

## IRS Enforcement and Administration of Section 871(m) and Related Withholding Provisions During the Phase-In Period

Notice 2016-76

### I. PURPOSE

This notice provides taxpayers with guidance for complying with final and temporary regulations under sections 871(m), 1441, 1461, and 1473 of the Internal Revenue Code (the Code) (collectively, referred to as the section 871(m) regulations) in 2017 and 2018, and explains how the Internal Revenue Service (IRS) intends to administer those regulations in 2017 and 2018. Because amendments to the section 871(m) regulations are expected, the Treasury Department and the IRS have determined that it is appropriate to phase in the application of certain rules in the section 871(m) regulations to facilitate the implementation of those regulations. Comments have noted that taxpayers and withholding agents will face challenges complying with certain aspects of the section 871(m) regulations by their applicability date of January 1, 2017. Those challenges include designing, building, and testing new withholding and reporting infrastructure for dealers, issuers, and other withholding agents; implementing new system requirements for paying agents and clearing organizations; and enhancing and developing data sources for determining whether transactions are section 871(m)

transactions.<sup>1</sup> In addition, certain taxpayers may face additional challenges applying for status as a qualified derivatives dealer (QDD) under the Qualified Intermediary (QI) withholding agreement (QI agreement) and implementing the QDD regime in a timely manner. The Treasury Department and the IRS have determined that the phased-in application of certain rules as provided by this notice—in combination with the expected changes to the final and temporary regulations—will allow for the orderly implementation of the section 871(m) regulations.

As described in detail in section III of this notice, this notice provides as follows:

- For 2017,<sup>2</sup> the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations in enforcing the section 871(m) regulations for any delta-one transaction;
- For 2018, the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations in enforcing the section 871(m) regulations for any non-delta-one transaction;
- For 2017, withholding agents may rely on a simplified standard for determining whether transactions are combined transactions pursuant to §1.871-15(n);

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<sup>1</sup> Unless otherwise provided, for purposes of this notice, terms that are defined in the section 871(m) regulations and in the proposed QI agreement in Notice 2016-42 (for example, “section 871(m) transaction,” “qualified derivatives dealer,” “delta,” “dividend equivalent,” “underlying security,” “payment,” and “QDD tax liability”) have the meanings described in those documents.

<sup>2</sup> Unless otherwise provided, all references to years refer to calendar years.

- For 2017, withholding agents may remit amounts withheld for dividend equivalent payments quarterly;
- For 2017 and following years, a QDD's section 871(m) amount is to be determined by calculating the net delta exposure of the QDD;
- For 2017, the IRS will take into account the extent to which the QDD made a good faith effort to comply with the QDD provisions in the QI agreement when enforcing those provisions;
- Prospective QDDs may apply for QDD status on or before March 31, 2017, and, if accepted by the IRS, be treated as having QDD status as of January 1, 2017;
- Before receiving a QI-EIN, QDDs may provide a statement on a Form W-8IMY that the QDD is "awaiting QI-EIN," and withholding agents may rely on this statement, to the extent permitted in this notice; and
- The section 871(m) regulations will not apply to certain existing exchange-traded notes specifically identified in section III.D of this notice until January 1, 2020.

The anti-abuse rule provided in §1.871-15(o) will apply during the phase-in years described in this notice. As a result, a transaction that would not otherwise be treated as a section 871(m) transaction (including as a result of this notice), may be a section 871(m) transaction under §1.871-15(o).

## II. BACKGROUND

Section 871(m) treats dividend equivalent payments as U.S. source dividends for purposes of chapters 3 and 4 and sections 871(a), 881, and 4948(a). As a result,

dividend equivalent payments are amounts subject to withholding (as defined in §1.1441-2(a)) for purposes of sections 1441 through 1443 and withholdable payments (as defined in §1.1473-1(a)) for purposes of sections 1471 and 1472. Accordingly, a withholding agent generally is required to deduct and withhold a tax equal to 30 percent on any dividend equivalent payment made to a foreign person unless an exception from, or lower rate of, withholding applies pursuant to the Code or regulations thereunder, or an applicable income tax treaty.

The Treasury Department and the IRS issued the section 871(m) regulations in several parts. On December 5, 2013, final regulations (TD 9648) were published at 78 FR 73079. On September 18, 2015, final regulations and temporary regulations (TD 9734) were published at 80 FR 56866 (2015 final regulations). Also on September 18, 2015, the Federal Register published a notice of proposed rulemaking by cross-reference to temporary regulations and a notice of public hearing at 80 FR 56415 (2015 proposed regulations). Correcting amendments to the 2015 final regulations were published on December 7, 2015, in the Federal Register at 80 FR 75946, and on December 7, 2015, in the Federal Register at 80 FR 75956.

