

# US Qualified Intermediary

2 December 2016

# Section 1: Introduction



# Overview of QI requirements and benefits

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- ▶ Any person, US or non-US, making a payment of US source fixed or determinable, annual or periodical income ("FDAP") to a non-US person is generally required to withhold tax (WHT) at 30% on such payment of income
- ▶ A non-US intermediary may obtain Qualified Intermediary (QI) status and thereby avoid passing tax documentation of beneficial owners to upstream withholding agents
- ▶ QI status also allows, by election, to report to the IRS on a pooled basis rather than a recipient specific basis in certain circumstances
- ▶ The primary overall benefit of QI status is to provide privacy for both QI and its customers and reduce the burden of recipient specific reporting
- ▶ Other benefits include collective refunds claims which allow QIs to seek a refund on behalf of its direct payees. The direct payees, therefore, are not required to file returns with the IRS to obtain refunds, but rather may obtain them from the QI

# Section 2: New QI regime



# New QI Agreement

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- ▶ A draft of the new Qualified Intermediary (“QI”) Agreement (Revenue Procedure 2016-42) was released 1 July 2016
- ▶ Once finalized, this Agreement will be effective starting 1 January 2017
- ▶ The previous QI Agreement (Revenue Procedure 2014-39) expires 31 December 2016
- ▶ All existing QIs wishing to continue QI status will be required to renew their QI Agreements before 31 March 2017.
- ▶ Eligible entities may obtain Qualified Derivatives Dealer (“QDD”) status for section 871(m) purposes (to be covered separately)

# Key features of the new QI Agreement

## QI compliance programme

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- ▶ The QI must establish a compliance programme with the following key features:
  - ▶ Written policies and procedures for fulfilling QI requirements
  - ▶ Training for business lines responsible for documenting, reporting, or withholding
  - ▶ Systems and processes for collecting and reporting data
  - ▶ Monitor business changes and developments/changes in QI requirements, including FATCA requirements, and establish a mechanism for communicating these updates.
  - ▶ The QI must designate a responsible officer (“RO”) to certify compliance to the IRS regarding the compliance programme
  - ▶ RO is required to arrange for the performance of 1 periodic review for the certification period and this can be conducted for any calendar year covered by the certification period

# Key features of the new QI Agreement

## Compliance certification

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- ▶ Two possible certifications of internal controls
  - ▶ Effective internal controls, or
  - ▶ Qualified certification
- ▶ Periodic review
  - ▶ Provide factual information detailed in Annex I of QI Agreement
  - ▶ Waivers of requirement are available by request to IRS
- ▶ RO may rely on either an internal or external reviewer
  - ▶ The reviewer must be independent
  - ▶ The reviewer may be an employee or third party (e.g., certified public accountant, attorney, consultant) or any combination thereof
- ▶ RO may rely on any “reasonable procedure” that enables them to make the certification
  - ▶ Must perform due diligence and document the method relied upon

# Certification of effective internal controls

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- ▶ All QIs will need to make a certification regarding its internal controls for entire certification period
- ▶ The first certification period generally comprises years 2015 – 2017. The first certification is due 1 July 2018
- ▶ The certification relates to both the QI's obligations under the QI Agreement and its FATCA requirements (including its obligations as a QDD to the extent such status is elected)
- ▶ In order to make the certification of effective internal controls, the QI must remediate any identified material failures and put controls in place to prevent a reoccurrence
- ▶ ROs do not have the luxury of waiting to review internal controls because they need sufficient time to remediate any issues before the certifications are due
- ▶ To satisfy the new requirements, ROs should establish:
  - ▶ Good governance and oversight structures; and
  - ▶ Effective IT systems and operations that produce reliable data to support the certifications



# Certification of effective internal controls (cont'd)

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- ▶ The certification must state that
  - ▶ QI has established a compliance programme that remains in effect
  - ▶ QI maintains effective internal controls over its documentation, withholding, and reporting obligations under the QI Agreement and for FATCA purposes
  - ▶ No material failures were identified, or if a material failure was identified, it was corrected by date of certification
  - ▶ Certification is based upon information known to the RO
  - ▶ RO must document procedures, processes or reviews relied upon in making the certification

