INTERNATIONAL

PROP. REGS. APPLY 'DELTA' APPROACH FOR DIVIDEND-EQUIVALENT PAYMENTS TO FOREIGN PERSONS

By Jeffrey L. Rubinger and Nadia E. Kruler

JEFFREY L. RUBINGER is a partner, and NADIA E. KRULER is an associate, in the Miami law firm of Bilzin Sumberg Baena Price & Axelrod LLP. Both have previously written for THE JOURNAL.

By replacing the seven-factor test in the prior Proposed Regulations, Treasury and the IRS have broadened the scope of Section 871(m) and increased the number of transactions to which withholding is potentially applicable.

EDITED BY SANFORD H. GOLDBERG, J.D., HERBERT H. ALPERT, J.D., AND MICHAEL J. MILLER, J.D.

Section 871(m) was enacted in 2010 to curb the perceived abuse of foreign persons using derivatives—primarily notional principal contracts (NPCs) or swaps—to replicate the ownership of an underlying U.S. equity without such person being subject to U.S. withholding tax on the underlying dividend. Under Section 871(m), a "dividend-equivalent payment" is treated as a dividend from U.S. sources and therefore (unless exempt under an applicable income tax treaty) subject to a 30% U.S. withholding tax.

Treasury and the IRS issued Proposed Regulations in 2012 that applied a seven-factor approach to determine whether the use of an NPC by a foreign person was a tax-avoidance transaction that would trigger the application of Section 871(m).[1] Recently, however, Treasury and the IRS withdrew the 2012 Proposed Regulations and issued new Proposed Regulations (REG-120282-10, 12/4/13) under Section 871(m) that apply a more objective standard.

Under the 2013 Proposed Regulations, a "delta" approach is used to determine whether payments pursuant to a derivative contract will be subject to U.S. federal income tax under Section 871(m). Under this method, if the ratio of the change in the FMV of a derivative contract to the change in the FMV of the property referenced by the contract (i.e., the underlying U.S. security) is at least 0.70 when the long party acquires the transaction, the dividend-equivalent payment will be subject to a 30% U.S. withholding tax under Section 871(m).

This represents a dramatic change from the approach contemplated under the 2012 Proposed Regulations and clearly does not provide for a taxpayer-friendly result. The 2013 Proposed Regulations will significantly broaden the scope of transactions that will be covered by Section 871(m), and include transactions that previously may have escaped that section's application. For example, under the 2012 Proposed Regulations, a foreign person generally was able to continue to rely on the special source rule for swap payments set forth in Reg. 1.863-7(b), and therefore enter into a total return equity swap in order to obtain a more efficient after-tax position in a dividend-paying U.S. stock than a direct investment would provide.

On the same date the 2013 Proposed Regulations were issued, Treasury and the IRS also issued final Regulations (TD 9648, 12/4/13) that substantially adopt the 2012 Temporary Regulations. Under those Temporary Regulations, the statutory definition of a specified NPC was extended to payments made before 2014. The final Regulations, however, extend the applicability of that statutory definition to payments made before 2016. According to Treasury, an extension of the statutory definition is necessary because the 2013 Proposed Regulations depart significantly from the 2012 Proposed Regulations' approach for determining whether an NPC is a specified NPC.

Withholding on U.S. source payments and Section 871(m). Unlike U.S. persons—who are subject to U.S. federal income tax on their worldwide income—foreign (i.e., non-U.S.) persons are subject to U.S. federal income taxation on only certain defined types of income considered to come from U.S. sources. Generally, U.S. taxation applies to only the following two specified categories of income received by foreign persons:

1. Certain passive types of U.S. source income, e.g., interest, dividends, rents, annuities, and other types of "fixed or determinable annual or periodical income," collectively known as "FDAP income."[2]

1 See Rubinger and LePree, "New Temporary and Proposed Regulations Attack Some Cross-Border Equity Swap Payments, 116 JTAX 212 (April 2012).

2 Sections 871(a) and 881(a).

2. Income that is effectively connected to a U.S. trade or business (ECI).[3]

FDAP income generally is subject to a 30% gross withholding tax, which must be withheld by the withholding agent or payor of such item where the payee is a foreign person (though the 30% rate is subject to reduction or elimination where an income tax treaty with the U.S. applies). ECI, on the other hand, is subject to U.S. federal income tax on a net basis at the same graduated tax rates that generally are applicable to U.S. persons, and is paid by the foreign taxpayer along with its required annual U.S. tax return.

TAXATION OF U.S. SOURCE DIVIDENDS

As noted above, foreign investors in the U.S. generally are subject to a 30% gross-basis withholding tax on U.S. source dividend payments that are not effectively connected with a U.S. trade or business. If applicable, however, a bilateral U.S. income tax treaty with the investor's home country may reduce or in some cases fully eliminate this tax.

Some non-U.S. investors not otherwise able to eliminate the withholding tax by treaty have sought instead to avoid the tax through the use of alternative investments that provide economics similar to a direct investment in shares of a U.S. company, but that do so without triggering the accompanying U.S. withholding tax liability. Historically, the two most common such alternative investments were securities lending transactions and NPCs.

