TaxNewsFlash

United States

No. 2016-556
December 14, 2016

KPMG report: Relief provided for looming section 871(m) regulations in Notice 2016-76

The U.S. Treasury Department and IRS on Friday, December 2, 2016, released an advance version of Notice 2016-76 that formally announces delays in the effective date of certain portions of the section 871(m) regulations—as informally announced several weeks ago.

Notice 2016-76 also makes changes to the Qualified Derivatives Dealer (QDD) rules, including a one-year extension of the Qualified Securities Lender (QSL) rules.

Notice 2016-76 [PDF 266 KB] is structured as an announcement of changes that Treasury and the IRS will make to the final and temporary regulations under section 871(m), but is intended to be relied upon currently by taxpayers and withholding agents.

The following discussion describes the provisions of and observations about Notice 2016-76. Read a prior report of initial impressions about the notice in ***TaxNewsFlash-United States***

Delayed implementation of section 871(m)

Notice 2016-76 announces Treasury's and the IRS's intention to amend the effective dates of section 871(m) with respect to notional principal contracts (NPCs) and equity-linked instruments (ELIs) (e.g., options, futures, forwards, convertible debt, and structured notes). The notice does not change the effective date rules for securities loans (except as noted below) or repos subject to the current rules. Below is a summary of the changes:

- Section 871(m) will apply to NPCs and ELIs that have a delta of one—including combined transactions with a delta of one—that are issued on or after January 1, 2017.

© 2016 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

- Section 871(m) will only apply to non-delta one NPCs and ELIs that are issued on or after January 1, 2018.
- Withholding agents will be considered to meet the deposit requirements for section 871(m) dividend equivalent payments in 2017 if they make deposits of amounts withheld during a calendar quarter on or before the last day of the calendar quarter.
- Taxpayers may continue to rely on Notice 2010-46 (the QSL rules) in determining withholding on securities loans in 2017.
- Section 871(m) will not apply to a specific list of exchange-traded notes (ETNs) until January 1, 2020.

In connection with these staggered effective dates, Notice 2016-76 also announced that 2017 and 2018 will be considered "phase-in years" for delta one instruments and non-delta one instruments, respectively. During the phase-in years, the IRS will administer and enforce the section 871(m) rules by taking into account the extent to which a taxpayer or withholding agent made a good faith effort to comply with the regulations.

Notice 2016-76 contains specific examples of evidence of a "good faith effort" by a withholding agent—including efforts to make its documentation and withholding compliant, implementing the simplified combination rules (discussed below), providing the required information to other parties to the transaction, and implementing the substantial equivalence test for 2018. Any person that does not make a good faith effort to comply with the regulations will not be given relief from IRS administration or enforcement, including penalties.

Treasury and the IRS also announced that withholding agents will not be required to apply the combination rule as currently written in the regulations. Instead, during 2017, withholding agents are only required to combine over-the-counter (OTC) transactions that are priced, marketed, or sold in connection with each other. Withholding agents will not be required to combine any listed securities that are issued prior to 2018. Long parties, however, were granted no relief and are still expected to comply with the combination rule as written in the regulations.

KPMG observation

The delays provide welcome relief for parties to potential section 871(m) transactions. Taxpayers and withholding agents only need to withhold and report on delta one transactions in 2017. However, any product could be structured as a delta one product, so taxpayers and withholding agents still need to determine that they have considered the application of these rules to all products that could be potential section 871(m) transactions—i.e., all financial instruments other than stock that directly or indirectly reference U.S. equities. Additionally, no effective date relief is provided with respect to delta one transactions on baskets of U.S. equities, non-qualified indices, and covered partnerships.

Withholding agents could benefit from the effective date relief, but also need to pay attention to the "good faith effort" rule for the phase-in years. The one-year delay for

© 2016 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

non-delta-one transactions, the simplified combination rule, the extension of the existing QSL rules, and the quarterly deposit rules should give withholding agents more time to prepare for the new regulations. Some of the challenges that may remain for withholding agents (e.g., withholding on delta one listed securities, identifying qualified indices and covered partnerships) may be difficult to address by January 1, 2017. As a result, it is important that withholding agents separately document the efforts they have taken to be compliant.

Notice 2016-76 provides limited relief to the combination rule. Specifically, the notice adopts the narrower "priced, marketed, or sold" standard for withholding agents—i.e., only requiring withholding agents to combine transactions that are priced, marketed, or sold in connection with each other—and limits the application of the combination rule to OTC positions, excluding listed securities. This relief, however, only applies to transactions that are issued in 2017. Notice 2016-76 explicitly rejects the securities industry's suggestion to use "priced, marketed, or sold" as a long-term solution for the combination rule. Therefore, it appears likely that the combination rule set forth in the current regulations will need to be applied to transactions issued in or after 2018.

