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This may not be used or cited as precedent.

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## Agenda

**Day 1:**

Technical Overview:

1. Common Equity Derivative Transactions
2. Section 871(m) Overview
3. QDD and Eligible Entity
4. QDD Tax Liability
5. Few Additional Points

**Day 2:**

Duties and Obligations of a QDD:

1. QDD Application
2. Documentation Requirements
3. Withholding and Reporting Obligations
4. QDD Compliance

Examples

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## Duties and Obligations: Application for QDD Status

Who Can Apply for QDD Status?:

- An eligible entity that is a QI
  - "Any other person otherwise acceptable to the IRS" category → is not meant to significantly expand the definition of an eligible entity, it is meant to give the IRS the discretion to accept an entity that is very similar to the specified categories of eligible entities but that does not satisfy the precise technical requirements in the definition as an eligible entity.
- Each home office or branch that is a QI must qualify independently and be approved to act as a QDD
  - The application should note why the applicant is an eligible entity
  - If applicable, applicant must provide the name and jurisdiction of its regulator (and the regulator of its home office)
- A partnership can apply to be a QDD if it qualifies as an eligible entity → additional terms that would apply in the case of an agreement entered into with a partnership

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## Duties and Obligations: Application for QDD Status

What Information Should an Applicant Provide?:

- Applicants must apply to enter into a QI agreement and include the information on the application relating to QDDs:
  - Business operated
  - Types of potential section 871(m) transactions for which it makes payments (and approximate value in U.S. dollars)
  - Types of potential section 871(m) transactions and underlying securities for which it receives payments (and approximate value in U.S. dollars)
  - Equity derivatives dealer business activities
  - Each applicant applicant's entity classification (such as a corporation, partnership, or disregarded entity)
  - Branch applicants → entity classification of its home office
  - Account Opening Procedures

**Note re Application in 2017:** Applicant may indicate that the value of the previous year's transactions is zero when relevant information is unavailable.

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**Duties and Obligations: Application for QDD Status Continued**

**What about a QI who is renewing its application and wants to become a QDD?:**

- A QI that seeks to renew its QI agreement and also seeks to act as a QDD must supplement the renewal request by providing all of the information required by the application relating to a QDD.

**What "know your customer" (KYC) requirements apply to QDD applicants?:**

- The KYC rules generally applicable to a QI also apply to a QDD
- If a QI is a FFI and applying for QDD status on behalf of the home office or any branch, the applicant may only act as a QDD if that branch is located in a jurisdiction identified on the IRS's Approved KYC List
- If a QI is a NFFE and applying for QDD status on behalf of the home office or any branch, the QDD is not required to be located in a jurisdiction identified on the IRS's Approved KYC List
  - These QDDs must document its account holders with withholding certificates

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**Duties and Obligations: Application for QDD Status Continued**

**Can a Foreign Branch of a U.S. financial institution apply to be a QDD?:**

- Yes, A foreign branch of a U.S. financial institution may also apply for QI and QDD status provided it separately qualifies as an eligible entity.

**What tax return does a foreign branch of a U.S. financial institution file?:**

- The QDD activities must be included on the appropriate U.S. income tax return (e.g., Form 1120, *U.S. Corporation Income Tax Return*)
  - Any income, deductions, or losses reported on the Form 1120 and pay its tax liability under chapter 1
  - A QDD that is a foreign branch of a U.S. financial institution does not have a separate QDD tax liability

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**Duties and Obligations: Documentation Requirements for a QDD**

**What type of Withholding Certificate must a QDD provide to its counterparties?:**

- A QDD must provide to its counterparties a QI withholding certificate (Form W-8IMY) indicating that it is receiving the payment as a QDD
- Form W-8IMY is being revised as follows:
  - Part 1, Question 3 will be revised to clarify that a QI may be a QDD
  - An additional certification will state that the QDD assumes primary withholding and reporting responsibilities under chapters 3, 4, and 61 and section 3406 for any payments it makes on potential section 871(m) transactions
  - The QDD will be required to identify its entity classification (Corporation, Partnership, or disregarded entity)
- In 2017, a QDD may provide a Form W-8IMY indicating that it is "awaiting QI-EIN" → generally a withholding agent may rely on this for up to 6-months

**What Additional Information a QDD provide on the Form W-8IMY?:**

- The QDD's Form W-8IMY must designate the accounts for which the QDD:
  - (1) Receives payments from potential section 871(m) transactions or underlying securities as a QDD;
  - (2) Receives payments on potential section 871(m) transaction for which withholding is not required;
  - (3) Receives payments on underlying securities for which withholding is required; and
  - (4) Identify the home office or branch that is treated as the owner for U.S. tax purposes, if applicable.

