IRS notice provides relief under Section 871(m) regulations and qualified derivatives dealer regime

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In brief

The Internal Revenue Service (IRS) and the US Department of the Treasury (Treasury) on December 2, 2016 issued Notice 2016-76 (Notice) providing highly anticipated guidance addressing specific challenges with implementing regulations under Section 871(m) of the Internal Revenue Code. The Notice introduces transitional relief in anticipation of expected amendments to the Section 871(m) regulations and the proposed qualified intermediary (QI) agreement. Portions of the Notice have been discussed in recent public comments by IRS and Treasury officials, but certain provisions may come as a surprise to stakeholders. The Notice introduces these key changes:

- A delayed effective date of January 1, 2018 for 'non-delta one' contracts,
- A simplified combination rule to be used only by withholding agents during 2017,
- Guidance on a 'good faith' standard which would apply to (1) 'delta one' contracts and qualified derivative dealers (QDDs) during 2017 and (2) 'non-delta one' contracts during 2018,
- Introduction of a 'net delta' approach for computing the QDD tax liability while also requiring withholding on actual dividends paid to QDDs,
- Procedures for QDDs and QDD counterparties relying on a provisional QDD status through completion of the application process,
- Extension of the qualified securities lender (QSL) provisions through the end of 2017, and
- A list of 25 specific exchange-traded notes (ETNs) exempt from Section 871(m) until January 1, 2020.

In detail

Final and temporary regulations under Section 871(m) released in September 2015 (the 2015 Regulations) generally impose a withholding tax on 'dividend equivalent amounts' paid or deemed paid to non-US taxpayers on derivatives over US equities. The 2015 Regulations were to be effective for all in-scope contracts issued on or after January 1, 2017. The Notice acknowledges the difficulty of implementing many of the novel concepts introduced in the 2015 Regulations and therefore grants temporary transitional relief in certain circumstances.

The following is a brief overview of the concepts introduced in the 2015 Regulations:

Delta

The 2015 Regulations attempt to impose a withholding tax on derivatives that economically mirror a direct investment in US equities. The regulations do this by applying a 'delta test' which covers a broad range of derivative transactions by bringing into scope any contract with a delta of 0.80 or higher. A derivative's delta generally reflects the ratio of a change in the value of a derivative contract relative to a change in the value of the asset referenced by the derivative. As such, the change in the value of a 'delta one' contract generally corresponds with the change in the value of the underlying referenced asset (e.g., a typical swap). In contrast, the value of a derivative with a delta of 0.80 would increase or decrease in an amount equal to 80% of the change in the value of the underlying referenced asset (e.g., an in the money call option).

Combination rule

The 2015 Regulations provide a combination rule that requires certain transactions to be combined to determine if the net result is a transaction that would have been in-scope. For example, a taxpayer could simultaneously purchase an 'at-the-money' call option and write an 'at-the-money' put option with the same expiration date. Taxpayers entering into these separate trades would benefit from any appreciation by exercising the call and would be exposed to any depreciation via an exercise of the put. The net result is that the taxpayer would effectively have a 'delta one' position with respect to the underlying asset. In such case, the combination rule would apply to impose withholding tax on each option even though neither option would have been subject to withholding on an individual basis.

While this example is relatively straightforward, the application of the combination rule quickly becomes complex when dealing with multiple potential combinations.

QDD

The 2015 Regulations introduced the concept of a QDD. Earlier this year, the IRS released Notice 2016-42, which spelled out new operational requirements for QDDs and clarified the types of entities that qualify for such status. QDD status is crucial for non-US derivatives dealers to ensure that they are not subject to withholding on dividend equivalent amounts received with respect to hedges in addition to withholding imposed on derivatives written to clients (i.e., cascading or duplicative withholding). In addition, taxpayers that are 'short' will not be required to withhold on dividend equivalent amounts paid to QDDs. This is critical for non-dealers as they generally do not have the systems capability/processes to withhold on such derivatives. There has been significant market uncertainty in this area as we approach the January 1, 2017 effective date. Since the proposed QI agreement has not been finalized, dealers have not been able to apply for QDD status, nor has it been clear how the rules would apply once a dealer becomes a QDD. For more information on the proposed QI agreement, see our Insight: Proposed qualified intermediary agreement includes qualified derivatives dealer provisions.