On July 1, 2016, the Treasury Department and the IRS released Notice 2016-42, 2016-29 IRB 67, containing a proposed QI agreement (the proposed QI agreement) that describes requirements and obligations that will be applicable to QDDs. The Treasury Department and the IRS have received written comments on Notice 2016-42. The Treasury Department and the IRS intend to publish a final QI agreement before the end

of 2016, taking into account these comments. The final QI agreement will be effective on or after January 1, 2017.

### III. ENFORCEMENT AND ADMINISTRATION OF COMPLIANCE WITH SECTION 871(M) DURING THE PHASED-IN YEARS

This section describes the phased-in application of the section 871(m) regulations. This notice does not apply to any transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(1).

#### A. Phased-In Application for Delta-One and Non-Delta-One Transactions

This notice announces that the Treasury Department and the IRS intend to amend the applicability dates of the section 871(m) regulations with respect to certain transactions.

##### 1. *2017 Phase-in Year for Delta-One Transactions*

Section 1.871-15(d)(2) and (e) will continue to apply with respect to any payment made with respect to any potential section 871(m) transaction issued on or after January 1, 2017, that has a delta of one—including a transaction that is a combined transaction under §1.871-15(n) (subject to the simplified standard provided in section III.B of this notice). However, as described in section III.A.3 of this notice, for taxpayers and withholding agents 2017 will be a phase-in year for any delta-one transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(2) or (e).

##### 2. *2018 Phase-in Year for Non-Delta-One Transactions*

The Treasury Department and the IRS have determined that taxpayers and withholding agents need additional time to implement the section 871(m) regulations

with respect to section 871(m) transactions other than delta-one transactions (non-delta-one transactions)—including transactions that are combined transactions under §1.871-15(n). Therefore, the Treasury Department and the IRS intend to revise §1.871-15(d)(2) and (e) to not apply to any payment made with respect to any non-delta-one transaction issued before January 1, 2018. In addition, 2018 will be a phase-in year for any non-delta-one transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(2) or (e).

### 3. *IRS Enforcement and Administration During the Phase-In Years*

When enforcing the section 871(m) regulations for the applicable phase-in year, the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations. For example, the IRS will take into account whether a withholding agent made a good faith effort to (1) build or update its documentation and withholding systems to comply with the section 871(m) regulations; (2) determine whether transactions are combined transactions under §1.871-15(n) (taking into account the simplified standard in section III.B of this notice for 2017); (3) report information to other parties to a transaction (as required under §1.871-15(p)); and (4) implement the substantial equivalence test provided in §1.871-15(h) for 2018. Any person that did not make a good faith effort to comply with the section 871(m) regulations will not be given relief from IRS administration or enforcement, including penalties.

During 2017, a withholding agent will be considered to have timely satisfied its

deposit requirements for section 871(m) dividend equivalent payments if it makes deposits of amounts withheld for dividend equivalents during any calendar quarter on or before the last day of that calendar quarter. The withholding agent should write "Notice 2016-76" on the center, top portion of the tax year 2017 Form 1042 tax return.

In addition, during 2017, taxpayers may continue to rely on Notice 2010-46. Notice 2010-46 will be obsoleted as of January 1, 2018.

B. Simplified Standard for Determining Whether Transactions Are Combined Transactions

For purposes of determining whether transactions are section 871(m) transactions, 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. §1.871-15(n). In applying this combination rule, a broker acting as a short party may presume (absent actual knowledge to the contrary) that transactions are not entered into in connection with each other if (1) the long party holds 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.

Comments to the final section 871(m) regulations noted that for withholding agents to comply with this combination rule would require the development of novel and

complicated systems to identify transactions entered into in connection with each other. These comments recommended replacing the existing rule with a requirement to combine contracts if the withholding agent has actual knowledge that the contracts were priced, marketed, or sold in connection with each other. The Treasury Department and the IRS have determined that the “priced, marketed, or sold” standard would provide an inadequate long-term substitute for the combination rule and would undermine enforcement of the section 871(m) regulations.

However, this notice provides a simplified standard for withholding agents to determine whether transactions entered into in 2017 are combined transactions. A withholding agent will only be required to combine transactions entered into in 2017 for purposes of determining whether the transactions are section 871(m) transactions 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 that are entered into in 2017.

