

# Clients & Friends Memo

## **New 871(m) Regulations Finalize Dividend Equivalent Payment Withholding Rules for Equity Derivatives**

**October 1, 2015**

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## I. Introduction

On September 17, 2015, the IRS and the Treasury Department issued final, temporary, and proposed regulations under section 871(m) of the Internal Revenue Code (collectively, the “new regulations”) that provide the rules for withholding on “dividend equivalent payments” on derivatives that reference U.S. equity securities.<sup>1</sup> In general, the rules narrow the class of derivatives that would have been subject to withholding under the proposed regulations issued in 2013 (the “2013 proposed regulations”).<sup>2</sup> For example, under the new regulations, a “simple contract” is not subject to withholding unless its delta is 0.80 or more whereas, under the 2013 proposed regulations, withholding would have been imposed if the delta was at least 0.70.<sup>3</sup> However, the new regulations still require withholding on “price return only” derivatives that do not provide for payments that reference dividends.<sup>4</sup>

In addition, the new regulations delay the effective date that would have applied under the 2013 proposed regulations. Under the new regulations, withholding is imposed on equity derivatives issued after 2016.<sup>5</sup> The 2013 proposed regulations generally would have applied to all payments made on an equity derivative after 2015, regardless of when the derivative was entered into.

Some of the most important aspects of the new regulations are:

- **Higher delta threshold of 0.80.** As mentioned above, the new regulations increase the delta threshold for a “simple” contract to determine whether an equity derivative is subject to withholding to 0.80, from 0.70 in the 2013 proposed regulations.<sup>6</sup> A simple contract is a derivative for which payments are calculated by reference to a single, fixed number of shares that can be ascertained when the derivative is issued, and that has a single maturity or exercise

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<sup>1</sup> Treasury Decision 9734 (September 17, 2015).

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

<sup>2</sup> We discussed the 2013 proposed regulations in a previous Clients and Friends Memo, which is available at <http://www.cadwalader.com/resources/clients-friends-memos/final-and-proposed-regulations-address-us-withholding-tax-on-dividend-equivalent-payments>.

<sup>3</sup> Treasury regulations section 1.871-15(e)(1).

<sup>4</sup> Treasury regulations section 1.871-15(i)(2)(ii).

<sup>5</sup> Treasury regulations section 1.871-15(r)(3). The new regulations would have imposed withholding on equity derivatives issued in 2016 that are still outstanding in 2018 and on all equity derivatives issued after 2016. The IRS and the Treasury subsequently revised these effective dates. See 80 FR 75946 (Dec. 7, 2015).

<sup>6</sup> Treasury regulations sections 1.871-15(d)(2)(i), (e)(1).

date with respect to which all amounts (other than any upfront payment or any periodic prepayments) are required to be calculated with respect to the underlying security.<sup>7</sup>

- **Special rules for complex contracts.** The new regulations do not apply the 0.80 delta test to “complex contracts” (i.e., all derivatives other than simple contracts). Instead, the new regulations adopt a “substantial equivalence” test that compares the change in value of a complex contract with the change in value of the shares of the equity security that would be held to hedge the derivative over an increase or decrease in the price of the equity security by one standard deviation.<sup>8</sup> If the proportionate difference between (1) the change in value of the complex contract and the change in value of its hedge is no greater than (2) the change in value of a benchmark simple contract with respect to the same shares with a delta of 0.80 and the change in value of its hedge, then the complex contract is substantially equivalent to the underlying security and dividend equivalent payments with respect to it are subject to withholding.<sup>9</sup>
- **Day-one delta test.** The new regulations test a derivative’s delta (or substantial equivalence) at initial issuance.<sup>10</sup> By contrast, the 2013 proposed regulations generally tested a derivative’s delta each time a foreigner acquired the derivative and each time a dividend was paid or (in the case of short-term derivatives) the derivative was disposed of. The day-one delta test makes it much easier for taxpayers to identify derivatives subject to withholding.
- **Convertible debt instruments.** Although the new regulations apply to convertible debt instruments (as did the 2013 proposed regulations), the combination of the increased 0.80 delta threshold and the day-one delta test will have the effect of exempting most traditional convertible debt instruments because they generally have deltas lower than 0.80 upon issuance.
- **Withholding on price return only derivatives.** As mentioned above, the new regulations retain the rule in the 2013 proposed regulations that requires withholding on an equity derivative that satisfies the 0.80 delta test or the substantial equivalence test even if the derivative does not provide for payments based on dividends, on the theory that dividend payments are implicit even in a contract that does not provide for them.<sup>11</sup> As discussed below, we believe that this rule continues to present statutory authority and tax treaty issues.
- **Simplified rules for determining the amount of a dividend equivalent payment subject to withholding.** Under the 2013 proposed regulations, the amount of the dividend equivalent payment subject to withholding was equal to the per share dividend amount with respect to the underlying security, multiplied by the number of shares of the underlying security referenced in the contract, multiplied by the delta at the time the dividend equivalent was

<sup>7</sup> Treasury regulations section 1.871-15(a)(14)(i).

<sup>8</sup> Temporary Treasury regulations section 1.871-15T(h).

<sup>9</sup> Temporary Treasury regulations section 1.871-15T(h)(1).

<sup>10</sup> Treasury regulations section 1.871-15(g)(2) (delta); Temporary Treasury regulations section 1.871-15T(h)(1) (substantial equivalence).

<sup>11</sup> Treasury regulations section 1.871-15(i)(2)(ii).

determined. Determining the delta each time the dividend equivalent is determined would have been particularly difficult as an administrative matter. The new regulations require delta to be determined only at the time a derivative is issued.<sup>12</sup>

- **Withholding on short-term options.** The new regulations impose withholding on an equity option with a delta of 0.80 or more, even if the option has a term of one year or less and is not exercised. The 2013 proposed regulations did not require withholding on lapsed short-term options.
- **Presumptions for combined transactions.** The 2013 proposed regulations required a withholding agent to withhold on an equity derivative that failed the delta test if, after using “reasonable diligence,” the withholding agent concluded that the derivative had been entered into “in connection with” another derivative and, when combined, the derivatives satisfied the delta test. The new regulations retain this rule,<sup>13</sup> but add two helpful presumptions for short-party brokers. First, a short-party broker may presume that transactions are not entered into in connection with each other if the long party holds the transactions in separate accounts, so long as the broker does not have actual knowledge that the long party used the separate accounts to avoid section 871(m) or that the transactions were entered into in connection with each other.<sup>14</sup> Second, a short-party broker may presume that transactions are not entered into in connection with each other if they are entered into at least two business days apart, so long as the broker does not have actual knowledge that the transactions were entered into in connection with each other.<sup>15</sup> These presumptions do not apply to long parties;<sup>16</sup> thus, all transactions that are entered into in connection with each other are combined for purposes of determining whether a long party is subject to tax under section 871(m), but, if the short party benefits from a presumption, this tax may not be collected through withholding.
- **Qualified indices.** Derivatives that reference a “qualified index” are not subject to withholding under section 871(m).<sup>17</sup> The new regulations test whether an index is a qualified index on the first business day of the calendar year in which a derivative is issued, whereas the 2013 proposed regulations generally required testing each time a foreigner acquired the derivative.<sup>18</sup> The new regulations generally retain the definition of “qualified index.” However, the new regulations remove the requirement in the 2013 proposed regulations that any rebalancing of the index be based on objective rules, thereby permitting the S&P 500 Index and other major stock indices that rebalance based on subjective criteria to qualify as qualified indices.<sup>19</sup> The

<sup>12</sup> Treasury regulations section 1.871-15(g)(2).

<sup>13</sup> Treasury regulations section 1.871-15(n)(1).

