

Clients & Friends Memo

Final and Proposed Regulations Address U.S. Withholding Tax on U.S. Equity Derivatives

December 13, 2013

I. Introduction

On Tuesday, December 4, the IRS and the Treasury Department issued proposed regulations that, if finalized as proposed, would dramatically increase the extent to which U.S. withholding tax is imposed on U.S. equity derivatives. On the same day, the IRS and the Treasury Department also issued final regulations that extend the current withholding rules for these derivatives through December 31, 2015.

Very generally, the proposed regulations would impose U.S. withholding tax on any derivative that references one or more U.S. equities that pay dividends, even if the derivative does not explicitly reference a dividend payment, unless the derivative has a delta of less than 0.70 with respect to the underlying stock or qualifies for one of several narrow exceptions. Delta is the ratio of the change in the fair market value of a derivative to the fair market value of the underlying stock.

Although the proposed regulations generally would dramatically increase the extent to which U.S. withholding tax is imposed on derivatives that reference U.S. equities, they stop short of imposing withholding tax on all such derivatives, and therefore invite financial engineering to avoid the withholding tax. The proposed regulations also would not impose withholding tax on some derivatives that provide for payments that are subject to withholding tax under the current rules. And they will be difficult for the IRS to enforce. Finally, the proposed regulations mark the first time that the IRS has proposed a rule based on delta. The use of delta could have broad potential application in the taxation of financial instruments, possibly to define straddles, wash sales, constructive ownership and sale transactions.

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

II. Section 871(m) and the Final Regulations

Payments of U.S.-source dividends to foreign persons generally are subject to a 30% U.S. withholding tax.¹ By contrast, payments that reference dividends under most equity swaps historically were not treated as U.S.-source dividends and were not subject to U.S. withholding tax. Section 871(m) was enacted to prevent foreign persons from avoiding the withholding tax on U.S.-source dividends. Under section 871(m) and temporary regulations issued in 2012, any “dividend equivalent payment”—that is, a payment that is contingent upon, or determined by reference to, the payment of a U.S.-source dividend—made before January 1, 2014 to a foreign party under an equity swap is subject to a 30% U.S. withholding tax if:

- the foreign party transfers the underlying stock to its counterparty in connection with the transaction (*i.e.*, the underlying stock “crosses in”),
- the counterparty transfers the underlying stock to the foreign party at the termination of the transaction (*i.e.*, the underlying stock “crosses out”),
- the underlying stock is not readily tradable on an established securities market, or
- the underlying stock is posted as collateral to the foreign party in connection with the transaction.²

The final regulations extend these rules through December 31, 2015.

Under section 871(m) and the final regulations, a 30% U.S. withholding tax will be imposed on every dividend equivalent payment to a foreign party under an equity swap beginning January 1, 2016, except to the extent new regulations are issued that provide that the swap does not have the potential for tax avoidance. The proposed regulations would define the class of equity swap that does not have the potential for tax avoidance, and therefore is not subject to U.S. withholding tax.

III. The Proposed Regulations

A. In General

Under the proposed regulations, beginning January 1, 2016, any dividend equivalent payment to a foreign party under an equity swap, and any dividend equivalent payment to a foreign party under any other derivative that is acquired on or after March 5, 2014, would be subject to a 30% U.S. withholding tax if, at the time the foreign party enters into or acquires the derivative, the “delta” of

¹ U.S.-source dividends are not subject to a 30% U.S. withholding tax if the dividends are effectively connected to the foreigner’s conduct of a trade or business in the United States. In this case, the dividends are subject to U.S. federal net income tax. Certain tax treaties reduce the rate of withholding below 30%.

² In addition, under section 871(m), any substitute dividend made to a foreign party pursuant to a securities lending or sale-repurchase transaction that is a dividend equivalent payment is subject to a 30% U.S. withholding tax.

the derivative—that is, the ratio of the change in the derivative's fair market value to the change in the stock's fair market value—is at least 0.70 or is not reasonably expected to vary throughout the term of the derivative.³

Although the proposed regulations impose withholding only on dividend equivalent payments, the proposed regulations generally deem dividend equivalent payments to be made on any derivative that references U.S. dividend-paying stock, regardless of whether the derivative in fact references dividend payments. Accordingly, the proposed regulations generally would impose withholding tax on forward and future contracts that do not provide for and are not adjusted to account for dividend payments, and “price return only” swaps that do not reference dividend payments.