Significantly, Notice 2016-76 does not change the application of the current combination rule to long parties. Long parties, therefore, must still be prepared to comply with the current combination rule for positions that, when combined, will result in a delta one transaction. Consequently, long parties need to consider taking steps to be prepared to comply with this rule for positions issued in or after 2017. Given the breadth of the rule and the remaining uncertainties, long parties need to document their efforts to avail themselves of the "good faith" relief.

Notice 2016-76 generally exempts complex contracts in 2017. This is consistent with the idea that, even if delta could be calculated for complex contracts, such contracts should never have a delta of one.

The notice also lists specific ETNs that are currently excluded from section 871(m) and grants them a further reprieve until January 1, 2020. The delay applies only to ETNs that are specifically listed. Section 871(m) continues to apply to any other ETNs, including comparable ETNs that are not included in the list. Notice 2016-76 asks for comments on other delta one transactions issued before September 18, 2015, that will become subject to section 871(m) withholding on January 1, 2017. Sponsors and investors in other ETNs may want to consider providing comments.

QDD application process

Notice 2016-76 clarifies that prospective qualified intermediaries (QIs) have until March 31, 2017, to apply for QI status with the IRS (or to submit a renewal application for QI status) in order to be treated as QIs effective January 1, 2017. A prospective QI that applies after March 31, 2017, and that has not received any reportable payments prior to the time it submits its application will also be treated as having QI status effective January 1, 2017. All other prospective QIs will be treated as having QI status

© 2016 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

as of the first day of the month in which the QI application is complete and the QI has received its QI-EIN.

A prospective QI that intends to register as a QDD but has not done so—or has not yet received its QI-EIN—may represent that it is a QDD on a Form W-8IMY and indicate “awaiting QI-EIN” on line 8 of the Form W-8IMY from January 1, 2017, up until six months after the prospective QI has submitted its QI application, provided that it actually submits its application by March 31, 2017. A prospective QI that represents it is a QDD but later decides not to apply by March 31, 2017, does not actually apply by March 31, 2017, or has its application denied, is required to immediately notify any withholding agents to which it provided a Form W-8IMY identifying itself as a QDD that it no longer qualifies as a QDD. In addition, a QDD that has received its QI-EIN must provide the QI-EIN as soon as practical to any withholding agent to which it provided a Form W-8IMY with the “awaiting QI-EIN” status. The QI-EIN may be provided in any manner and does not require the submission of a new Form W-8IMY.

A QDD that has not yet obtained its QI-EIN will not be required to make deposits until three days after the receipt of its QI-EIN or, for QDDs applying for the Electronic Federal Tax Payment Systems (EFTPS), until three days after being enrolled in EFTPS, provided it enrolls in EFTPS within 30 days of receiving its QI-EIN.

KPMG observation

While the IRS has publicly stated that it will have the QDD portal ready by December 30, 2016, at the latest, and will release the final QI agreement by the end of 2016, prospective QIs will have the first three months of 2017 to confirm that they are willing to comply with the terms of the final QI agreement and submit their applications while being treated as QDDs.

The rules under Notice 2016-76 contain a discrepancy between the time period in which a QDD may use the “awaiting QI-EIN” status and the time in which a withholding agent may rely upon such status. A QDD may potentially use the “awaiting QI-EIN” status for six full months after its application deadline (i.e., as late as September 30, 2017, if it waits until March 31, 2017, to submit its application); however, a withholding agent that receives the Form W-8IMY will only be able to rely upon the form without a QI-EIN for six months after receipt (i.e., June 30, 2017, for a form provided on January 1, 2017). While the IRS does not expect that it will take over three months to process a QI application, if this does happen, withholding agents may potentially be required to reject the Form W-8IMY supplied by the QDD after the initial six-month period until a QI-EIN is provided, even though the QDD is technically able to rely upon this status for an additional three months.

QDD withholding and tax liability

Notice 2016-76 made a fundamental change to the withholding rules applicable to QDDs. While the previous rules provided that there would be no withholding imposed on payments to QDDs, the notice provides that a withholding agent is required to

© 2016 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. Printed in the U.S.A.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

withhold on actual dividend payments (i.e., dividends paid on physical shares and deemed dividends) paid to a QDD. Dividend equivalent payments made to a QDD that provides a valid Form W-8IMY will continue to be exempt from withholding tax.

Notice 2016-76 also changes the manner in which the QDD's tax liability is calculated. Rather than offsetting incoming payments with specific offsetting transactions, Notice 2016-76 shifts to a net delta approach for calculating the QDD's section 871(m) liability. A QDD's section 871(m) amount is now determined by calculating the QDD's net delta exposure measured in shares and then multiplied by the dividend amount per share. This section 871(m) amount may be offset by the amount of tax paid by the QDD on the receipt of the same dividend payment on the same underlying security (i.e., the amount of tax withheld on the actual incoming dividend) but may not be reduced below zero. Therefore, Notice 2016-76 establishes a floor equal to the amount of tax paid on the amount of actual dividends received by the QDD, determined at the QDD's relevant treaty rate.