# Periodic review

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- ▶ QIs that do not qualify for a waiver must, in addition to the certification, provide certain factual information to the IRS that is gathered as part of the QI's periodic review
- ▶ The specific factual information is detailed in Annex I of the Agreement
  - ▶ Factual information looks very much like the information previously required under the QI Agreement Revenue Procedure 2002-55
  - ▶ IRS did not (and is not expected to) provide detailed agreed-upon-procedures, as was the case under the old QI Agreement (Revenue Procedure 2000-12, and detailed in Revenue Procedure 2002-55)
- ▶ Results must relate to any one calendar year in the compliance period, at the discretion of the QI
- ▶ QI may use a sample to test accounts if it has more than 50 accounts

# Periodic review (continued)

## Comparison of old and new

Stream	Previous QI audit requirement	New periodic review requirement	EY observation
Scope	Limited to QI compliance	Expanded to cover QI, QDD, and FATCA	QI review team must be conversant with your FATCA compliance programme
Compliance	<ul style="list-style-type: none"> <li>▶ Primarily by QI audit report to the IRS</li> <li>▶ Responsibility: With auditor to communicate any issues to the IRS. Named 'QI responsible party' but limited certification required</li> </ul>	<ul style="list-style-type: none"> <li>▶ Certification of Internal Controls required from RO which includes certification that a periodic review has been performed.</li> <li>▶ Responsibility: with RO to make certification and provide factual information</li> </ul>	<ul style="list-style-type: none"> <li>▶ This constitutes a significant stakeholder realignment</li> <li>▶ ROs must understand what they will get and will want to be comfortable with the process</li> </ul>
Population	<ul style="list-style-type: none"> <li>▶ Main populations for samples to be selected from- Direct, Indirect, and US accounts that received reportable amounts</li> </ul>	<ul style="list-style-type: none"> <li>▶ Many populations dependent on whether specific scenarios have occurred across all QI designated accounts, regardless of reportable amounts</li> </ul>	<ul style="list-style-type: none"> <li>▶ Underpins need for clear data request templates setting out the information you need to provide now, even for those staff who have been through testing before</li> </ul>
Samples	<ul style="list-style-type: none"> <li>▶ Statistically valid samples selected from population</li> </ul>	<ul style="list-style-type: none"> <li>▶ Reviewer must document sampling method</li> <li>▶ No mandated sampling size or method</li> </ul>	<ul style="list-style-type: none"> <li>▶ Sound sampling methodology. We believe using the statistical sample safe harbour method is the best approach</li> </ul>
Testing	<ul style="list-style-type: none"> <li>▶ General: Audit tests prescriptive and well established</li> <li>▶ Documentation: Review of documentation in place for validity under chapter 3/61</li> <li>▶ Withholding: Spot check based on chapter 3/61</li> </ul>	<ul style="list-style-type: none"> <li>▶ General: Audit tests have expanded and contain more flexibility on how they are applied, as well as their subjectivity</li> </ul>	<ul style="list-style-type: none"> <li>▶ You will need a reviewer with a detailed understanding of the revised testing requirements and a clear approach and methodology to ensure tests are applied consistently and compliantly</li> </ul>
Audit report	<ul style="list-style-type: none"> <li>▶ Specified format and delivered to the IRS</li> </ul>	<ul style="list-style-type: none"> <li>▶ No specified format. Delivered to RO</li> <li>▶ Creates the need for a tailored report that must provide the factual information detailed in the Annex</li> </ul>	<ul style="list-style-type: none"> <li>▶ Creates the need for a tailored report that is meaningful for the RO</li> </ul>
Timing	<ul style="list-style-type: none"> <li>▶ Every 3 years according to audit cycle given by IRS</li> </ul>	<ul style="list-style-type: none"> <li>▶ Certification of internal controls with regard to three year certification period and periodic review for any one year during the three year compliance period</li> </ul>	<ul style="list-style-type: none"> <li>▶ You require a reviewer who can understand the requirements and can execute their job with confidence</li> </ul>