<sup>14</sup> Treasury regulations section 1.871-15(n)(3)(i).

<sup>15</sup> Treasury regulations section 1.871-15(n)(3)(ii).

<sup>16</sup> Treasury regulations section 1.871-15(n)(5)(ii).

<sup>17</sup> Treasury regulations section 1.871-15(l)(2).

<sup>18</sup> Treasury regulations section 1.871-15(l)(2).

<sup>19</sup> Treasury regulations section 1.871-15(l)(3)(v).

new regulations also allow indices to qualify as qualified indices if they are referenced by futures or option contracts that trade on certain foreign exchanges or boards of trade if U.S. stock comprises less than 50% of their weighting.<sup>20</sup> The 2013 proposed regulations required an index to be referenced by futures or options contracts that trade on a domestic securities exchange or board of trade.

- **No withholding until payment or settlement.** The new regulations do not require a short party to withhold on a foreign long party until a payment is made under the derivative or there is a final settlement of the derivative.<sup>21</sup> This rule is less burdensome than the analogous rule in the 2013 proposed regulations, which would have required brokers to withhold and remit tax on dividend equivalent payments during the term of the derivative, even if no payments were made. However, the new regulations (like the 2013 proposed regulations) require withholding on a final settlement (including a lapse of an option) even if the withholding agent is not required to make a payment to the foreign counterparty.<sup>22</sup>
- **No constant delta rule.** The new regulations eliminate the rule under the 2013 proposed regulations under which a derivative that was expected to have a constant delta was treated as having a delta of 1.0 with respect to an adjusted number of shares. Thus, for example, dividend equivalent payments on a swap that references 100 shares of IBM and has a constant delta of 0.50 generally will not be subject to withholding under the new regulations, whereas the 2013 proposed regulations would have treated this swap as referencing 50 shares of IBM and having a delta of 1.0.
- **No withholding on qualified derivatives dealers.** To reduce the potential for multiple withholdings on a single stream of dividends, the new regulations allow foreign securities dealers and foreign banks to avoid being subject to withholding on dividends and dividend equivalent payments by agreeing to assume primary withholding and reporting responsibility when they pass those amounts through to customers.<sup>23</sup>
- **Delayed effective date.** As mentioned above, under the new regulations, withholding is required on equity derivatives issued after 2016.<sup>24</sup> The 2013 proposed regulations generally would have applied to all payments made on an equity derivative after 2015 regardless of when the derivative was entered into.

Part II of this memorandum discusses the history and purpose of section 871(m). Part III discusses the new regulations.

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<sup>20</sup> Treasury regulations section 1.871-15(l)(3)(vii)(B).

<sup>21</sup> Treasury regulations section 1.1441-2(e)(8).

<sup>22</sup> Treasury regulations section 1.1441-2(e)(8)(ii)(C).

<sup>23</sup> Temporary Treasury regulations section 1.871-15T(q).

<sup>24</sup> Treasury regulations section 1.871-15(r)(3).

## II. The History and Purpose of Section 871(m)

Payments of U.S.-source dividends to foreigners generally are subject to a 30% U.S. withholding tax.<sup>25</sup> By contrast, payments under most equity derivatives historically were not subject to withholding, even if they were contingent upon, or determined by reference to, a U.S.-source dividend.<sup>26</sup> Thus, substitute dividend payments on equity swaps with respect to U.S. equity securities generally were not subject to withholding.

In the early 2000s, several banks entered into “yield-enhancement strategies” with foreign hedge funds that used derivatives to eliminate dividend withholding on U.S. equities. Under these strategies, a foreign hedge fund transferred its U.S. stock to a bank shortly before the stock’s ex-dividend date, and then entered into an equity swap with the bank that referenced the stock, thereby preserving the fund’s economic position with respect to the stock. This permitted the fund to receive substitute dividend payments under the equity swap free of withholding, and to reacquire the stock shortly after the dividend payment. A 2008 report by the Senate’s Permanent Subcommittee on Investigations detailing this transaction led to the enactment of section 871(m).<sup>27</sup>

Under section 871(m), any dividend equivalent payment to a foreigner under an equity swap is subject to a 30% U.S. withholding tax if:

- The foreigner transferred the underlying stock to its counterparty in connection with the transaction (i.e., the underlying stock “crossed in”);
- The counterparty transferred the underlying stock to the foreigner at the termination of the transaction (i.e., the underlying stock “crossed out”);
- The underlying stock was not readily tradable on an established securities market; or
- The underlying stock was posted as collateral to the foreigner in connection with the transaction.<sup>28</sup>

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<sup>25</sup> See section 871(a). Income tax treaties may reduce the withholding rate. In addition, U.S.-source dividends are not subject to withholding if the dividends are effectively connected to the foreigner’s U.S. trade or business. In this case, the dividends are instead subject to U.S. federal net income tax. See sections 881(a); 882.

<sup>26</sup> See Treasury regulations section 1.863-7(b)(1) (source of swap income generally determined by reference to the residence of the recipient); Treasury regulations section 1.1441-4(a)(3)(1) (no withholding on swaps); Treasury regulations section 1.1441-2(b)(2)(i) (gains from the sale of property, including option premium and gains from the settlement of a forward contract, are not “fixed or determinable annual or periodical income” subject to withholding).

<sup>27</sup> See Staff, U.S. Senate Permanent Subcommittee on Investigations, “Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends” (Sep. 11, 2008), available at <http://www.hsgac.senate.gov/imo/media/doc/091108DividendTaxAbuse.pdf?attempt=2>.

<sup>28</sup> Section 871(m)(3). In addition, under section 871(m)(2)(A), any substitute dividend paid to a foreigner under a securities loan or sale-repurchase transaction is subject to withholding.

Thus, the statutory language of section 871(m) imposes withholding on a limited group of equity swaps that, like the yield-enhancement strategies of the early 2000s, bear indicia of actual stock ownership by a foreigner through an agent.

Section 871(m) also gives the IRS authority to identify other swaps that should be subject to withholding, and imposes withholding tax on every equity swap beginning on March 18, 2012, except to the extent that regulations are issued that provide that the equity swap does not have the potential for tax avoidance.<sup>29</sup> The IRS has repeatedly extended the March 18, 2012 deadline, and the new regulations further extend the deadline to 2017, at which point the delta test and substantial equivalence test will replace the four statutory factors described above to determine whether a transaction has the potential for tax avoidance.<sup>30</sup>

Finally, section 871(m) authorizes the IRS to impose withholding tax on “any other payment” that it determines is “substantially similar” to payments that are otherwise subject to withholding under section 871(m).<sup>31</sup> The new regulations use this authority to impose withholding tax on all U.S. equity derivatives, including debt instruments with embedded equity-linked components, and not just equity swaps. The new regulations retain a nominal distinction between “notional principal contracts” (i.e., swaps) and other “equity linked instruments,” but the rules apply equally to both classes of instruments. This memorandum refers to both categories as equity derivatives.

In 2012, the IRS issued an initial set of proposed regulations under section 871(m).<sup>32</sup> In response to considerable criticism from market participants, in 2013 the IRS withdrew those proposed regulations and issued the 2013 proposed regulations.<sup>33</sup> The new regulations revise and finalize the 2013 proposed regulations, and include rules relating to the substantial equivalence test and qualified derivatives dealers in temporary and proposed form.

### III. The New Regulations

#### A. In General

Under the new regulations, all equity derivatives are potentially subject to withholding under section 871(m). To determine whether an equity derivative is subject to withholding under section 871(m),

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<sup>29</sup> Section 871(m)(3)(B).

<sup>30</sup> Treasury regulations section 1.871-15(r).

<sup>31</sup> Section 871(m)(2)(C).