Taxation of Securities Lending Transactions

In 1997, Treasury and the IRS issued Regulations that treat a substitute payment made under a securities lending transaction involving shares of a U.S. issuer as being from U.S. sources.[4] The Regulations source these substitute payments in the same manner as the related underlying dividends, causing the substitute payments to be subject to U.S. withholding tax when paid to a foreign investor.[5] As a result, securities lending transactions are no longer an effective means of investing in U.S. equities while avoiding U.S. withholding tax.

Despite these Regulations, however, taxpayers relied on Notice 97-66, 1997-2 CB 328, to avoid U.S. withholding tax in foreign-to-foreign securities lending transactions. In Notice 97-66, the IRS announced that it intended to propose new Regulations to address foreign-to-foreign withholding with respect to substitute dividend payments.

The Notice provided that until such Regulations were issued, the amount of U.S. withholding tax to be imposed with respect to a foreign-to-foreign substitute dividend payment would be the amount of the underlying dividend multiplied by a rate equal to the excess of (1) the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over (2) the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment.

Without such a rule, foreign-to-foreign securities lending transactions could result in overwithholding. This is because a substitute dividend payment made in this situation with respect to U.S. securities would be subject to a 30% withholding tax when paid by the foreign stock borrower to the foreign stock lender as would the actual dividend payment made by the U.S. issuer to the foreign stock borrower.

The problem was that taxpayers were abusing the language of Notice 97-66 to completely eliminate U.S. withholding tax rather than just use such language to avoid the problem of cascading withholding taxes. For example, taxpayers would take the position that a substitute dividend payment made in a securities lending transaction between two non-treaty persons would be completely exempt from U.S withholding tax because the excess of the rate of U.S. withholding that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute dividend payment (e.g., 30%) over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment (e.g., 30%) would be zero. This clearly was not the Service's intent when it issued Notice 97-66.[6]

This led to the issuance of Notice 2010-46, 2010-1 CB 757, which limits the ability of stock borrowers and lenders to rely on Notice 97-66. Under the 2010 guidance, the relief afforded by Notice 97-66 is available only to persons who have no reason to know that a securities lending transaction avoids all withholding taxes.

Taxation of NPCs

Under Reg. 1.863-7(b), promulgated more than 20 years ago, the source of income from an NPC is deter-

3 Sections 871(b) and Section 882.
4 Reg. 1.871-7(b)(2).
5 *Id.*
6 See Staff of the [Senate] Permanent Subcommittee on Investigations, 110th Cong., 2d Sess. *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends* (Comm. Print, 2008).

Datalogics Unix Job 1 jgraf/0/8129 22-JAN-14 11:19
Style: /opus/environments/proda/edsys/pager/style/journal.bst File: /tigredata/tigredata01/jtax/jtax_557488.txt
Seq: 3 Color: 0c: Format: rls$prod:journal.fmtFree lead 68D*points, Next 240D, Vjust JCE1:2

mined by reference to the residence of the person earning that income. Consequently, such income generally was not subject to U.S. withholding tax under Reg. 1.1441-4(a)(3) when earned by a foreign investor.

As a result, a non-U.S. taxpayer that wished to gain exposure to a particular U.S. stock without being subject to U.S. withholding tax on the related U.S. source dividend could enter into a total return equity swap, instead of acquiring the shares directly. A typical total return swap would be structured as follows: Taxpayer *A* would enter into a five-year equity swap with an investment bank whereby (1) at the end of each year, *A* would receive from the bank an amount equal to the sum of (a) any dividends paid with respect to a share of the underlying stock during such year, and (b) the increase, if any, in the FMV of a share of the underlying stock over the course of the year; and (2) at the end of each year, *A* will pay to the bank an amount equal to the sum of (a) an interest rate (typically LIBOR) multiplied by the FMV of the underlying share at the beginning of the year, and (b) the decrease, if any, in the FMV of the underlying share over the course of the year. The bank would hedge its position by purchasing the underlying shares.

Not surprisingly, the IRS early on expressed some concern about the potential for abuse of this rule. For example, the Preamble to the NPC Regulations issued in 1993 indicated that the Service was "considering whether notional principal contracts involving certain specified indices (e.g., one issuer's stock) should be excluded from the general sourcing rules of sections 861 through 865...."[7]

Nonetheless, this source rule was widely acknowledged and applied until more recently, when the IRS, increasingly concerned about specific potential abuses, heightened its scrutiny of certain hedge funds and financial institutions engaging in equity swap activity. In 2009, withholding tax enforcement was designated a Tier I issue by the Service.[8]

After increased audit activity of certain funds and banks, Treasury and the IRS determined that some foreign investors were relying on Reg. 1.863-7(b) to avoid U.S. withholding tax by entering into certain alternative transactions, such as the following series of steps:

1. Selling shares of a U.S. company to a U.S. financial institution prior to the ex-dividend date,

2. Entering into a "total return swap" with the financial institution that is tied to the value of the shares sold,

3. Receiving a dividend-equivalent payment from the financial institution pursuant to the total return swap when the underlying dividend is paid, and

4. Terminating the total return swap after receiving the dividend-equivalent payment and reacquiring shares in the same U.S. corporation.

In the foregoing example of a total return swap, the financial institution typically would hedge its swap position by simultaneously holding shares in the U.S. corporation. This arrangement effectively passed the U.S. source dividend through to the non-U.S. investor without triggering a withholding tax obligation in the U.S.

