

Client Alert

Phase in and Modification of the Section 871(m) Rules

December 05, 2016

Summary

On December 2, 2016, the US Internal Revenue Service (the "IRS") issued Notice 2016-76 (the "Notice"), announcing that the Treasury and the IRS will phase in the application of certain of the section 871(m) rules in 2017 and 2018 in order to facilitate the implementation of section 871(m).¹ Specifically, the Notice provides that for 2017 section 871(m) will apply only to newly issued delta-one instruments (instruments whose changes in value correlate on a one-to-one basis with changes in the value of an underlying US security) and that administration and enforcement of the rules, including penalty assessments, will take account of "good faith" efforts made by withholding agents.² Non-delta-one transactions will first become subject to section 871(m) in 2018 and the IRS also will apply the same good faith standard to withholding agents for that year. These delays provide some relief for issuers, dealers, investors, and financial intermediaries that are still struggling to meet the technical and logistical requirements of determining whether an instrument is subject to section 871(m) and, if applicable, the related withholding and reporting. The IRS also announced that in combining transactions for purposes of determining whether the transactions in the aggregate constitute a section 871(m) transaction, a withholding agent (but not a long party) will only be required to combine transactions entered into in 2017 if the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other.

The Notice provides certain relief for qualified derivative dealers (each, a "QDD") by using a QDD's "net delta exposure" with respect to an underlying equity to determine tax liability and, for 2017, taking account of good faith efforts to comply with the QDD requirements of a qualified intermediary agreement (a "QI agreement" and the entity entering into such an agreement, a "QI") when enforcing those provisions.

The Notice also exempts, until 2020, certain exchange traded notes that are delta-one instruments (so as not to negatively affect their liquidity and fungibility while issuers work to unwind those notes). The Notice indicates that the Treasury intends to make amendments to the final and temporary regulations to reflect these changes. Finally, the Notice provides that during

¹ References to sections are to sections of the Internal Revenue Code of 1986.

² Transactions that were subject to section 871(m) prior to January 1, 2017 will continue to be subject to those rules.

2017 taxpayers may continue to rely on Notice 2010-46, but that such Notice will be obsolete as of January 1, 2018.³

Background

Very generally, section 871(m) treats certain payments on an instrument that directly or indirectly references US-source dividends as "dividend equivalent payments" that are subject to US withholding tax. Prior to the enactment of section 871(m), the United States generally did not impose withholding tax on dividend equivalent payments on derivative instruments such as equity swaps and structured products. Withholding tax is generally levied only on US-source income and prior to section 871(m), dividend equivalent payments on derivatives generally were sourced outside the United States when paid to non-US persons.

Non-Delta-One Instruments Not Subject to Section 871(m) Until 2018

The Notice states that the Treasury Department and the IRS have determined that taxpayers and withholding agents need additional time to implement the section 871(m) regulations. Thus, for transactions entered into in 2017, only transactions with a delta of one (taking account of the combined transaction rule) will be subject to section 871(m), and withholding agents will be given some latitude in their compliance with the regulations. As discussed below, this means that only newly issued "simple" (and not "complex") contracts will potentially be subject to section 871(m) during 2017. The section 871(m) rules will apply to non-delta-one transactions, including complex contracts, beginning in 2018.⁴

Prior to the Notice, an equity-linked instrument (which term is defined very broadly to include any financial instrument that references the value of one or more underlying securities) was subject to section 871(m) as of January 1, 2017 if it had a delta of 0.80 or greater (in the case of a "simple" contract) or if it met the "substantial equivalence" test (in the case of a "complex" contract). Contracts with indeterminate deltas are classified as complex contracts.

A simple contract is a contract that references a fixed number of shares of the underlying security and has a single maturity or exercise date with respect to which all amounts (other than upfront or periodic payments) due under the contract are required to be calculated.⁵ Delta means the

³ Notice 2010-46 provides that (i) a non-US financial institution that is a qualified securities lender (a "QSL") that receives a substitute dividend payment and is obligated to make an offsetting substitute dividend payment with respect to identical securities is not subject to withholding on the substitute dividend payments it receives, provided it withholds and reports on the substitute dividend payments it makes and (ii) withholding agents are permitted, under a so-called "credit forward system" to reduce withholding on a substitute dividend payment by an amount that has been previously withheld, but only to the extent there is sufficient evidence that the tax was actually withheld. With the phase-out of the QSL program and the credit forward system, US-source substitute dividend payments that are not made to an eligible QDD after 2017 may, absent new regulations, be subject to withholding tax multiple times as payments are made through a chain of transactions to non-US persons.