<sup>32</sup> 77 Federal Register 3108 (January 23, 2012). We discussed the 2012 proposed regulations in a previous Clients and Friends Memo, which is available at <http://www.cadwalader.com/resources/clients-friends-memos/new-proposed-and-temporary-regulations-address-u.s.-withholding-tax-on-cross-border-equity-de>.

<sup>33</sup> 78 Federal Register 73079 (December 5, 2013).

the delta test (for simple contracts) or the substantial equivalence test (for complex contracts) is applied to the derivative at inception or upon a subsequent significant modification of the derivative.<sup>34</sup> If the derivative satisfies the relevant test, then any dividend equivalent payments with respect to the derivative are subject to a 30% withholding tax (or less under a tax treaty) upon their payment or upon the termination of the derivative (including by offset or lapse). If the derivative does not satisfy the delta test or substantial equivalence test at issuance, then it is never subject to withholding (unless it is significantly modified and the significantly modified derivative is subject to section 871(m)).<sup>35</sup>

### **B. The Delta Test for Simple Contracts**

The delta test applies only to simple contracts.<sup>36</sup> A derivative is a simple contract if:

- All amounts to be paid or received on maturity, at exercise, or on any other payment determination date with respect to the underlying equity security are calculated by reference to a single, fixed number of shares of the equity security;
- The number of shares of the underlying equity security can be determined when the contract is issued; and
- The derivative has a single maturity or exercise date with respect to which all amounts (other than any upfront payment or any periodic payments) are required to be calculated with respect to the underlying equity security.<sup>37</sup>

For this purpose, the number of shares of an underlying security generally is the number of shares of the underlying security stated in the contract. However, if the transaction modifies that number by a factor or fraction or otherwise alters the amount of any payment, the number is adjusted to take into account the factor, fraction, or other modification.<sup>38</sup> Thus, if the long party to a transaction receives or makes payments based on 200% of the appreciation of 100 shares of stock, the number of shares of the underlying security is 200 shares. A contract has a single exercise date even though it may be exercised by the holder at any time on or before the stated expiration of the contract.<sup>39</sup> Thus, an American-style option is a simple contract, even though the option may be exercised by the holder at any time on or before the expiration of the option, so long as amounts

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<sup>34</sup> Treasury regulations section 1.871-15(a)(6) (definition of "issue"). A significant modification of a derivative is treated as a retirement of the unmodified derivative and an issuance of a new derivative with the modified terms. There are no clear rules as to when a non-debt derivative is treated as significantly modified.

<sup>35</sup> As described above, the modified derivative would be treated as a new derivative for federal income tax purposes.

<sup>36</sup> Treasury regulations sections 1.871-15(d)(2)(i), (e)(1).

<sup>37</sup> Treasury regulations section 1.871-15(a)(14)(i).

<sup>38</sup> Treasury regulations section 1.871-15(j)(3).

<sup>39</sup> Treasury regulations section 1.871-15(a)(14)(i).

due under the option are determined by reference to a single, fixed number of shares on the exercise date.

If a simple contract has a delta of 0.80 or more, it is subject to withholding under section 871(m).<sup>40</sup> Delta is the ratio of the change in the fair market value of a derivative to a small change in the fair market value of the number of shares of the equity security referenced by the derivative.<sup>41</sup> The higher a derivative's delta, the better its fair market value tracks the fair market value of the underlying, and the more economically equivalent it is to the underlying. A "delta one" derivative tracks the underlying on a dollar-for-dollar basis.

Under the new regulations, the delta of a derivative is tested only when the derivative is issued.<sup>42</sup> Although this rule simplifies the 2013 proposed regulations (which, as mentioned above, tested a derivative's delta on multiple occasions), it has the unfortunate consequence of causing options and other derivatives that are listed on an exchange to be treated differently from their over-the-counter analogs. A listed option is treated as issued each time it is acquired from the exchange (and not when it is listed) and, because of the manner in which listed options are traded, a transfer of a listed option also may be treated as an issuance under the new regulations. Thus, the delta of a listed option generally must be tested each time a foreigner acquires the option from the exchange, and may also have to be tested each time the option is subsequently transferred to a foreigner, whereas the delta of an over-the-counter option is tested only when the option is first sold. (If the over-the-counter option is subsequently significantly modified, it would be treated as reissued on the date of the modification, and the modified instrument therefore would be reevaluated on the date of the modification.)<sup>43</sup> Similarly, if an issuer lists a class of equity-linked notes on an exchange, and investors purchase the notes from the exchange at different times, then the notes will be treated as issued upon each acquisition (and not when the notes are listed).

The delta of an equity derivative that is embedded in a debt instrument or other derivative is determined without taking into account changes in the market value of the components of the debt instrument or other derivative that are not directly related to the equity element of the instrument (such as the debt component of a convertible debt instrument).<sup>44</sup>

The new regulations provide a rule of administrative convenience for derivatives with more than nine reference stocks. If the short party holds an exchange-traded security (such as an exchange-traded fund) as a hedge, and the exchange-traded security references substantially all of the underlying

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<sup>40</sup> Treasury regulations sections 1.871-15(d)(2)(i), (e)(1).

<sup>41</sup> Treasury regulations section 1.871-15(g)(1).

<sup>42</sup> Treasury regulations section 1.871-15(g)(2).

<sup>43</sup> Treasury regulations section 1.871-15(a)(6) (definition of "issue").

<sup>44</sup> Treasury regulations section 1.871-15(g)(1).

securities, then, instead of calculating a separate delta for each referent, the short party may calculate the derivative's delta with respect to the hedge.<sup>45</sup> Short parties to index-linked derivatives may find this rule helpful where the reference index is not a "qualified index" (as described below in Part III.H.1).

As mentioned above, the 2013 proposed regulations included a 0.70 delta threshold, and the new regulations increased this threshold to 0.80. We suspect that the IRS and the Treasury Department always expected the final regulations to use a 0.80 delta standard. Eighty percent is a common threshold for tax purposes;<sup>46</sup> 70% is not. Moreover, practitioners often use an 80% delta standard to determine whether a party to a derivative "constructively owns" a financial asset under section 1260. It would have been odd to apply a lower standard under section 871(m) than the standard used to test constructive ownership.<sup>47</sup>

### C. The Substantial Equivalence Test for Complex Contracts

A derivative that references a U.S. equity security and does not qualify as a simple contract is referred to in the new regulations as a "complex" contract.<sup>48</sup> For example, if a derivative provided a foreigner with 200% of a reference stock's upside, subject to a cap, and 100% of the reference stock's downside, then it would not qualify as a simple contract and would be treated as a complex contract because payments are not calculated by reference to a single, fixed number of shares of the underlying security.<sup>49</sup>

Similarly, "worst-of" basket notes (whose return is calculated by reference to the worst-performing stock in a basket) and notes with "digital" returns (whose return does not fluctuate smoothly in correlation to the price of the reference stock) are treated as complex contracts.

As mentioned above, delta is the ratio of the change in the fair market value of a derivative to a small change in the fair market value of the number of shares of the equity security referenced by the derivative.<sup>50</sup> Delta is more difficult or impossible to determine for complex contracts that reference

<sup>45</sup> Treasury regulations section 1.871-15(g)(3).

<sup>46</sup> See, e.g., section 368(c); section 1504.

<sup>47</sup> See New York State Bar Association Tax Section, Report on Proposed Regulations under Section 871(m), at 25-26 (May 20, 2014), available at [https://www.nysba.org/Sections/Tax/Tax\\_Section\\_Reports/Tax\\_Reports\\_2014/Tax\\_Section\\_Report\\_1306.html](https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1306.html).

<sup>48</sup> Treasury regulations section 1.871-15(a)(14)(ii).