Industry Directive on Total Return Swaps

In January 2010, the IRS issued an industry directive on total return swaps addressing the examination of U.S. financial institutions that had entered into such transactions.[9] The directive was intended to assist IRS field agents in examining transactions involving swaps and foreign investors in order to determine whether the swaps should be respected, or whether instead they should be disregarded and recharacterized (for example, as direct ownership of the stock by the long party) such that withholding would be required on the purported dividend equivalents.

Section 871(m)

Congress added Section 871(m) to the Code as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, effective for payments made after 9/13/10.[10] This section provides that certain dividend-equivalent payments are treated as U.S. source dividends. Under Section 871(m)(2)(A), these include "any substitute dividend made pursuant to a securities lending or sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States." Thus, in contrast to the approach of the directive, the statute does not treat the long party in such transactions as the owner of the underlying stock, but rather changes the source of the dividend-

7 See the Preamble to TD 8491, 10/14/93.

8 See, e.g., Stewart, "Withholding Tax Compliance Expected to Increase, IRS Official Says," 2009 TNT 20-5 (2/3/09).

9 IRS Deputy Commissioner, International, "Industry Directive on Total Return Swaps ('TRSs') Used to Avoid Dividend Withholding Tax," LMSB-4-1209-044 (1/14/10), available at www.irs.gov/businesses/corporations/article/0,,id=218225,00.html. See also *Dividend Tax Abuse, supra* note 7.

10 P.L. 111-147, 3/18/10. The provision was originally enacted as Section 871(l), but was later redesignated as Section 871(m).

Datalogics Unix Job 1 jgraf/0/8129 22-JAN-14 11:19
Style: /opus/environments/proda/edsys/pager/style/journal.bst File: /tigredata/tigredata01/jtax/jtax_557488.txt
Seq: 4 Color: 0c: Format: rls$prod:journal.fmtFree lead 29D*points, Next 120D, Vjust JCE1:1

equivalent payment in order to permit withholding.

Under Sections 871(m)(2)(B) and (C), dividend-equivalent payments include payments under a "specified notional principal contract that (directly or indirectly) [are] contingent upon, or determined by reference to, the payment of a dividend from sources within the United States," as well as any other payment determined by the IRS to be substantially similar to the enumerated dividend equivalents. In this way, Section 871(m) reverses the general sourcing rule for payments made under an NPC to a non-U.S. investor when the contract is a specified NPC.

Section 871(m)(3)(A) provides that an NPC is a specified NPC if any of the following is true:

- In connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract (i.e., there is a "crossing-in").
- In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract (i.e., there is a "crossing-out").
- The underlying security is not readily tradable on an established securities market.
- In connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.
- The contract is identified by IRS as a specified NPC.

These categories of specified NPCs are limited. Section 871(m)(3)(B) provides, however, that any payment made after 3/18/12[11] on an NPC that is contingent on or is determined by reference to U.S. source dividends would be treated as a payment on a specified NPC unless "the Secretary determines that such contract is of a type which does not have the potential for tax avoidance." This impending deadline provided the impetus for the promulgation of the previously issued Temporary and Proposed Regulations—otherwise, as of 3/19/12 *all* NPCs would have been treated as specified NPCs, substantially increasing the scope of Section 871(m) and the compliance burden for financial institutions entering into such contracts with non-U.S. investors.

Under the 2012 Proposed Regulations, an NPC with respect to which any one of the below seven factors was present would have been a specified NPC:

1. The long party is "in the market" on the same day that the parties price the NPC or when the NPC terminates.

2. The underlying security is not regularly traded on a qualified exchange.

3. The short party posts the underlying security as collateral and the underlying security represents more than 10% of the collateral posted by the short party.

4. The term of the NPC has fewer than 90 days.

5. The long party controls the short party's hedge.

6. The notional principal amount is greater than 5% of the total public float of the underlying security or greater than 20% of the 30-day daily average trading volume, as determined at the close of business on the day immediately preceding the first day of the term of the NPC.

7. The NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

THE 2013 PROPOSED REGULATIONS

Treasury and the IRS received a number of comments regarding the 2012 Proposed Regulations. The main issues are addressed below.

Definitions—The 'Delta' Approach

After consideration of the comments, Treasury and the IRS acknowledged that the seven-factor approach to identify a specified NPC did not provide the best framework to determine whether an NPC "is of a type which does not have the potential for tax avoidance" and that it would be difficult to administer, both for the Service and for withholding agents. As a result, the 2013 Proposed Regulations withdraw the seven-factor approach in favor of an objective test that measures a derivative's delta to determine whether a contract is subject to tax under Section 871(m).

According to the Preamble to REG-120282-10, Treasury and the IRS believe that the delta-based standard will prevent taxpayers from avoiding withholding tax by electing derivative exposure to U.S. equities rather than physical ownership. The Preamble states:

"A transaction has the 'potential for tax avoidance' if it approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security. In many cases, a long party is indifferent as to whether to invest in a derivative or a physical position because the derivative and

11 That is, two years after the date of enactment; see *id.*

the physical position provide comparable economic returns. Furthermore, the short party will often hedge an NPC or ELI [(i.e., an "equity-linked investment")] by acquiring physical securities in proportion to the delta of the derivative to which it is exposed. When dividends paid on physical securities are subject to tax while dividend equivalents with respect to economically comparable derivatives are not, those derivatives have a potential for tax avoidance regardless of whether a long party is using the derivative in a particular case to avoid tax. Accordingly, the Treasury Department and the IRS favor a delta approach that objectively identifies transactions in which the long party is able to sufficiently approximate the economic returns associated with an underlying security."

