Executive summary

The US Treasury Department (Treasury) and Internal Revenue Service (IRS) released the anticipated Internal Revenue Code Section 871(m) transition guidance in Notice 2016-76 (the Notice) on 2 December 2016, providing transition rules for complying with the withholding requirements of Section 871(m). The guidance set forth in the Notice includes: (i) limiting the additional transactions in scope for calendar year 2017 to delta-one transactions; (ii) limiting the application of the combination rules for calendar year 2017; (iii) providing that the IRS will consider “good faith” efforts in its enforcement for calendar years 2017 and 2018; (iv) modifying the calculation of a qualified derivative dealer’s (QDD’s) tax liability; and (v) extending the qualified securities lender (QSL) regime by one year.

With approximately two working weeks remaining before the regulations under Section 871(m) (the Regulations) take partial effect, taxpayers affected by the Notice should quickly review the new guidance and determine how to respond. In the immediate term, long parties must concentrate on whether and how delta-one combined trades affect them; short parties must focus on withholding on the subset of trades that they have made “good faith” efforts to determine are delta-one while still identifying, communicating and disseminating information about all potential Section 871(m) transactions. Further, non-US short-party broker-dealers will need to assess quickly whether they wish to pursue QDD status in
light of the changes to the QDD tax liability previewed in the Notice and make such representations to counterparties in the near term. Those non-US broker-dealers who solely engage in securities lending transactions will have another year to transition to QDD status.

Detailed discussion

Background

Section 871(m) treats “dividend equivalent payments” made with respect to certain derivatives transactions referencing dividend-paying US equities as actual US-source dividends subject to withholding under Sections 1441 and 1442 (chapter 3 or NRA withholding) and 1471 and 1472 (chapter 4 or the Foreign Account Tax Compliance Act (FATCA)). Prior to issuance of the Notice, the Regulations generally would have applied Section 871(m) to certain notional principal contracts (NPCs) and equity-linked instruments (ELIs) referencing a US equity if issued or entered on or after 1 January 2017, assuming that these either had a delta of 0.8 or greater or met the substantial equivalence test (SET) at issuance. An NPC or ELI not meeting the delta or SET threshold may still have been subject to Section 871(m) if acquired in connection with another NPC or ELI and the combined transaction had a delta of 0.8 or greater or met the SET.

Section 871(m) provides broad authority to Treasury to exempt financial intermediaries from gross withholding tax, instead allowing netting of offsetting transactions. The Regulations provide a withholding exception for payments made to QDDs.

Key provisions in Notice 2016-76

Delta-one trades for 2017

The Notice indicates that withholding generally will not be required on any payment made with respect to any non-delta-one transaction issued or entered before 1 January 2018. However, the IRS does not define what is meant by the term “delta-one.” This definition could be: (i) qualitative, based on common product naming conventions; (ii) quantitative, based on a numerical computation; or (iii) some hybrid of the two approaches. The difference between a qualitative and quantitative approach may be illustrated with contracts such as options, which are generally known in the industry for not providing delta-one exposure, but which may from time to time have a numerically calculated delta of one (e.g., zero-strike call options). Products commonly referred to as “delta-one” by the industry may not have a delta of precisely one. Differences in calculation methodology also might lead to different deltas.

It may be argued that delta-one products are limited to simple contracts. Complex contracts are generally expected to have an indeterminate delta. The Notice implies that complex contracts are not in scope in 2017 based on statements indicating that the SET used for identifying relevant complex contracts should be in place by 2018.

Key observations for short parties: Given that the short party is often the “determining party,” short parties will need to decide what it means for a trade to be delta-one. Short-party broker-dealers will still need to consider the anti-abuse provisions of the regulations and establish policies around any non-delta-one trade characteristics that may be deemed abusive (e.g., a call option with a 0.95 delta issued in 2017).

Key observation for long parties: While long parties generally may rely on short-party assessments of what trades are, or are not, in scope as delta-one for 2017, this reliance would be misplaced in the combined transaction space. The following is a summary of how the combined transaction rules will apply to long parties as well as short parties in 2017 and 2018.

Combination trade rules

There is significant transition relief provided for short-party broker-dealers in the combined transaction space in 2017. Unless these parties price, market or sell a combined trade with a delta of one in an over-the-counter (OTC) product in 2017, they will not be responsible for identifying potential Section 871(m) trades as in-scope, absent actual knowledge (e.g., because of long-party assertions that certain trades should be combined).

