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New Proposed Regulations Under Section 871(m) Adopt a Single Factor Test but Delay Effective Date Until 2016

On December 4, 2013, the Treasury Department and the Internal Revenue Service (the "IRS") released new final and proposed regulations under section 871(m) of the Internal Revenue Code regarding the imposition of US federal withholding tax on certain equity-linked payments. Under the final regulations, swap payments made after March 18, 2012, but prior to January 1, 2016, will continue to be subject to the existing sourcing rules contained in section 871(m). Under the proposed regulations, beginning January 1, 2016, payments made under swaps and certain other financial instruments with respect to US equities that have a "delta" of 0.7 or greater would be treated as US source income under section 871(m) (generally regardless of whether such payments are determined by reference to US-source dividends) and, thus, potentially subject to US withholding tax. The proposed regulations represent a fundamental change in the government's approach to cross-border derivative payments with respect to US equities by replacing a proposed regime that would subject to withholding tax only transactions that have specific indices of tax avoidance with a new system that essentially treats all cross-border equity derivatives on US equities with a sufficiently high delta as abusive tax avoidance transactions. The proposed regulations raise many difficult questions relating to tax policy, economic impact on markets and companies and administrability, among others.

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While many market participants will be relieved that the current rules on "specified NPCs" are extended through December 31, 2015, there should be a great deal of concern that the new proposed regulations, as described fully below, generally would treat all equity swaps, forwards, options and other derivatives that have a delta of 0.7 or greater as subject to section 871(m) withholding without regard to whether any specific indicia of tax avoidance is present. As explained in the preamble to the new regulations, the Treasury Department and the IRS believe that all equity swaps and other derivatives captured by the new proposed regulations, subject only to two narrow exceptions, have the "the potential for tax avoidance" and thus would be subject to section 871(m) withholding. This is in sharp contrast to the prior proposed regulations which allowed market participants to avoid potential section 871(m) withholding on equity swaps so long as none of seven particular factors was present (or, alternatively, so long as payments were not actually contingent on or determined by reference to dividends on the underlying security). While the approach taken in the proposed regulations may be simpler in certain respects (perhaps in response to comments concerning the complexity of the prior proposed regulations), the broad and over-inclusive nature of the single factor approach may have substantial adverse effects on markets and investors.

Background

US withholding tax generally is imposed on certain types of US source income, including dividends, paid to foreign persons.[1] In general, swap payments are not subject to US withholding tax because payments made to a foreign person under a notional principal contract ("NPC") are treated as foreign source income.[2] Prior to the enactment of section 871(m), the treatment of swap payments made to a foreign person as foreign source income applied even where the swap payments were based on US source dividends.

In contrast, dividends are generally sourced by reference to the residence of the payor corporation.[3] Consequently, dividends paid by US corporations to foreign holders generally are treated as US source income and subject to US withholding tax at a 30 percent rate (subject to reduction pursuant to an applicable tax treaty).

In recent years, the IRS increasingly focused on the enforcement of US withholding tax on dividends by examining both financial institutions and foreign persons. Specifically, the IRS has targeted transactions such as total return swaps on US equities that it believes have the potential for withholding tax avoidance.[4]

1 I.R.C. §§ 871 and 881.

2 Treas. Reg. § 1.863-7(b)(1). This sourcing rule has been in effect since 1991.

3 I.R.C. § 861(a)(2).

4 As part of this enforcement effort, the IRS issued an industry directive (the "Directive") in January 2010 to assist revenue agents in developing the facts necessary to determine whether a transaction that is in the form of a swap will be respected as an NPC or will be recast as some other arrangement. Internal Revenue Service, Industry Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax, LMSB-4-1209-044 (January 14, 2010). See our prior client publication dated January 26, 2010 entitled "IRS Industry Directive on Total Return Swaps Used to Avoid Dividend Withholding Tax" available at www.shearman.com in the Tax practice area. *See also* Staff of the S. Comm. on the Permanent Subcommittee on Investigations, 110th Cong., Dividend Tax Abuse: How Offshore Entities Dodge Taxes on US Stock Dividends (Comm. Print 2008).

Section 871(m)

Section 871(m) was enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act.[5] Under section 871(m), "dividend equivalent" payments are treated as US source income. The term "dividend equivalent" is defined to include payments made on a "specified notional principal contract" (a "specified NPC") on or after September 14, 2010 that are contingent upon, or determined by reference to, the payment of dividends on US securities.[6] Accordingly, such payments when made to a foreign person are generally subject to US withholding tax at a 30 percent rate (subject to reduction pursuant to an applicable tax treaty).[7]

Pursuant to section 871(m)(3)(A), an NPC is considered a specified NPC if:

- in connection with entering into the contract, any "long party" to the contract transfers the underlying security to any "short party" (*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 (*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; or
- the contract is identified by the Treasury Department as a specified NPC.

