

Client Alert

December 6, 2016

IRS Guidance for Implementation of the Section 871(m) Regulations

On December 2, 2016, the Internal Revenue Service (“IRS”) released an advance version of Notice 2016-76¹ (the “Notice”) and followed through on its promise to provide taxpayers with guidance for complying with final and temporary regulations under Sections² 871(m), 1441, 1461, and 1473 of the Internal Revenue Code (collectively, the “Section 871(m) regulations”).³ Section 871(m) is the Code provision that treats “dividend equivalents”⁴ paid under certain contracts as dividends from sources within the United States and therefore subject to U.S. withholding tax if paid to a non-U.S. person.

In the Notice, the Treasury Department and the IRS announced their intention to amend the Section 871(m) regulations to phase in the application of certain rules to facilitate implementation of the Section 871(m) regulations. The Notice acknowledged taxpayers’ challenges in complying with certain aspects of the Section 871(m) regulations and provides some relief. Most significantly, and as discussed below, the Notice announces the Treasury Department’s and the IRS’s intention that the effective date for the application of Section 871(m) will be January 1, 2017 for delta-one instruments and January 1, 2018 for non-delta-one instruments. Amendments to the Section 871(m) regulations will be forthcoming.

Important highlights of the Notice include:

- **Phased-In Application for Delta-One and Non-Delta-One Transactions.** The Notice indicates that the Section 871(m) regulations will continue to apply beginning January 1, 2017, to any payment with respect to a potential 871(m) transaction⁵ that has a delta of one, including combined transactions; however, 2017 will be a phase-in year for such transactions. As for non-delta-one transactions, the Treasury

¹ Available at <https://www.irs.gov/pub/irs-drop/n-16-76.pdf>.

² All references are to the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury regulations promulgated thereunder.

³ The Treasury first released temporary and proposed regulations under Section 871(m) on January 23, 2012 (the “2012 Proposed Regulations”), expanding the circumstances under which a notional principal contract (“NPC”) would be considered a specified notional principal contract (“specified NPC”). The 2012 Proposed Regulations thus introduced a seven-factor test for determining whether an NPC is a specified NPC. In response to comments and criticism from the industry, on December 5, 2013, the Treasury proposed a wholly new approach, issued new proposed regulations (the “2013 Proposed Regulations”), and finalized temporary regulations. Most significantly, the 2013 Proposed Regulations replaced the seven-factor test with a single-factor “delta” test for determining whether an instrument has the potential for tax avoidance through payment of dividend equivalent amounts. On September 17, 2015, the Treasury released final and temporary regulations (the “Final Regulations”), generally adopting the 2013 Proposed Regulations and the delta approach but with significant changes. For a summary of the 2015 Final and Temporary Regulations, please see our client alert available at <https://media2.mofo.com/documents/150921dividendequivalent.pdf>.

⁴ Under Section 871(m)(2), a dividend equivalent is defined as (i) any substitute dividend (made pursuant to a securities-lending or repo transaction), (ii) any amount paid pursuant to a specified NPC that is contingent on, or determined by reference to, the payment of a U.S.-source dividend, and (iii) any amount that the Treasury determines is substantially similar to a payment described in (i) and (ii).

⁵ See Section 1.871-15(a)(12). A “Section 871(m) transaction” is any securities-lending or sale-repurchase transaction, specified NPC, or specified ELI. A “potential Section 871(m) transaction” is any securities-lending or sale-repurchase transaction, NPC, or ELI that references one or more underlying securities.

Client Alert

Department and the IRS have determined that taxpayers and withholding agents need additional time to implement the Section 871(m) regulations. As a result, the Treasury Department and IRS have announced their intention to amend the Section 871(m) regulations so that the regulations will not apply to payments made with respect to any non-delta-one transaction before January 1, 2018; 2018 will also be a phase-in year for these non-delta-one transactions. When enforcing the Section 871(m) regulations for the applicable phase-in years, the IRS will afford relief to taxpayers or withholding agents who have made a good faith effort to comply with the regulations. Relevant considerations for the determination of good faith include whether a withholding agent made a good faith effort to: (i) build or update its documentation and withholding systems to comply with the Section 871(m) regulations, (ii) determine whether transactions are combined, (iii) report information required under the Section 871(m) regulations, and (iv) implement the substantial equivalence test. For 2017, a withholding agent will be considered to have timely satisfied its deposit requirements if it makes deposits of amounts withheld for dividend equivalents during any calendar quarter on or before the last day of the relevant quarter. The withholding agent should write "Notice 2016-76" on the center top portion of the 2017 tax return filed on IRS Form 1042.