Key observation for short parties: As many long parties may not have the ability to withhold or self-assess timely, it is conceivable that short-party broker-dealers will receive information from long parties effectively requiring short parties to withhold on combined transactions in both the OTC and listed space in 2017. The combination relief provided to short parties in 2017 does not extend to 2018, for which the Notice requires short-party broker-dealers to apply the presumption rules detailed in the Section 871(m) Regulations to all potentially combinable transactions issued in 2018 and onward that reach a combined delta of at least 0.8.
Key observation for long parties: The explicit lack of any relief provided to long parties in this area will require them to assess whether any trading strategies they employ in the listed option space, as well as in OTC transactions, reach delta-one (e.g., a long call purchased at-the-money with a 0.5 delta combined with a short put written at-the-money with a 0.5 delta over the same underlying security). If such combined transactions approach, but do not reach, delta-one, they need not be brought into scope until 2018, assuming that taxpayers are not purposely converting delta-one trades to trades that are slightly under the delta-one threshold. Long parties should complete status quo assessments now to establish a baseline expectation of what trades may be in scope entering into 2017.

QDD tax liability computation
The Notice retains the QDD tax liability but revises the calculation to apply only when the QDD has a positive net delta exposure to an underlying security. According to the Notice, a QDD's tax liability, specifically its “Section 871(m) amount,” will be determined by calculating the net delta exposure to an underlying security (measured in number of shares) of the QDD, multiplied by the relevant dividend amount per share. The Notice further provides that a QDD will no longer be exempt from withholding under chapters 3 and 4 on actual dividend payments it receives and instead the withholding exemption will apply only to dividend equivalent payments. But the QDD may claim a credit for the withholding tax paid on any dividend payments received on the same underlying security5 to reduce (but not below zero) its “Section 871(m) amount.”

Key observations for short parties: If a QDD is perfectly hedged it will not have a “Section 871(m) amount” but only to the extent the QDD hedges with derivatives transactions and not the physical security. As withholding on actual US-source dividends has been in place for many years, such adjustment should not present many operational difficulties in theory but for the fact that the change was announced very late in the year, requiring systems logic to be rewritten and re-tested under a tight timeframe.

Delayed sun-setting of QSL regime
The Notice provides some partial relief to QSLs and those relying on the credit forward system of Notice 2010-46 by extending reliance on Notice 2010-46 through the end of 2017. However, the Notice also confirms that the QSL regime and the credit forward system will end on 31 December 2017, and confirms that QSLs will need to become QDDs beginning 1 January 2018, to be exempt from withholding on substitute dividend payments.

Key observations for short parties: Those currently facing QSLs need not collect new Forms W-8 from them for trading in 2017 to the extent that the short parties have a valid form on file.

Application for QDD status
The Notice provides that an entity intending to submit the application for QDD status on or before 31 March 2017, may represent QDD status on a Form W-8IMY until the end of the sixth full month after the month in which it actually submits the application, provided that the application is submitted by 31 March 2017.

The Notice also provides that the Form W-8IMY should include an “awaiting QI-EIN” statement on its face. Although unclear, it is anticipated that an entity would state “awaiting QI-EIN” only if it is not already a QI. The Notice also provides that a withholding agent may rely on the “awaiting QI-EIN” for six months after receipt. In such cases, the applicant must provide its QI-EIN, in any manner, to its withholding agent as soon as practicable after the QDD receives its QI-EIN. If an entity is denied QDD status or later decides not to apply for QDD status, it must immediately inform the withholding agent.

Key observations for short parties: Short parties will be faced with entering into contracts lasting longer than six months and not knowing whether they can rely on the representation of their counterparties’ QDD status for the life of their contracts. The Notice does not require that the short party retroactively apply withholding if an entity does not obtain QDD status, but the short party/withholding agent will have to identify the entity on an attachment to Form 1042.

Remitting and withholding
For calendar year 2017, the Notice provides that withholding agents may remit amounts withheld for dividend equivalent payments quarterly. Deposits made by the last day of the calendar quarter will be considered timely and thus not subject to interest or penalties for failure to timely deposit. The withholding agent using this deposit schedule must write “Notice 2016-76” on the center, top portion of the tax year 2017 Form 1042 tax return.
Further, in response to taxpayer requests and uncertainty on the application of Treas. Reg. Section 1.1461-2(b), the Notice provides that a withholding agent will not be subject to penalties for failure to deposit withholding tax as long as remittance is made by 15 March of the year following the calendar year in which the withholding agent failed to withhold. This clarification dispels an interpretation that some withholding must have occurred for the penalty relief.

Under the Notice, the IRS will also allow a QDD that did not have a QI-EIN prior to 1 January 2017, or the effective date of its QDD status to deposit withheld amounts the QDD must deposit within three days of receiving its QI-EIN without penalty. Similarly, if a QDD enrolls in the Electronic Federal Tax Payment Systems (EFTPS) within 30 days of receiving a QI-EIN, the IRS will also not assess failure-to-deposit penalties for withheld amounts, provided such amounts are deposited within three days of the QDD being enrolled in EFTPS.