⁴ The IRS has not defined the term delta-one, but any attempt to get the benefit of the delayed effective date for an instrument that has a delta of close to, but not exactly, one, may be treated as having a delta of one under the anti-abuse rule of Treasury Regulation § 1.871(m)-15(o).

⁵ The reference to a single maturity or exercise date does not require that the single exercise date be on a specified date. The preamble to the section 871(m) regulations provides that the "fact that a contract has more than one expiry,

ratio of the change in fair market value of the contract relative to a small change in the fair market value of the referenced property.

A complex contract, any contract that is not a simple contract, is tested under the more involved "substantial equivalence test," which broadly attempts to compare the extent to which a contract tracks the value (at various testing prices) of its underlying hedge with how a simple contract benchmark tracks the value of its initial hedge.⁶

The delay in effective dates for non-delta-one instruments means that instruments that qualify as complex contracts are not subject to section 871(m) until 2018. As a practical matter, many structured products have a delta of one, which would subject them to section 871(m) if issued in 2017 and reference US securities.

As indicated above, the Notice also provides that during the 2017-2018 phase-in period, the IRS will offer limited relief to withholding agents that make good faith efforts to comply with the section 871(m) regulations and the Notice.

Simplified Combination Rule for 2017

Under a simplified combination rule, a withholding agent will be required during 2017 to combine transactions for purposes of determining whether they are subject to section 871(m) only when the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Withholding agents will not be required to combine any transactions that are listed securities if they are entered into in 2017. This simplified standard only applies to withholding agents, and does not apply to taxpayers that are long parties to transactions potentially subject to section 871(m).⁷ Transactions that are entered into in 2017 that are combined under this simplified standard will continue to be treated as combined 871(m) transactions in future years even if a portion of the combined transactions are disposed of. In addition, transactions entered into in 2017 that are not combined under this simplified standard will not (with respect to withholding agents) become combined transactions as a result of applying the broader combination rule that will apply starting in 2018.⁸

or a continuous expiry, does not preclude the contract from being a simple contract. Thus, an American-style option is a simple contract even though the option may be exercised by the holder at any time on or before the expiration of the option if amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date. Most [notional principal contracts] and [equity-linked instruments] are expected to be simple contracts and remain subject to the delta test described above."

⁶ A complex contract is a section 871(m) transaction with respect to an underlying security, if, for that underlying security, the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change in value of the simple contract benchmark and its initial hedge.

⁷ Although this alleviates some burden on withholding agents, investors may be required to combine transactions under the non-transitional rule and, thus, require dealers or other short counterparties to calculate and furnish them section 871(m) information.

⁸ The general rule that will apply after 2017 provides that two or more transactions are treated as a single transaction when (1) a long party (or a related person) enters into multiple transactions that reference the same underlying security, (2) the combined potential section 871(m) transactions replicate the economics of a transaction that would be a section 871(m) transaction, and (3) the transactions were entered into in connection with each other. A broker acting as a short party may presume (absent actual knowledge to the contrary) that transactions are not entered into

Qualified Derivative Dealers

Prior Notice 2016-42 proposed new provisions to the QI agreement that would permit an eligible entity to act as a QDD.⁹ Under that notice, withholding agents were not required to withhold on payments made to a QDD acting as a principal (and not as an intermediary) with respect to (i) potential section 871(m) transactions and (ii) underlying securities, in each case, if the QDD provided a valid withholding certificate to the withholding agent.¹⁰ However, the QDD would, among other things, have to agree to (i) assume primary withholding responsibility for all payments made with respect to potential 871(m) transactions as a principal and (ii) remain liable for tax on any dividend or dividend equivalent payments it receives in its dealer capacity to the extent that the offsetting dividend equivalent payment on an underlying security the QDD is contractually obligated to make is less than the dividend and dividend equivalent amount the QDD received.