On the other hand, the proposed regulations exempt derivatives whose delta is less than 0.70 with respect to the underlying stock (and is reasonably expected to vary throughout the term of the derivative), and therefore invite foreign investors to structure derivatives that provide for dividend equivalent payments to have a variable delta that is less than 0.70. Options, debt instruments, and variable share forward contracts can all be structured to have variable deltas of less than 0.70. Moreover, under the proposed regulations, a foreign investor that currently holds a physical U.S. equity security and is subject to withholding tax could sell the security to its counterparty and simultaneously enter into a derivative on the security that provides for a variable delta of less than 0.70, and escape U.S. withholding tax on the dividend equivalent payments. This foreign investor is subject to withholding under the final regulations and would have been subject to withholding under prior proposed regulations under section 871(m), but is not under the new proposed regulations.

B. Multiple reference stocks

If a derivative references the stock of more than one issuer, the derivative's delta generally is determined separately with respect to each stock, without taking into account any other stock or other property or liability. So, for example, if an equity swap provides a foreign party with 100% upside, downside, and dividend exposure to 100 shares of IBM stock and 100 shares of Apple stock during the term of the swap, under the proposed regulations, the swap's delta is determined

³ If the delta of a derivative is not reasonably expected to vary throughout the term of the instrument, then the derivative is treated as having a delta of 1.0 with respect to an adjusted number of reference shares. For example, if an equity swap provides a foreign party with 50% upside, downside, and dividend exposure to 100 shares of a stock during the term of the swap, and the swap's fair market value is expected to appreciate or depreciate by \$0.50 for every \$1.00 that the stock appreciates or depreciates at the time the foreign party enters into the swap (i.e., the delta is not reasonably expected to vary throughout the term of the instrument), then the swap will be treated as having a delta of 1.0 with respect to 50 shares of the stock (instead of having a delta of 0.50 with respect to 100 shares of the stock).

solely with respect to the IBM stock and solely with respect to the Apple stock (so that, in this example, the delta would be 1.00 for each).⁴

The proposed regulations provide an exemption from U.S. withholding tax under section 871(m) for dividend equivalent payments made with respect to a “qualified index.” A qualified index is an index that, at the time the derivative is entered into or acquired by the foreign party:

- references at least 25 securities,
- references only long positions with respect to component securities,
- contains no component security that represents more than 10% of its weighting,
- is modified or rebalanced only according to predefined objective rules and set dates or intervals,
- does not provide a dividend yield from component securities that exceeds 150% of the dividend yield reported on the S&P 500 index for the month immediately preceding the date the foreign party enters into or acquires the derivative, and
- is referenced by futures or option contracts that trade on a national securities exchange or a domestic board of trade.⁵

An index is also a qualified index if, at the time the derivative is entered into or acquired by the foreign party, the index is composed solely of long positions in assets and the referenced component underlying U.S. equity securities in the aggregate comprise 10% or less of the index’s weighting. Thus, no withholding would be required for dividend equivalent payments on a total return swap with respect to an index of international equities where U.S. equities comprise 10% or less of the index’s weighting.

C. Related transactions and anti-abuse rule

If a foreign party or a person related to the foreign party enters into or acquires more than one position with respect to the same stock, and the transactions are entered into “in connection with” each other (whether or not they are entered into simultaneously or with the same counterparty),

⁴ As drafted, the proposed regulation could provide for harsh results in certain cases. For example, assume that a derivative provides a foreign person with the excess, if any, of the dividends paid by IBM on 100 shares of stock over the dividends paid by Apple on 100 shares of stock, plus the appreciation, if any, of 100 shares of IBM stock over the appreciation, if any, of 100 shares of Apple stock, and requires the foreign party to pay the excess of the depreciation, if any, of 100 shares of IBM stock over the depreciation, if any, of 100 shares of Apple stock. The regulations appear to require withholding on the gross amount of dividends on 100 shares of IBM stock, presumably on the theory that the contract could have been written as a long swap on IBM shares and a separate short swap on Apple shares.