# Waiver of periodic review requirement

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- ▶ Similar to the old QI Agreement (Revenue Procedure 2000-12), a QI may request a waiver for the periodic review requirement
- ▶ To be eligible for the waiver, a QI must:
  - ▶ Make a certification of effective internal controls
  - ▶ Be compliant with all periodic certifications (including those required for FATCA)
  - ▶ Have reportable amounts not in excess of \$5 million for any calendar year of the QI Agreement (e.g., 2015-2017); and
  - ▶ Have timely filed Forms 1042, 1042-S, 945, 1099 and 8966, as applicable, for all years of the QI Agreement
  - ▶ Must not act as a QDD

# Section 3: Consequences of non-compliance with QI regime



# Consequences of non-compliance

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- ▶ IRS expectations of NQI's is that they follow US regulations exactly as required by US Financial Institutions
- ▶ The NQI's customer information will be shared with US Withholding Agents and the IRS, and potentially withheld upon at higher percentages to the extent inaccurate or incomplete documentation is used
- ▶ If overwithholding occurs, NQI customers must apply for refunds individually with the IRS
- ▶ Reporting to IRS must be done on an individual basis
- ▶ Customers may prefer interacting with a QI for privacy concerns

# Section 4: Next steps and how EY can help



# Next steps...

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- ▶ Firms should prepare an initial proposal of the impact of the new regime to identify key next steps
- ▶ Firms should put in place an internal governance structure for implementing and monitoring the QI regime, including attestation arrangements with Business Unit Leaders
- ▶ Firms should put in place a robust documented internal compliance programme
- ▶ Firms should conduct mock reviews to identify any material failures and plan remediation
- ▶ Firms should plan certification and period review process



# How EY can help

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- ▶ Conduct gap analysis for QI compliance programme
- ▶ Assist with setting up procedures, trainings, etc for compliance programme
- ▶ Assist with attestation arrangements for RO certification
- ▶ Perform mock review testing to identify any material failures
- ▶ Provide remediation assistance for material failures
- ▶ Assist with certification statement report templates
- ▶ Assist with W-Form review checklists
- ▶ Perform period review testing and assistance with factual information compilation
- ▶ Assist with QDD and/or FATCA