Transactions that are entered into in 2017 that are combined under this simplified standard will continue to be treated as combined transactions for future years and will not cease to be combined transactions as a result of applying §1.871-15(n) or disposing of less than all of the potential section 871(m) transactions that are combined under this rule. Transactions that are entered into in 2017 that are not combined under this simplified standard will not become combined transactions as a result of applying §1.871-15(n) to these transactions in future years, unless a reissuance or other event

causes the transactions to be retested to determine whether they are section 871(m) transactions. This simplified standard only applies to withholding agents, and does not apply to taxpayers that are long parties to potential section 871(m) transactions.

C. Phase-in Year for Qualified Derivatives Dealers

A QI that is an eligible entity is permitted to be a QDD, provided that the entity enters into a QI agreement under §1.1441-1(e)(5) and (6). Generally, a QDD described in §1.1441-1(e)(6) will be liable for tax under section 881 on the dividend equivalents it receives in its capacity as an equity derivatives dealer only to the extent described in paragraph III.C.1 of this notice, provided that the QDD complies with its QDD obligations under the QI agreement.

Comments requested that eligible entities be given sufficient time to enter into QI agreements, determine their QDD tax liability, and comply with their reporting and withholding obligations. To facilitate implementation of the QDD system, paragraph III.C.2 of this notice describes how the IRS will administer the QDD rules for 2017.

1. *Net Delta Computation for QDD's Section 871(m) Amount*

A QDD is liable for tax under section 881(a)(1) on dividends on physical shares or deemed dividends (together "actual dividends") received by the QDD. Section 1.871-15T(q)(1), however, provides that a QDD is exempt from withholding under chapters 3 and 4 on actual dividends and dividend equivalents that the QDD receives in its capacity as an equity derivatives dealer, although the QDD remains liable for tax under section 881 to the extent that dividends and dividend equivalent payments the QDD

receives on an underlying security exceed the dividend equivalent payments the QDD is obligated to make with respect to the same dividend on the same underlying security.

This notice announces that the Treasury Department and the IRS intend to revise §1.871-15(q)(1) to provide that a QDD will remain liable for tax under section 881(a)(1) and subject to withholding under chapters 3 and 4 on actual dividends it receives, and that the QI agreement will provide that a QDD's "section 871(m) amount" will be determined by calculating the net delta exposure (measured in number of shares) of the QDD on the date provided in §1.871-15(j)(2), multiplied by the relevant dividend amount per share. A QDD's net delta exposure will be determined by aggregating the delta of all physical positions and potential section 871(m) transactions (as defined in §1.871-15(a)(12)) with respect to an underlying security entered into by the QDD in its equity derivatives dealer capacity. If a QDD calculates net delta for non-tax business purposes, that net delta ordinarily will be the delta used for this purpose. A QDD's tax liability on the section 871(m) amount associated with an underlying security will be reduced (but not below zero) 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.

## *2. General Phase-in Year for QDDs*

For purposes of the IRS's enforcement and administration of the QDD rules in the section 871(m) regulations and the relevant provisions of the QI agreement for 2017, the IRS will take into account the extent to which the QDD made a good faith

effort to comply with the section 871(m) regulations and the relevant provisions of the QI agreement. The QI agreement will accordingly 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 made a good faith effort to comply with the relevant terms of the QI agreement. Any QDD that has not made a good faith effort to comply with its QDD obligations will not be given any relief from IRS administration or enforcement during 2017, including penalties.

### 3. *Effective Date of QI Agreement*

The proposed QI agreement described in Notice 2016-42 provides a three-month window in which to apply for a QI agreement within a calendar year. In particular, section 2.23 of the proposed QI agreement allows a prospective QI to have its QI agreement effective as of January 1 in any given year in which the QI applies on or before March 31 of that year. For a prospective QI that applies after March 31 of a given year and that has not received any reportable payments before the date the application is submitted, the effective date of the QI agreement will be January 1 of that year. For a prospective QI that applies after March 31 of a given year and that has received a reportable payment in the year before the date the application is submitted, the effective date of the QI agreement will be the first day of the first month in which both the QI application is complete and the QI has received its QI-EIN. For a QI that is renewing its QI agreement, the effective date of the QI agreement when renewed by March 31, 2017, will be January 1, 2017.