<sup>49</sup> As mentioned above in Part III.B., the number of reference shares is adjusted to account for leverage. So, although the contract notionally references a single share, because the contract pays 200% of appreciation and 100% of depreciation, it would be deemed to reference two shares for appreciation and only one share for depreciation.

<sup>50</sup> Treasury regulations section 1.871-15(g)(1).

different shares or different numbers of the same shares depending on the performance of the underlying securities. Accordingly, the new regulations introduce the substantial equivalence test to determine which complex contracts are subject to withholding under section 871(m).<sup>51</sup>

To apply the substantial equivalence test, the new regulations require that a “simple contract benchmark” be established. The simple contract benchmark is a simple contract that is closely comparable to the complex contract, has a delta of 0.80, references the applicable underlying security referenced by the complex contract, and has the same maturity as the complex contract.<sup>52</sup> The relationship between the simple contract benchmark and the shares underlying it is compared to the relationship between the complex contract and the shares that would be used to hedge it over the range of prices of the underlying security represented by an increase in price by one standard deviation and a decrease in price by one standard deviation.<sup>53</sup> If the proportionate difference between the change in value of the complex contract and the change in value of its hedge within the standard deviation range is equal to or less than the corresponding change for the simple contract benchmark and the shares underlying it, then the complex contract tracks its hedge more closely than the simple benchmark contract tracks its hedge (i.e., the shares underlying it). Since the simple benchmark contract has a delta of 0.80, and the complex contract has a greater correlation with its hedge, the complex contract is subject to withholding under section 871(m).<sup>54</sup>

The substantial equivalence test was not part of the 2013 proposed regulations. As a result, the test appears in the form of temporary and new proposed regulations, and the IRS has requested comments on the test's effectiveness, administrability, and application to contracts with multiple referents.

If a complex contract references more than nine stocks and, to hedge the complex contract, the short party holds an exchange-traded security (such as an exchange-traded fund) that references substantially all of the underlying securities, then the short party may treat the exchange-traded security as the underlying stock for purposes of the substantial equivalence test.<sup>55</sup>

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- 51 The substantial equivalence test is a version of the “proportionality” test that the Securities Industry and Financial Markets Association (“SIFMA”) recommended in its report on the 2013 proposed regulations. See SIFMA, Submission on Proposed Regulations under Section 871(m), at 11 (May 7, 2014), available at [http://www.sifma.org/comment-letters/2014/sifma-submits-comments-to-the-irs-and-treasury-on-proposed-regulations-implementing-section-871\(m\)-of-the-internal-revenue-code/](http://www.sifma.org/comment-letters/2014/sifma-submits-comments-to-the-irs-and-treasury-on-proposed-regulations-implementing-section-871(m)-of-the-internal-revenue-code/).
- 52 Temporary Treasury regulations section 1.871-15T(h)(2).
- 53 Over a normal distribution, approximately 68.27% of all outcomes occur within the range represented by one standard deviation from the mean. See Wikipedia, Standard Deviation (last visited September 29, 2015), available at [https://en.wikipedia.org/wiki/Standard\\_deviation#Rules\\_for\\_normally\\_distributed\\_data](https://en.wikipedia.org/wiki/Standard_deviation#Rules_for_normally_distributed_data).
- 54 Temporary Treasury regulations section 1.871-15T(h)(1).
- 55 Temporary Treasury regulations section 1.871-15T(h)(6). Also, as is the case with the delta test, the substantial equivalence of an equity derivative that is embedded in a debt instrument or other derivative is determined without taking into account

The new regulations do not describe how to test for substantial equivalence if a complex contract references more than one but fewer than 10 stocks, or references more than nine stocks but the short party does not hold an exchange-traded security as a hedge. Instead, the new regulations provide simply that taxpayers should apply “the principles of the substantial equivalence test” to complex contracts that are not explicitly addressed.<sup>56</sup> Short parties to derivatives with multiple referents might develop different methods of applying the principles of the substantial equivalence test.

#### **D. Dividend Equivalent Payments**

Once an equity derivative satisfies the delta test or the substantial equivalence test, “dividend equivalent payments” under the derivative are subject to withholding.

##### **1. Definition of “Payment”**

A payment for these purposes includes any gross amount that references the payment of a dividend and that is used to compute any net amount transferred to or from the long party, even if the long party makes a net payment to the short party or no amount is paid because the net amount is zero.<sup>57</sup> Thus, a short party that is not required to make net payments to the long party may still have withholding obligations that it would have to fund itself, unless it negotiates to receive indemnification payments from the long party.

One of the most controversial features of the new regulations is their retention of the rule from the 2013 proposed regulations that a payment includes not only an actual dividend payment, but also an estimated dividend payment that is implicitly taken into account in computing one or more of the terms of the transaction, such as interest rate, notional amount, or purchase price.<sup>58</sup> Effectively, this means that all equity derivatives that satisfy the delta test or the substantial equivalence test and reference dividend paying U.S. stock will be subject to withholding, even if they do not provide for the payment of substitute dividend payments to the long party and the long party does not bear any economic risk with respect to the amount of future dividends.

For example, assume that a contract with a delta of 0.90 provides a foreigner with IBM’s upside and downside, but not its dividends. Under the new regulations, the foreigner will be subject to withholding on a “dividend equivalent payment” based on the actual dividends paid by IBM (or

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any unrelated changes in the value of the debt instrument or other derivative. Temporary Treasury regulations section 1.871-15T(h)(1).

<sup>56</sup> Temporary Treasury regulations section 1.871-15T(h)(1).

<sup>57</sup> Treasury regulations section 1.871-15(i)(1).

<sup>58</sup> Treasury regulations section 1.871-15(i)(2)(ii).

based on estimated dividends, if the short party specifies a reasonable estimate at issuance), even though the foreigner is not entitled to any dividends. Effectively, the contract deems the foreigner to receive a substitute dividend payment (subject to gross basis withholding) and then pay the dividend back to its counterparty (without a deduction or other offset against the withholding). This is true even if no payment is required under the contract until termination and, at termination, the foreigner is not entitled to receive any amounts.

It is easy to understand why the IRS and the Treasury Department included this rule for short-term derivatives. A delta-one price return only derivative issued very shortly before the reference stock's ex-dividend date provides the foreign long party with the economic equivalent of a dividend because the short party bears little dividend risk (the amount of the dividend has been declared and is unlikely to change).<sup>59</sup> However, the rule potentially imposes withholding on amounts that a long party is not entitled to in the case of longer-term contracts and even short-term options that lapse, and therefore could be subject to legal challenge.

It is hard to imagine that Congress intended the statutory language of section 871(m) to introduce a tax on deemed payments. Section 871(m) imposes a tax on "payments" that are contingent upon, or determined by reference to, U.S.-source dividends.<sup>60</sup> There is no suggestion in the statute, or in the corresponding legislative history, that Congress intended the word to include an "implicit dividend" that is not economically received by the long party. Imagine if the IRS and the Treasury Department wrote a regulation that deemed foreigners to receive dividends subject to withholding when no dividends were actually paid and the foreigners did not receive any economics represented by a dividend.<sup>61</sup>

Moreover, the new regulations' broad definition of "payment" arguably violates the nondiscrimination provisions of many income tax treaties to which the United States is a party. These provisions generally prohibit the United States from imposing a more burdensome tax on

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<sup>59</sup> There is always some risk that a corporation will not pay a declared dividend. For example, in 2010, British Petroleum canceled a dividend that it had declared before the Deepwater Horizon oil spill in the Gulf of Mexico. See American Bar Association Section of Taxation, Comments on Proposed Regulations Issued under Section 871(m), at 20, fn. 43 (October 17, 2014), available at <http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/101714comments.authcheckdam.pdf>. But there arguably is a period of days or weeks leading up to an ex-dividend date during which the risk of nonpayment is immaterial.

