

CLIENT MEMORANDUM

IRS Notice 2016-76 on Phase-In Periods for Section 871(m) Dividend Equivalent Regulations and Qualified Derivatives Dealer Rules

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AUTHOR

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On December 2, 2016, the Internal Revenue Service issued Notice 2016-76¹ detailing the timelines for the phase-in of certain regulations and other guidance under section 871(m) of the Internal Revenue Code on dividend equivalent payments and related withholding provisions including qualified derivatives dealer status. Since 2013, the U.S. Department of the Treasury and the IRS have issued a series of final, temporary and proposed regulations on dividend equivalent payments, as well as IRS Notice 2016-42 on qualified intermediary (“QI”) agreements. Notice 2016-76 provides further guidance as to the phase-in and effective dates for section 871(m) implementation.

For example, Notice 2016-76 provides that section 1.871-15(d)(2), (e) and (n) of the section 871(m) regulations will be effective as to specified notional principal contracts and equity-linked instruments with payments on potential section 871(m) delta-one transactions and “combined” transactions as defined therein beginning on January 1, 2017. A delta-one transaction is a transaction where the ratio of the change in the fair market value of a notional principal contract or an equity-linked instrument to a change in the fair market value of the number of shares of the underlying referenced security is equal to one.

¹ Notice 2016-76, 2016-51 IRB is available [here](#).

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Notice 2016-76 provides a simplified standard for withholding agents to determine whether transactions entered into in 2017 are to be “combined.” The section 871(m) regulations provide that two or more potential 871(m) transactions must be combined into a single section 871(m) transaction if: (1) a long party enters into multiple transactions based on the same security; (2) the economics of potentially combined transactions replicate the economics of a section 871(m) transaction; and (3) the parties entered into the transactions in connection with each other. A short broker without any actual knowledge to the contrary may presume that the transactions are not “in connection with each other” if the long party holds the transactions in separate accounts or the transactions were entered into two or more business days apart. Notice 2016-76 provides a simplified test whereby during 2017 a withholding agent need only combine over-the-counter transactions entered into during 2017 that are “priced, marketed, or sold in connection with each other.” This standard only applies to withholding agents; it does not apply to long taxpayers. Transactions that are combined under this modified standard will continue to be considered combined transactions moving forward, and transactions that are not combined under this modified standard will not be treated as combined in the future absent a reissuance or other event that would trigger a withholding agent to reevaluate the transactions.

When enforcing the regulations with respect to delta-one transactions during 2017, the IRS will consider a withholding agent’s good faith attempts to comply with the regulations by: (1) building and updating its documentation and withholding systems; (2) identifying combined transactions; and (3) reporting all required information. Quarterly deposits for amounts withheld during 2017 on dividend equivalent payments will be deemed timely deposited, and taxpayers may continue to rely on Notice 2010-46 until January 1, 2018.

Regulations section 1.871-15(d)(2), (e) and (n) will apply to any payment on non-delta-one potential section 871(m) transactions, including combined transactions, beginning on January 1, 2018. As above, when enforcing the regulations with respect to non-delta-one transactions during 2018, the IRS will consider a withholding agent’s good faith attempts to comply with the regulations and, in addition to the factors listed above, will consider an agent’s efforts to implement the substantial equivalence test. During 2018, taxpayers will not be able to rely on the quarterly deemed-timely provision or Notice 2010-46 (which will expire effective January 1, 2018).

Notice 2016-76 confirms that a withholding agent that underwithholds on a dividend equivalent payment to a foreign person is entitled to withhold on future payments to the foreign person or to use other property to satisfy withholding requirements. A withholding agent has until March 15 of the year after the year in which it underwithheld to satisfy withholding requirements using this method without penalty.

Notice 2016-76 provides several phase-in rules for the new regulations that apply to qualified derivatives dealers (“QDDs”). For example, QDDs will only be liable for tax on dividend equivalent payments it receives to the extent described in the Notice. Under Notice 2016-76, a QDD’s “section 871(m) amount” is the QDD’s “net delta exposure” multiplied by the dividend amount per share, with a QDD’s net delta exposure defined as the aggregate of all physical positions and potential section 871(m) transactions, as long as the QDD uses the net delta for non-tax business purposes as well. If a QDD pays tax on a dividend payment under section 881(a)(1), the QDD’s section 871(m) tax liability on the

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same underlying security is reduced (but not below zero) by any section 881(a)(1) tax paid. During 2017, the IRS will consider in enforcing and administering the applicable requirements a QDD's good faith attempts to comply with its QDD obligations.

Under previous IRS guidance, a non-U.S. financial institution (or other taxpayer) that applies for a new QI agreement on or before March 31 of any given year is treated as having an effective QI agreement beginning on January 1 of that year. Under Notice 2016-76, any new QI agreement application submitted after March 31 of a given year will be treated as effective on January 1 of that year only if no reportable payments have yet been received. If reportable payments have been received, the QI agreement is effective on the first day of the first month in which the application is complete and the taxpayer has received its QI-EIN. All QI agreement renewals submitted by March 31, 2017 are effective January 1, 2017.

A prospective QDD that submits its application for QDD status on or before March 31, 2017, or intends to submit its application by March 31, 2017, may represent to withholding agents that it became a QDD as of January 1, 2017, while its application is pending for six months from the date on which it submitted its application. A prospective QDD that withdraws its application, that fails to submit its application by March 31, 2017, or that has its application denied must immediately notify all withholding agents. A QDD must include its QI-EIN on all Form 8-IMYs it provides in its capacity as a QDD once its QDD application is approved, or indicate that it is "awaiting QI-EIN" on all Form 8-IMYs.

Notice 2016-76 also announced that Treasury regulations section 1.871-15(d)(2) and (e) regarding specified notional principal contracts and equity-linked instruments will not apply to 25 certain exchange-traded notes specifically listed by name until January 1, 2020 and that have been in continuous distribution since before a 2015 grandfathering date.

Notice 2016-76 does not apply to transactions under regulations section 1.871-15(d)(1). The anti-abuse rule contained in section 1.871-15(o) will apply during the entire phase-in period.

If you have any questions regarding this memorandum, please contact Joseph A. Riley (212-728-8715; jriley@willkie.com) or the Willkie attorney with whom you regularly work.

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