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IRS Issues Transitional Guidance for Section 871(m) Phase-In

December 5, 2016

Executive Summary

On Friday, December 2, 2016, the U.S. Internal Revenue Service issued Notice 2016-76, providing long awaited guidance regarding the "phased-in" application of the Section 871(m) regulations (the tax regulations that would impose U.S. withholding tax on certain dividend equivalent payments made on equity swaps and other equity-linked derivatives). The notice was issued following industry concerns that systems and process upgrades necessary to comply with many aspects of the new Section 871(m) regulations would be difficult to achieve by the stated applicability date of January 1, 2017.

Consistent with prior IRS comments, these transitional rules retain a January 1, 2017 effective date for Section 871(m) derivative products that have a delta of one ("delta-one products"). The notice defers the effective date to January 1, 2018 for products that are not delta-one products, which would include lower-delta transactions as well as complex contracts that are not classified by delta. These transition rules also provide a simplified standard for withholding agents required to identify transactions that are to be combined for Section 871(m) classification purposes (though this relief is not extended to long parties, such as hedge funds holding long derivative positions).

Notice 2016-76 specifies changes and provides additional guidance relating to the Qualified Derivative Dealer (QDD) regime. Of note, payments of actual dividends, not dividend equivalents to a QDD, will now be subject to withholding. For purposes of determining the QDD's Section 871(m) amount, a component of a QDD's tax liability, the IRS appears to have adopted a SIFMA proposal to calculate this amount based on the QDD's net delta exposure to a particular underlying stock in lieu of the formula set forth in the proposed Qualified Intermediary (QI) Agreement issued earlier this year.

Significant to non-U.S. financial institutions engaged in securities lending and repo transactions, the transition notice indicates that Notice 2010-46, effectively the Qualified Securities Lender (QSL) regime, may continue to be relied upon by taxpayers until the end of 2017. Previously, the expectation was that the QSL regime would be obsolete once the QDD regime begins as of January 1, 2017.

Notwithstanding the relief provided by the notice, the guidance provided generally means that industry participants will have to continue to complete systems upgrades to account for Section 871(m) screening and withholding by January 1, 2017. In part, even though the delta threshold for Section 871(m) eligibility has moved from 0.8 to 1.0, the fact will remain that for products with variable delta, screening must still be performed to determine if a particular contract is delta one. Moreover, for delta-one products, the calculation of the Dividend Equivalent Amount (DEA) must still be made and appropriate withholding determined.

A summary of the specific changes and their implications are provided below.

Analysis

1. **Only Delta-One Products in Scope for 2017.** For transactions entered into in 2017, only delta-one products are in scope.

Implications: Products that have variable delta e.g. listed options that sometimes (even though not often) can reach a delta of one will still need to be screened for eligibility. Lower-delta contracts and complex contracts, which presumably would be contracts that do not have a delta of one are out of scope.

2. **Non-Delta-One Products in Scope Beginning 2018.** For transactions entered into beginning 2018, contracts that are not delta-one contracts will also be in scope for Section 871(m) eligibility.

Implications: Products will need to be screened for Section 871(m) eligibility based on a 0.8 delta threshold, instead of 1.0 delta, and thus more contracts would likely be impacted for potential withholding and reporting. Complex contracts will become in scope, meaning that a process needs to be in place for substantial equivalence testing for Section 871(m) eligibility.

3. **Enforcement Relief for Good Faith Efforts.** For phase-in years 2017 and 2018, the IRS will take into account good faith efforts by the taxpayer to comply with requirements applicable to those years for enforcement purposes e.g. penalty assessments. Good faith efforts include effort to: build or update documentation and withholding systems, determine whether transactions need to be combined, effect required reporting and, for 2018, implement substantial equivalence testing for complex contracts.

Implications: Having a process or system in place, even though imperfect, may serve as an argument against penalties in the event of an audit. There should be a trail of efforts taken e.g. in-house analysis and internal builds, discussions and development with outside vendors, etc. to comply with Section 871(m) requirements.

4. **Simplified Combined Transaction Standard in 2017 for Withholding Agents.** For transactions entered into in 2017, a withholding agent is required to combine transactions for Section 871(m) screening only when the transactions are over-the-counter i.e. not listed securities and the transactions are priced, marketed and sold with each other.

Implications: For withholding agents, this rule simplifies combined transaction analysis somewhat for 2017. Note, however, that this transitional rule does not apply to the long party e.g. hedge fund holding a long position). For the long party, analysis still needs to be made as to whether two or more transactions have been entered into in connection with each other and whether if combined the transactions would result in a Section 871(m) transaction. For the long party, this analysis would extend beyond over the counter transactions.

5. **Quarterly Deposits of Section 871(m) Taxes.** For 2017, the IRS will allow withholding agents to deposit taxes withheld on dividend equivalent amounts on or before the last day of the calendar quarter in which the taxes are withheld.