# Section 871(m)



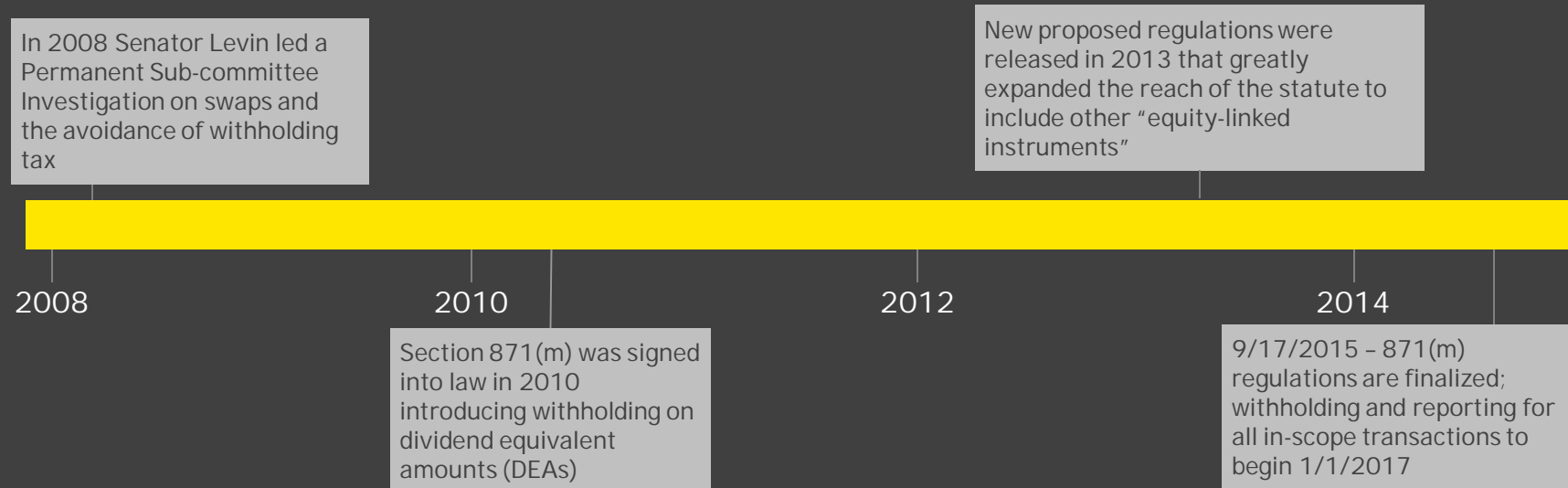
# Section 1: Introduction



# Section 871(m) Overview

Section 871(m) is a new IRS regulation that requires tax withholding on non-US persons that hold equity derivative products. The withholding tax is applied to the dividends associated with the underlying security.

Timeline of events:



## Criteria to determine section 871(m) eligibility on a given transaction

- ▶ In-scope product (see below)
- ▶ Long party may be a non-US person (at original issuance or on the secondary market)
- ▶ Referenced security is a US equity
- ▶ Value of delta is  $\geq 0.8$  (or substantial equivalence test for complex transactions) \* phased implementation

## Impacted products (in-scope products)

- ▶ Swaps
- ▶ Options (Listed)
- ▶ Options (OTC)
- ▶ Futures
- ▶ Forwards
- ▶ Structured notes
- ▶ Securities lending
- ▶ Repurchase agreements
- ▶ Convertible debt
- ▶ Compensation agreements
- ▶ Derivatives over equity-linked indices
- ▶ Other equity-linked contracts

# Section 871(m) - Exceptions

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- ▶ Dividend equivalent payments made with respect to the following contracts are not subject to s871(m) withholding:
  - ▶ Qualified indices
  - ▶ Certain M&A transactions
  - ▶ Life insurance and annuities
  - ▶ Employee compensation
  - ▶ Dividends withheld upon under Section 305(c)

# Section 871(m)

## Roles and impacted parties

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One of the unique aspects of the 871(m) are the number of roles a given financial institution can play in the lifecycle of a given in-scope 871(m) contract

Roles:

- ▶ A long party – Party to a potential section 871(m) transaction with respect to an underlying security that is entitled to a dividend equivalent payment. A position is long if its value is positively correlated to the value of the underlying
  - ▶ This includes agents and intermediaries of the long party principal
- ▶ A short party – Party to a potential section 871(m) transaction with respect to an underlying security that makes a dividend equivalent payment. A position is short if its value is negatively correlated to the value of the underlying security
  - ▶ This includes agents and intermediaries of the short party principal
- ▶ Determining party – Party responsible for identifying the transaction as being subject to section 871(m), calculating the DEA, and calculating the deltas (or substantial equivalence test for complex transactions) used for determination and withholding. The short party to the transaction is the determining party, unless a broker/dealer is transacting with a non-broker/dealer, in which case, the broker/dealer is considered the determining party
- ▶ Withholding agent – US or foreign person that has control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding.
  - ▶ occurs

Will be required to withhold on the later of when the DEA is determined and a payment

- |                            |                            |                    |                       |                 |
|----------------------------|----------------------------|--------------------|-----------------------|-----------------|
| ▶ Foreign investors        | ▶ Hedge funds              | ▶ Asset managers   | ▶ Custodians          | ▶ Prime brokers |
| ▶ Wealth managers          | ▶ Executing brokers        | ▶ Clearing brokers | ▶ Interdealer brokers | ▶ Dealers       |
| ▶ Hedge fund administrator | ▶ Vender service providers | ▶ Clearinghouses   | ▶ Exchanges           |                 |