While securities lending transactions and total return swaps referencing stock are the most common types of equity-linked transactions that provide the long party with either a dividend or a dividend equivalent equal to the dividend paid on the referenced stock, other transactions that are linked to U.S. equities also may provide for dividend equivalents. The Preamble provides that an ELI that has economic terms that are substantially similar to a payment made pursuant to a securities lending or a specified NPC creates the same potential for avoidance of U.S. withholding tax as those transactions.

Accordingly, the 2013 Proposed Regulations define a dividend-equivalent payment to include a specified NPC or a specified ELI.[12] An ELI is defined as any financial transaction (other than a securities lending or sale-repurchase transaction or an NPC) that references the value of one or more underlying securities.[13] "ELI" includes instruments such as forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments with payments linked to underlying securities.[14]

As noted above, to determine whether a transaction is a specified NPC or specified ELI, the 2013 Proposed Regulations replace the seven-factor test in the 2012 Proposed Regulations with a single-factor test:

- With respect to payments made after 2015, a specified NPC is any NPC that has a delta of 0.70 or greater when the "long party" "acquires" the transaction.[15]
- Similarly, a specified ELI is any ELI that has a delta of 0.70 or greater when the long party acquires the transaction.[16]

Example. The terms of an NPC require the long party to pay the short party an amount equal to all of the depreciation in the value of 100 shares of stock X and an interest-rate based return. In return, the NPC requires the short party to pay the long party an amount equal to all of the appreciation in the value of 100 shares of stock X and any dividends paid by X on those shares. The value of the NPC will change by \$1 for each \$0.01 change in the price of a share of stock X. The NPC therefore has a delta of 1.0 (\$1.00/(\$0.01 $\times$ 100)).[17]

If a transaction references more than one underlying security, the taxpayer must determine whether the transaction is a Section 871(m) transaction with respect to each underlying security. A transaction, therefore, may be a Section 871(m) transaction with respect to one or more underlying securities referenced in the transaction, but may not be treated as a Section 871(m) transaction with respect to other underlying securities referenced by that same transaction. For example, if an ELI references underlying security A and underlying security B, and it has a delta of 0.90 with respect to A and 0.30 with respect to B, the ELI is a specified ELI with respect to A and is not a specified ELI with respect to B.[18]

Furthermore, an NPC or ELI will be treated as having a delta of 1.0 with respect to an underlying security when it has a constant delta with respect to the underlying security at

12 Prop. Reg. 1.871-15(c)(1). A payment pursuant to a Section 871(m) transaction that references a distribution with respect to an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to Sections 871 or 881, or to withholding under Chapters 3 or 4, if the long party owned the underlying security referenced by the Section 871(m) transaction. For example, if a specified NPC references stock in a regulated investment company that pays a capital gains dividend described in Section 852(b)(3)(C) which would not be subject to withholding tax if paid directly to the long party, then an NPC payment determined by reference to the capital gains dividend is not a dividend equivalent; see Prop. Reg. 1.871-15(c)(2)(i). Furthermore, a payment pursuant to a Section 871(m) transaction is not a dividend equivalent to the extent that the payment is treated as a distribution taxable under Section 305; see Prop. Reg. 1.871-15(c)(2)(ii).

13 Prop. Reg. 1.871-15(a)(4).

14 *Id.*

15 Prop. Reg. 1.871-15(d)(2). For this purpose, a long party is the party to a potential Section 871(m) transaction with respect to an underlying security that is entitled to a dividend equivalent; see Prop. Reg. 1.871-15(a)(7)(i). Moreover, "acquire" means to enter into, purchase, accept by transfer, by exchange, or by conversion, or otherwise acquire a potential Section 871(m) transaction; see Prop. Reg. 1.871-15(a)(1).

16 Prop. Reg. 1.871-15(e). The 2013 Proposed Regulations require that the delta of an NPC or ELI be determined in a commercially reasonable manner, and that if a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of the Regulations. See Prop. Reg. 1.871-15(g)(1).

17 Prop. Reg. 1.871-15(g)(3), Example 1.

18 *Id.*

the time it is acquired by the long party.[19] For this purpose, an NPC or ELI will be treated as having a constant delta with respect to an underlying security if the NPC or ELI has a delta that is not reasonably expected to vary during the term of the transaction with respect to that underlying security.

According to the Preamble, the purpose of this rule is to prevent taxpayers from avoiding the application of the 2013 Proposed Regulations by using transactions that reduce delta while retaining the economics of owning a set amount of shares. For example, a transaction that provides 50% of the appreciation, dividends, and depreciation on 200 shares of stock X throughout the term of the transaction (and therefore has a delta of 0.50) will be treated as a contract that provides 100% of the same exposure on 100 shares of stock X (and therefore has a delta of 1.0).[20]

Treasury and the IRS are requesting comments regarding whether taxpayers could avoid the constant delta rule by structuring transactions with the potential for de minimis delta variability and whether such transactions should be deemed to have a constant delta.