The Notice

Phased-in approach

The Notice does not affect swaps currently in scope under the 2015 Regulations (e.g., swaps that were already in scope because there was a 'cross in' or 'cross out'). The Notice is consistent with a preview provided by government officials in that implementation of the remaining rules under the 2015 Regulations will be phased-in as follows:

- *2017 'delta one' phase-in*: The 2015 Regulations will apply to 'delta one' trades (including 'delta one' trades via the combination rule) issued on or after January 1, 2017.
- *2018 'non-delta one' phase-in*: The 2015 Regulations will apply to any other contract with a delta of 0.80 or higher (including trades in scope via the combination rule) issued on or after January 1, 2018.

Observation: *Similar to the 2015 Regulations, the Notice does not define 'delta one.' Transactions with a delta that is very close to one may well be in scope (such as certain forward contracts and put/call combinations). The Notice states that the anti-abuse rule included in the final 2015 Regulations will apply during the phase-in period, which could result in transactions that technically are not 'delta one' being subject to withholding tax.*

Good faith effort to comply with the regulations

The Notice states that the IRS will take into account the extent to which a taxpayer or withholding agent made a 'good faith' effort to comply with the regulations during each transitional period. Factors to be considered in evaluating whether a 'good faith' effort has been made include whether a withholding agent made a good faith effort to:

- build or update its documentation and withholding systems to comply with the 2015 Regulations,
- determine whether transactions met the combination rule,
- report information to other parties to the transaction, and

- implement for 2018 the substantial equivalence test provided in the 2015 Regulations.

Observation*: These provisions are helpful for broker/dealers that generally have a withholding requirement and have provided comments on how they are impacted by the 2015 Regulations. There unfortunately is little guidance on the application of the good faith standard to activities required by long parties.*

Simplified combination rule for 2017

The Notice applies a simplified combination rule for 2017 that softens a withholding agent's obligation. Withholding agents will be required to combine transactions for 2017 if they are over-the counter derivatives (e.g., excludes listed options) that are priced, marketed, or sold in connection with each other. Combined transactions under this rule will remain in scope in future years, even if components are settled or transferred. Transactions that are not combined under the simplified combination rule generally will not be eligible for combination by withholding agents in future years.

Observation: *The simplified combination rule is available only to withholding agents and may not be used by long parties. Therefore, hedge funds and other non-US investors that purchase calls and write puts still will be required to review their positions (both listed and over the counter) over time and apply the original combination rule. While only combinations that result in 'delta one' transactions will be in scope for 2017, there is some uncertainty as to how precisely the term 'delta one' should be interpreted. For example, would a put and call be subject to combination in 2017 if their combined delta was 1.05? The anti-abuse rule presumably would apply if such a transaction were structured with the intention of avoiding Section 871(m), but there may be a gray area where there was no avoidance intent.*

Underwithholding relief clarification

The Notice clarifies that a withholding agent that does not properly withhold may adjust the amount withheld prior to the due date for filing Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding,* without extension (i.e., March 15) without incurring a penalty for failure to deposit or failure to pay.

Observation: *This clarification is especially welcome for withholding agents that may not know how much withholding is required until after withholding otherwise might be required under the regulations (e.g., swaps over publicly traded partnerships).*

Grandfathering for listed ETNs

ETN issuers have the ability to create/issue additional new ETNs which share the same CUSIP and must be fungible to maintain liquidity. However, only ETNs in existence before January 1, 2017 would be eligible for grandfathering, creating a fungibility issue with respect to an ETN that has issuances before and after January 1, 2017. In order to preserve the market liquidity of such ETNs, the Notice provides that the 2015 Regulations do not apply to a specific list of 25 ETNs until January 1, 2020. The IRS requested comments as to whether there are additional ETNs that existed prior to the issuance of the 2015 Regulations and may grant relief for such ETNs through published guidance.