- ***Simplified Standard for Determining Whether Transactions Are Combined Transactions.*** The Notice also provides a simplified standard for determining when two or more transactions should be combined to determine whether the transactions are subject to Section 871(m). Under the Final Regulations, two or more transactions are combined if (i) the long party (or a related person) enters into multiple transactions that reference the same underlying security, (ii) the transactions, if combined, replicate the economics of a transaction that would be subject to Section 871(m), and (iii) the transactions were entered into in connection with each other. A short party may presume that transactions are not entered into in connection with each other if either (i) the long party holds the transaction in separate accounts and the short party does not have actual knowledge that the accounts were created separately to avoid Section 871(m), or (ii) the transactions were entered into two or more business days apart. Comments to the Final Regulations noted that this would be an overly burdensome standard and requested a relaxed standard that would only charge a short party with knowledge that transactions were entered into in connection with each other if the short party had actual knowledge that the transactions were "priced, marketed or sold" together. Although the IRS rejected this approach in the Final Regulations, the Notice adopts this standard for transactions entered into in 2017. Therefore, for 2017, a broker may presume that transactions should not be combined for Section 871(m) purposes unless the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Transactions that are listed securities entered into in 2017 are therefore not subject to the combination rule.
- ***Phase-In Year for Qualified Derivatives Dealers.***
 - *QDD Rules Generally.* The Notice provides phase-in and administrative rules for Qualified Derivatives Dealers ("QDDs"). Generally, under the QDD regime, no U.S. federal withholding will be required on payments of dividend equivalents made to an entity that qualifies as a QDD that received those payments as principal. The Final Regulations provided requirements for a

Client Alert

Qualified Intermediary (“QI”) to be treated as a QDD and set out the responsibilities associated with becoming a QDD. On July 1, 2016, the IRS released the new QI Agreement in proposed form (the “Proposed QI Agreement”), which expanded on the responsibilities of QDDs and provided more specific rules.⁶

- *Withholding on Dividends Paid to a QDD.* In a departure from the Final Regulations and the Proposed QI Agreement, the Notice announces the Treasury Department’s and the IRS’s intention to amend the Final Regulations to provide that 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. Under the Final Regulations and the Proposed QI Agreement, QDDs were not subject to such withholding.
- *Changes to Calculating QDD Tax Liability.* Under the Proposed QI Agreement, a QDD must determine and pay its “QDD tax liability,” which generally includes (i) its “Section 871(m) Amount,” (ii) its dividends that are not on underlying securities associated with potential Section 871(m) transactions, (iii) its dividend equivalents received as a QDD in its non-dealer capacity, and (iv) any other U.S. source payments it receives as a QDD with respect to potential Section 871(m) transactions. Further, the Proposed QI Agreement defines the “Section 871(m) amount” as the sum of the amounts by which, for each dividend on each underlying security (i) the dividends on underlying securities associated with potential Section 871(m) transactions and dividend equivalent payments that the QDD receives in its dealer capacity exceed (ii) the dividend equivalent payments and the qualifying offsetting payments that the QDD makes or is contractually obligated to make in its dealer capacity. The Notice states that the Proposed QI Agreement will be revised to provide that a QDD’s “Section 871 Amount” will be determined by calculating the “net delta exposure” (measured in number of shares) of the QDD, 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 with respect to an underlying security entered into by the QDD in its equity derivatives dealer capacity. If a QDD calculates delta for non-tax business purposes, that net delta ordinarily will be the delta used for this purpose. A QDD’s tax liability on its Section 871(m) Amount associated with an underlying security will be reduced by the amount of tax paid by the QDD on the receipt of the same dividend payment on the same underlying security.
- *Phase-In Year.* In 2017, the IRS will take into account the extent to which a QDD made a good faith effort to comply with rules in the IRS’s administration and enforcement of the QDD rules in the Final Regulations and the Proposed QI Agreement. The Proposed QI Agreement will be revised to provide that, for 2017, a QDD will be considered to satisfy the applicable QDD obligations under the final QI agreement, provided that the QDD made a good faith effort to comply with the QI agreement. Any QDD that does not make a good faith effort will not be given any relief from IRS administration or enforcement during 2017, including penalties.