Treasury and the IRS also acknowledge that a long party may enter into multiple transactions that reference the same underlying security to substantially replicate the economics of owning the underlying security. For example, a taxpayer may purchase a call option and sell a put option (i.e., enter into a collar) referencing the same underlying security that individually have a delta below 0.70 but together have a delta that exceeds 0.70. If Section 871(m) were to apply to each transaction separately, neither transaction would be a Section 871(m) transaction even though the economics of the positions when considered together are the same as another transaction that would be a Section 871(m) transaction.

Therefore, the 2013 Proposed Regulations treat multiple transactions as a single transaction for purposes of determining if the transactions are a Section 871(m) transaction with respect to an underlying security when a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other.[21] A withholding agent, however, is not required to withhold on a dividend equivalent paid pursuant to a transaction that has been combined with one or more other transactions unless the withholding agent knows that the long party (or a related person) entered into the potential Section 871(m) transactions in connection with each other.[22]

Example. Foreign taxpayer (FT) purchases a call option with a term of six months that references 100 shares of stock X, and simultaneously sells a six-month put option on 100 shares of stock X. The delta of the call option is 0.45 and the delta of the put option is 0.40 at the time FT acquired each option. Because the purchased call option and the sold put option are entered into simultaneously by FT and reference the same underlying security, the facts and circumstances indicate that the call option and the put option are entered into in connection with each other and are treated as a combined transaction. Accordingly, the call option and the put option are treated as a combined transaction to compute delta. The delta of the combined purchased call option and written put option is 0.85 (i.e., 0.45 + 0.40). The combined transaction is therefore a specified ELI.[23]

For purposes of applying the previous rule, combined transactions are tested each time the long party (or a related person) acquires a potential Section 871(m) transaction and the deltas used to determine whether the combined transactions are Section 871(m) transactions are the deltas of each of the combined transactions at that time. Moreover, if a potential Section 871(m) transaction is a Section 871(m) transaction, either by itself or as a result of a combination, it does not cease to be a Section 871(m) transaction as a result of applying this rule.

Example. Foreign taxpayer (FT) purchases a call option with a term of one month that references 100 shares of stock X. At the time, the delta of the call option is 0.75. Two weeks later, FT re-evaluates its position in stock X and writes a two-week put option on 100 shares of stock X. At the time FT writes the put option, the delta of the call option is 0.35 and the delta of the put is 0.25.

FT's purchased call option has an initial delta of 0.75 and therefore is a specified ELI and a Section 871(m) transaction. FT's purchased call option and sold put option reference the same underlying security. Because FT sold the put option referencing stock X to adjust its economic position associated with the call option referencing stock X, these options are entered into in connection with each other and are treated as a combined transaction. Because the delta of the combined transaction is tested on the date that FT entered into the additional transaction, the delta of the combined purchased call option and sold put

19 Prop. Reg. 1.871-15(g)(2).
20 See Prop. Reg. 1.871-15(g)(3), Example 3.
21 Prop. Reg. 1.871-15(l)(1).
22 Prop. Reg. 1.1441-1(b)(4)(xxiii).
23 Prop. Reg. 1.871-15(l)(6), Example 1.

option is 0.6 (0.35 + 0.25). The combined transaction is not a specified ELI, but the purchased call option remains a specified ELI.[24]

Dividend-Equivalent Payments

The 2013 Proposed Regulations also include rules for identifying a payment as a dividend equivalent. Prop. Reg. 1.871-15(h)(1) provides that a payment includes any gross amount that references the payment of a dividend and that is used in computing 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 payment is made because the net amount is zero.

In the 2013 Proposed Regulations, a dividend equivalent includes any amount that references the payment of a U.S. source dividend. In addition to an actual payment of dividends and an estimated payment of dividends, a dividend equivalent includes any other contractual term of a potential Section 871(m) transaction that is calculated based on an actual or estimated dividend.[25]

For example, when a long party enters into an NPC that provides for payments based on the appreciation in the value of an underlying security but does not explicitly entitle the long party to receive payments based on regular dividends, the 2013 Proposed Regulations treat the price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining other terms of the NPC, such as in the payments that the long party is required to make to the short party or in setting the price of the underlying securities referenced in the price return swap.

Example. Foreign taxpayer (FT) enters into a price return swap contract that entitles him to receive payments based on the appreciation in the value of 100 shares of stock X and requires him to pay an amount based on LIBOR plus any depreciation in the value of stock X. The swap contract does not explicitly entitle FT to payments based on dividends paid on stock X during the term of the contract and the swap contract does not contain any reference to an estimated dividend amount. The LIBOR rate on the swap contract, however, is reduced to reflect expected annual dividends on stock X.

Because the LIBOR leg of the swap contract is reduced to reflect estimated dividends and the estimated dividend amount is not specified, the foreign taxpayer is treated as receiving the actual dividend amount and those amounts are treated as dividend equivalents under the Proposed Regulations.[26]

Amount of Dividend-Equivalent Payments

The 2013 Proposed Regulations provide that the amount of the dividend equivalent for a specified NPC or a specified ELI equals the per-share dividend amount with respect to the underlying security multiplied by the number of shares of the underlying security multiplied by the delta of the transaction at the time the amount of the dividend equivalent is determined.[27] The number of shares is subject to adjustment in order to take into account any factor, fraction, or other alteration provided by the Section 871(m) transaction. For example, if a total return swap entitles a long party to receive a payment based on the appreciation and dividend amount on 100 shares multiplied by a factor of 1.50, the number of shares of the security for the purpose of the dividend-equivalent amount calculation is 150.[28]