Observation: *While this relief is welcome and effective for many ETNs, this list does not include every ETN subject to Section 871(m). Investors, withholding agents, and other market participants should consider whether a particular ETN has been included and the tax consequences that may apply if a currently outstanding ETN is not on the list.*

Quarterly withholding deposits

A special rule for 2017 provides that withholding agents will be considered to have timely satisfied their deposit requirements for Section 871(m) dividend equivalent payments if they make deposits of amounts withheld for dividend equivalents during any calendar quarter on or before the last day of that calendar quarter. The withholding agent should write 'Notice 2016-76' on the top, center portion of the 2017 Form 1042.

Observation: *This provision will be particularly helpful in the first and second quarters of 2017 as withholding agents struggle to understand the implementation of these provisions, particularly in anticipation of further regulatory guidance.*

Applicability of Notice 2010-46

Another special rule for 2017 allows taxpayers to continue to rely on Notice 2010-46, which provides specific rules for dividend equivalent payments made by borrowers of US equities to QSLs.

Observation: *A non-US dealer that already is qualified as a QSL does not need to apply for QDD status for 2017 simply to avoid cascading withholding for stock loan activity. Since many QSLs are not QIs, these dealers have additional time to consider becoming a QI-QDD. This should be helpful for QSLs that otherwise are not engaged in derivatives activity. The extension of Notice 2010-46 is particularly helpful in avoiding cascading or duplicative withholding in connection with substitute dividends paid to securities lenders. Under the QSL regime, cascading or duplicative withholding can be avoided under the credit forward method or when the lender acts as a QSL. The IRS has indicated in the preamble to the proposed QI agreement that the credit forward provisions currently being employed under the QSL regime will not be applicable once the QSL regime is* *replaced by the QDD regime. After the QSL regime sunsets, QDD status will be the sole method of eliminating cascading withholding on substitute dividends in connection with stock lending activity as the credit forward method will not be available under the QDD regime.*

QDD provisions

The IRS acknowledges that additional challenges apply for QDD status under the proposed QI agreement and for attempting to implement the QDD regime in a timely manner. The Notice states that a final QI agreement will be published before the end of 2016 and will be effective on January 1, 2017.

QDD receipt of actual dividends and 'net delta' approach

Under the proposed QI agreement, QDDs were allowed to receive actual dividends as well as dividend equivalent payments in their capacity as dealers without being subject to withholding. The QDD's 'Section 871(m) amount' (i.e., the basis for its Section 871(m) liability) would have been calculated by reducing actual dividends and dividend equivalent payments received by the amount of qualifying dividend equivalent payments made to counterparties with respect to the same dividends for the same underlying securities.

The Notice provides that the Section 871(m) regulations will be revised to provide that QDDs always will be subject to withholding tax on any actual US source dividends received. For this purpose, actual dividends include deemed dividends (e.g., Sections 302 and 305(c) dividends). In addition, a QDD's 'Section 871(m) amount' for a particular dividend will be determined based on the QDD's 'net delta exposure' (measured in number of shares) for the relevant underlying security on the relevant date. A QDD's 'net delta exposure' will be determined by aggregating the delta of all physical positions and potential Section 871(m) transactions with respect to an underlying security entered into by the QDD in its equity derivatives dealer capacity. Any 'net delta' calculated for non-tax business purposes ordinarily will be the delta used for this purpose. The QDD's Section 871(m) liability will be reduced (but not below zero) by the withholding tax paid on the actual dividends received on the shares included in the 'net delta' calculation.

Observation: *Imposing withholding on all actual dividends received by QDDs is a significant change from the 2015 Regulations. While the language in the Notice is somewhat unclear, the mechanism for calculating the QDD tax liability generally should result in such withholding being offset against withholding that the QDD is required to levy on a Section 871(m) transaction with a non-US counterparty. It is anticipated that this result will be achieved by embedding a credit forward provision in the Section 871(m) regulations.*

As an example of how such a provision could work, assume a QDD in the UK wrote a 'delta one' contract over a basket of US equities to a counterparty subject to 15% withholding on US source dividends. The QDD then hedges with the physical equities and is withheld at 15% on the actual dividends it receives. While this is not clear from the language in the Notice, we understand that the QDD would not be obliged to withhold additional tax on the dividend equivalent payments on the contract (rather, it can 'credit forward' the tax withheld from the actual dividends it received). We anticipate this principle to be confirmed in forthcoming IRS guidance.