# Determining Party Rules

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- ▶ If a broker-dealer is a party to a potential section 871(m) transaction with a counterparty or customer that is not a broker or dealer, then the broker-dealer is the determining party
- ▶ If both parties are broker-dealers, then the short party is the determining party
- ▶ If neither party is a broker-dealer, then the short party is the determining party
- ▶ A “party to the transaction” can request information from the Determining Party regarding the delta, dividend equivalent amounts, etc. The information requested must be provided within a reasonable time, not to exceed 10 business days and communicated
- ▶ A “party to the transaction” is any person that is a long party or short party to a potential section 871(m) transaction, any agent or intermediary acting on behalf of the long party or short party or any person acting as an intermediary with respect to the potential section 871(m) transaction

# Section 2: Interaction with QDD





# What is a QDD?

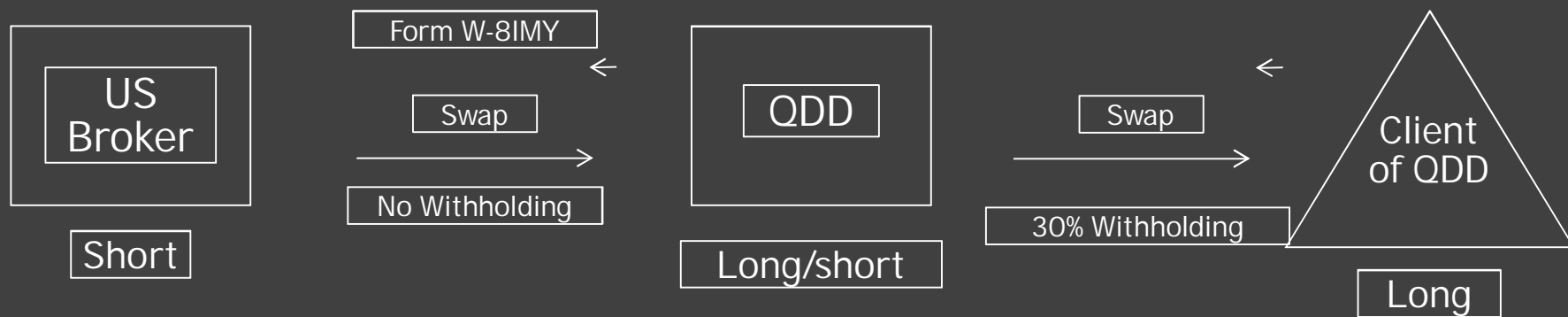
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- ▶ The US proposed a guidance to expand the QI regime to include Qualified Derivatives Dealers (QDDs) in order to avoid multiple withholding on the same stream of dividends - QDDs would not be subject to withholding on dividends or DEAs when acting as a QDD with respect to a transaction
- ▶ s871(m) imposes 30% withholding tax (or lower treaty rate) on dividend equivalent amounts (DEAs) from derivatives that reference US equities that pay dividends
- ▶ When receiving dividends or DEAs on hedges, non-US derivative dealers would be subject to US withholding tax and would also need to withhold on DEAs to its counterparties, resulting in a second layer of US withholding tax
- ▶ QDD solves this issue:
  - ▶ If a valid W8-IMY is provided, a withholding agent will not be required to be withhold on certain payments when the QDD is acting as a principal in a transaction

# What is a QDD?

- ▶ When acting as principal - in dealer or non-dealer capacity - QDD provides a new version of Form W-8IMY to a withholding agent and receives gross payments

However, it is still important to know for tax calculation purposes whether a payment is received in a dealer or non-dealer capacity



# Who can be a QDD?

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- ▶ An “eligible entity” is one of the following:
  - ▶ Securities dealer that is subject to regulatory supervision in the jurisdiction it operates in
  - ▶ Bank that issues potential s871(m) transactions and receives dividends or DEAs on hedges of transactions with customers
  - ▶ Entity wholly owned by a bank described above
- ▶ Foreign branches of US financial institutions (USFIs)
  - ▶ Similar to QI status, QDD status provides the benefits of using KYC documentation and reporting recipients on a pooled basis
- ▶ Cannot act as a QDD:
  - ▶ Entities wholly owned by dealers
  - ▶ With respect to income effectively connected with the entity's trade or business in the United States
  - ▶ For payments received as an intermediary