Implications: Theoretically, if there are issues with withholding systems as of January 1, 2017 that might be fixed during the first quarter, this quarterly deposit rule may provide a bit of additional leeway for a late correction or enhancement to the withholding process.

6. **QDD Guidance Updated.** There are quite a few changes and updates to the QDD regime. Some of the changes raises additional questions answers to which may need to wait until the final QI Agreement is issued (expected before the end of 2016).

(i) Withholding agents may continue to rely on Notice 2010-46 during 2017.

This indicates that the QSL regime may continue in effect in 2017. Withholding agent systems that have coded to exclude QSL's in 2017 will now need to be updated to accommodate QSL's.

(ii) Notice 2016-76 states that a QDD is NOT exempt from withholding on dividends and deemed dividends (actual dividends) paid to the QDD.

This raises questions where the QDD is hedging its short exposure via a direct share purchase rather than another derivative transaction subject to Section 871(m). Seemingly, this could result in cascading withholding tax if a QDD hedges by purchasing direct shares.

(iii) The IRS seems to have adopted the SIFMA recommendation that QDD tax liability on what was known as the "Section 871(m) amount" be based on a net delta approach.

Previously, the QDD tax liability was based, at least in part, on the excess of dividends and dividend equivalents received by the QDD as broker dealer over the dividend equivalent amounts and other qualified offsets paid by the QDD. Industry participants argued that this prior approach often resulted in imperfect offsets, especially when one leg of the trade is conducted via an exempt transaction e.g. low delta or qualified index. The net delta approach instead would allow the QDD to determine its Section 871(m) amount by calculating the net delta exposure (measured in number of shares) of the QDD on the date the dividend equivalent is determined, multiplied by the relevant dividend amount per share. A QDD's net delta exposure is determined by aggregating the delta of all physical positions and potential 871(m) transactions with respect to an underlying U.S. security entered into by the QDD in its equity derivatives dealer capacity.

Implications: The new net delta approach may rely on non-tax determinations of a QDD's net delta position that may exist already in risk management processes at the QDD. This addresses some of the "gaps" presented by the prior formula

for determining the Section 871(m) amount and, moreover, may allow the tax determination to leverage off existing business functionality. It may be worth reviewing the final QI agreement to better evaluate how this rule now works in light of the fact that a QDD would be withheld upon with respect to actual dividends on physical positions.

(iv) A financial institution can certify to QDD status on a Form W-8IMY prior to submitting a QI-QDD application or prior to having received approval.

Prior to receiving approval and a QI-EIN, a QDD may write in "Awaiting QI-EIN" on the Form W-8IMY and simply forward the QI-EIN once received. A withholding agent may generally continue to treat the Form W-8IMY with this notation as valid until 6 months after receipt. Due diligence systems will need to be coded for this new case scenario.

(v) The transition notice provides rules on when the new QI agreement would be effective - generally January 1, 2017 if application is made prior to March 31, 2017.

(vi) The IRS will look at good faith efforts by a QDD to comply with QDD obligations for enforcement activity relating to 2017.

(vii) A QDD generally can hold off on depositing withheld taxes until the receipt of its QI-EIN.

7. **Specified List of Pre-Existing ETNs will be Exempt.** The IRS is allowing certain exchange traded notes (ETNs) issued prior to the publication of the 2015 final Section 871(m) regulations and that have been in continuous distribution i.e. new securities are created using same symbol under the same offering documents as to be fungible with previously issued securities to be exempt until January 1, 2020. This transition rule essentially allows these securities to continue to be fungible, with a more extended wind-down period. The IRS provides a list of these exempt securities, together with their CUSIPs.

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IHS Markit has developed, in consultation with its financial institutional clients, solutions to address Section 871(m) compliance obligations both for front office trading desks and back office tax and operations teams. Please let us know if you wish to discuss your Section 871(m) concerns and how IHS Markit can assist with your compliance goals.

Impact to Existing CTI Tax Tools: For existing users of CTI Tax Solutions applications, the transition notice will require some changes to several of our existing tools.

MD³: In part, we expect to update MD³ logic to accommodate Form W-8IMY's where a QDD has not obtained a QI-EIN and writes in "Awaiting QI-EIN". We plan also to update the logic to continue to allow QSL designations for a Form W-8IMY post-1/1/17.

Withholding Module: In terms of the withholding module, a QDD was expected to be exempt from both actual dividends as well as dividend equivalents from Section 871(m) transactions. As QDD's would appear now to be subject to withholding tax on actual dividends, the withholding logic would need to be changed.

871(m) Tool: We expect few changes for the initial release of the Section 871(m) tool, except to move the eligibility criteria for a Section 871(m) transaction to a delta of 1.0 instead of 0.8, but the logic for the additional QDD functionality scheduled for next year will need to be reworked based on the new guidance and the final QI agreement to be released at the end of this year. Moreover, we are considering adding as a future enhancement functionality to screen as exempt ETNs that appear on the new IRS exempt ETN list.