Key observations for short parties: Existing QIs with EINs will need to submit and pay their QDD tax liability even if they have not yet been approved for QDD status. Unfortunately, it does not appear that interest will be waived for a QDD unable to make deposits due to an IRS failure to timely provide a process for obtaining an EIN.

Exchange Traded Notes (ETNs)
The Notice provides grandfathering status to certain ETNs that, absent this explicit exception, may have been in scope beginning 1 January 2017.

Taxpayers’ principal concern with notes traded on exchanges is additional issuances of the identical note by the issuer and the inability to track when a particular note was issued. Recognizing that it would be disruptive to the market to have a note that is essentially the same treated as out-of-scope in some taxpayers’ hands and in-scope for others, the IRS specified in the Notice certain designated ETNs as out-of-scope until 1 January 2020, regardless of later issuances.

Key observations for short parties: Short issuers of delta-one ETNs that are not specified but that were originally sold prior to 2017 may only receive comparable treatment by pursuing a private letter ruling or awaiting further potentially favorable guidance from the IRS. Such approaches may be time-consuming, costly or both. In the interim, withholding on dividend equivalent amounts would appear to be required.

Key observations for long parties: Long parties may continue to invest in the list of explicitly specified ETNs in the Notice until they are unwound or 2020 arrives, whichever occurs first. Non-specified delta-one ETNs will present a less desirable investment alternative.

“Good faith” efforts
Similar to the standards applicable when FATCA was introduced and the original Section 1441 Regulations were released, the Notice provides that the IRS will consider the “good faith” efforts by taxpayers and withholding agents to comply with the requirements of Section 871(m). Although that type of exception is welcome, the Notice does not define the good faith standard, which could result in inconsistent application on examination.

Taxpayers should take steps now to establish and document the organization-wide efforts they have made to implement the Section 871(m) Regulations. The Notice lists factors (primarily aimed at short-party broker-dealers) to determine good faith: what the withholding agent did to: (1) build or update its documentation and withholding systems; (2) determine whether transactions are combined transactions (taking into account the simplified standard for 2017); (3) report information to other parties to a transaction; and (4) implement the SET for complex transactions in 2018. In short, the taxpayer should record what steps it took, when it took them, and the level of effort involved to build its compliance system in the hopes of qualifying for a good faith exception should that be necessary.

Key observations for long parties: A primary area of concern for long parties in demonstrating “good faith” will be the areas of the Regulations where they have the best access to knowledge, including identifying combined transactions as well as engaging in short trades against otherwise qualified indices. Even in 2017, when in-scope transactions will be limited, long parties will need to assess and document the extent to which any combined trades achieve delta-one exposure. Long parties also should assess and document the extent to which they offset or economically hedge long index trades, particularly when offsetting positions reflect more than 5% of the index. Parties entering short transactions facing non-US broker-dealers will need to be prepared to withhold, receive documentation establishing that no withholding is required (including QDD certifications), or make other arrangements to ensure withholding tax is paid.
Key items excluded from Notice 2016-76 for which guidance is still needed

There are many Section 871(m) implementation issues that were not addressed in the Notice. Some of these issues are described next.

**Covered partnership guidance**

Absent guidance, “determining” or “responsible parties” and other stakeholders are struggling to find a reasonable solution for potentially “covered partnerships.” A covered partnership is one that: (i) carries on a trade or business of dealing or trading in securities; (ii) holds significant investments in securities; or (iii) directly or indirectly holds an interest in a lower-tier partnership that is a covered partnership. To make the covered partnership determination and ascertain the amount of a partnership’s distribution that is a dividend, Treasury has publicly supported the concept of using the Schedule K-1 of the partnership. However, absent guidance further delaying when withholding is required for transactions referencing covered partnerships, the Schedule K-1 is not furnished in time for amounts to be withheld by 15 March.

**Shorting qualified indices**

Certain indices referencing broad-based exposure to US equities will be exempt from withholding if they are considered “qualified” unless subsequently disqualified on the basis of excessive shorting in the hands of a particular investor. The reasonable diligence standard requires short-party broker-dealers to apply some inquiry or analysis to this determination. However, the long party may not be willing to provide representations to the short party, and, perhaps most importantly, no “presumption rules” such as those applicable for combined transactions apply to assist short parties in this area. In the absence of rules that require long parties to be proactive in sharing information in this space, short parties may find it impossible to carry out diligence effectively in this area and be forced to withhold protectively.

**Working with nonqualified indices**

Indices that fail to reach “qualified” status at issuance generally will be subject to withholding based on constituent-level data. The potential burden associated with this general rule may be reduced if certain requirements are met that would enable an index-level view to apply instead. For example, using the dividend yield for publicly traded indices in lieu of tracking the dividends of every US equity component in an index is permissible. However, this yield may be excessive if there are non-US equities paying dividends included in the index. The appropriateness of making adjustments to the yield in such instances is not addressed. Whether a constituent-level view or index-level view is taken, implementation issues abound. More guidance is needed to give taxpayers a true path forward.