# QDD compliance obligations

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- ▶ A QDD will be subject to the same certification and periodic review requirements as other QIs, but limited to potential s871(m) transactions – if not also acting as a QI
- ▶ The QDD must establish a compliance program
- ▶ The QDD must designate a responsible officer (“RO”) to certify compliance to the IRS:
  - ▶ RO is responsible for policies, procedures and training material of QDD process and personnel
  - ▶ RO is required to arrange for the performance of 1 periodic review for the certification period

# Section 3: Challenges



# New Regime, New Challenges

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- ▶ s871(m) introduces withholding tax on derivative products where no taxes historically applied – even when there is no movement of cash to the counterparty
- ▶ Product scoping and business readiness activities will be required to understand scope and implementation effort required
- ▶ Positions, investment strategies and implications to business models need to be evaluated
- ▶ Roles and potential for QDD status need to be understood and evaluated
- ▶ New processes and procedures to comply will need to be developed

# Potential Systems and Operational Challenges

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- ▶ The following items highlight the potential operational and technology areas/systems impacted by s871(m):
  1. Inability to identify contracts that are potentially in-scope for s871(m), including partnerships and qualified indexes, during pre-trade contract modelling that could have significant impact on contract economics.
  2. Delta used at time of modelling a bilateral contract is not retained currently.
  4. Determining parties will need to establish an auditable form of communication to clients and related parties for in-scope transactions – thus far no industry solution has been developed
  5. No current process to link both the corporate action (e.g., mergers, stock splits) and dividend events to the in-scope derivative contracts
  6. No process to fund withholding liability on implicit payments (e.g., cashless payment)