Where the transaction provides for a payment based on an estimated dividend, the 2013 Proposed Regulations provide that the actual amount of the dividend payment must be used to calculate the dividend-equivalent amount unless the short party identifies a reasonable estimated dividend amount in writing in an offering document or the documents governing the terms of the transaction at the inception of the transaction.[29] If the estimated dividend is supported by the required documentation, the calculation of the dividend-equivalent amount is based on the lesser of the amount of the estimated dividend and the amount of the actual dividend paid.[30]

The amount of the dividend equivalent is generally determined on the earlier of the date the underlying security becomes ex-dividend or the record date of the dividend.[31] If, however, the specified NPC or a specified ELI has a term of one year or less when acquired, the amount of the dividend equivalent is determined on the date the long party disposes of the transaction.[32]

The delta of a Section 871(m) transaction at the time that the amount of the dividend-equivalent amount is determined is used solely for purposes of determining the amount of the dividend equivalent

24 Prop. Reg. 1.871-15(i)(6), Example 3.
25 Prop. Reg. 1.871-15(h)(2)(ii).
26 Prop. Reg. 1.871-15(h)(4), Example 2.
27 Prop. Reg. 1.871-15(i)(1)(ii)(A).
28 Prop. Reg. 1.871-15(i)(1)(ii)(B)(2).
29 Prop. Regs. 1.871-15(h)(2)(i) and (iii).
30 Prop. Reg. 1.871-15(h)(2)(iv).
31 Prop. Reg. 1.871-15(i)(2)(i).
32 Prop. Reg. 1.871-15(i)(2)(ii). For this purpose, "dispose of" means to sell, exercise, terminate, allow to lapse or expire, transfer, settle (in cash or otherwise), cancel, exchange, convert, surrender, forfeit, or otherwise dispose of or allow to expire. *Id.* The Preamble indicates that "a long party that acquires an option with a term of one year or less that is a specified ELI will not incur a withholding tax if the option lapses," despite that a lapse of an ELI is included in the definition of "dispose of."

at that time, and the transaction is not re-tested to determine if it is a Section 871(m) transaction.[33] As a result, the delta used to determine the amount of the dividend equivalent may be different from the delta used to determine whether a transaction is a Section 871(m) transaction. For example, if a transaction had a delta of 0.80 when acquired by the long party and was a Section 871(m) transaction, the transaction remains a Section 871(m) transaction and continues to be subject to tax even if the delta is below 0.70 at the time the amount of the dividend equivalent is determined.[34] Likewise, if the transaction had a delta below 0.70 at the time of acquisition, the transaction will not become a Section 871(m) transaction if the delta increases above 0.70 during the time the long party holds the transaction.

Section 871(m) Exceptions

The 2013 Proposed Regulations provide two exceptions to the definition of a Section 871(m) transaction.

Under the first exception, if a qualified dealer, in its capacity as a dealer, enters into a transaction as the long party, the transaction does not constitute a Section 871(m) transaction.[35] A qualified dealer is any dealer in securities that is subject to regulatory supervision by a government authority.[36] To qualify under this exception, the dealer must provide a written certification to the short party confirming that the dealer is a qualified dealer acting in its capacity as a dealer in securities and that the dealer will withhold and deposit any tax imposed by Section 871(m) with respect to any Section 871(m) transactions that the dealer enters into as a short party.[37]

Under the second exception, a transaction does not qualify as a Section 871(m) transaction if it obligates one or more persons (including the taxpayer) to acquire more than 50% or more of the entity issuing the underlying securities. To qualify for the exception, the taxpayer must furnish a written certification to the short party that it meets these requirements.[38]

Look-Through Rule for Noncorporate Entities

Generally, under the 2013 Proposed Regulations "underlying security" refers to any interest in an entity that is taxable as a C corporation if a payment with respect to that interest could give rise to a U.S. source dividend.[39] The 2013 Proposed Regulations include a look-through rule, however, for interests in entities other than C corporations. Under this rule, a transaction that references an interest in an entity that is not a C corporation for federal tax purposes is treated as referencing the allocable portion of the underlying securities or potential Section 871(m) transactions held directly or indirectly by the entity.[40] The look-through rule does not apply, however, if the underlying securities and potential Section 871(m) transactions represent, in the aggregate, 10% or less of the interest in the entity at the time the long party enters the transaction and there is no plan or intention for acquisitions or dispositions that would cause the underlying securities to represent more than 10% of the referenced interest in the entity.[41]

Example. Actively traded partnership A owns a pro rata interest in partnership B that represents 10% of the value of an interest in partnership A, and partnership B owns an interest in underlying security X that represents 20% of the value of an interest in partnership B. Therefore, underlying security X represents 2% of the value of a pro rata interest in partnership A. Accordingly, a pro rata interest in partnership A qualifies for the exception to the look-through rule and underlying security X is not treated as referenced by a transaction that references a pro rata interest in partnership A.[42]

Anti-Abuse Rule

The 2013 Proposed Regulations contain an anti-abuse rule that provides if a taxpayer acquires a transaction with a principal purpose of avoiding the application of Section 871(m), the IRS may treat any payment made with respect to such transaction as a dividend equivalent.[43] As a result, the Service may adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, adjust the timing of payments, combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions, and otherwise depart from the rules of this section as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent.