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**Duties and Obligations: What Document Must a QDD Obtain from its Counterparties?**

What efforts must a QDD make to obtain documentation from its customers?:

- A QDD is required to obtain a withholding certificate (or other appropriate documentation) from each of its counterparty to whom it makes a dividend equivalent payment.
- The general documentation requirements applicable to a QI apply to a QDD → A QDD agrees to use best efforts to obtain documentation from customers for which it is acting as a QDD and to whom it makes a reportable payment
- When a QDD cannot reliably associate a payment with valid documentation from the customer → presumption rules under chapter 3 or 4 apply (under section 3406 if backup withholding is required).

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**Duties and Obligations: QDD's Obligation to Withhold**

Assumption of Primary Withholding Responsible: A QDD must assume primary withholding responsibility for purposes of chapters 3 and 4 for all payments it makes as a QDD

- **Dividend equivalent Payments:** A QDD must treat any dividend equivalent as a U.S. Source dividend
- **Non-Dividend equivalent Payments:** A QDD also assumes primary withholding responsibility for any U.S. source FDAP payments made with respect to a potential section 871(m) transaction even if the payment is not a dividend equivalent
- **Treaty Rates:** If a QDD pays a dividend equivalent to a beneficial owner claiming a treaty benefits under the dividends article of an applicable income tax treaty, it may reduce the rate of withholding under chapter 3
- **Election re Other payments:** A QI can elect whether or not to assume primary withholding responsibility for purposes of chapters 3 and 4 for payments for which it is not required to act as a QDD

Backup Withholding: A QDD is responsible for backup withholding under section 3406 for payments made as a QDD with respect to any potential section 871(m) transaction provided the amount paid is an amount subject to chapter 3 or 4 withholding or a reportable payment under chapter 61.

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**Duties and Obligations: QDD's Obligation to Withhold Continued**

Time for Withholding: A QDD must withhold with respect to a dividend equivalent payment on the dividend payment date for the applicable dividend

- When stock has a record date that is earlier than the payment date → dividends are considered paid on the payment date
- The 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
- A QDD must determine whether any payment it makes on a potential section 871(m) transaction is a dividend equivalent.

Deposits: A QDD must deposit amounts withheld as provided under section 6302 (see §1.6302-2) by electronic funds transfer as provided under §31.6302-1(h).

- If the QDD has accumulated at the close of any calendar month an aggregate amount of undeposited taxes of \$200 or more → deposit is due by the 15th day of the following month
- If at the close of any quarter-monthly period within a calendar month, the aggregate amount of undeposited taxes is \$2,000 or more → deposit is due within 3 business days after the close of such quarter-monthly period

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**Duties and Obligations: QDD's Reporting Obligations**

**Self-Reporting:** The QDD (other than a foreign branch of a U.S. financial institution) must report its QDD tax liability under chapters 3 and 4 on Form 1042 and must report its QDD tax liability on the appropriate U.S. tax return.

- For 2017, the appropriate form is a Form 1120-F.
- It is expected that a QDD tax liability will be reported on a QDD by QDD basis (that is, each QDD branch or QDD home office would separately report the QDD tax liability)
- Reconciliation statement prepared (and available upon request) that tracks the section 871(m) amount for each dividend separately for each QDD

**Separate Forms 1042-S:** When QI is acting as both a QI and a QDD, it must file separate Forms 1042-S to report payments made in each capacity

- Box 12b requires the withholding agent to identify the appropriate chapter 3 status should be checked on the Form 1042-S:
  - Code 12 = Qualified Intermediary
  - Code 35 = Qualified Derivatives Dealer

**Payments to U.S. Persons:** A QI acting as a QDD must assume primary Form 1099 reporting provided the amount paid is a reportable payment under chapter 61.

