Clients&FriendsMemo

Proposed QI Agreement Addresses Cascading Withholding on Dividend Equivalents

July 5, 2016

On July 1, the U.S. Internal Revenue Service issued Notice 2016-42, which proposes changes to the qualified intermediary (QI) agreement to address cascading U.S. withholding tax on dividends and "dividend equivalents" received and paid by qualified derivatives dealers (QDDs) with respect to U.S. equity securities.

Background

As discussed in a prior Clients & Friends Memo, section 871(m) of the Internal Revenue Code imposes withholding on "dividend equivalents" paid on derivatives that reference U.S. equity securities. The regulations under section 871(m) can result in multiple withholdings on the same stream of dividends. For example, when a non-U.S. bank holds U.S. stock and issues derivatives with respect to the stock to non-U.S. investors, the non-U.S. bank may be subject to withholding on dividends paid on the stock, and also may be required to withhold on the dividend equivalents that it pays on the derivatives.

Certain foreign financial institutions and foreign clearing houses can receive U.S.-source dividends and dividend equivalents without being subject to withholding tax if they certify to the withholding agent that they are receiving the payments as intermediaries (and not as principals) and have entered into a QI agreement with the IRS under which they have agreed to assume primary withholding responsibility with respect to the payments. However, banks and dealers often cannot act as qualified intermediaries with respect to a dividend or dividend equivalent because they receive the payment as principals (for example, as part of a dynamic hedge that offsets one or more transactions to which the bank or dealer is a short party).

Proposed Changes

The newly proposed rules under Notice 2016-42 would mitigate cascading withholding by expanding the QI regime to include QDDs. Under the proposed rules, a QDD is a QI that is either:

- A securities dealer that is regulated as a dealer in the jurisdiction in which it was organized or operates; or

- A bank that is regulated as a bank in the jurisdiction in which it was organized or operates (or a wholly owned affiliate of such a bank) that issues U.S. equity derivatives to customers and receives dividends or dividend equivalent payments on its hedges of these derivatives.

Very generally, a QDD would not be subject to withholding on dividends or dividend equivalents that it receives as a principal if it:

- Assumes primary withholding and reporting responsibilities with respect to the payments;

- Agrees to remain liable for any tax on dividends and dividend equivalents it receives to the extent that it does not make offsetting payments as a short party on another transaction that references the same stock; and

- Complies with certain compliance procedures.

The new QI agreement is proposed to be effective beginning January 1, 2017 for QIs that sign or renew the agreement before March 31, 2017.

A copy of Notice 2016-42 can be found here.

*   *   *   *   *

If you have any questions, please contact any of the following attorneys:

Mark Howe	+1 202 862 2236	mark.howe@cwt.com
Jason Schwartz	+1 202 862 2277	jason.schwartz@cwt.com
Brian Foster	+1 212 504 6736	brian.foster@cwt.com
Ray Shirazi	+1 212 504 6376	ray.shirazi@cwt.com
Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com