4. *Certifying QDD Status with QI Application Pending or Prior to Filing*

A QDD must provide a valid Form W-8IMY to a withholding agent certifying that it is a QDD, and the withholding agent is not required to withhold on any payment with respect to a potential section 871(m) transaction (including an actual section 871(m) transaction) that it makes to the QDD in its QDD capacity. Before approval of its QI agreement and QDD status, an applicant that has submitted a QI application applying for QDD status on or before March 31, 2017, may 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. An applicant that has not yet submitted a QI application applying for QDD status but that intends to submit that application on or before March 31, 2017, may 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 actually submits its QI application requesting QDD status, provided that it submits that application by March 31, 2017. However, a QDD applicant may not represent that it is a QDD if it no longer intends to submit a QI application applying for QDD status by March 31, 2017, or its application has been denied. In addition, an applicant may not represent that it is a QDD if it receives a notice from the IRS stating that the QDD applicant may not make the representation until the applicant's QI and QDD status has been approved. (The IRS will generally only issue such notices in cases where an application is not substantially complete or when the IRS has determined on a preliminary basis that it will not enter into a QI agreement with the applicant or that the applicant is not an eligible entity.)

In cases where an applicant certifies to QDD status before its QDD application is approved, the applicant must immediately notify any withholding agent to whom it has certified that it no longer qualifies as a QDD if (1) it determines that it no longer intends to submit a QI application applying for QDD status by March 31, 2017, (2) it does not submit the application by March 31, 2017, or (3) its application is denied. The withholding agent will be required to inform the IRS of any notifications it receives when it files its Form 1042, listing the name and EIN (if available) of each person whose QDD certification was withdrawn for any of these reasons. When an applicant provides a valid W-8IMY with a QDD certification to a withholding agent, the withholding agent is not required to withhold on payments with respect to potential section 871(m) transactions made to the QDD when the QDD is acting as a principal (that is, not as an intermediary), unless it has been notified that the W-8IMY is no longer valid, including for the reasons mentioned above.

A withholding agent is required to withhold on any actual dividend paid to a QDD, whether the dividend is paid to the QDD in its capacity as a dealer in equity derivatives or otherwise.

5. *Certifying QDD Status and Depositing Withheld Amounts Pending Receipt of QI-EIN*

The IRS will issue a QI employer identification number (QI-EIN) upon approval of a QI application. After an applicant receives a QI-EIN from the IRS, the applicant must include its QI-EIN on any Form W-8IMY that the applicant provides as a QDD. If an applicant must provide a Form W-8IMY certifying its QDD status to a withholding agent

before it has received a QI-EIN, the applicant should indicate that it is awaiting a QI-EIN by writing “awaiting QI-EIN” on line 8 of Part I of the form. If an applicant provides an “awaiting QI-EIN” statement on a Form W-8IMY, the applicant must provide its QI-EIN to its withholding agent as soon as practicable after the QDD receives its QI-EIN. It is not necessary, however, for the applicant to provide a newly executed Form W-8IMY with its QI-EIN after it receives its QI-EIN or after it receives the fully executed QI agreement, provided all of the information on the original form remains valid. The applicant may furnish its QI-EIN to its withholding agent in any manner agreed to by the applicant and its withholding agent. If an applicant is denied QDD status, it must notify the withholding agent immediately.

A withholding agent that receives a Form W-8IMY with an “awaiting QI-EIN” statement may treat the person that provides the form as a QDD unless it knows, or has reason to know, that the provider of the form cannot validly represent that it is a QDD. A withholding agent is not required to determine when a QDD applied for an agreement or if it is actually in possession of a fully executed agreement. A withholding agent is also not required to verify whether a QDD’s EIN is a QI-EIN. A withholding agent may only rely on a Form W-8IMY that says “awaiting QI-EIN” for up to six months after receipt, unless a QI-EIN is provided to the withholding agent within that time.

The IRS will not assess any penalties for a QDD’s failure to deposit withheld amounts before the date the QDD receives its QI-EIN, provided that within 3 days of receiving its QI-EIN the QDD deposits any amounts that the QDD was previously

required to deposit. In addition, if a QDD applies to enroll in the Electronic Federal Tax Payment Systems (EFTPS) within 30 days of receiving a QI-EIN, no penalty will be assessed for the QDD's failure to deposit withheld amounts, provided that within 3 days of being enrolled in EFTPS the QDD deposits any amounts that the QDD was previously required to deposit.