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**Duties and Obligations of a Withholding Agent Making Payments to a QDD:**

- **Non-QDD Payments Received by a QDD:** all payments (other than dividend equivalent payments) made to a QDD with respect to underlying securities will be subject to withholding and reporting if the payments would be subject to withholding and reporting to a non-QDD.
  - A QDD will be subject to withholding on dividends (including deemed dividends) beginning with those payments received on or after January 1, 2018
  - A QDD will be subject to withholding on all payments, other than dividend equivalents, received by the QDD with respect to underlying securities.
- **Separate Form 1042-S to Each QDD:** when a withholding agent makes a payment to a QDD that is subject to reporting under chapter 3 or 4, a separate Form 1042-S is required for each QDD
  - Each home office QDD and each branch QDD should receive a separate Form 1042-S.

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**Duties and Obligations: Compliance with QI Agreement-Responsible Officer**

**Who is the Responsible Office for purposes of QDD compliance?**

- Generally, the responsible officer is an officer of the QI with sufficient authority to fulfill the duties of a responsible officer, including the requirements to periodically certify and to respond to requests by the IRS for additional information to review the QI's compliance.
- Only a QI's responsible Officer may make the certification to the IRS
- A QI's responsible officer may designate a specific person to be responsible for QDD compliance
  - The QI application and the Accounts Management System must identify the responsible officer

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**Duties and Obligations: Compliance Program**

- The responsible office must establish a compliance program. The compliance program components applicable to a QI generally apply to a QDD as well.
- For a QDD, the compliance program specifically includes the following:
  - **Written Policies and Procedures:** addressing the documentation, withholding, reporting, and other obligations, and necessary to satisfy its QDD tax liability
  - **Training:** communicating the policies and procedures to any line of business that entering into potential section 871(m) transactions as a QDD
  - **QDD Tax Liability Determinations:** ensuring that the QDD has appropriate systems to:
    - Identify section 871(m) transactions, potential section 871(m) transactions;
    - Calculate the amount of dividends received in its QDD equity derivatives dealer capacity and the section 881 taxes paid thereon,
    - Calculate its net delta exposure,
    - Determine the dividend amount per share,
    - Determine its section 871(m) amount (and the related section 881 taxes paid), and its QDD tax liability amount
    - Determine the amount of dividend equivalent payments made by the QDD

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**Duties and Obligations: Periodic Review**

What information must the QDD provide as part of the Periodic Review:

- QDD must require a reviewer to test obligations under the QI agreement regarding its QDD activities. The periodic review for the certification period will evaluate the QDD's:
  - Determinations as to whether or not transactions are section 871(m) transactions;
  - Computations and determinations of dividend equivalent amounts, dividends, and taxes paid;
  - Determinations regarding whether transactions are in its equity derivatives dealer capacity,
  - Net delta exposure computation,
  - Section 871(m) amount and the calculation of its QDD tax liability
  - Calculations of any other amounts required to be included on the reconciliation schedule.
- Sampling is permitted to test accounts provided that the QDD has more than 60 accounts
  - The QDD and QI activities must be reviewed separately

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**Duties and Obligations: Periodic Review Continued**

- If the reviewer determines that underwithholding has occurred, the QDD must report and pay any amount due.
- The reviewer must review accounts of a QDD that received a reportable payment to determine whether the QDD has documented the status of account holders properly
- The reviewer must determine that the QDD withheld when required on payments that it made with respect to potential section 871(m) transactions
- The results of the periodic review must be documented in a written report addressed to the responsible officer and must be available to the IRS upon request. The report for a QDD must also include:
  - The number of accounts that were not correctly categorized (such as improperly designated as principal accounts or non-principal accounts, equity derivatives dealer or non-equity derivatives dealer accounts).
  - Errors with the QDD tax liability (such as, incorrect determination of the net delta exposure, the section 871(m) amount and the taxes on the section 871(m) amount)

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**Duties and Obligations: Periodic Review Continued**

- The reviewer must determine whether the amounts of income, taxes, and other information reported was accurate by:
  - (1) reviewing the reconciliation schedule and any information used to prepare the schedule or compute its QDD tax liability, reviewing the amounts required to determine the QDD's section 871(m) amounts and its QDD tax liability over the applicable period, and reviewing such information to determine whether the section 871(m) amounts and QDD tax liability have been properly calculated;
  - (2) reviewing amounts shown on Forms 1042 and Forms 1042-S to determine whether the QDD properly took the information into account (for example, to calculate its QDD tax liability)
- The reviewer must review accounts designated as accounts for which QI acted as a QDD to determine whether:
  - (1) The QI acted as a QDD for all potential section 871(m) transactions and underlying securities for which it is required to be a QDD (and not any other transactions); and
  - (2) the section 871(m) amount includes only the amounts in its equity derivatives dealer capacity and not amounts in its non-equity derivatives dealer capacity.

