

US IRS issues final Section 871(m) regulations on dividend equivalent payments on derivatives referencing US equities, extends transition relief

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration [here](#).

Also available is our [EY Global Tax Alert Library](#) on ey.com.

The United States (US) Internal Revenue Service (IRS) has issued final regulations ([TD 9887](#), 2019 final regulations) under Internal Revenue Code¹ Section 871(m) with guidance for entities that hold certain US equities and financial products referencing US-source dividends. In [Notice 2020-2](#), issued concurrently with the 2019 final regulations, the IRS has announced that it is extending the transition relief provided in Notice 2018-72 for two additional years and that it plans to amend the Section 871(m) regulations to reflect the delayed effective/applicability dates. This guidance is relevant for entities making payments to non-US entities on derivatives and other financial instruments referencing US equity securities.

This Alert assumes general familiarity with Section 871(m) and its concepts and prior IRS guidance and proposed guidance.

The 2019 final regulations, which adopt 2017 proposed regulations without substantive change, define "broker," include guidance on the determination of "delta" for options listed on a foreign regulated exchange, and clarify withholding tax responsibilities for transactions with multiple brokers or dealers.

Background

Section 871(m) treats “dividend equivalent payments” made with respect to certain derivative transactions referencing dividend-paying US equities as actual US-source dividends subject to withholding under Sections 1441 and 1442 (chapter 3 or NRA withholding) and 1471 and 1472 (chapter 4 or the *Foreign Account Tax Compliance Act (FATCA)*).

In January 2017, the IRS issued final and temporary regulations under Section 871(m) (2017 final and temporary regulations), clarifying some obligations of agents that are responsible for withholding on relevant products and of broker-dealers generally charged with identifying the products that are subject to the Section 871(m) rules, as well as providing elections to reduce implementation concerns. The 2017 regulations also adopted the “qualified derivatives dealer” rules announced in Notice 2016-76 and incorporated into the final Qualified Intermediary (QI) agreement. Proposed regulations cross-referencing the 2017 temporary regulations were issued concurrently (2017 proposed regulations).

In August 2017, the IRS issued [Notice 2017-42](#), which extended transition relief for certain portions of the 2017 final regulations. Subsequently, in February 2018, the IRS issued [Notice 2018-5](#), which permitted withholding agents to apply the transition rules to securities loans to which Section 871(m) applies from Notice 2010-46 in 2018 and 2019. [Notice 2018-72](#), issued in September 2018, further extended certain transition relief and permitted withholding agents to apply the transition rules from Notice 2010-46 in 2020.

2019 final regulations

The 2019 final regulations adopt the 2017 proposed regulations without substantive change and withdraw the corresponding 2017 temporary regulations.

The 2019 final regulations define broker for purposes of Section 871(m) as a broker within the meaning of Section 6045(c), “except that the term does not include any corporation that is a broker solely because it regularly redeems its own shares.”

The 2019 final regulations include rules on whether a foreign exchange is a regulated exchange such that, under the Section 871(m) regulations, the delta² of an option that is listed on the foreign regulated exchange may be calculated based on the delta of that option at the close of business on the business day before the date of issuance. To constitute a regulated exchange under the Section 871(m) regulations, the 2019 final regulations specify that the foreign exchange must (1) be regulated by a government agency in the jurisdiction in which the market is located, (2) maintain certain requirements designed to protect investors and to prevent fraud and manipulation, (3) maintain rules to promote active trading of listed options, and (4) have had trades for which the average trading volume exceeded US\$10 billion³ per day during the prior calendar year (the \$10 billion threshold).

The IRS declined to adopt the sole comment received on the 2017 proposed regulations, which had requested the elimination of the \$10 billion threshold. The IRS explained that the threshold was intended to ensure that there is sufficient trading on the exchange to prevent price manipulation.

Finally, consistent with the 2017 proposed regulations, the 2019 final regulations include rules identifying which party to a potential Section 871(m) transaction is responsible for determining whether a transaction is a Section 871(m) transaction when multiple brokers or dealers are involved in the transaction.

Notice 2020-2

Notice 2020-2 extends the transition relief included in Notice 2018-72 for two years, including extending the phase-in application of the Section 871(m) regulations for delta-one and non-delta-one transactions. Thus, the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the Section 871(m) regulations when enforcing those regulations for (1) any delta-one transaction in 2017 through 2022, and (2) any non-delta-one transaction (such as, in most cases, an option) that will come within Section 871(m)’s scope in 2023. Perhaps most importantly, the rules requiring withholding generally will not apply to any payment made for any non-delta-one transaction issued before 1 January 2023.

The Notice 2020-2 extended transition relief also includes:

- ▶ Extending through 2022 the simplified standard included in Notice 2016-76 (and previously extended in Notices 2017-42 and 2018-72) for withholding agents to determine whether transactions are combined transactions
- ▶ Extending the phase-in relief for qualified derivatives dealers (QDDs) such that a QDD will not be subject to tax on dividends and dividend equivalents received in 2021 and 2022 in its equity derivatives dealer capacity or to withholding on those dividends
- ▶ Extending the transition rules for securities loans and the credit forward system included from Notice 2010-46 for payments made in 2021 and 2022

The IRS plans to amend the Section 871(m) regulations to incorporate the delayed effective/applicability dates. Until those regulations are issued, taxpayers may rely on the provisions of Notice 2020-2.

Implications

The extension of the phase-in period for certain provisions of the Section 871(m) regulations and guidance permitting withholding agents to apply transition rules for payment in 2021 and 2022 provide financial industry participants

additional time to implement the complex systems and processes necessary to comply with the rules of the Section 871(m) regulations. In particular, the continued temporary exclusion of non-delta one transactions from withholding tax under Section 871(m) will generally eliminate the amount of tax withheld under that section on options with deltas between 0.8 and 1.0. However, taxpayers should consider whether such options may still be subject to the anti-avoidance rule, which is currently in effect. The extension is arguably more favorable for broker-dealers and other withholding agents that are relieved of the responsibility of applying more onerous withholding rules in certain cases involving multiple trades. Taxpayers with long exposure to US equities, including asset management industry participants, will need to apply additional guidelines to their trading parameters to ensure that no additional self-assessment is required beyond what withholding agents are withholding, if anything.

The combined transaction rules and the extension of Section 871(m) to options were two of the most controversial – and difficult to implement – provisions of the existing guidance. It is understood that the IRS and Treasury are revisiting several issues under Section 871(m). It is too early to predict whether and how the guidance might change in the future.

Endnotes

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. The “delta” of an instrument is a measure of the relationship between changes in value of the instrument and changes in value of the underlying stock at the time delta is measured. If a transaction has a delta of 1.0 then one would expect changes in the value of the instrument and changes in the value of the underlying stock to mirror each other exactly. One would expect options to have a delta less than, and frequently significantly less than, 1.0.
3. Currency references in this Alert are to US\$.

For additional information with respect to this Alert, please contact the following:

Ernst and Young, LLP (United States), International Tax and Transaction Services - Capital Markets Tax Practice

- ▶ Matthew Stevens, *Washington, DC* matthew.stevens@ey.com
- ▶ Lena Y Hines, *Los Angeles* lena.hines@ey.com

Ernst and Young, LLP (United States), International Tax and Transaction Services, New York

- ▶ Lauren Lovelace lauren.lovelace@ey.com

Ernst and Young, LLP (United States), International Tax and Transaction Services - Financial Services Organization, Boston

- ▶ Matthew S. Blum matt.blum@ey.com

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2019 EYGM Limited.
All Rights Reserved.

EYG no. 005933-19Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com