<sup>60</sup> Section 871(m)(2)(B).

<sup>61</sup> Deemed dividends under section 305(b) and (c) are distinguishable because a change in the conversion ratio of convertible debt and other transactions described in section 305(b) and (c) have the economic effect of a dividend to the stockholder.

residents of the other signatory state than it imposes on U.S. residents.<sup>62</sup> The United States does not tax U.S. residents on implicit dividends with respect to price return only contracts.<sup>63</sup>

The new regulations contain a presumption that, in certain cases, mitigates the harsh result of the implicit dividend rule. Under the new regulations, if the short party specifies a reasonable estimated dividend amount in the offering or transaction documents at issuance, and the long party is not entitled to a “true up” or other upward adjustment for actual dividends, then the short party is treated as paying the estimated amounts.<sup>64</sup> The new regulations specifically provide that, if the underlying security is not expected to pay a dividend, a reasonable estimate of the dividend amount may be zero.<sup>65</sup> Thus, presumably, a delta-one price return only swap on Berkshire Hathaway (which historically has not paid dividends) that provides for a dividend estimate of zero would not be subject to withholding, even if Berkshire Hathaway declares a dividend during the term of the swap, as long as the foreigner in fact does not receive any economics with respect to the dividend.

However, the dividend estimate will apply for determining the amount of withholding even if the actual dividend payments turn out to be less than the estimated amount. Thus, if the parties to the derivative estimate the amount of the dividend for withholding tax purposes, the foreign long party may be deemed to receive a dividend in excess of any dividend actually paid on the underlying stock.<sup>66</sup>

Foreign long parties that enter into price return only derivatives should negotiate the amount of the reasonable estimated dividend amount to limit their potential withholding liabilities.

## 2. Amount of Withholding

For simple contracts, the amount of withholding under section 871(m) is 30% of the product of three items: (1) the per share dividend amount; (2) the number of reference shares; and (3) the derivative’s delta.<sup>67</sup>

- **The per share dividend amount.** If the short party specifies a reasonable estimated dividend in the relevant offering document or operative documents, and the long party is not entitled to a

<sup>62</sup> See, e.g., United States Model Income Tax Convention, Article 24 (November 15, 2006).

<sup>63</sup> Taxing noneconomic amounts is materially different from taxing original issue discount, mark-to-market gains, subpart F income, or deemed dividends, which represent accretions to wealth.

<sup>64</sup> Treasury regulations section 1.871-15(i)(2)(iii).

<sup>65</sup> Treasury regulations section 1.871-15(i)(2)(iii).

<sup>66</sup> Treasury regulations section 1.871-15(i)(2)(iii). By contrast, under the 2013 proposed regulations, the long party would have been deemed to receive the lesser of the actual and estimated dividends.

<sup>67</sup> Treasury regulations section 1.871-15(j)(1)(ii).

true up for actual dividends, then the amount of the per share dividend is the lesser of the estimate and the actual dividend.<sup>68</sup> If the derivative “true up” or otherwise adjusts for the actual dividend, then the true-up payment (in addition to the estimated dividend) is added to the per share dividend amount.<sup>69</sup> In all other cases, the per share dividend is the actual dividend.<sup>70</sup>

- **The number of reference shares.** The number of reference shares is adjusted to take into account any “leveraging” provided by the derivative<sup>71</sup>. For example, if a total return swap provides for 125% upside and downside with respect to 100 shares of stock, then the number of reference shares is 125.
- **The derivative’s delta.** A derivative’s delta is determined at initial issuance.<sup>72</sup>

For complex contracts, the amount of the withholding is 30% of the product of two items: (1) the per share dividend amount (determined as described above); and (2) the amount of underlying stock that would fully hedge the contract at initial issuance.<sup>73</sup>

#### E. Timing of Withholding

As mentioned above, because dividend equivalent payments include gross amounts that reference the payment of a U.S.-source dividend, and either may not be payable to the long party, or may be offset or credited against amounts payable by the long party, the new regulations may impose withholding in excess of the amount due to the long party under the derivative.

To limit the situations in which a short party has to withhold but lacks funds from which to withhold, the new regulations provide that withholding is not required until the later of two events:<sup>74</sup>

- **A payment is made by either party, or the derivative is disposed of or terminates.** A payment must actually be made to trigger withholding. An upfront or premium payment is not treated as a payment for this purpose.<sup>75</sup> Similarly, a payment does not occur if each party is

<sup>68</sup> Treasury regulations section 1.871-15(i)(2)(iii).

<sup>69</sup> Treasury regulations section 1.871-15(i)(2)(iv).

<sup>70</sup> Treasury regulations section 1.871-15(i)(2)(i).

<sup>71</sup> Treasury regulations section 1.871-15(j)(3).

<sup>72</sup> Treasury regulations section 1.871-15(g)(2). By contrast, under the 2013 proposed regulations, the delta of a long-term derivative would have been calculated at the earlier of the stock’s ex-dividend date and the record date of the dividend, and the delta of a short-term derivative would have been calculated when the foreigner disposed of the derivative. Under these rules, foreigners would not have been subject to withholding on short-term options that they allowed to lapse, since the 2013 proposed regulations also provided that the delta of a short-term option at lapse was zero.

<sup>73</sup> Treasury regulations section 1.871-15(j)(1)(iii).

<sup>74</sup> Treasury regulations section 1.1441-2(e)(8)(i).

<sup>75</sup> Treasury regulations section 1.1441-2(e)(8)(iii).

required to make an equal periodic payment so that no net payment is made. However, a disposition of a derivative, including by settlement, offset, termination, expiration, lapse, or maturity is treated as a payment subject to withholding.<sup>76</sup>

Under a rule of administrative convenience, if a derivative references a basket of more than 25 U.S. equity securities, then the short party is permitted to treat all dividends on the securities as paid on the last day of the calendar quarter.<sup>77</sup> For example, suppose that a delta-one total return swap on a basket of 25 U.S. stocks requires the foreign long party to make monthly LIBOR-based payments. Under this rule, the short party can withhold at the end of each calendar quarter instead of each month.<sup>78</sup> Short parties to basket-linked derivatives may find this rule helpful where the reference basket is not a “qualified index” (as described below in Part III.H.1).

- **The dividend equivalent amount is determined.** The dividend equivalent amount generally is determined on the earlier of the dividend record date and the day immediately preceding the ex-dividend date.<sup>79</sup>

This rule still requires withholding agents to satisfy their withholding obligations from their own funds in a number of situations. For example, on the lapse of an option, a short party may be required to remit withholding to the IRS in excess of the premium it has received. Moreover, if a derivative is sold or assigned, it is unclear whether withholding responsibility falls on the short party (who may not know of the transfer), the transferee (who may not have sufficient information to determine the amount of withholding), or the long party’s broker (who appears to be the most appropriate withholding agent in this scenario, but who the new regulations do not clearly designate as the withholding agent in this scenario). In any case, the withholding agent may not have funds from which to withhold, unless it has negotiated to receive the funds from the long party.

Short parties have already required long parties to indemnify them in many master trading agreements so that they can remit the proper amount of withholding to the IRS.<sup>80</sup>

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<sup>76</sup> Treasury regulations section 1.1441-2(e)(8)(ii).

<sup>77</sup> Treasury regulations section 1.871-15(i)(3)(i).

<sup>78</sup> Treasury regulations section 1.1441-2(e)(8)(ii)(B).

<sup>79</sup> Treasury regulations section 1.871-15(j)(2).

<sup>80</sup> See, e.g., International Swaps and Derivatives Association, Inc. (ISDA), 2010 Short Form HIRE Act Protocol (November 30, 2010), available at <http://www.isda.org/isda2010shortformhireactprot/shortformhireactprot.html>.