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**Duties and Obligations: Certification of Internal Controls**

- The responsible officer must make the certification required by the QI Agreement and must disclose any material failures that occurred during the certification period (or a prior certification period if not previously discovered and disclosed).
- Material failures related to QDDs:
  - Failing to establish written policies regarding its obligations as a QDD under this Agreement;
  - Failing to satisfy or timely pay its QDD tax liability;

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**Duties and Obligations: Calendar Year 2017 Phase-in**

- **Calendar Year 2017 = Phase-in Year for QDDs:** QDDs must make a good faith effort to comply with the section 871(m) regulations and the relevant provisions of the QI agreement
  - **Relaxed Enforcement:** If a QDD makes a good faith effort, it is expected that the IRS will take that into account when enforcing and administering the QDD rules → if QDD does not act in good faith, it is not entitled to Phase-in relief
  - **Exemption for Withholding:** When a QDD receives (1) a dividend on physical shares of stock or (2) a dividend equivalents → those payments are not subject to tax if received in the QDD's capacity as an equity derivatives dealer
  - **Periodic Review:** A QDD is not required to perform a periodic review with respect to its QDD activities or provide the factual information specified in Appendix I.
  - **QDD Certification:** the certification of internal controls as applicable to its QDD activities is not required for the certification period ending in calendar year 2017 → QDD only needs to certify that it has made a good faith effort to comply with the relevant provisions of the QI Agreement
    - The certification is not required to be filed → QDD must retain a record of the certification and supporting information until the end of the calendar year 2022

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**Example 1: Documentation Required**

USA Corp → 100 Shares → QDD (15%)  
 Foreign Broker Dealer → TRS: 200 Shares of USA Corp → QDD (15%)  
 QDD (15%) → TRS: 150 Shares of USA Corp → Foreign Corp 1 (15%)  
 QDD (15%) → W-BEN → Foreign Corp 1 (15%)  
 QDD (15%) → W-BEN → Foreign Corp 2 (30%)  
 Foreign Corp 2 (30%) → Call Option (Delta 0.5): 300 Shares of USA Corp → QDD (15%)

- Assume all transaction are in the QDD's equity derivatives dealer capacity
- QDD provides a Form W-8IMY to USA Corp. and Foreign Broker Dealer
  - The Form W-8IMY indicates that it is acting as a QDD and assumes primary withholding responsibility
- Assuming that both are the beneficial owners of the transactions, QDD receives the appropriate W-8BEN from Foreign Corp. 1 and Foreign Corp. 2
  - Foreign Corp. 1 completes Part II of the W-8BEN claiming treaty benefits

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**Example 2: Withholding on 2017 Q1 Dividend**

USA Corp → 100 Shares → QDD (15%)  
 Foreign Broker Dealer → TRS: 200 Shares of USA Corp → QDD (15%)  
 QDD (15%) → TRS: 150 Shares of USA Corp → Foreign Corp 1 (15%)  
 QDD (15%) → W-BEN → Foreign Corp 1 (15%)  
 QDD (15%) → W-BEN → Foreign Corp 2 (30%)  
 Foreign Corp 2 (30%) → Call Option (Delta 0.5): 300 Shares of USA Corp → QDD (15%)

- Assume that USA Corp pays a \$1 per share dividend in the 1<sup>st</sup> Quarter 2017.
- USA Corp does not withhold on the dividend payment to QDD. [See §1.1441-1\(b\)\(4\)\(xiii\)\(C\).](#)
- Foreign Broker Dealer does not need to withhold on its dividend equivalent payment to QDD because it received a valid form W-8IMY. [See §1.1441-1\(b\)\(4\)\(xiii\)\(B\).](#)
- QDD will withhold \$22.50 (1.00x150x15%) with respect to the dividend equivalent payment to Foreign Corp. 1. [See §1.1441-1\(b\)\(4\)\(xv\).](#)
- QDD will not withhold on the call option held by Foreign Corp. 2 because a call with a delta of 0.5 is not a section 871(m) transaction. [See §1.1441-1\(b\)\(4\)\(xx\).](#)
- Note: Section 871(m) Amount is zero (long positions = short positions)