According to the Preamble, Treasury and the IRS will continue to scrutinize other transactions that are not covered by Section 871(m) and that may be used to avoid U.S. federal income tax and U.S. withholding. In addition, the Service may

33 Prop. Reg. 1.871-15(i)(1)(ii)(C).
34 *Id.*
35 Prop. Reg. 1.871-15(j)(1)(i).
36 Prop. Reg. 1.871-15(j)(1)(ii)(A).
37 Prop. Reg. 1.871-15(j)(1)(ii)(B).
38 Prop. Reg. 1.871-15(j)(2).
39 Prop. Reg. 1.871-15(a)(11).
40 Prop. Reg. 1.871-15(m)(1).
41 Prop. Reg. 1.871-15(m)(2).
42 *Id.*
43 Prop. Reg. 1.871-15(n).

challenge the U.S. tax results claimed in connection with transactions that are designed to avoid the application of Section 871(m) using all available statutory provisions and judicial doctrines (including the substance over form doctrine, the economic substance doctrine under Section 7701(o), the step transaction doctrine, and tax ownership principles) as appropriate. For example, according to the Preamble, nothing in Section 871(m) precludes the IRS from asserting that a contract labeled as an NPC or other equity derivative is in fact an ownership interest in the equity referenced in the contract.

Reporting and Withholding Requirements

The 2013 Proposed Regulations also make several changes to the reporting and withholding requirements. If a broker or dealer is a party to a potential Section 871(m) transaction with a counterparty that is not a broker or dealer, the broker or dealer is required to determine whether the transaction is a Section 871(m) transaction and, if so, the amount of the dividend equivalents.[44] If both parties are brokers or dealers, or if neither party is a broker or dealer, the short party must determine whether the transaction is a Section 871(m) transaction and the amounts of the dividend equivalents.

The party required to make the determinations is required to exercise reasonable diligence to determine whether the transaction is a Section 871(m) transaction, any dividend equivalents, and any other information necessary to apply the rules of Section 871. The determinations are binding on the parties to the potential Section 871(m) transactions and to the withholding agent, but are not binding on the IRS.[45]

In addition, certain persons involved in the transaction are entitled to request information from the party required to make the determinations when that information is necessary to satisfy their withholding or information reporting obligations or to determine their tax liability.[46]

The 2013 Proposed Regulations include amendments to the Section 1441 withholding Regulations specifically dealing with dividend equivalents. The Regulations provide that a withholding agent is not required to withhold on a dividend equivalent until the later of (1) the time that the amount of the dividend equivalent is determined and (2) the time that the withholding agent is deemed to have control over the money or property of the long party.[47]

A withholding agent is deemed to have control over the money or property of the long party when either (1) money or property has been paid to or from the long party, (2) the withholding agent has custody of the money or property of the long party at any time on or after the amount of the dividend equivalent is determined, or (3) the transaction provides for an upfront payment or prepayment of the purchase price.[48] The long party is liable for U.S. tax on the dividend equivalent even though the withholding agent is not required to withhold due to lack of control of money or other property of the long party.

Amounts paid with respect to an NPC or ELI will not be subject to withholding if the transaction is not a Section 871(m) transaction or is subject to an exception.[49] It is not necessary to provide documentation establishing that an NPC or ELI has a delta that is less than 0.70 at the time it was acquired by the long party. The withholding exemptions regarding qualified dealers and corporate acquisitions, however, apply only if the long party furnishes the required documentation.

Qualified Index Rules

The 2013 Proposed Regulations also revise the rules pertaining to indices. A qualified index is treated as a single security that is not an underlying security for the purposes of Section 871(m).[50] An index is a qualified index if it references 25 or more component underlying securities, references only long positions in component underlying securities, contains no component underlying security that represents more than 10% of the underlying securities in the index, and is modified or rebalanced only according to predefined objective rules at set dates or intervals.[51]

In addition, a qualified index must not provide a dividend yield that is greater than 1.5 times the current dividend yield of the S&P 500 Index.[52] Finally, futures contracts or option contracts on the index must trade on a registered national securities exchange.[53]

Notwithstanding these rules, the 2013 Proposed Regulations provide a safe harbor for indices that primarily reference assets other than underlying securities. Under the safe harbor provision, an index is a qualified index if the index is comprised solely of long positions in assets and the referenced component un-

44 Prop. Reg. 1.871-15(o)(1).
45 *Id.*
46 Prop. Reg. 1.871-15(o)(3).
47 Prop. Reg. 1.1441-2(d)(5).
48 Prop. Reg. 1.1441-2(d)(5)(ii).
49 Prop. Reg. 1.1441-1(b)(4)(xxii).
50 Prop. Reg. 1.871-15(k)(1).
51 Prop. Regs. 1.871-15(k)(2)(i) through (iv).
52 Prop. Reg. 1.871-15(k)(2)(v).
53 Prop. Reg. 1.871-15(k)(2)(vi).

derlying securities in the aggregate comprise 10% or less of the index.[54]

If an index has a component that is not an underlying security, that component is not taken into account for purposes of determining whether an index is a qualified index, except to meet the safe harbor requirements.[55]

If a transaction references a qualified index and one or more underlying securities, the qualified index will remain a qualified index only if the transaction does not reference a short position in any referenced component underlying security of the qualified index, other than a short position with respect to the entire qualified index (for example, a cap or a floor).[56] If, in connection with a transaction that references a qualified index, a taxpayer (or a related person) enters into one or more transactions that reduce exposure to any referenced component underlying security of the index, other than transactions that reduce exposure to the entire index, then the potential Section 871(m) transaction is not treated as referencing a qualified index.[57]

Certain Contingent Interest

Section 871(h)(1) generally provides that foreign persons are not subject to the 30% U.S. withholding tax on U.S. source portfolio interest, including certain types of contingent interest payments. The types of contingent interest payments that are exempt from withholding include interest that is determined by reference to (1) changes in the value of property (including stock) that is actively traded within the meaning of Section 1092(d) (other than property described in Section 897(c)(1) or (g)); (2) the yield on property described in (1), or (3) changes in any index of the value of property described in (1).