**Aligning payment dates for QDDs and US/non-QDD withholding agents**

US withholding agents and other non-QDDs serving as withholding agents face different timing rules for withholding than QDDs, with the former withholding as “payments” are made on their derivative contracts and the latter withholding as the underlying equity itself pays dividends. Implementing two different rule sets based on the withholding agent’s status creates operational difficulties.

**Eligible entities**

The “eligible entity” definition in Treas. Reg. Section 1.1441-1T(e)(6)(ii) does not include subsidiaries of regulated securities dealers and bank holding companies, which precludes many entities from becoming QDDs even though they will have signed a QI agreement affirming their willingness to comply with the obligations of a QDD. The IRS has made public statements that the verbiage in the QI Agreement providing that a QI must act as a QDD for all payments with respect to potential Section 871(m) transactions and underlying securities means that QDD status applies at an entity level and not at a branch level. However, the IRS also stated that it would consider whether a branch-level election could be provided.

**Treaty issues for QDDs**

Many QDDs operate in jurisdictions with which the US has negotiated income tax treaties. While source countries are generally afforded the right to determine how to characterize income for purposes of applying the appropriate treaty article, certain key treaty partners believe the US has misinterpreted what may be treated as dividends under their respective treaties. Accordingly, these jurisdictions have stated that they technically will not be able to grant foreign tax credits where QDDs voluntarily pay US tax based on QI agreements that they execute with the US.
Endnotes

1. All “Section” references are to the Internal Revenue Code of 1986, as amended (the Code). The regulations published under the Code are referred to as the “Regulations.”

2. The withholding on NPCs and ELIs is in addition to the withholding already applicable to the dividend equivalents in securities lending and sale-repurchase transactions under Section 871(m).

3. For additional background on the guidance in Notice 2016-42 on the requirements to become a QDD, see EY Global Tax Alert, US IRS releases proposed Qualified Intermediary Agreement, dated 7 July 2016.

4. A zero-strike call option is a call option in which the strike price is set at zero. A non-marketable asset typically underlies this option. The buyer of the option will have full participation in the underlying price in an indirect or derivative way. If the underlying asset increases in value, the buyer receives the appreciation value.

5. This methodology is similar to QSL regime, which did not exempt QSLs from withholding on dividend payments but allowed a credit forward system to offset the withholding tax due for any offsetting substitute dividend payment with respect to the same security.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, International Tax Services – Capital Markets Tax Practice**
- Alan Munro, Washington, DC  +1 202 327 7773  alan.munro@ey.com
- Matthew Stevens, Washington, DC  +1 202 327 6846  matthew.stevens@ey.com

**Ernst & Young LLP, International Tax Services**
- Lauren Lovelace, New York  +1 212 773 8790  lauren.lovelace@ey.com

**Ernst & Young LLP, Information Reporting & Withholding**
- Justin O’Brien, New York  +1 212 773 4767  justin.obrien@ey.com
- Maria Murphy, Washington, DC  +1 202 327 6059  maria.murphy@ey.com
- Tara Ferris, New York  +1 212 360 9597  tara.ferris@ey.com

**Ernst & Young LLP, Wealth and Asset Management**
- Jun Li, New York  +1 212 773 6522  jun.li@ey.com

**Ernst & Young LLP, Banking and Capital Markets**
- Sean Conroy, New York  +1 212 773 3238  sean.conroy@ey.com

---

**International Tax Services**

Global ITS, Alex Postma, Tokyo

ITS Director, Americas, Jeffrey Michalak, Detroit

ITS Markets Leader, Americas, Stephen O’Neil, New York

Ernst & Young LLP, National Director of ITS Technical Services, Jose Murillo, Washington

**ITS Regional Contacts, Ernst & Young LLP (US)**

Northeast
Johnny Lindroos, McLean, VA

Financial Services
Chris J Housman, New York

Central
Mark Mukhtar, Detroit

Southeast
Scott Shell, Charlotte, NC

Southwest
Amy Ritchie, Austin

West
Beth Carr, San Jose, CA

Canada - Ernst & Young LLP (Canada)
Albert Anelli, Montreal
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.
For more information about our organization, please visit ey.com.

About Ernst & Young's International Tax Services practices
Our dedicated international tax professionals assist our clients with their cross-border tax structuring, planning, reporting and risk management. We work with you to build proactive and truly integrated global tax strategies that address the tax risks of today’s businesses and achieve sustainable growth. It's how Ernst & Young makes a difference.

International Tax Services

© 2016 EYGM Limited.
All Rights Reserved.
EYG no. 04310-161US
1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com