While the categories of specified NPCs enumerated in the statute are relatively narrow, section 871(m)(3)(B) provided that any payment made after March 18, 2012 on an NPC that is contingent upon, or determined by reference to, US source dividends would be treated as a payment made on a specified NPC unless the Treasury Department determined that the swap is of a type that lacks tax avoidance potential.

On January 19, 2012, the Treasury Department and the IRS issued: (1) temporary regulations that applied to swap payments made after March 18, 2012 and before January 1, 2013 (the "Prior Temporary Regulations"), and (2) proposed regulations that would have applied to swap payments made on or after January 1, 2013 (the "Prior Proposed Regulations").[8] The effective date of the Prior Proposed Regulations was delayed on August 31, 2012, when the Treasury Department and the IRS amended the Prior Temporary Regulations to extend the current rules to swap payments made on or before December 31, 2013.[9]

[5] The relevant provision was enacted as section 871(l), but was subsequently redesignated as section 871(m) pursuant to P.L. 111-226, § 217(b)(2).

[6] I.R.C. § 871(m)(2)(B). Section 871(m) also applies to substitute dividend payments made under certain securities lending and sale-repurchase transactions. I.R.C. § 871(m)(2)(A).

[7] Contrary to the approach taken in the Directive, the statutory provision does not treat the party with long exposure under the swap as the owner of the underlying equity for US federal income tax purposes, but instead changes the source of income derived from the swap.

[8] T.D. 9572, 26 C.F.R. Part 1; REG-120282-10. See our prior client publication dated January 23, 2012 entitled "Temporary and Proposed Regulations Regarding US Withholding Tax on Certain Equity Swap Payments" available at www.shearman.com in the Tax practice area.

[9] T.D. 9572, 26 C.F.R. Part 1; RIN 1545-BK53.

The Prior Proposed Regulations

The Prior Proposed Regulations were proposed to apply to payments made on or after January 1, 2014. The Prior Proposed Regulations would have made several important changes and clarifications to the existing statutory regime, including broadening the definition of "specified NPC." Under the Prior Proposed Regulations, an NPC would have been considered a specified NPC if it fell into one of the following seven categories: [10]

- *Long Party "In the Market"*. The first of the seven categories would have applied where the long party to the NPC is "in the market" with respect to the underlying security on the same day or days that the parties price the NPC or on the same day or days that the NPC terminates, subject to a *de minimis* exception.
- *Underlying Security not Regularly Traded*. The second category would have applied if: (1) the underlying security was not listed on one or more qualified exchanges at the time the NPC was priced, or (2) the underlying security was not traded on at least 15 trading days during the 30 trading days prior to the date the parties priced the NPC.
- *Underlying Security Posted as Collateral*. Under the third category, subject to a *de minimis* exception, an NPC would have been considered a specified NPC if the short party to the NPC posted the underlying security with the long party as collateral.
- *Term of Fewer than 90 Days*. Under the fourth category, an NPC with a term of fewer than 90 days would be considered a specified NPC.
- *Long Party Controls Short Party's Hedge*. The fifth category would have covered situations in which the long party controlled the short party's hedge of its short position by controlling the short party's acquisition of stock or directing the short party to sell its hedge to a particular purchaser at a specific price and date, and where the long party entered into the NPC using an "underlying equity control program." [11]
- *Significant Notional Principal Amount*. Under the sixth category, an NPC would have been considered a specified NPC if the aggregate notional principal amount of the securities underlying the NPC and any NPCs the long party and its affiliates held with respect to the same securities was greater than either: (1) 5 percent of the total public float of that class of security; or (2) 20 percent of the 30-day average daily trading volume determined as of the close of the business day immediately preceding the first day in the term of an NPC.
- *Special Dividend NPC*. An NPC would have been considered a specified NPC under the seventh and last category if the NPC was entered into on or after the announcement of a special dividend and prior to the ex-dividend date for such dividend.

The Prior Proposed Regulations also would have expanded the definition of "dividend equivalent" for purposes of section 871 by adding a third category of "substantially similar" payments, which would have treated as US source income certain payments made under "equity-linked instruments," such as futures contracts, forward contracts and options. [12]

[10] Prop. Reg. § 1.871-16(c).

[11] Prop. Reg. § 1.871-16(c)(5).

[12] Prop. Reg. § 1.871-15(d)(2). While not entirely clear, by treating such an equity-linked instrument as an NPC for purposes of the Prior Proposed Regulations, this provision appeared to cause an equity-linked instrument to be subject to the re-sourcing rule of section 871(m) only if it would have been described in one of the seven categories of specified NPCs had it been an NPC.

The inclusion of equity-linked instruments (and, in particular, options) in the types of instruments potentially subject to section 871(m) introduced the potential for that provision to apply to instruments that did not directly correlate with the underlying security (and might, in fact, have very low correlation with such security).