⁵ The qualified index exemption was intended to permit a foreign person to hold a total return swap on the S&P 500 without withholding under section 871(m). However, it is not clear that the S&P 500 index is modified or rebalanced according to predefined objective rules on set dates or intervals, because the sponsor has discretion as to the timing of modifications to the index components. We expect the definition of “qualified index” to be clarified to include the S&P 500 index and similar indices.

then the positions are aggregated to determine whether any dividend equivalent payments under the positions are subject to withholding tax under section 871(m).⁶ Thus, if a foreign party enters into an equity swap that provides the foreign party with dividend equivalent payments, but capped upside and downside so that the equity swap has a delta that is less than 0.70 with respect to the underlying equity, and the foreign person also buys a call option and sells a put option so that the combined delta of the three derivatives is at least 0.70 with respect to the equity security, the foreign party would be subject to U.S. withholding tax with respect to the dividend equivalent payments on all three derivatives.

The proposed regulations do not define “in connection with,” but provide that if a foreign party enters into a transaction to adjust its economic position with respect to a stock, the foreign party is treated as having entered into the transaction in connection with any transactions that the foreign party has previously entered into with respect to the stock.

For example, assume a foreign party purchases a six-month call option that has a delta of 0.60 with respect to the stock of a U.S. issuer and, three months later, when the call option still has a delta of 0.60, writes a put option that causes the delta of the combined derivatives to be 0.90 with respect to stock of the same issuer. Dividend equivalent payments under the call option after the sale of the put option would be subject to withholding tax under section 871(m) because, at the time the foreign party sells the put option, the delta of the combined transaction is at least 0.70.

The regulations require a counterparty to withhold on a dividend equivalent payment only if, after conducting reasonable diligence, the counterparty reasonably believes that the payment is subject to withholding tax under section 871(m). In each of the foregoing examples, if the counterparty to one transaction did not have any knowledge of the other transactions, it would have no obligation to withhold. It will be difficult for the IRS to enforce the proposed regulations against foreign investors in these cases.

The proposed regulations also contain an anti-abuse rule that permits the IRS to treat any dividend equivalent payment with respect to a transaction that is entered into with a principal purpose of avoiding the proposed regulations as subject to a 30% withholding tax.

⁶ It is unclear from the language of the proposed regulations whether a “dividend return only” swap and a “price return only” swap can be aggregated under this rule if the “price return only” swap does not itself provide for dividend equivalent payments, since a precondition for aggregation is that the foreign party be the “long party” with respect to each transaction, and the proposed regulations define “long party” as the party that is entitled to a dividend equivalent payment.

D. Definition of dividend equivalent payment

Dividend equivalent payments include actual payments, estimated dividend payments, and adjustments to a derivative's interest rate, notional amount, purchase price, premium, strike price, or other terms to account for dividends or estimated dividends. In addition, dividend equivalent payments include gross amounts that reference the payment of a U.S.-source dividend and are used in computing any net amounts due under a derivative.⁷

For example, if a swap provides a foreign party with upside and downside exposure to a stock, and requires the foreign party to pay a LIBOR-based rate to its counterparty that is reduced to reflect expected annual dividends on the stock, then the foreign party is treated as receiving dividend equivalent payments by reason of the reduction. This is true even if no payment is required under the swap until termination and, at termination, the foreign party is not entitled to receive any amounts under the swap.

Dividend equivalent payments also include payments to a foreign party under a derivative that references interests in a partnership or other "pass-through entity" to the extent that the payments are attributable to U.S.-source dividends, unless the underlying stock represents no more than 10% of the referenced interests at the time the foreign party enters into or acquires the derivative and there is no "plan or intention" for acquisitions or dispositions that would cause the underlying stock to represent more than 10% of the referenced interests.

