

Clients & Friends Memo

IRS Phases in Section 871(m) Dividend Equivalent Withholding

December 5, 2016

On December 2, the U.S. Internal Revenue Service issued Notice 2016-76, which phases in the application of withholding on dividend equivalent payments under section 871(m). Under the notice, withholding applies only to delta-one transactions in 2017, and applies to other U.S. equity transactions beginning after 2017. A delta-one transaction tracks the underlying on a dollar-for-dollar basis.

In addition, the notice generally provides that:

- When enforcing section 871(m) in 2017 (for delta-one transactions) and 2018 (for non-delta-one transactions), the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with section 871(m).
- In 2017, withholding agents will be required to combine transactions for purposes of determining whether the transactions are subject to withholding under section 871(m) only if the transactions are over-the-counter transactions and are priced, marketed, or sold in connection with each other. (This simplified standard applies only to withholding agents, and not to long parties. Thus, a long party may still owe substantive tax with respect to equity-linked derivatives that are entered into in connection with each other and, when combined, have a delta of at least .80, even if the withholding agent does not withhold.)
- The IRS intends to revise the proposed QI agreement issued under Notice 2016-42 to (1) impose withholding on actual dividends paid to a QDD, (2) calculate a QDD's tax liability under section 871(m) by reference to the QDD's "net delta exposure," and (3) provide additional phase-in rules for QDDs for 2017. We discussed Notice 2016-42 in our [Clients & Friends Memo](#).
- Withholding under section 871(m) will not apply until 2020 to certain existing exchange-traded notes that are specifically identified in the notice.

A copy of Notice 2016-72 can be found [here](#). For a comprehensive discussion of section 871(m), see our [Clients & Friends Memo](#).

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