

Extension of the Phase-in Period for the Enforcement and Administration of Section 871(m)

Notice 2017-42

I. PURPOSE

This Notice provides taxpayers with additional guidance for complying with the 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 2018¹ and 2019. Specifically, this Notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to amend the section 871(m) regulations to delay the effective/applicability date of certain rules in those final regulations. This Notice also extends the phase-in period provided in Notice 2016-76, 2016-51 I.R.B. 834, for certain provisions of the section 871(m) regulations.

The anti-abuse rule provided in §1.871-15(o) will continue to 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

On September 18, 2015, the **Federal Register** published final regulations and

¹ Unless otherwise provided, all references to years refer to calendar years.

temporary regulations (TD 9734, 80 FR 56866), which finalized a portion of a 2013 notice of proposed rulemaking (78 FR 73128), and introduced new temporary regulations based on comments received with respect to that notice of proposed rulemaking (80 FR 56415) (2015 final regulations and 2015 temporary regulations, respectively).

On December 19, 2016, the Treasury Department and the IRS published Notice 2016-76, 2016-51 I.R.B. 834, which provided for the phased-in application of certain provisions of the section 871(m) regulations to allow for the orderly implementation of those final regulations.²

On December 30, 2016, the Treasury Department and the IRS released Revenue Procedure 2017-15, 2017-3 I.R.B. 437, which contains the final QI withholding agreement (2017 QI Agreement), including the requirements and obligations applicable to qualified derivatives dealers (QDDs).

On January 24, 2017, the **Federal Register** published final regulations and temporary regulations (TD 9815, 82 FR 8144) (the 2017 regulations), which finalized the 2015 notice of proposed rulemaking (80 FR 56415) that was issued in conjunction with the 2015 temporary regulations. The effective/applicability dates in the 2017 final regulations reflect the phased-in application described in Notice 2016-76. See Treas. Reg. §1.871-15(r)(3).

As described in more detail in sections III through V of this Notice, this Notice

² The terms used in this Notice have the meanings provided in the section 871(m) regulations.

extends parts of the phase-in period described in both Notice 2016-76 and Rev. Proc. 2017-15 for one additional year. Dealers, issuers, and other withholding agents have indicated that the phase-in period for delta-one transactions provided in Notice 2016-76 and Rev. Proc. 2017-15 has provided them with valuable time to test and further develop their withholding and reporting systems. Even with the 2017 phase-in period, these market participants have indicated that they would benefit from additional time to refine their systems based on the testing that has occurred in 2017. In addition, dealers, issuers, and other withholding agents continue to design, build, and test new withholding and reporting systems that will enable testing and withholding on non-delta-one transactions, and have requested additional time to complete those systems before being required to comply with the section 871(m) regulations with respect to non-delta-one transactions. Finally, consistent with Executive Order 13777 (82 FR 12285), the Treasury Department and the IRS continue to evaluate the section 871(m) regulations and consider possible agency actions that may reduce unnecessary burdens imposed by the regulations.

III. EXTENSION OF THE PHASE-IN YEAR FOR DELTA-ONE AND NON-DELTA-ONE TRANSACTIONS

This section describes the extension to the phased-in application of the section 871(m) regulations to delta-one and non-delta-one transactions. This Notice does not apply to any transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(1) (providing that before January 1, 2017, a notional principal contract (NPC) is a specified NPC if certain factors are present).

The Treasury Department and the IRS have determined that it is appropriate for taxpayers and withholding agents to have additional time to implement the section 871(m) regulations for 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 the effective/applicability date for §1.871-15(d)(2) and (e) to provide that these rules will not apply to any payment made with respect to any non-delta-one transaction issued before January 1, 2019.

Notice 2016-76 provides that 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 with respect to delta-one transactions in 2017 and non-delta-one transactions in 2018 when it enforces the section 871(m) regulations. This Notice extends the periods during which the enforcement standards provided by Notice 2016-76 will apply. Consistent with this extension, 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 (1) any delta-one transaction in 2017 and 2018, and (2) any non-delta-one transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(2) or (e) in 2019.

Similarly, 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 2017 QI Agreement, this Notice extends through 2018 the period during which 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 2017 QI Agreement. In addition, the IRS intends to revise the 2017 QI Agreement to provide that a QDD will be considered to satisfy the obligations that apply specifically to a QDD under that agreement for 2018 provided that the QDD makes a good faith effort to comply with the relevant provisions of the 2017 QI Agreement.

IV. EXTENSION OF THE SIMPLIFIED STANDARD FOR DETERMINING WHETHER TRANSACTIONS ARE COMBINED TRANSACTIONS

Notice 2016-76 provided a simplified standard for withholding agents to determine whether transactions entered into in 2017 are combined transactions. Specifically, a withholding agent is required to combine transactions entered into in 2017 for purposes of determining whether the transactions are section 871(m) transactions only when the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Withholding agents are not required to combine any transactions that are listed securities entered into in 2017.

