On August 4, 2017, the IRS issued Notice 2017-42 (the “Notice”), which delays three key aspects of Sec. 871(m) regulatory compliance until January 1, 2019: (1) the application of withholding to equity-linked instruments (“ELIs”) with a delta (defined below) of between 0.8 and 1.0; (2) the full “combination rule” set forth therein; and (3) the related rules for Qualified Derivatives Dealers (“QDDs”). Section 871(m) imposes U.S. withholding tax on swaps, other notional principal contracts and equity-linked derivative contracts in connection with dividends paid on related U.S. stocks.

Industry organizations had requested an additional delay in the effective date of these rules due to the complexities of complying with the related aspects of the Section 871(m) regulations. Although the Notice does not eliminate the Sec. 871(m) rules as they relate to ELIs (for which many financial market participants have been strenuously arguing), the one year additional delay is welcome relief in preparing withholding systems for compliance with the rules. The Notice also indicates that the IRS and Treasury continue to study the regulations in compliance with Executive Order 13777, which requires that all agencies analyze their regulations to consider actions to reduce unnecessary regulatory burdens on the regulated.

**Anti-Abuse Limits Relief Under the Notice**

In spite of the relief and the delay afforded by the Notice, the anti-abuse rule of Treas. Reg. 1.871-15(o) still applies. Thus, specific transactions that are generally exempt from coverage because of the delayed enforcement provided in both the Notice and Notice 2016-76, but which are specifically intended to avoid the rules, may still be treated as 871(m) transactions under the anti-abuse rule.
Delta-One Only Withholding Extended Through 2018

“Delta” is the term generally used to describe the ratio of the change in value of an ELI to the change in value of its related underlying stock, given a small change in the fair market value of such stock. The fair market value of an ELI with a delta of one (a delta-one ELI) perfectly tracks changes in value of the related stock. The 871(m) regulations will generally subject ELIs with a delta of 0.8 or greater to withholding; however, in order to provide transitional relief and reduce withholding burdens during the transition period, Notice 2016-76 provided that for 2017, only delta-one ELIs would be subject to withholding (and that the 0.8 delta threshold for withholding would be delayed until January 1, 2018). ELIs with a delta between 0.8 and 1.0 are referred to as non-delta-one transactions.

The Notice provides additional relief by further delaying the requirement to withhold on non-delta-one transactions during 2018. Instead, the requirement to withhold on non-delta-one transactions that have a delta of 0.8 or greater (or meet the substantial equivalence test) will only apply to those instruments issued on or after January 1, 2019. Thus, the Notice extends the previous extension given by Notice 2016-76 and generally requires withholding during 2017 and 2018 only on delta-one transactions.

The good-faith effort provisions of Notice 2016-76 are also extended for delta-one transactions; the IRS will take into account compliance efforts for delta-one transactions in 2017 and 2018 and non-delta-one transactions in 2019. In sum, enforcement of delta-one transactions is extended by a year, enforcement of non-delta-one transactions is delayed by a year, and good faith efforts to comply will be acknowledged by the IRS during both respective phase-in periods.

The Full Combination Rule Is Delayed An Additional Year Until 2019

Under the Notice, the combination rule receives an additional year of simplified operation for withholding agents. The full combination rule set forth in Treas. Reg. 1.871-15(n) is complicated and raises significant compliance challenges. However, the IRS has repeatedly indicated that a rule combining ELIs is essential because investors and traders typically enter into combinations of ELI transactions to obtain a net benefit of multiple transactions. Such net activity raises potential withholding avoidance concerns. Because of the additional compliance challenges in combining ELIs and applying withholding rules to combinations, Notice 2016-76 delayed the applicability of the full combination rule and provided for a simplified combination rule in the interim during 2017. The Notice extends this delay and the application of the simplified combination rule through calendar year 2018.

The simplified standard announced by Notice 2016-76 provided that 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” and is not required to combine transactions involving listed securities in 2017.

If ELIs are combined under the simplified rule in 2017 and 2018, such combination(s) will continue to be so treated going forward and will not cease to be combined by applying the full combination rule in Treas. Reg. 1.871-15(n) or by disposing of a portion of such combined transaction(s). Conversely, transactions not combined under the simplified rule will not subsequently become combined using the full combination rule. However, if a reissuance or other event causes retesting of the transactions as 871(m) transactions after the full combination rule comes into effect in 2019, the transactions would then be retested for combination under the full rule.

QDD Rules Delays

The QDD rules of the 871(m) regulations and the related provisions in the 2017 qualified intermediary (“QI”) agreement have an additional period, through 2018, during which good faith efforts of the QDD to comply with the regulations regarding net delta
withholding will be taken into account. Also, the QI agreement will be revised 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.” QDDs receiving a dividend or a dividend equivalent payment in 2017 were not subject to tax under Sec. 881(a)(1) and Chapter 3 and 4 withholding.

The Notice states that the regulations will be amended to provide that a QDD will not be subject to tax in both 2017 and 2018 as an equity derivatives dealer or for Chapter 3 and 4 withholding for dividends or deemed dividends. Withholding under the net delta approach now begins in 2019. The Notice also provides that “[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)” and 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.” The QI agreement will also be amended to provide that “a QDD is not required to perform a periodic review with respect to its QDD activities for calendar year 2017 and 2018” instead of the current 2017.

**Conclusion**

Overall, the new Notice provides welcome relief, recognizing industry attempts at compliance with and the significant remaining hurdles presented by the complex 871(m) regulations. The additional delay to full enforcement of non-delta-one transactions, the full combination rule and the QDD rules allows further development and testing time to fully implement correct technological solutions. Extension of the period during which the IRS will recognize good faith industry efforts at compliance should provide further comfort to withholding agents taking steps to comply with the rules.

Although the Notice provides helpful relief, the regulations remain in effect for the numerous delta-one instruments already requiring calculation of dividend equivalent amounts on a daily basis. And though the Notice explicitly states the regulations remain under scrutiny in light of Executive Order 13777, it does not seem that a full withdrawal of the regulations is anticipated as the Notice also provides that amendments to the regulations are forthcoming.

Despite the important temporary relief provided by the Notice, only an additional year delay through 2018 is provided. Substantial compliance challenges and the danger of substantial withholding tax liabilities and tax penalties for noncompliance remains. There is very little time between now and January 1, 2019 and difficult obstacles must be overcome in order to avoid severe tax costs.

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