D. List of Exchange Traded Notes (ETNs) with Delayed Effective Date

ETNs that reference underlying securities and are delta-one transactions will generally become subject to section 871(m) beginning on January 1, 2017. The Treasury Department and the IRS are aware that a certain number of these ETNs existed before the issuance of the 2015 final regulations and have been in continuous distribution (meaning that issuers continuously “create”—that is, issue and sell—new ETNs based on the same offering documents as the original ETN securities). The newly created ETNs have the same ticker symbol and CUSIP code as the previously issued ETNs and are therefore fungible with ETNs previously issued under the same offering documents. An ETN that is a delta-one transaction under the section 871(m) regulations but that is issued before January 1, 2017, however, would not be subject to section 871(m) withholding, while an identical newly created ETN issued on or after January 1, 2017, would be subject to section 871(m) withholding. This difference would result in otherwise identical ETNs not being fungible for tax purposes, even though they are indistinguishable for commercial and other legal purposes.

To permit issuers time to unwind the identified ETNs, maintain fungibility, and

preserve market liquidity, the Treasury Department and the IRS intend to amend §1.871-15(r)(3) to provide that §1.871-15(d)(2) and (e) (regarding specified NPCs and specified ELIs, respectively) will not apply to the following ETNs (identified by name, ticker symbol, and CUSIP number) until January 1, 2020:

<u>Ticker Symbol</u>	<u>ETN Name</u>	<u>CUSIP</u>
CAPE	BARCLAYS ETN+ SHILLER CAPE	06742A669
CEFL	ETRACS MONTH PAY 2X LEV C/E	90270L842
CSLS	X-LINKS LONG/SHORT EQUITY	22542D878
CSMA	X-LINKS MERGER ARBITRAGE ETN	22542D845
DIVC	C-TRACKS ETN MILLER/HOWARD	17322H149
DOD	ELEMENTS-DOGS OF DOW	25153Q658
DVYL	ETRACS 2X DJ SEL DVD ETN	90268G607
EEH	ELEMENTS SPECTRUM ETN	870297504
FBG	FI ENHANCED BIG CAP GR ETN	90267L508
FBGX	FI ENHANCED LARGE CAP GROWTH	902677780
FIBG	CS FI ENHANCED BIG CAP GROW	22539T563
FIEG	FI ENHANCED GLOBAL HI YLD	25155L293
FIGY	FI ENHANCED GLOBAL HIGH YLD	06742C152
FLGE	FI LARGE CAP GROWTH ENHANCED	22542D423
GCE	CLAYMORE CEF GS CONNECT ETN	362273104

HDLV	ETRACS 2X HI DIV LOW VOL ETN	90270L727
HOML	ETRACS MON RST 2XLEV ISE EX	90274P302
HOMX	ETRACS ISE EXCLUSIV HOMEBUIL	90274P310
LRET	ETRACS MONTHLY PAY 2XLEVERAG	90274R100
MORL	ETRACS MONTHLY PAY 2XLEVERAG	90269A302
RODI	BARCLAYS RETURN ON DISABILIT	06740D830
SDYL	ETRACS 2X S&P DVD ETN	90267L409
SMHD	ETRACS MON PAY 2X LEV US SM	90274D838
WIL	BARCLAYS WOMEN IN LEADERSHIP	06742W430
WMW	ELEMENTS LKD TO MORNINGSTAR	25153Q708

Comments are requested on whether there are other delta-one ETNs that are not included in this list but that existed before September 18, 2015, and that will become subject to section 871(m) withholding on January 1, 2017. The Treasury Department and the IRS will consider allowing other ETNs that meet these criteria to be subject to the delayed effective date, if appropriate—either through published guidance or in a private letter ruling.

**IV. ADJUSTING UNDERWITHHOLDING BEFORE THE DUE DATE (WITHOUT EXTENSIONS) FOR FILING FORM 1042**

Under §1.1461-2(b), a withholding agent that fails to withhold on a payment made to a beneficial owner may withhold on a future payment made to the beneficial

owner or may satisfy the tax from property that it holds in custody for the beneficial owner or from property over which it has control. That additional withholding or satisfaction of tax must be made no later than the due date (not including extensions) for filing Form 1042 for the year in which the underwithholding occurred. Under the IRS's interpretation of §1.1461-2(b), a withholding agent that adjusts its underwithholding pursuant to these procedures will not be subject to any penalties for failure to deposit or failure to pay under sections 6656, 6672, and 7202 when it timely deposits the additional amounts withheld or otherwise obtained. Therefore, a withholding agent that fails to withhold on a dividend equivalent payment made to a foreign person may rely on the procedures in §1.1461-2(b) to adjust its underwithholding without penalty before March 15 of the year following the year in which the underwithholding occurred.

#### V. DRAFTING INFORMATION

The principal authors of this notice are D. Peter Merkel and Karen Walny of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Mr. Merkel or Ms. Walny at (202) 317-6938 (not a toll-free call).