In addition, under Notice 2016-42 a QDD (other than a foreign branch of a U.S. financial institution), had to determine and pay its section 871(m) amount, which in very general terms, was the excess (if any) of (x) the dividend equivalent payments and dividends on underlying securities related to potential section 871(m) transactions over (y) the dividend equivalent payments and "qualifying dividend equivalent offsetting payments" that the QDD was obligated to make with respect to the same underlying dividend.¹¹ However, qualifying dividend equivalent offsetting payments did not include payments on hedges if such payments did not actually constitute a dividend equivalent payment (e.g. because the delta on a simple contract hedge was less than 0.8 upon issuance). This definition effectively prevented the QDD from netting some dividend type payments to customers even though those payments were hedging its dealer positions.

Notice 2016-76 addressed this concern by having QDDs utilize a net delta methodology in determining what payments can offset the dividend equivalent payments and dividends on underlying securities received by the QDD in its dealer capacity. If a QDD calculates its net delta for non-tax purposes, that calculation will ordinarily be the delta used for this purpose. However, the Notice also announced that the Treasury would revise the section 871(m) regulations to require withholding on actual dividends paid to a QDD (these were exempt under Notice 2016-42 as well). Although a QDD's tax liability on the section 871 amount associated with an underlying security will

in connection with each other if (1) the long party holds or reflects the transactions in separate accounts (unless the broker has actual knowledge that the separate accounts were created or used to avoid section 871(m)) or (2) the transactions are entered into two or more business days apart.

⁹ In general terms, an eligible entity is (i) a regulated dealer in securities or (ii) a regulated bank (or wholly owned entity of such a bank) that issues potential section 871(m) transactions to customers and receives dividends or dividend equivalent payments pursuant to potential section 871(m) transactions to hedge those transactions issued to customers, including in each case a foreign branch of a U.S. financial institution that otherwise meets the requirements of an eligible entity.

¹⁰ A potential section 871(m) transaction is any securities lending or sale-repurchase transaction, notional principal contract or equity-linked instrument that references one or more underlying securities. An underlying security is any interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend (with special rules applicable to instruments that reference interests in partnerships).

¹¹ A "qualifying dividend equivalent offsetting payment" is in general (a) any payment made or contractually obligated to be made to a United States person that would be a dividend equivalent payment if made to a person who was not a United States person and (b) any payment made to a foreign person that would be a dividend equivalent payment if the payment were not treated as income effectively connected with the conduct of a U.S. trade or business.

be reduced by the amount of tax paid by the QDD in its capacity as an equity derivatives dealer under section 881(a)(1) on the receipt of the same dividend payment on that same underlying security, such reduction will not be below zero. Consequently, a QDD that hedges its obligation to make dividend equivalent payments with the purchase of actual dividend paying stock (as opposed to with a hedge, such as a total return swap, on which it receives a dividend equivalent payment) will be subject to tax on the actual dividend received without obtaining a corresponding deduction for the dividend equivalent payment it makes to its customer. This is a material change from the section 871(m) regulations and will effectively compel dealers to hedge their exposure via a derivative (as opposed to with physical stock). Interestingly, the reason for this change was neither highlighted in the summary, nor explained in the main body, of the Notice, but its intent was orally confirmed by IRS personnel.

The Notice adopts 2017 as a phase-in year for QDDs, and provides that the QI agreement will provide that a QDD will be considered to satisfy the obligations that apply specifically to a QDD under the QI agreement for 2017, provided that the QDD makes a good faith effort to comply with the relevant terms of the QI agreement. Further, the Notice adopts certain transitional provisions that, among other things, permit (i) an eligible entity to receive QDD status retroactive to January 1, 2017 if it applies for such status on or prior to March 31, 2017, (ii) an applicant for QDD status to 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 submits its QI application requesting QDD status and (iii) a QDD to deposit withheld amounts (that it was otherwise required to deposit) within three days after it receives its QI-EIN. QDDs will also be permitted to indicate its status as "awaiting QI-EIN" on a W-8IMY and withholding agents will be able to rely on the statement as provided in the Notice.

Further Information

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