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# ***IRS defers effective date for section 871(m) regulations***

August 11, 2017

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## ***In brief***

The Internal Revenue Service (IRS) and the US Department of the Treasury (Treasury) on August 4, 2017 published Notice 2017-42 (Notice) deferring for another year the effective date for portions of the regulations under Section 871(m) of the Internal Revenue Code. The Notice extends the relief provisions currently in effect under Notice 2016-76, Rev. Proc. 2017-15, and the 2017 Section 871(m) regulations (described below). The Notice provides:

- that transactions in-scope based on their delta through the end of 2018 are limited to 'delta one' transactions; as a result, transactions with a delta less than 1 but greater than .8 (delta .80 transactions) will not be in scope until January 1, 2019,
- that the simplified combination rule will continue to apply for withholding agents until December 31, 2018,
- for the deferral of withholding on actual and deemed dividends paid to qualified derivatives dealers (QDDs) until January 1, 2019 and
- for the extension of the good faith periods for the implementation of Section 871(m).

***Observation:*** *The deferral provided by Notice 2017-42 has been anticipated by market participants who have been struggling to implement the guidance issued at the end of 2016 and the beginning of 2017. In particular, the changes to the Qualified Intermediary (QI) Agreement applicable to QDDs have raised significant questions for issuers of financial products linked to US equities in the international financial markets.*

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## ***In detail***

### ***Background***

Final and temporary regulations under Section 871(m) released in September 2015 (the 2015 Section 871(m) Regulations) generally impose a withholding tax on 'dividend equivalent amounts' paid or deemed paid to non-US taxpayers on derivatives over US equities.

The IRS and Treasury on December 2, 2016 issued Notice 2016-76 (the 2016 Notice), which granted temporary transitional relief in certain circumstances and announced prospective changes to the 2015 Section 871(m) Regulations. In particular, the 2016 Notice provided that the regulations would be changed so that in 2017 only delta-one transactions

would be subject to reporting and withholding under Section 871(m). In addition, the 2016 Notice provided for a phased-in approach to Section 871(m) for 2017 and 2018, set forth a simplified approach to the combination rule for withholding agents for 2017 and outlined significant changes to the treatment of QDDs.

The IRS on January 19, 2017 issued final, temporary, and proposed regulations under Section 871(m) (the 2017 Section 871(m) Regulations). The 2017 Section 871(m) Regulations made changes to the 2015 Section 871(m) Regulations consistent with the 2016 Notice and Rev. Proc. 2017-15 as well as making extensive changes to the 2015 Section 871(m) Regulations in response to industry comments.

Prior PwC Tax Insights have addressed changes in Notice 2016-76 ([IRS notice provides relief under Section 871\(m\) regulations and qualified derivatives dealer regime](#)), the 2016 QI Agreement ([IRS releases final qualified intermediary agreement](#)), the new QDD provisions in the 2016 QI Agreement ([Final qualified intermediary agreement includes qualified derivatives dealer provisions](#)) and the 2017 Section 871(m) Regulations ([IRS issues final, temporary, and proposed regulations under Sections 871\(m\) and 1441 dealing with dividend equivalent payments](#)).

#### **Notice 2017-42**

The Notice extends the Section 871(m) regime currently in effect for 2017 through the end of 2018. In particular, the following relief provisions have been extended for one year:

- **Delta one standard.** The 2016 Notice and the 2017 Section 871(m) regulations limited the application of the Section 871(m) rules to 'delta one' transactions for 2017. The Notice extends this relief by providing that only 'delta one' transactions will be in scope through the end of 2018. Accordingly, trades subject to the delta .80 standard or the substantial equivalence test should generally not be in scope prior to 2019 (subject to the application of

the anti-avoidance rules as described below).

- **Simplified combination standard for withholding agents.** The 2016 Notice provided a simplified standard for 2017 for withholding agents to apply the combination rule which requires them to combine transactions entered into with a single counterparty (and related parties) only if they are priced, marketed, or sold in connection with each other. This simplified standard has been extended through 2018. Note that this standard applies only to short parties; long parties are still potentially required to combine all trades entered into in connection with each other.
- **Withholding on actual/deemed dividends paid to QDDs.** The final QI Agreement made substantial changes to the calculation of the tax liability of QDDs. In particular, the computation was changed from a matching of dividend equivalents received and paid to a net delta computation. That change caused the government to be concerned that dividends could escape withholding completely. Accordingly, the QI Agreement and the 2017 Section 871(m) Regulations provided that all actual and deemed dividends paid to QDDs would be subject to withholding. The mechanics of that computation were considerably different from those proposed in the draft QI Agreement. The government has responded to requests from taxpayers for additional time to implement the new net delta approach by deferring until 2019 the requirement to withhold on

actual and deemed dividends paid to a QDD.

- **Additional QDD relief.** As discussed above, a QDD generally will be subject to tax on actual/deemed dividend and dividend equivalent amounts received in an equity derivatives dealer capacity based on a net delta calculation. This requirement was scheduled to become effective beginning in 2018; pursuant to the Notice, a QDD will be required to calculate its net delta only in connection with the receipt of such amounts in its capacity as an equity derivatives dealer beginning in 2019. In addition, the Notice provides that a QDD will not be required to perform a periodic review for 2017 or 2018.
- **Extension of the good faith standard.** The 2016 Notice and Rev. Proc. 2017-15 both provide that the IRS will take into account whether parties act in good faith in the implementation of the Section 871(m) regulations and the QI Agreement in their enforcement of the Section 871(m) provisions. The 'good faith' periods are extended to the end of 2018 for delta-one transactions and for QDDs and through 2019 for non-delta-one transactions.

The Notice stresses that the extensions and good faith approach are subject to the anti-avoidance rule; that is, persons who deliberately enter into transactions to avoid the application of Section 871(m) will not be able to rely on the relief provisions.

**Observation:** *The extension of the good faith standard for 'delta one' transactions is certainly welcome. However, it is not clear what activities (or lack thereof) constitute*

'good faith' in 2017 and that ambiguity remains equally with this relief. For example, it is possible that an approach that may qualify as good faith efforts in 2017 may not qualify in 2018.

### The takeaway

The Notice provides a very welcome respite to market participants who have been struggling to implement the provisions of the 2016 Notice, the 2017 Section 871(m) regulations and the QI Agreement. The changes in approach implemented in those documents were extensive and challenging. It is extremely helpful to taxpayers to have another year to

comply. In addition, taxpayers can take additional comfort in knowing that any controls, processes or procedures that are put in place for 2017 can be further refined and enhanced before January 1, 2019.

An additional noteworthy takeaway is the Notice states that 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, consistent with the Trump Administration's Executive Order 13777 (82 FR 12285) issued February 24, 2017. This review has been requested by industry trade

associations and the Chamber of Commerce in comment letters; however, the Section 871(m) regulations did not make the list of eight regulations that will be modified or repealed in Notice 2017-38, released July 7, 2017. (See our [Insight: Treasury to review debt reclassification, international, partnership regulations](#) for more information on Notice 2017-38.) The mention in the Notice that the Treasury and IRS are still contemplating additional actions likely indicates that additional guidance on some portion of the Section 871(m) regulations will be forthcoming.

### Let's talk

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