 2017 (the “871(m) regulations”). These new rules have special significance for QSLs since the new 871(m) regulations, when fully implemented, are expected to phase out the current QSL regime and assimilate it within a new Qualified Derivatives Dealer (QDD) framework.

QDD status will be incorporated as part of the Internal Revenue Service’s Qualified Intermediary (QI) program. This is an important change since not all QSLs are currently QIs (and thus a financial institution that is not a QI and that wishes to retain a status similar to that of QSL would need to enter into a QI Agreement with the IRS). Even for financial institutions that are currently QIs, the new QDD framework will require an update to the current QI Agreement with specific obligations attendant on QIs that act as QDDs.

Provided below is information on specific requirements of the new QDD regime (although further guidance from the IRS is forthcoming) and some background information on what it means to be a QI. In addition, described briefly at the end of the note are some services and tools that Markit | CTI Tax Solutions can provide to financial institutions interested in obtaining QDD status.

### What is a QI Agreement?

---

QDD status will only be available to a QI. In order for a financial institution to become a QI it will need to enter a QI agreement with the IRS.

A QI agreement is a contract between the IRS and a non-US financial institution that allows the non-US withholding agent to accept the responsibilities of a US withholding agent with respect to documentation, withholding (or determination of withholding rates), and tax reporting on Forms 1042-S. There are several benefits of QI status to the financial institution (and its clients): 1) it is able to avoid passing tax documentation from underlying owners/account holders to US withholding agents when investing in US assets, 2) the QI framework expands the types of documents that the QI is allowed to collect for certain investors, and 3) the withholding agent is able to avoid disclosure of its direct non-US clients to the IRS because of the modified (pooled) 1042-S reporting allowed for QIs.

The IRS is expected to issue a new version of its QI agreement that would incorporate the specific responsibilities of a QI that acts as QDD. The new QDD regime would not be in effect before January 1<sup>st</sup> 2017.

Similar to the QSL regime, a financial institution that enters into a QI agreement to act as QDD would be exempt from US withholding tax when paid substitute dividends, but the QDD regime would apply to a broader range of dividend equivalents from equity derivatives, e.g. payments on swaps that reference US dividends. In exchange,

the QDD would agree with the IRS to conduct proper withholding and reporting or pay applicable tax liabilities depending on the terms of offsetting derivative transactions it enters, if any.

## Who can become a QI?

---

A QI agreement may be entered into by foreign financial institutions (FFIs), foreign clearing organizations and foreign branches of US financial intuitions or clearing organizations. Other entities may be approved by the IRS on a case-by-case basis.

However, current temporary regulations appear to limit the types of financial institutions that can act as QDDs to dealers in securities and banks and bank affiliates that receive and make payments under equity derivatives subject to the section 871(m) regulations.

Under current guidance, it appears that custodians and clearing organizations that are eligible to obtain QSL status have not been included as eligible entity types that would qualify for QDD status. The intent may be that these organizations would generally act as intermediaries (and not as principal) and would be able to obtain relief from cascading withholding tax simply by virtue of being a withholding QI. This classification restriction, however, may especially impact clearing organizations and custodians that are currently not QIs. Further guidance from the IRS would be helpful in evaluating the status of these organizations under the newly proposed QI-QDD regime.

For QI purposes, it should be noted that a financial institution must also be resident in an IRS-approved jurisdiction in order to sign a QI agreement. These jurisdictions can be found on the IRS website (<https://www.irs.gov/Businesses/International-Businesses/List-of-Approved-KYC-Rules>). Recent additions to the list of QI approved jurisdictions have come from the group of countries that have an Inter-Governmental agreement (IGA) for FATCA purposes, as the IRS has grown more comfortable with the KYC/AML procedures in a variety of new jurisdictions through the IGA process. If you do not find your jurisdiction on the list but your jurisdiction does have an IGA, it is possible that you may sponsor QI approval by the IRS for your jurisdiction.

## What are the obligations of a QI?

---

A QI is generally responsible for soliciting and validating IRS Forms W-8, W-9, or one of the forms of KYC documentation listed in the IRS -approved jurisdictional QI KYC Attachment for each account holder in the QI population. The QI is required to determine the withholding rate that will apply to each account considering the documentation provided and source and character of the income paid. The QI may act as a withholding QI where it will receive full payments of income from the upstream withholding agent and make tax deposits with the IRS through the Electronic Federal Tax Payment System (EFTPS). Alternatively, the QI may act as a non-withholding QI. In this scenario it will provide withholding statements to upstream withholding agents to designate the proper rates of withholding that will then be collected and deposited by the upstream withholding agent. The third major obligation of a QI is to report the income earned on Forms 1042-S and 1099. A QI is allowed to issue 1042-S reporting for their direct clients on a pooled basis, which means that all accounts earning a specific type of

income with a similar tax rate and exemption code will be reported on a single Form 1042-S, to the recipient name "Withholding Rate Pool." As such, none of the direct investors will be disclosed to the IRS.