## F. Related Transactions

### 1. In General

If a foreigner or a person related to the foreigner enters into or acquires two or more positions that would have been subject to withholding under section 871(m) if they were a single derivative and are entered into “in connection with” each other (whether or not they are entered into simultaneously or with the same counterparty), then the positions are combined and are subject to tax under section 871(m).<sup>81</sup> For example, if a foreigner enters into an equity swap with a delta of less than 0.80 and, in connection with entering into the swap, enters into another derivative so that the combined delta of the two derivatives is 0.80 or more, the foreigner will be subject to withholding under section 871(m) on the two derivatives.

Once a transaction becomes subject to withholding under this rule, it remains subject to withholding, even if the foreigner terminates some of the related positions and continues to hold only positions with a combined delta of less than 0.80.<sup>82</sup> By contrast, if a foreigner acquires a single derivative with a delta of 0.80 or more, and then significantly modifies the derivative so that the delta of the modified derivative is less than 0.80, then the modified derivative will not be subject to withholding.

### 2. “In Connection With”

The regulations do not define the “in connection with” standard. However, the new regulations provide brokers that act as short parties with two helpful presumptions that apply for purposes of determining their withholding obligations. First, a short-party broker may presume that transactions are not entered into in connection with each other if the long party holds the transactions in separate accounts, so long as the broker does not have actual knowledge that the long party used the separate accounts to avoid section 871(m) or that the transactions were entered into in connection with each other.<sup>83</sup> Second, a short-party broker may presume that transactions entered into at least two business days apart are not entered into in connection with each other, so long as the broker does not have actual knowledge that the transactions were entered into in connection with each other.<sup>84</sup> Short parties that are brokers and enter into transactions that do not satisfy the

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<sup>81</sup> Treasury regulations section 1.871-15(n)(1).

<sup>82</sup> Treasury regulations section 1.871-15(n)(2).

<sup>83</sup> Treasury regulations section 1.871-15(n)(3)(i).

<sup>84</sup> Treasury regulations section 1.871-15(n)(3)(ii). Short-party brokers may (but are not required to) assume that all transactions were entered into at 4:00 P.M. Treasury regulations section 1.871-15(n)(5)(i).

conditions for these presumptions are required to exercise “reasonable diligence” to determine whether the transactions were entered into in connection with each other.<sup>85</sup>

These presumptions do not apply to the long party.<sup>86</sup> Accordingly, if the presumptions apply, the long party may owe tax that is not withheld by the short party. However, the IRS will presume that a long party did not enter into two or more transactions in connection with each other if the long party properly reflected those transactions on separate trading books, or if the long party entered into the transactions at least two business days apart.<sup>87</sup> The IRS may rebut either presumption with facts and circumstances showing that the transactions were entered into in connection with each other, and will presume that a long party *did* enter into the transactions in connection with each other if the transactions were entered into on the same trading book within one business day of each other.<sup>88</sup> The IRS will treat all transactions as entered into at 4:00 P.M.<sup>89</sup>

### G. Partnership-Linked Derivatives

The new regulations “look through” a partnership to equity derivatives held by the partnership if the partnership is a “covered partnership.”<sup>90</sup> A covered partnership is a partnership that is a securities dealer or securities trader, has significant investments in securities, or directly or indirectly holds an interest in a lower-tier partnership that is a covered partnership.<sup>91</sup> A partnership has significant investments in securities if:

- At least 25% of the partnership's assets consist of U.S. stock or U.S. equity derivatives; or
- The partnership holds at least \$25 million of U.S. stock and U.S. equity derivatives.<sup>92</sup>

<sup>85</sup> Treasury regulations section 1.871-15(p)(1). The new regulations provide only that a short-party broker that satisfies the conditions is entitled to a “presumption” and is not required to exercise reasonable diligence. It is unclear whether the IRS could rebut the presumption by proving that the short-party broker should have known (without exercising any diligence) that two or more transactions were entered into in connection with each other. For example, assume that a long party enters into ten transactions with a short-party broker that satisfy the conditions for a presumption. However, the short-party broker has actual knowledge that nine of the transactions were entered into in connection with other transactions that cause them to be subject to withholding under section 871(m). The short-party broker has no actual knowledge with respect to the tenth. If the short-party broker does not withhold on the tenth, may the IRS rebut the presumption and impose withholding liability on the short-party broker?

<sup>86</sup> Treasury regulations section 1.871-15(n)(5)(ii).

<sup>87</sup> Treasury regulations section 1.871-15(n)(4).

<sup>88</sup> Treasury regulations section 1.871-15(n)(4).

<sup>89</sup> Treasury regulations section 1.871-15(n)(5)(i).

<sup>90</sup> Treasury regulations section 1.871-15(m)(1).

<sup>91</sup> Treasury regulations section 1.871-15(m)(1).

<sup>92</sup> Treasury regulations section 1.871-15(m)(2)(i).

For purposes of this test, the value of a partnership's assets is tested on the last day of the taxable year immediately preceding the issuance of the partnership-linked derivative, unless either party actually knows that a subsequent transaction has caused the partnership to cross either of the thresholds.<sup>93</sup> In addition, the value of a swap, futures contract, forward contract option, or "similar" contract held by the partnership is deemed to be the contract's notional amount.

The 2013 proposed regulations would have looked through all partnerships if U.S. stock and U.S. equity derivatives represented more than 10% of their value. However, we suspect that the relaxation of this rule will have limited use. Derivatives with deltas of greater than 0.80 with respect to non-publicly traded partnership interests raise ownership issues. Asset management companies that are publicly traded partnerships (such as AllianceBernstein Holding L.P., Kohlberg Kravis Roberts & Co. L.P., The Blackstone Group L.P., and Oaktree Capital Group, LLC) will be looked through because they hold interests in lower-tier partnerships (such as hedge funds or private equity funds) that are covered partnerships because they have significant investments in securities. Publicly traded natural energy partnerships may not be treated as covered partnerships, but likely also would not have been covered partnerships under the 2013 proposed regulations.

When the partnership look-through rule does apply, it will be very difficult for short parties to administer. A partnership discloses an investor's allocable share of U.S.-source dividends on Schedule K-1. The partnership is not required to provide Schedule K-1 to investors until the due date for filing the partnership's tax return, which may be later than the date that payments are required to be made on a derivative that references the partnership. Moreover, Schedule K-1 does not disclose the amount of dividend equivalent payments that the partnership received under U.S. equity derivatives. Accordingly, short parties may avoid entering into derivatives that reference partnership interests, feel compelled to over-withhold on derivatives that reference partnerships, or demand indemnification for any liability they incur for under-withholding.

## **H. Exceptions from Withholding**

### **1. Qualified Indices**

#### **a. In General**

The new regulations provide an exemption from U.S. withholding tax under section 871(m) for dividend equivalent payments made with respect to a "qualified index."<sup>94</sup> In general, a qualified

<sup>93</sup> Treasury regulations section 1.871-15(m)(2)(ii). Short parties, which are responsible for withholding under section 871(m), will want foreign long parties to represent that they have no such knowledge.

<sup>94</sup> Treasury regulations section 1.871-15(l)(2). This rule interprets section 871(m)(4)(C), which provides that "an index or fixed basket of securities shall be treated as a single security."

index is a passive, diversified index of publicly traded securities that is widely used by market participants.<sup>95</sup> The two types of qualifying indices are broad-based indices and non-U.S. indices, each as described below.

The new regulations determine whether an index is a qualified index as of the first business day of the calendar year in which the transaction is issued.<sup>96</sup> Thus, if a derivative with respect to an index is issued on June 30, the index is tested as of January 1, even if the index is no longer a qualified index on June 30. However, if a principal purpose of the transaction is to use this rule avoid section 871(m), the anti-abuse rule described in Part III.K. would disqualify the index.