Most other types of contingent interest payments, however, are excluded from the definition of portfolio interest.[58] Section 871(h)(4)(A)(ii) grants Treasury authority to impose tax on contingent interest when necessary to prevent the avoidance of federal income tax. The Preamble explains that because most contingent debt instruments are either referenced to a qualified index, have an embedded option with a delta below 0.7, or both, they provide the potential to be used by a nonresident alien or a foreign corporation to avoid Section 871(m). To combat this potential avoidance,[59] the Proposed Regulations provide that contingent interest does not qualify as portfolio interest to the extent the interest is a dividend equivalent.[60]

Effective Dates

The 2013 Proposed Regulations generally will be effective for payments made on or after the date that the Regulations become final. Certain provisions of the 2013 Proposed Regulations, however, will apply at different dates:

- The definition of a specified NPC in the 2013 Proposed Regulations will apply to payments made pursuant to a specified NPC after 2015. For payments made before 2016, the definition of a specified NPC is the definition provided in Section 871(m)(3)(A).
- For specified ELIs, the rules of the 2013 Proposed Regulations will apply to payments made after 2015, but only with respect to an ELI that was acquired by the long party after 3/4/14.

CONCLUSION

The shift to a delta-based approach under the 2013 Proposed Regulations to determine whether the use of an NPC by a foreign person is a tax-avoidance transaction represents a dramatic change from the seven-factor test contemplated under the 2012 Proposed Regulations and clearly does not provide for a taxpayer-friendly result. The 2013 Proposed Regulations will significantly broaden the scope of transactions that will be subject to Section 871(m) beyond what was likely intended to be covered by Congress.

For example, under the 2013 Proposed Regulations, withholding will now be required on many collar transactions when there is a foreign counterparty. In addition, the 2013 Proposed Regulations essentially create a dividend-equivalent payment in situations where no dividend-equivalent payment actually exists in the case of a price return swap. Because of these and other transactions that are now potentially covered under Section 871(m), it

54 Prop. Reg. 1.871-15(k)(3).
55 Prop. Reg. 1.871-15(k)(5).
56 Prop. Reg. 1.871-15(k)(6).
57 *Id.*
58 See Section 871(h)(4). Portfolio interest does not include interest that is determined by reference to any (1) receipts, sales, or other cash flow of the debtor or related person; (2) any income or profits of the debtor or a related person; (3) any change in value of any property of the debtor or a related person; or (4) any dividend, partnership distributions, or similar payments made by the debtor or a related person. See Section 871(h)(4)(A)(i).
59 A handful of income tax treaties that have been concluded by the U.S. still exempt contingent interest from U.S. withholding tax, including the U.S.-Czech Republic income tax treaty, the U.S.-Russia income tax treaty, the U.S.-Greece income tax treaty, and the U.S.-Norway income tax treaty. The existing treaties with Hungary and Poland that are still in effect also exempt contingent interest from U.S. withholding tax, although those treaties will be replaced with newer treaties in the near future that will no longer provide for this exemption.
60 Prop. Reg. 1.871-14(h). See Ltr. Rul. 200933002 for an example of a structure that allowed foreign persons to avoid U.S. withholding tax on contingent interest that was tied to actively traded property.

Datalogics Unix Job 1 jgraf/0/8129 22-JAN-14 11:19
Style: /opus/environments/proda/edsys/pager/style/journal.bst File: /tigredata/tigredata01/jtax/jtax_557488.txt
Seq: 11 Color: 0c: Format: rls$prod:journal.fmtFree lead 4595DMpoints, Next 0D, Vjust RE

would not be surprising to see these issues raised in comments to the IRS.

Adopting the delta method represents a dramatic change from the approach contemplated under the 2012 Proposed Regulations and clearly does not provide for a taxpayer-friendly result.

Some non-U.S. investors not otherwise able to eliminate the withholding tax by treaty have sought instead to avoid the tax through the use of alternative investments that provide economics similar to a direct investment in shares of a U.S. company.

In contrast to the approach of the directive, the statute does not treat the long party in such transactions as the owner of the underlying stock, but rather changes the source of the dividend-equivalent payment in order to permit withholding.

Accordingly, the 2013 Proposed Regulations define a dividend-equivalent payment to include a specified NPC or a specified ELI.

If a transaction references more than one underlying security, the taxpayer must determine whether the transaction is a Section 871(m) transaction with respect to each underlying security.

The delta used to determine the amount of the dividend equivalent may be different from the delta used to determine whether a transaction is a Section 871(m) transaction.

The determinations are binding on the parties to the potential Section 871(m) transactions and to the withholding agent, but are not binding on the IRS.