



United States Tax Alert

Notice 2017-42: Extended effective date for Section 871(m) withholding on dividends

On August 4, 2017, Treasury and the IRS issued Notice 2017-42, "Extension of the Phase-in Period for the Enforcement and Administration of Section 871(m)" (the "Notice"). The Notice essentially extends certain aspects of the final and temporary regulations under Internal Revenue Code section 871(m) published on September 15, 2015 in the Federal Register as TD 9734, 80 FR 56866 (the "Final Regulations"). Notice 2016-76, 2016-51 I.R.B. 834, published on December 19, 2016, provided phased-in application of certain parts of the Final Regulations to provide taxpayers additional time for administration of section 871(m) treatment of non-delta one equity derivative contracts and to coordinate such treatment with the requirements of the new Qualified Intermediary (QI) agreement.

Notice 2016-76 overview

Notice 2016-76, which announced reversal of the dividend exemption treatment in Notice 2016-42, as well as a simplified standard for the combination rule during an interim period, provided originally that the tax on US-source dividends received by a Qualified Derivative Dealer (QDD) in derivative dealer capacity would not apply through December 31, 2017, and the interim simplified standard for the combination rule would also apply for the 2017 year. Notice 2017-42 extends these original extended due dates by one additional year through December 31, 2018 along with extending the good faith compliance relief for the QDD provisions of the Qualified Intermediary (QI) agreement, as discussed below.

New Notice 2017-42

In Notice 2017-42, Treasury and the IRS have provided additional time for taxpayers and withholding agents to implement the Final Regulations applicable to:

- (i) Non-delta one transactions: extended through 2018
- (ii) Simplified standard for combined transactions under Treas. Reg. §1.871-15(n): extended through 2018

Under the simplified standard, withholding agents are required to combine transactions entered into in connection with each other. Notice 2016-76 provided that for 2017 only, transactions need be combined only when they are “over-the-counter” (OTC) transactions that are priced, marketed or sold in connection with each other. Listed transactions are not required to be combined in 2017. This approach is extended through 2018. However, OTC transactions that are combined in 2017 and 2018 (i.e., OTC transaction that are entered into in connection with each other) will continue to be treated as combined for future years. Transactions that are not combined in 2017 and 2018 will not be combined in future years unless reissued or events require retesting.

The effective/applicability date for non-delta one transactions described in Treas. Reg. §1.871-15(d)(2) and (e) will not apply to any payment made with respect to any non-delta one transaction issued before January 1, 2019.

- (iii) US-source dividends paid to a QDD: withholding and Section 881(a) liability deferred through 2018

Treasury has changed its policy on the treatment of dividends paid to QDDs. Originally, 2015 final regulations with implementation for QDDs and QIs in Notice 2016-42 issued July 1, 2016 in advance of the QI revenue procedure provided that dividends paid to documented QDDs were not subject to withholding or to QDD tax liability if the QDD had offsetting payments made in the QDD’s dealer capacity. Notice 2016-76 announced a reversal of this treatment, and revised final regulations issued in 2017 provided that US-source dividends payable to documented QDDs would be subject to withholding and to QDD tax liability regardless of the QDD’s offsetting exposure. This reversal was a replacement of the offsetting payment regime announced in Notice 2016-42, a trade-off for Treasury having provided a “net delta exposure” regime in response to requests in industry comments. The implementation of withholding and the QDD liability on the dividends was delayed for all US-source dividends received by the QDD in its capacity as a derivatives dealer in 2017.

Notice 2017-42 extends the exemption from withholding to a documented QDD and the QDD’s exemption from section 881(a) liability on dividends received in the QDD’s dealer capacity for dividends paid to the QDD through 2018. The Notice does not provide any exemption for dividends received by the QDD in any other capacity than as a derivatives dealer. All dividends received in non-dealer capacity remain subject to gross basis tax liability to the taxpayer that is also the QDD.

Enforcement standards

The good faith standard for attempting to comply with the requirements of the final regulations is extended an additional year for both delta one and non-delta one transactions as follows:

- (i) Delta one transactions: good faith compliance will be applicable for effective transactions in both 2017 and 2018
- (ii) Non-delta one transactions pursuant to Treas. Reg. §1.871-15(d)(2) or (e): good faith compliance will be applicable for effective transactions in 2019
- (iii) QDD enforcement: extends through 2018 the period in which a QDD made a good faith effort to comply with the relevant provisions of the 2017 QI agreement

In addition, despite not having originally been included in the list of regulations subject to review, Notice 2017-42 states that consistent with Executive Order 13777, Treasury and the IRS continue to evaluate the Final Regulations and consider possible agency actions that may reduce unnecessary burdens imposed by the regulations.

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