Finally, custodians and paying agents may be pressed to modify systems before January 1, 2017 to withhold on actual dividends paid to QDDs.

Phased-in relief

The IRS will take into account the extent to which a QDD makes a good faith effort to comply with the regulations and provisions of the QI agreement during 2017. This enforcement relief will be provided specifically for the QI agreement. A QDD that does not make a good faith effort will not benefit from the enforcement relief and may face penalties.

Retroactive application

The QI agreement may be effective as of January 1, 2017 if applied for or renewed by March 31, 2017. The January 1 effective date also may apply if the QI receives no reportable payments prior to its application. Otherwise, the QI agreement is effective on the first day of first month in which the QI-employer identification number (EIN) is received.

QDD status certification

The Notice contains helpful provisions for entities that intend and qualify to become QDDs. The following procedures will apply as the new QI agreement is being implemented:

- An applicant that has submitted a QI application applying for QDD status on or before March 31, 2017 may represent that it is a QDD on Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting,* until the sixth full month after the month in which it applied.
- An applicant that has not yet submitted a QI application applying for QDD status but that intends to submit that application on or before March 31, 2017, may represent on a Form W-8IMY that it is a QDD until the end of the sixth full month after the month in which it actually submits its QI application requesting QDD

status, provided that it submits that application by March 31, 2017.

Before receiving a QI-EIN, QDDs may provide a statement that it is ‘awaiting QI-EIN’ on line 8, part I of Form W-8IMY. Withholding agents may rely on this statement to the extent permitted in the Notice. An applicant that notified withholding agents that it would become a QDD must immediately notify such withholding agents if:

- it no longer intends to be a QDD,
- it does not apply by March 31, 2017, or
- its application is denied.

A withholding agent may rely on an ‘awaiting QI-EIN’ form and will not be required to withhold on QDDs acting as a principal (i.e., not an intermediary) with respect to potential Section 871(m) transactions, but, as discussed above, will be required to withhold on actual dividends paid in any capacity. While the withholding agent can rely on the QDD status for six months, it cannot rely on such form if it knows or has reason to know that the provider cannot represent validly that it is a QDD. There is no requirement to verify that a received EIN is a QI-EIN. Once a QI receives its QI-EIN, it can furnish it to withholding agents without providing a new Form W-8IMY so long as the other information on the original form remains valid.

Observation: *Short parties will need to establish procedures for tracking the documentation provided by QDDs and verifying their receipt of a QI-EIN by the relevant expiration date.*

Time to make deposits

A QDD will not be subject to penalties if it deposits any required amounts within three days of receiving its QI-EIN. A similar rule applies with respect to applications to enroll in the Electronic Federal Tax Payment Systems.

The takeaway

The Notice provides much anticipated and welcome relief for stakeholders that were struggling to meet the fast-approaching effective date of Section 871(m). The one-year deferral for ‘non-delta one’ products and the introduction of a good faith standard during phase-in years are especially welcomed by many stakeholders especially those still working on system and process enhancements needed to comply. While the simplified combination rule and the enumerated good faith factors are helpful to withholding agents, long parties cannot use the simplified combination rule nor is it clear what factors would be taken into account in determining what constitutes a good faith effort.

The simplified combination rule, quarterly depositing of withholding taxes, adoption of a ‘net delta’ standard for QDD liability, and the permissive QDD application/certification process all reflect the government’s desire to be responsive to the concerns that have been raised; however, they do require stakeholders to revisit current plans and adjust appropriately just weeks before the implementation date. As January 1, 2017 approaches, market participants should carefully consider how to best mitigate any risks introduced by the 2015 Regulations, as supplemented by the Notice and impending future guidance.

Let's talk

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