This Notice extends the period during which this simplified standard for combined transactions applies to include 2018. Transactions that are entered into in 2017 and 2018 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 and 2018 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. See §1.871-15(g)(2) (providing that the delta of a potential section 871(m) transaction generally is determined on the earlier of when the transaction is (1) priced or (2) issued); see also §1.871-15(a)(6) (defining the term “issue” to include “an issuance as a result of a deemed exchange pursuant to section 1001”). This simplified standard applies only to withholding agents, and does not apply to taxpayers that are long parties to potential section 871(m) transactions.

V. EXTENSION OF PHASE-IN RELIEF FOR QUALIFIED DERIVATIVES DEALERS

Section 1.871-15T(q)(1) of the 2015 temporary regulations provided that when a QDD received a dividend or dividend equivalent payment and the QDD was contractually obligated to make an offsetting dividend equivalent payment on the same underlying security in an amount that was less than the dividend and dividend equivalent amount received, the QDD would be liable for tax under section 871(a) or 881 for the difference. The 2015 final regulations provided that a withholding agent who made a payment of a dividend to a qualified intermediary acting as a QDD was not required to withhold on that payment if the withholding agent reliably associated the payment with a valid qualified intermediary withholding form containing a certification described in §1.1441-1(e)(3)(ii)(E). See §1.1441-1(b)(4)(xxii) of the 2015 final regulations.

Comments requested that the Treasury Department and the IRS adopt a different

method of determining a QDD's tax liability. Those comments generally requested that this method be based on the QDD's net delta exposure for each underlying security. The Treasury Department and the IRS agreed that the net delta approach was an administrable and accurate method for a QDD to determine its residual exposure to underlying securities, and the 2017 final regulations adopted the net delta exposure method.

In adopting the net delta approach, the Treasury Department and the IRS were concerned that the exemption from withholding on dividends paid to a QDD, when combined with the net delta exposure method, could result in U.S. source dividends escaping U.S. tax completely in certain circumstances. Therefore, the 2017 final regulations revised §§1.871-15(q)(1) and 1.1441-1(b)(4)(xxii) to provide that a QDD remains liable for tax under section 881(a)(1) and subject to withholding under chapters 3 and 4 on dividends. However, to allow taxpayers time to implement the net delta approach, the 2017 QI Agreement and the 2017 final regulations provided that dividends and dividend equivalents received by a QDD in its equity derivatives dealer capacity in 2017 will not be subject to tax under section 881(a)(1) or subject to withholding under chapters 3 and 4.

This Notice announces that the Treasury Department and the IRS intend to amend §§1.871-15(q)(1) and (r)(3), and 1.1441-1(b)(4)(xxii)(C) to provide that a QDD will not be subject to tax on dividends and dividend equivalents received in 2017 and 2018 in its equity derivatives dealer capacity or withholding on dividends (including

deemed dividends).

Section 4.01(1) of Rev. Proc. 2017-15 provides that a QDD will be required to compute its section 871(m) amount using the net delta approach beginning in 2018. This Notice provides that a QDD will be required to compute its section 871(m) amount using the net delta approach beginning in 2019.

A QDD will remain liable for tax under section 881(a)(1) on dividends and dividend equivalents that it receives in any capacity other than as an equity derivatives dealer, and on any other U.S. source FDAP payments that it receives (whether or not in its equity derivatives dealer capacity). In addition, a QDD is responsible for withholding on dividend equivalents it pays to a foreign person on a section 871(m) transaction, whether acting in its capacity as an equity derivatives dealer or otherwise.

Finally, section 10.01(C) of the 2017 QI Agreement provides that: "For calendar year 2017, a QDD is not required to perform a periodic review with respect to its QDD activities (as otherwise required by section 10.04 of this Agreement) or provide the factual information specified in Appendix I." This Notice provides that a QDD is not required to perform a periodic review with respect to its QDD activities for calendar year 2017 and 2018. Note that a QDD must use the same year for the periodic review of its QI activities and its QDD activities. A QI that is a QDD must choose 2019 or a later year within its periodic review period in which to perform its periodic review unless its applicable periodic review period ends in 2018 or an earlier year.

VI. TAXPAYER RELIANCE

Before the promulgation of the amendments to the section 871(m) regulations and the 2017 QI Agreement, taxpayers may rely on the provisions of this Notice regarding the proposed amendments described in sections III and V. Withholding agents may rely on the simplified standard for determining whether transactions are combined transactions as described in section IV.

VII. DRAFTING INFORMATION

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