⁶ See IRS Notice 2016-42, 2016-29 I.R.B. 67. For further information on Notice 2016-42, see our client alert available at <https://media2.mofo.com/documents/160805taxtalk.pdf>.

Client Alert

- *Effective Date of QI Agreement.* The Notice provides further clarification for the effective date of the Proposed QI Agreement once it is finalized.
 - For a prospective QI applying before or on March 31 of a calendar year, its agreement will be effective as of January 1 of such year.
 - For a prospective QI applying after March 31 of a calendar year that has not received any reportable payments before the date the application is submitted, the effective date of its agreement will also be January 1 of such calendar year.
 - For a prospective QI applying after March 31 of a calendar year who has received a reportable payment in that year before the date the application is submitted, the effective date of its application will be the first day of the first month in which both the QI application is complete and the QI received its QI-EIN.
 - For a QI that is renewing its QI agreement,⁷ if renewed by March 31, 2017, the effective date of its QI agreement will be January 1, 2017.
- *Certifying QDD Status with QI Application Pending or Prior to Filing.* The Notice provides flexibility in certifying QDD status for prospective QDDs with applications pending. Before approval of a prospective QDD's QI agreement and QDD status, a prospective QDD that submitted a QI application applying for QDD status on or before March 31, 2017, may represent on an IRS Form W-8IMY that it is a QDD for six months after it submits such application. Similarly, a prospective QDD that intends to submit an application may represent on an IRS Form W-8IMY that it is a QDD until six months after the month in which it actually applies, provided that such prospective QDD applies by March 31, 2017. However, a prospective QDD may not represent QDD status if it (i) receives a notice from the IRS that the prospective QDD may not make the representation until the applicant's QI and QDD status have been approved, or (ii) no longer intends to submit an application by March 31, 2017. Finally, in cases where a prospective QDD certifies 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 it (i) no longer intends to apply by the deadline, (ii) does not apply by the deadline, or (iii) has its application denied.
- *Certifying QDD Status and Depositing Withheld Amounts, Pending Receipt of QI-EIN.* The Notice also provides administrative rules for certifying QDD status, pending the receipt of a QI employer identification number ("QI-EIN"). Upon approval of a QI application, the IRS will issue a QI-EIN. Once an applicant obtains a QI-EIN, the applicant must include such QI-EIN on any IRS Form W-8IMY that the applicant provides as QDD. If an applicant must certify QDD status before receiving its QI-EIN, the applicant can write "awaiting QI-EIN" on its IRS Form W-8IMY. A

⁷ All existing QI agreements expire on December 31, 2016, so the Proposed QI Agreement is proposed to be effective starting January 1, 2017.

Client Alert

withholding agent that receives an IRS Form W-8IMY with such a statement may treat the party providing the form as a QDD, unless the withholding agent knows or has reason to know the provider cannot validly represent that it is a QDD. A withholding agent can only rely on an IRS Form W-8IMY stating “awaiting QI-EIN” for up to six months after receipt, unless a QI-EIN is provided to the withholding agent within that time. Finally, the IRS will not assess any penalties for a QDD’s failure to deposit withheld amounts before such QDD receives its QI-EIN, provided the QDD deposits the amounts the QDD was previously required to deposit within three days of receiving its QI-EIN.