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**Example 3: Withholding on 2018 Q1 Dividend**

USA Corp → 100 Shares → QDD (15%)  
 Foreign Broker Dealer → TRS: 200 Shares of USA Corp → QDD (15%)  
 QDD (15%) → TRS: 150 Shares of USA Corp → Foreign Corp 1 (15%)  
 QDD (15%) → W-BEN → Foreign Corp 1 (15%)  
 QDD (15%) → W-BEN → Foreign Corp 2 (30%)  
 Foreign Corp 2 (30%) → Call Option (Delta .5): 300 Shares of USA Corp → QDD (15%)

- Assume the facts are the same as Example 2, except USA Corp. pays a \$1 per share dividend in Q1 of 2018
- USA Corp must withhold on the dividend payment to QDD because the exemption from withhold on actual dividends only applies in 2017. [See §1.1441-1\(b\)\(4\)\(xiii\)\(C\).](#)
  - USA Corp. would withhold \$15.
- The withholding obligations of Foreign Broker Dealer and QDD will be the same as in Example 2.
- Note: Section 871(m) Amount is zero (long positions = short positions) and QDD is not entitled to a refund for the amount withheld by USA Corp.



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**Example 4: Net Delta Exposure to USA Shares on Q1 2018**

- The facts are the same as Example 1, except that Foreign Corp. 2 has purchased a Call Option on 150 with a delta of 0.8. Also, assume that the deltas of the transactions remain the same as the initial delta. This example also assumes that QDD calculates its long and short exposure in a commercially reasonable manner that only takes the delta and the number of shares into account.
- QDD calculates its net delta exposure to USA Corp. shares at the end of the ex-dividend date for the Q1 dividend. See §1.871-15(q)(4).
  - QDD's Long Exposure to USA Corp: 300 shares (100 x Delta 1.0) + (200 x Delta 1.0)
  - QDD's Short Exposure to USA Corp: 270 shares (150 x Delta 1.0) + (150 x Delta 0.8)
  - Net Delta Exposure: 30 Shares
- QDD's Tax Liability with respect to its section 871(m) amount for the Q1 2018 dividend is \$0.
  - QDD's section 871(m) amount with respect to USA Corp.'s Q1 dividend is \$30 (Net delta exposure (30) x per share dividend amount (\$1))
  - The tax liability on the section 871(m) amount (\$30 x 15% = \$4.5) is reduced (but not below zero) by the tax paid by the QDD on the dividend it received (\$100 x 15% = \$15).

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**Example 5: Net Delta Exposure With Multiple QDD Branches**

- Each QDD must determine its net delta exposure separately and only take into account transactions recognized and attributable to that QDD for U.S. federal tax purposes.
- All transactions are in the QDD's equity derivatives dealer capacity and with respect to the same stock and dividend

Home Office QDD	QDD Branch A	QDD Branch B
Withholding:	Withholding:	Withholding:
- 0% withholding by Foreign Customer A	- 0% withholding by Foreign BD 2	- 0% by Home Office QDD on TRS with QDD Branch
- 0% withholding by Foreign BD 1	- 30% withholding by QDD Branch A	- 30% by QDD Branch B on TRS with Foreign Corp 2
- 0% withholding by QDD on Call Option		
- 0% on TRS with QDD Branch B		
Net Delta: 100 Shares	Net Delta: 0 Shares	Net Delta: 0 shares
Long Positions: 200	Long Positions: 100	Long Positions: 0
Short Positions: 100	Short Positions: 100	Short Positions: 100

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**Example 6: Low Delta Calls Option with Customers**

- Assume that USA Corp pays a \$1 per share dividend in the 1<sup>st</sup> Quarter 2018.
- USA Corp must withhold on the dividend payment to QDD because the exemption from withhold on actual dividends only applies in 2017. See §1.1441-1(b)(4)(xxii)(C).
  - USA Corp. would withhold \$15.
- Foreign Broker Dealer does not need to withhold on its dividend equivalent payment to QDD because it received a valid form W-BMY. See §1.1441-1(b)(4)(xxii)(B).
- QDD will not withhold on the call options held by Foreign Corp. 1 and Foreign Corp. 2 because a call with a delta of 0.5 is not a section 871(m) transaction. See §1.1441-1(b)(4)(xxi).
- Note that the QDD does not have a withholding obligation on call options with customers and the section 871(m) amount is zero because long positions equal the short positions