E. Amount of dividend equivalent payment

The proposed regulations define a dividend equivalent payment as the product of three items:

- The amount of the per share dividend. If a derivative provides for a payment based on an estimated dividend that is not adjusted to reflect the amount of the actual dividend, and the formula for determining the estimated dividend is specified in the relevant offering document or operative documents, then the amount of the per share dividend is the lesser of the estimate and the actual dividend.
- The number of reference shares. The number of reference shares is adjusted to take into account any "leveraging" provided by the derivative. For example, if a total return swap provides a foreign party with 125% upside, downside, and dividend exposure to 100 shares of stock, then the number of reference shares is 125.

⁷ However, after the amount of a dividend equivalent payment has been determined, withholding is not required with respect to the payment until the money or property of the party that is subject to withholding is under the custody or control of the counterparty.

- The delta of the derivative. For this purpose, if a derivative has a term of more than one year, the delta of the derivative is calculated at the earlier of the stock's ex-dividend date and the record date of the dividend. If a derivative has a term that is one year or less, the delta of the derivative is calculated when the foreign party disposes of its position in the derivative.⁸

Thus, if a foreign party enters into a two-year total return swap with respect to 100 shares of a U.S. equity security, but the swap provides for capped upside and downside exposure with respect to the security and therefore has a delta of 0.75 at the time it is entered into, and a delta of 0.90 at the stock's ex-dividend date and at the record date of the dividend, then the amount of the dividend equivalent payment that is subject to withholding tax under the proposed regulations is the amount of dividends paid by the underlying issuer with respect to 100 shares of its stock, multiplied by 0.90.

F. Exemptions for foreign dealers and M&A transactions

The proposed regulations exempt dividend equivalent payments to a foreign dealer from withholding tax if the dealer certifies to its counterparty in writing that it is entering into the transaction in its capacity as a securities dealer and will withhold any tax imposed under section 871(m) with respect to transactions that it enters into as a short party in its capacity as a securities dealer. The proposed regulations also exempt dividend equivalent payments to a foreign party that is obligated to acquire more than 50% of the value of the entity issuing the underlying securities (i.e., pursuant to a stock purchase or merger agreement).

G. Reporting by brokers and dealers

Under the proposed regulations, 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 U.S. withholding tax under section 871(m), and must provide to its counterparty the delta of the derivative at each relevant testing time, the timing and amount of any dividend equivalent payments, the amount of any tax withheld, and any other information necessary to apply the proposed regulations within 14 days after the counterparty requests the information. In all other cases, the short party—that is, the party that is required to withhold on the dividend equivalent payment—must determine and provide this information.

Accordingly, under the proposed regulations, brokers, dealers, and other short parties will be required to determine the delta of each equity derivative when they enter into the derivative with a foreign party (or when the foreign party acquires the derivative), and on the ex-dividend date for the

⁸ The proposed regulations provide that the delta of an option at exercise is treated as 1.0, and the delta of an option at lapse is treated as 0.0. Therefore, a foreign party that acquires an option with a term of one year or less will not be subject to U.S. withholding tax under section 871(m) with respect to the option if the option lapses.

underlying stock, the record date for the underlying stock and/or the date their counterparty disposes of its position. These parties also will be required to determine whether an index is a qualified index each time they enter into an equity derivative with a foreign party (or the foreign party acquires the derivative).

H. Potential “cascading” of withholding tax

The proposed regulations may result in multiple withholdings on the same stream of dividends. For example, if a foreign party holds a U.S. equity security and enters into a short forward contract with respect to the equity security with a foreign counterparty, it will be subject to withholding tax on dividends paid with respect to the equity security, and will be required to withhold tax on dividend equivalent payments under the forward contract. The withholding tax on dividend equivalent payments would, in effect, be a second withholding tax with respect to the dividends.

I. Possible broader application of delta

The proposed regulations for the first time use the concept of delta to provide an objectively determinable standard to distinguish financial instruments for tax purposes. Delta could potentially replace a number of vague definitions that exist in the tax code to define straddles, wash sales, and constructive ownership and constructive sale transactions.

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

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