# Section 4: Next steps and how EY can help



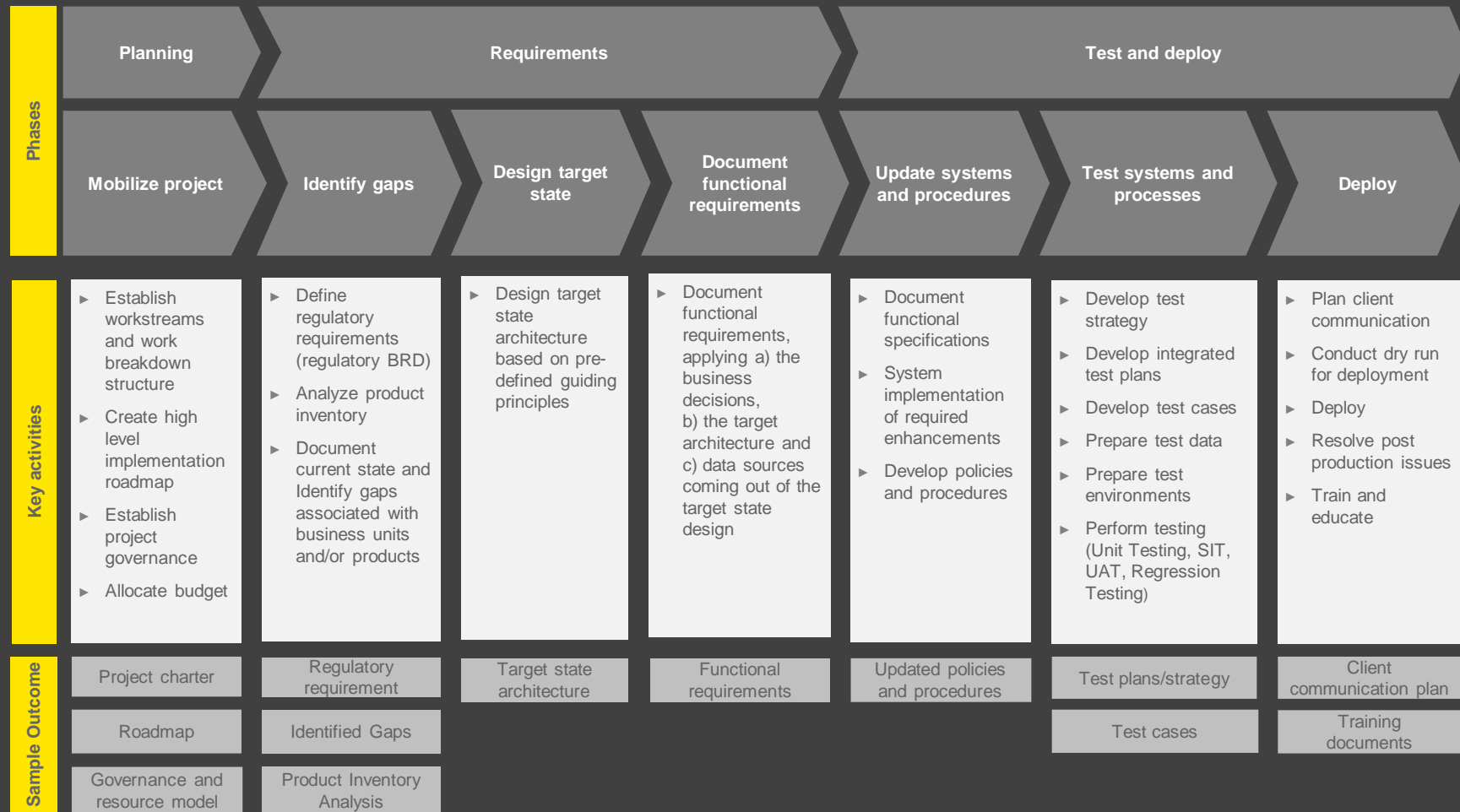


# Immediate next steps.....

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- ▶ Firms must perform analysis to determine the number of products potentially in scope for s871(m)
- ▶ The business must engage practically to address the challenges associated with s871(m) using a current state and gap analysis
- ▶ Firms must review the impact of s871(m) with key stakeholders
- ▶ Firms must give due consideration to whether it falls within the QDD rules
- ▶ Firms must establish a plan for compliance and secure resourcing

# EY Service Offering – 871 (m) Implementation Support Example



# Our section 871 (m) accelerators

Accelerators	<p><i>Regulatory Business Requirements Document (BRD)</i></p> <ul style="list-style-type: none"> <li>▶ The Regulatory Business Requirements Document (BRD) is a comprehensive set of regulatory business requirements that firms can leverage to implement their section 871(m) capabilities. The BRD facilitates the creation of the functional requirements, design and development of the section 871(m) solutions.</li> </ul>
	<p><i>Data Dictionary</i></p> <ul style="list-style-type: none"> <li>▶ The Data Dictionary outlines the key data attributes of section 871(m). This will enable a firm to not only identify and define key data attributes, but also to facilitate the logical to actual data mapping required for development.</li> </ul>
	<p><i>Risk Exposure Indicator (REI)</i></p> <ul style="list-style-type: none"> <li>▶ The Risk Exposure Indicator allows a firm to understand where their greatest exposure lies from a product perspective. By analyzing a firm's product inventory and associated dividend equivalents, EY can use this information to project the potential withholding exposure for a given in-scope product.</li> </ul>
	<p><i>Product Playbook</i></p> <ul style="list-style-type: none"> <li>▶ EY's Product Playbook is a comprehensive set of over 25 product scenarios that enumerate how specific contracts would be in scope and the associated withholding amounts. These scenarios can help firms at various stages in the project lifecycle, from functional requirements to testing.</li> </ul>

Phases where our Accelerators significantly reduce a firm's implementation timeline

	Impact assessment	Design target state	Functional requirement	Update systems/ procedures	Test systems and processes
Risk exposure indicator	✓	✓			
Regulatory BRD	✓	✓	✓		✓
Data dictionary		✓	✓	✓	
Product playbook scenarios	✓	✓	✓	✓	✓
Testing CoE					✓



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