#### **b. Broad-Based Index**

The first type of qualified index is an index that, at the time the derivative is entered into or acquired by the foreigner:<sup>97</sup>

- References at least 25 securities (whether or not the securities are U.S. stock);
- References only long positions, other than short positions with respect to the entire index (such as caps or floors) and short positions that represent no more than 5% of the aggregate value of the index's long positions;
- Does not contain any one U.S. stock that represents more than 15% of its weighting, or any collection of five or fewer U.S. stocks that together represent more than 40% of its weighting;
- Is modified or rebalanced only according to publicly stated, predefined criteria (which may require interpretation by the sponsor);
- Did not provide a dividend yield in the immediately preceding calendar year from U.S. stock that exceeded 150% of the annual dividend yield reported on the S&P 500 index for that year; and
- Is referenced by futures or option contracts that trade on either (1) a national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade that is designated as a contract market by the Commodity Futures Trading Commission, or (2) a foreign exchange or board of trade that the IRS has determined is a "qualified board of trade" under section 1256,<sup>98</sup> or that has an effective "no action" letter from the CFTC permitting direct access from the United States, if U.S. stock comprises less than 50% of its weighting and it otherwise meets the definition of a qualified index.

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<sup>95</sup> Treasury regulations section 1.871-15(l)(1).

<sup>96</sup> Treasury regulations section 1.871-15(l)(2).

<sup>97</sup> Treasury regulations section 1.871-15(l)(3).

<sup>98</sup> The IRS has determined that Eurex Deutschland (Germany), the London International Financial Futures and Options Exchange, ICE Futures Canada, the Dubai Mercantile Exchange, ICE Futures, Mercantile Division of the Montreal Exchange, and International Futures Exchange (Bermuda) are qualified boards of trade.

This exemption clearly was intended to permit a foreigner to hold a total return swap that references the S&P 500 index without being subject to withholding tax. However, some broad-based indices are referenced by exchange-traded funds, but not by exchange-traded futures or option contracts.<sup>99</sup> These indices would not be qualified indices. It is unclear why the regulations exempt an index-linked derivative from withholding tax only if the index is referenced by exchange-traded futures or option contracts, and not if the index is referenced by exchange-traded funds.

### c. Non-U.S. Index

An index also is a qualified index if U.S. stocks represent no more than 10% of its weighting.<sup>100</sup>

Many global indices are too heavily weighted in U.S. reference stocks to satisfy this test, and therefore would have to satisfy the broad-based test to be qualified indices. However, many global indices will not satisfy the broad-based test. For example, the MSCI World Index is traded on Eurex Deutschland (which is a qualified board of trade), but U.S. stock consistently represents more than 50% of its weighting.<sup>101</sup> There is no clear policy rationale for excluding the MSCI World index from the definition of "qualified index."

## 2. Due Bills

A purchase of publicly traded stock typically is not entered into the company's books for three business days. To ensure that the proper investors receive the company's dividends, stock exchanges typically set a stock's ex-dividend date (which is the date on and after which the stock no longer trades with its dividend) two business days before the record date (which is the date on which the company checks its books to see who is entitled to the dividend). This way, only investors that purchased stock before the ex-dividend date will receive a dividend because only those investors will have been entered into the company's books by the record date.

However, because stock prices adjust on an ex-dividend date to account for the dividend, a large special dividend could cause the price of a stock to plummet before the special dividend is paid, which could inappropriately trigger margin calls. To avoid this, for special dividends of at least 25% of a company's stock price, stock exchanges typically set the ex-dividend date *after* the record date.

<sup>99</sup> These include the CRSP Total Stock Market Index (referenced by Vanguard Total Stock Market ETF, which has more than \$52.5 billion of assets under management), the MSCI US Prime Market Growth Index (referenced by Vanguard Growth ETF, which has more than \$18.7 billion of assets under management), the Financial Select Sector Index (referenced by State Street Financial Select Sector SPDR ETF, which has more than \$17.7 billion of assets under management), and dozens more.

<sup>100</sup> Treasury regulations section 1.871-15(l)(4).

<sup>101</sup> See MSCI World Index Fact Sheet, available at [https://www.msci.com/resources/factsheets/index\\_fact\\_sheet/msci-world-index.pdf](https://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-index.pdf) (as of August 31, 2015, U.S. stock represented 57.96%).

Then, to ensure that the proper investors still receive the dividend, stock exchanges require stock that is purchased after the record date but before the ex-dividend date to trade with a “due bill” attached. The dividend first is paid to the shareholders of record and then, on the due bill settlement date (which typically occurs two days after the ex-dividend date), the amount of the dividend is withdrawn from their accounts and paid over to the due bill holders.

Even though due bill payments are economically identical to dividend payments, the tax law does not treat them as dividends.<sup>102</sup> From a pure policy perspective, it would seem appropriate to treat due bill payments as dividend equivalent payments. However, the new regulations generally exempt due bill payments of the type described above from withholding, presumably out of concern that requiring withholding on due bills could adversely affect the orderly functioning of the markets.<sup>103</sup>

### 3. M&A Transactions

The new regulations exempt dividend equivalent payments from withholding if they are made to one or more long parties that are obligated to acquire more than 50% of the value of the underlying corporation.<sup>104</sup>

This exception is far narrower than it should be. Suppose that a foreign acquirer agrees to purchase 20% of the outstanding stock of a domestic target and that, pursuant to the plan of acquisition, the target agrees to pay a pre-closing dividend to its current shareholders and to reduce the purchase price by the amount of the dividend. Under the new regulations, the stock purchase agreement would be a delta-one derivative, and the foreign acquirer would be deemed to receive a substitute dividend payment with respect to which the seller would be obligated to withhold. In the context of an acquisition, this is the wrong result. The transaction is better viewed as a purchase price adjustment than as a dividend equivalent payment, and does not give rise to

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<sup>102</sup> See Revenue Ruling 82-11, 1982-1 C.B. 51.

<sup>103</sup> See New York State Bar Association Tax Section, Report on Proposed Regulations under Section 871(m), at 30 (May 20, 2014) (“It would appear as a pure policy matter that this would be an appropriate application of section 871(m). However, we understand that due bills are a fairly common occurrence with respect to exchange-traded stock, and we are not familiar with the mechanics of these procedures, so we are concerned that requiring withholding in these circumstances could have an adverse impact on the orderly functioning of the exchanges.”), available at [https://www.nysba.org/Sections/Tax/Tax\\_Section\\_Reports/Tax\\_Reports\\_2014/Tax\\_Section\\_Report\\_1306.html](https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1306.html); American Bar Association Section of Taxation, Comments on Proposed Regulations Issued under Section 871(m), at 12 (October 17, 2014) (“Although the payment under a due bill would appear to fall within the scope of a dividend equivalent, it is unclear to us whether the frequency of due bills with respect to publicly traded equities may mean that treating them as dividend equivalents would impede the orderly functioning of the capital markets.”), available at <http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/101714comments.authcheckdam.pdf>.

<sup>104</sup> Treasury regulations section 1.871-15(k).

any obvious tax avoidance concerns.<sup>105</sup> To avoid this trap for the unwary, the target would have to pay the dividend to the seller before the stock purchase agreement is signed, or after the stock is sold. However, each of these potential solutions may present commercial issues and could be subject to the anti-abuse rule described in Part III.K.