The QDD will continue to be required to withhold on outgoing dividend equivalent payments made to non-U.S. persons. Under the rules as drafted, there is no credit forward system that would permit the QDD to offset withholding on the outgoing dividend equivalent payment by the amount withheld on an incoming actual dividend payment. Therefore, Notice 2016-76 reintroduces the possibility of cascading withholding resulting from withholding being applied both to the incoming actual dividend and to the outgoing dividend equivalent payment.

KPMG observation

The imposition of withholding on actual dividends was done as a result of the change to the calculation of the QDD tax liability from specifically matching offsetting payments to the net delta approach requested by industry. As we understand it, Treasury and the IRS were concerned that due to the increased flexibility permitted under the net delta approach, a QDD could potentially be perfectly hedged with instruments having deltas below 0.8. In such case, no tax would be computed on the QDD's receipt of an actual dividend or on the outgoing substitute dividend payment to the counterparty, and withholding would need to be imposed on the actual dividend in order for the IRS not to get whipsawed.

While the approach taken in Notice 2016-76 has the potential to lead to cascading withholding when the QDD holds physical U.S. shares offshore, such a result may be mitigated by shifting the physical hedge shares to the United States. The approach taken under the notice was predicated on the assumption that foreign dealers rarely hold physical U.S. shares outside of the United States, such that the cascading withholding possibility was more a theoretical issue than a practical one. To the extent that dealers are holding physical shares outside of the United States and are unable to easily move those shares to the United States, it is important to raise this issue with Treasury and the IRS.

© 2016 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Notice 2016-76 seems to suggest that a QDD typically should provide a Form W-8IMY to withholding agents, to avoid being withheld upon when receiving dividend equivalent payments. However, in circumstances when a QDD is receiving an actual dividend, the QDD would be unable to claim a reduced treaty rate on Form W-8IMY. Therefore, when receiving actual dividends, the QDD likely will provide a Form W-8BEN-E so that it can make a treaty claim, when applicable. It is expected that the IRS will issue further guidance illustrating this outcome, as well as addressing which EIN should be used by a QDD that provides a Form W-8BEN-E for an actual dividend.

Timing of deposits when under-withholding has occurred

Notice 2016-76 states that it is the IRS's position that when a withholding agent has under-withheld on a payment, but is able to satisfy the under-withholding in the manner provided in Reg. section 1.1461-2(b) (e.g., by withholding on future payments to the beneficial owner or by satisfying the tax from property of the beneficial owner held by or controlled by the withholding agent) prior to the filing deadline for Form 1042 (not including extensions), no penalties for failure to deposit or to pay tax will apply. While the notice discusses this rule in the context of under-withholding on dividend equivalent payments, the language is broad enough to apply to under-withholding for all payments under chapters 3 and 4 of the Code.

KPMG observation

This interpretation is a significant departure from the process currently followed by the industry and by IRS examination teams. In fact, the satisfaction of under-withholding in a later period generally will trigger an automatic late deposit penalty on the current and prior Forms 1042. The Form 1042 draft instructions for the 2016 tax year amend this result so that the withholding agent is instructed to enter the tax liability for the period that the under-withholding is corrected—rather than the period in which the payment for which the under-withholding occurred was made. Therefore, it appears that the late-deposit penalty will not be triggered when under-withholding is corrected within the permissible time periods for the 2016 Form 1042. Given the broad scope of the language contained in Notice 2016-76, it also appears this notice may be used to counter late-deposit penalties that were applied as a result of under-withholding in prior years, provided the under-withholding was resolved prior to March 15th of the following year.

For more information, contact a tax professional with KPMG's Washington National Tax

Questions about section 871(m), contact:

Mark Price | +1 202 533 4364 | mhprice@kpmg.com

Dan Mayo | +1 973 315 2658 | dmayo@kpmg.com

© 2016 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Questions about U.S. withholding agent, QI or QDD questions, contact:

Laurie Hatten-Boyd | +1 206 913 4489 | lhattenboyd@kpmg.com

Danielle Nishida | +1 212 954 2774 | daniellenishida@kpmg.com

The information contained in TaxNewsFlash is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230, as the content of this document is issued for general informational purposes only, is intended to enhance the reader's knowledge on the matters addressed therein, and is not intended to be applied to any specific reader's particular set of facts. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG International is a Swiss cooperative that serves as a coordinating entity for a network of independent member firms. KPMG International provides no audit or other client services. Such services are provided solely by member firms in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any member firm in any manner whatsoever.

Direct comments, including requests for subscriptions, to Washington National Tax. For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.

To unsubscribe from TaxNewsFlash-United States, reply to Washington National Tax.

Privacy | Legal

© 2016 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.