- **List of Exchange-Traded Notes (ETNs) with Delayed Effective Date.** Certain ETNs have been in continuous distribution. Issuers continuously issue and sell new ETNs based on the same offering document as the original ETN. The newly created ETN shares the same ticker symbol and CUSIP code as the previously issued ETN and are therefore fungible with the previously issued ETN for non-tax purposes. Under the Final Regulations, Section 871(m) generally does not apply to delta-one ETNs that reference underlying securities issued before January 1, 2017. This can create a fungibility problem for tax purposes where a newly created ETN issued after January 1, 2017 has the same ticker symbol and CUSIP as a prior created ETN issued before January 1, 2017. To permit issuers time to unwind such ETNs, maintain fungibility, and preserve market liquidity, the Notice provides that the Treasury Department and the IRS intend to amend the Final Regulations to delay the application of Section 871(m) (*i.e.* Sections 1.871-15(d)(2) and (e)) to specified NPCs and specified ELLs until January 1, 2020, for the following ETNs (the “Delayed Effective Date ETNs”) listed in Exhibit A. The Delayed Effective Date ETNs are delta-one ETNs that (i) existed before September 18, 2015, and (ii) have been in continuous distribution (as described above). The Notice seeks comments on whether there are other similar delta-one ETNs that (i) have existed before September 18, 2015 and (ii) will become subject to Section 871(m) withholding on January 1, 2017, and that should be added to the list of Delayed Effective Date ETNs list either through published guidance or in a private letter ruling.
- **Adjusting Underwithholding Before the Due Date (Without Extensions) For Filing IRS Form 1042.** Section 1.1461-2(b) relates to the withholding of additional tax when underwithholding occurs and provides that 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 the property over which it has control. Such additional withholding of additional tax must be made no later than the due date (not including extensions) for filing IRS Form 1042 for the year in which the underwithholding occurred. The Notice clarifies that the IRS’s interpretation of Section 1.1461-2(b) is that a withholding agent may rely on the procedures in Section 1.1461-2(b) to adjust its underwithholding without penalty before March 15 of the year following the year in which the underwithholding occurred.

Client Alert

Select observations:

- **Specified NPCs entered into before January 1, 2017 excluded from the Notice.** The Notice does not apply to a specified NPC (as described in Section 1.871-15(d)(1)) entered into before January 1, 2017.
- **Anti-abuse rule continues to apply in 2017 and 2018.** The Notice provides that the anti-abuse rule in Section 1.871-15(o) will continue to apply during the phase-in years of 2017 and 2018. 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 Section 1.871-15(o).
- **Nature of IRS relief is unclear.** The Notice provides that relief will be offered to taxpayers upon a showing of good faith effort to comply with the Section 871(m) regulations. It is unclear what such relief entails. For example, would the IRS forgive the taxpayer only for penalty or would the IRS also forgive the taxpayer for the tax liability? The Notice merely provides that the IRS will not grant relief for administration or enforcement (including penalties) for taxpayers who do not make a good faith effort to comply.
- **Delayed Effective Date ETNs.** The list of Delayed Effective Date ETNs are only for ETNs that existed before September 18, 2015. The Notice does not provide any relief for delta-one ETNs created after September 18, 2015 but issued before January 1, 2017.
- **Future Guidance Around the Corner?** While the Notice does provide some relief, it leaves some ambiguities from the Final Regulations unresolved including (i) how the dividend equivalent amount should be determined for instruments referencing master limited partnerships with corporate subsidiaries, (ii) whether dividend equivalent amounts for a convertible debt instrument should be determined by reference to dividends paid on the convertible debt instrument (including dividend equivalents and Section 305(c) dividends) or by reference to the shares underlying the convertible debt instrument, and (iii) whether withholding should be delayed until an actual cash payment is made on a Section 871(m) transaction.⁸

⁸ Industry groups such as the Securities Industry and Financial Markets Association and the New York State Bar Association have commented on such ambiguities, among others. See New York State Bar Association Tax Section Report No. 1340 dated March 28, 2016 and the comment letter from the Securities Industry and Financial Markets Association dated March 31, 2016.

Client Alert

Exhibit A – Delayed Effective Date ETNs (until January 1, 2020)

| Ticker Symbol | ETN Name | CUSIP |
|---------------|------------------------------|-----------|
| 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 |

Client Alert

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