#### 4. Other Exceptions

The new regulations contain the following additional exceptions from withholding:

- **Section 305 Dividends.** Under section 305 of the Code, a change to the conversion price or conversion ratio of a convertible debt instrument held by a foreigner may be treated as a dividend and subject to withholding. To avoid multiple withholdings on the same dividends, the new regulations reduce the withholding under section 871(m) by any amount treated as a dividend under section 305.<sup>106</sup>
- **Life Insurance and Annuities.** Life insurance, endowment, and annuity contracts may include payments that are determined by reference to U.S. dividends (e.g., with respect to variable life insurance). However, under current law, foreigners generally are subject to withholding on payments and withdrawals from a life insurance, endowment, or annuity contract issued by a domestic insurance company. The IRS and the Treasury Department concluded that the taxation of these contracts issued by domestic insurance companies is adequately addressed under existing law and that there is no section 871(m) withholding with respect to these contracts.<sup>107</sup> The IRS and the Treasury Department continue to consider whether section 871(m) should apply to foreign life insurance, endowment, and annuity contracts. The new regulations provide that, until further guidance is issued, no withholding under section 871(m) is imposed on these contracts issued by a foreign corporation that is predominately engaged in an insurance business and would be taxable as an insurance company if it were a domestic corporation.<sup>108</sup>
- **Employee compensation.** The new regulations provide that equity-based compensation, such as restricted stock, is not subject to withholding under section 871(m).<sup>109</sup> The grant of equity-based compensation may be subject to withholding as wages. In addition, after restricted stock vests, a foreign holder will be subject to withholding on actual dividends paid on the stock.

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<sup>105</sup> See New York State Bar Association Tax Section, Report on Proposed Regulations under Section 871(m), at 45 (May 20, 2014), available at [https://www.nysba.org/Sections/Tax/Tax\\_Section\\_Reports/Tax\\_Reports\\_2014/Tax\\_Section\\_Report\\_1306.html](https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1306.html).

<sup>106</sup> Treasury regulations section 1.871-15(c)(2)(ii).

<sup>107</sup> Temporary Treasury regulations section 1.871-15T(c)(2)(iv)(A).

<sup>108</sup> Temporary Treasury regulations section 1.871-15T(c)(2)(iv)(B).

<sup>109</sup> Treasury regulations section 1.871-15(c)(2)(v).

## I. Reporting by Brokers and Dealers

If only one party to a derivative is a broker or dealer, then the broker or dealer is required to exercise reasonable diligence to determine whether payments under the derivative are subject to withholding under Section 871(m),<sup>110</sup> and must provide the other parties (including any agents or intermediaries) with the timing and amount of any dividend equivalent payments, the derivative's delta, the amount of any tax withheld, and any other information necessary to apply the new regulations within 10 business days after the parties request the information. In all other cases, the short party must determine and provide this information.<sup>111</sup>

Accordingly, under the new regulations, brokers, dealers, and other short parties are required to determine and report whether a derivative is a simple contract or a complex contract, its delta or substantial equivalence, whether any reference index is a qualified index, the amount of any dividend equivalent payment, and the timing and amount of any withholding.

Many structured notes and other derivatives are held through a depository (such as the Depository Trust & Clearing Corporation or its affiliates), and customers purchase the derivatives through brokers that face the depository. The ultimate customers are the long parties for tax purposes, but the issuer will not know the identities of these customers. To comply with the new regulations, issuers likely will have to set up call centers or websites to notify the ultimate customers whether their derivatives are subject to withholding.

## J. "Cascading" Withholding

The new regulations may result in multiple withholdings on the same stream of dividends. For example, if a foreigner holds U.S. stock and enters into a short forward contract with respect to the stock with another foreigner, it generally will be subject to withholding on dividends paid on the stock, and will have to withhold on dividend equivalent payments under the forward contract. The withholding tax on the dividend equivalent payments would, in effect, be a second withholding tax with respect to the dividends.

Certain foreign financial institutions and foreign clearing houses can receive U.S.-source dividends and dividend equivalent payments without being subject to withholding tax if they certify to the withholding agent that they are receiving the payments as custodians (and not as beneficial owners) and have entered into a "qualified intermediary" agreement with the IRS under which they have agreed to assume primary withholding responsibility with respect to the payments. However,

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<sup>110</sup> A broker's application of the presumption rules described above in Part III.F.2. to determine whether to combine transactions in making this determination does not violate the "reasonable diligence" standard.

<sup>111</sup> Treasury regulations section 1.871-15(p)(1).

dealers often cannot act as qualified intermediaries with respect to a dividend or dividend equivalent payment because they receive the payment as beneficial owners (for example, as part of a dynamic hedge that offsets one or more transactions to which the dealer is a short party).

The new regulations mitigate cascading withholding by expanding the qualified intermediary regime to include “qualified derivatives dealers.”<sup>112</sup> A qualified derivatives dealer is a qualified intermediary that is either:

- A securities dealer that is regulated as a dealer in the jurisdiction in which it was organized or operates; or
- A bank that is regulated as a bank in the jurisdiction in which it was organized or operates (or a wholly owned affiliate of such a bank) that issues U.S. equity derivatives to customers and receives dividends or dividend equivalent payments on its hedges of these derivatives.<sup>113</sup>

Under the new regulations, a qualified derivatives dealer would not be subject to withholding on dividends or dividend equivalent payments if it:

- Certifies that it is acting as a qualified derivatives dealer;
- Agrees to assume primary withholding and reporting responsibilities with respect to the payments, and to determine whether payments it makes are dividend equivalent payments;
- Agrees to remain liable for tax on any dividends and dividend equivalents it receives to the extent that it does not make offsetting payments as a short party to another transaction that references the same stock; and
- Complies with certain compliance review procedures.<sup>114</sup>

The qualified derivatives dealer regime was not part of the 2013 proposed regulations on which the new regulations are based, so the IRS has introduced it in the form of temporary and new proposed regulations. The preamble to the new regulations provides that the IRS intends to revise its current form of qualified intermediary agreement before 2017 to reflect the qualified derivatives dealer regime. It is likely that virtually all foreign securities dealers, foreign banks, and affiliates of foreign banks that issue U.S. equity derivatives would become qualified derivatives dealers in order to eliminate withholding on their hedges.

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<sup>112</sup> Temporary Treasury regulations section 1.1441-1T(e)(6).

<sup>113</sup> Temporary Treasury regulations section 1.1441-1T(e)(6)(ii).

<sup>114</sup> Temporary Treasury regulations section 1.1441-1T(e)(6)(i).

**K. Anti-Abuse Rule**

The new regulations contain an anti-abuse rule that permits the IRS to subject any transaction to withholding if the transaction was entered into with a principal purpose of avoiding the regulations.<sup>115</sup> The anti-abuse rule grants extraordinarily broad discretion to the IRS. A purpose may be a principal purpose even though other purposes outweigh it. Thus, notwithstanding any contrary provision in the new regulations, the IRS may adjust the delta of a transaction, change the number of reference shares, adjust an estimated dividend amount, change the maturity, adjust the timing of payments, treat a transaction that references a partnership interest as referencing the assets of the partnership, and combine, separate or disregard transactions, or otherwise depart from the new regulations as necessary to determine whether the transaction includes a dividend equivalent payment.

For example, assume that a U.S. broker and a foreigner enter into a “dividend-stripping” partnership that holds a static pool of publicly traded U.S. stocks and allocates all dividends to the U.S. broker and all capital gains and losses to the foreigner. The purpose of the partnership is to provide the foreigner with price return only exposure to the stocks. The partnership would not be subject to the partnership look-through rule. However, under the anti-abuse rule, the IRS could look through the partnership and impose withholding on the foreigner’s partnership interest as if the foreigner had entered into a price return only swap with respect to the partnership’s stocks.

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If you have any questions about the foregoing, please contact any member of our [Tax Department](#).

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<sup>115</sup> Treasury regulations section 1.871-15(o).