A QI may act as a QI for only specific accounts that it holds at upstream withholding agents. It is not obligated to act as a QI for all accounts. However, a QI is obligated to comply with existing FATCA obligations for all accounts and certify its FATCA compliance directly to the IRS, irrespective of whether it is resident in a FATCA Model 1 IGA jurisdiction.

As a QDD, the QI would have special obligations:

(A) Provide withholding agents, e.g. a US withholding agent paying a substitute dividend payment, with a tax certificate indicating that the QI is acting as a QDD for the relevant payment;

(B) Agree to assume the primary withholding and reporting responsibilities, including the documentation provisions under chapters 3, 4, and 61, and section 3406 of the US Internal Revenue Code (and related provisions) on all dividends and dividend equivalents that it receives and makes in its dealer capacity;

(C) Obtain tax withholding certificates or other appropriate KYC documentation from the counterparties to whom the QDD pays a dividend equivalent;

(D) Determine whether a payment it makes to a counterparty is, in whole or in part, a dividend equivalent under the section 871(m) regulations;

(E) Agree to remain liable for tax on any dividend or payment of a dividend equivalent (as defined under the section 871(m) regulations) 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 on or with respect to the same underlying security (including when the QDD is not contractually obligated to make an offsetting dividend equivalent payment); and

(F) Comply with the compliance review procedures applicable to a QI that acts as a QDD under a QI agreement, which will specify the time and manner in which a QDD must:

(1) Certify to the IRS that it has complied with the obligations to act as a QDD (including its performance of a periodic review applicable to a QDD);

(2) Report to the IRS the dividend equivalent payments that it made and the dividends and dividend equivalent amounts received in determining offsetting payments; and

(3) Respond to inquiries from the IRS about obligations it has assumed as a QDD in a timely manner.

## What tools are available to assist withholding agents with their QI/QDD obligations?

---

Markit | CTI Tax Solutions offers a variety of different products and services to assist withholding agents around the world with their documentation, withholding and reporting, Automatic Exchange of Information (AEOI) obligations and resources that can assist financial institutions in obtaining and maintaining QI and QDD status.

**Consulting and outsourcing services:** Tax Solutions has a dedicated team of subject matter experts that can provide advice on applying for a QI agreement, receiving jurisdictional approval for QI attachments from the IRS, training and preparation for QI audits, conducting QI audits, and providing assistance with all facets of QI compliance. We can tailor our services to the specific needs of financial institutions that obtain QI status solely to become QDDs. Our Outsourcing team validates tax forms and produces tax reporting for many different types of organizations and can help with a QI's ongoing obligations in regards to due diligence and reporting.

**871(m) compliance tool:** Currently in development, the 871(m) compliance tool will assist financial institutions dealing with equity derivatives in the screening of transactions subject to the section 871(m) regulations, calculating required withholding rates, and generating reporting information for both counterparties and to the IRS.

**MD<sup>3</sup>®:** MD<sup>3</sup>® is a web-based application that will provide and maintain validations of US tax forms W-8 and W-9, and provides expiration date tracking for the forms. A separate module within the MD<sup>3</sup>® framework is available for Common Reporting Standard (CRS) Self-Certification due diligence as well.

**E-W8™:** E-W8™ is a web-based application that allows investors to log in to complete a tax form electronically. The application will pass back the relevant tax characteristics for each investor so that manual review of tax forms is unnecessary.

**Tax Withholding Module:** The Withholding Module accepts inputs regarding a payee's tax characteristics, and tax form validation, along with the character and source of the income paid, and will provide a withholding rate and reporting result for each income type applied.

**Tax Reporting:** Our Tax Reporting application is designed to produce reporting for IRS reporting requirements (Forms 1042-S, 1099, 8966 and IGA reporting), as well as fulfill AEOI reporting requirements under the CRS and CDOT regimes.

## Learn more

---

For more information, visit us at [www.markit.com/tax](http://www.markit.com/tax), contact us at [sales@markit.com](mailto:sales@markit.com) or call one of our offices:

London +44 20 7260 2000

Tokyo +81 3 6402 0130

Sydney +61 2 8076 1100

New York +1 212 931 4900

Toronto +1 416 777 4485

Boulder +1 303 417 9999

Amsterdam +31 20 50 25 800

Singapore +65 6922 4200

Dallas +1 972 560 4420

Frankfurt +49 69 299 868 100

Hong Kong +852 3478 3948