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# IRS Updates Transitional Guidance for Section 871(m) Tax Compliance

August 14, 2017

## Executive Summary

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On August 4, 2017, the IRS issued a notice providing an extension of certain transitional rules relating to the application of the section 871(m) tax regulations. These regulations impose U.S. withholding tax on a potentially broad array of derivative products that reference U.S. equity underliers. The new Notice 2017-42 recognizes that industry participants are still in the process of developing and testing systems to manage the screening, withholding calculations and reporting required under these regulations and extends certain transitional relief announced last year in Notice 2016-76 and as confirmed in regulatory updates issued in January 2017. Specifically, Notice 2017-42 provides the following relief:

## Analysis

1. **Non-Delta-One Products Out of Scope until 2019.** In order to allow industry participants more time to develop and test systems for non-delta-one products (derivatives that generally do not track underliers one-for-one), the Notice provides that the current grace period for non-delta-one products would be extended one year through 2018. Thus, non-delta-one derivatives (including complex contracts) are generally exempt from section 871(m) if issued prior to January 1, 2019.

***CTI Observations:*** *Delta-One products remain in scope. Note that certain products may have deltas at issuance that vary unpredictably depending on market conditions. For example, deltas for listed options may change depending on the contract's strike price vs. the price of the underlying stock and time to expiration. Taxpayers and withholding agents would still need to screen such contracts to determine if they have a delta of one and therefore would be in scope even during the transitional 2017 and 2018 years. More, integrating systems and mapping existing data feeds, whether for delta-one or non-delta-one products, to a section 871(m) logic engine and validation testing will take time, and financial institutions should consider such integration and testing early during this grace period for non-delta-one products.*

2. **Combined Transactions.** The new Notice also extends the simplified standard set forth in Notice 2016-76 in regards to combined transactions for one additional year. For 2018, as for 2017, withholding agents will only need to combine transactions for purposes of determining whether they are section 871(m) transactions if the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. There is no need to combine listed securities during this period.

***CTI Observations:*** *This extends the current standard that withholding agents need only to account for combined transactions that are OTC and priced, marketed or sold together. Note that this standard does NOT apply to long parties to the transaction such as a hedge fund taking positions in multiple derivatives. While the grace period has been extended, no further guidance was provided as to what the standards will be for evaluating combined transactions in the future. This will continue to be a difficult area to operationalize without additional IRS guidance.*

3. **Relief for Qualified Derivatives Dealers.** Notice 2017-42 extends the exemption for withholding on dividends paid to QDD's for one additional year (thus through 2018), and a QDD will not be subject to tax on dividends and dividend equivalents received in both 2017 and 2018 in its equity derivatives dealer capacity. QDD's will be required to use the net delta approach for calculating its section 871(m) amount (for the QDD's own tax liability) beginning in 2019 (instead of 2018). The QDD is also not required to conduct periodic review of its QDD activities for calendar years 2017 and 2018.

***CTI Observations:*** *There is no mention of the Qualified Securities Lender (QSL) regime in the Notice. This should mean that QSL status for financial institutions should expire as of December 31, 2017 and financial institutions that are QSLs may need to transition to QDD status prior to January 1, 2018. As part of this transition, a financial institution should consider the current withholding requirements that apply to QDD's; they need to withhold on dividend equivalent payments that they make to non-U.S. payees. In addition, they should consider the future obligations that apply to QDD's once the transitional grace period expires and begin integrating processes and systems that will allow them to determine their own section 871(m) tax liability. Note also that QDD's are not exempt from tax on dividends and dividend equivalents received in a non-dealer capacity and remain subject to withholding on other types of U.S. source income unless other exceptions apply.*

IHS Markit continues to work with its clients on addressing compliance obligations under section 871(m) through consulting and a section 871(m) compliance tool developed with industry partners. The experience from working with financial institutions on integrating the compliance tool with client data feeds and mapping appropriate feeds to a new section 871(m) process is that such integration requires time. The additional grace period provided by Notice 2017-42 will hopefully provide much-needed time for systems integration and testing. While a one-year extension for non-delta-one products may seem to be a long time, section 871(m) affects a wide spectrum of products that may be traded utilizing different information platforms and the mapping of each product to an integrated section 871(m) compliance process will need to account for added time for cross-functional discussions both within an institution and with vendors.

**More information about the Section 871(m) Compliance Tool from CTI Tax Solutions by IHS Markit may be found here:**

**<http://www.markit.com/Product/Tax-Solutions-Section-871>**