Importantly, and unlike under the Proposed Regulations (as described below), a payment would not have been a dividend equivalent if it was determined by reference to an estimate of an expected (but not yet announced) dividend without reference to or adjustment for the amount of any actual dividend.[13] Thus, under the Prior Proposed Regulations, a non-US investor could gain derivative exposure (and even delta 1 exposure) to US equity without triggering the application of section 871(m) so long as *either*:

- the derivative was not described in any of the seven categories set forth above, or
- the derivative did not pass through to the long party actual dividends on the underlying security (*i.e.*, the derivative was "price only").

Final Regulations (Applicable to Payments Made on or Before December 31, 2015)

On December 4, 2013, the Treasury Department and the IRS released: (1) final regulations that apply to swap payments made after March 18, 2012 and before January 1, 2016 (the "Final Regulations") and (2) proposed regulations that would apply to swap payments made on or after January 1, 2016 (the "Proposed Regulations").[14] The Final Regulations withdraw the Prior Temporary Regulations, and the Proposed Regulations withdraw the Prior Proposed Regulations.

Under the Final Regulations, the current categories of specified NPCs in section 871(m)(3)(A) will be extended until December 31, 2015 to allow the financial services industry time to develop appropriate systems and procedures to implement the Proposed Regulations, which depart from the seven-category specified NPC approach in the Prior Proposed Regulations.[15] Like the Prior Temporary Regulations, the Final Regulations do not "grandfather" any swaps, but instead continue the existing statutory regime for any payments made on or prior to December 31, 2015.

The Final Regulations generally adopt the provisions in the Prior Temporary Regulations, such as modifying Treas. Reg. § 1.863-7 to clarify that the general sourcing rule for swap payments does not apply to a dividend equivalent under section 871(m)[16] and providing that section 871(m) and the regulations thereunder apply to dividend equivalents received by foreign corporations.[17] One departure from the Prior Temporary Regulations is that the Final Regulations do not adopt Temp. Reg. § 1.1441-3T(i), which provided that a withholding agent could use a distributing corporation's estimates when determining the amount of a dividend equivalent. According to the preamble to the Final Regulations (the "Final Regulations Preamble"), the Treasury Department and the IRS believe that, in the event the dividend equivalent amount is uncertain, withholding agents can comply with Treas. Reg. § 1.1441-3(d)(1), which addresses withholding on payments

[13] Prop. Reg. § 1.871-15(b)(2).

[14] T.D. 9648, 26 C.F.R. Part 1; REG-120282-10, 26 C.F.R. Part 1.

[15] Treas. Reg. § 1.871-15(d)(1); T.D. 9648, 26 C.F.R. Part 1.

[16] Treas. Reg. § 1.863-7(a)(1).

[17] Treas. Reg. § 1.881-2(b)(3).

that include undetermined amounts of income.[18] In response to certain comments on the Prior Proposed Regulations, the Treasury Department and the IRS clarified in the Final Regulations Preamble that a financial intermediary or custodian that is a withholding agent under the definition provided in Treas. Reg. § 1.1441-7(a) should be considered a withholding agent for purposes of section 871(m).[19]

Proposed Regulations (Applicable to Payments Made on or After January 1, 2016)

The Proposed Regulations generally are proposed to apply to payments made on or after January 1, 2016.[20] In the case, however, of certain equity-linked instruments ("ELIs") (as defined below), the Proposed Regulations are proposed to apply only to payments made on or after January 1, 2016 on ELIs acquired by the long party on or after March 5, 2014.[21] Accordingly, taxpayers should both: (i) monitor derivatives they execute before January 1, 2016 and (ii) evaluate their existing portfolios of derivatives (to the extent such instruments are expected to continue into 2016) to determine whether any such instruments would be subject to withholding under the Proposed Regulations.

The Proposed Regulations provide that a "dividend equivalent" is: (i) any payment pursuant to a securities lending or sale-repurchase transaction that references the payment of a dividend from an underlying security; (ii) any payment pursuant to a specified NPC that references the payment of a dividend from an underlying security; (iii) any payment pursuant to a specified equity-linked instrument (a "specified ELI") that references the payment of a dividend from an underlying security; and (iv) any other substantially similar payment.[22]

As described in greater detail below, the Proposed Regulations make several important changes and clarifications to the existing statutory regime, including:

- broadening the definition of specified NPC to include any NPC[23] with a fair market value correlation (*i.e.*, a "delta") of 0.70 or greater with respect to an underlying security at the time the long party acquires the NPC (as discussed in greater detail below);
- expanding section 871(m) to apply to payments under certain ELIs (such as futures, forwards and options) (referred to as specified ELIs) acquired by the long party on or after March 5, 2014 to the extent that such derivatives have a delta of 0.70 or greater with respect to an underlying security at the time the long party acquires the specified ELI;[24]

[18] Final Regulations Preamble at 5. Under Treas. Reg. § 1.1441-3(d)(1), when a withholding agent makes a payment and the amount subject to withholding is unknown because such amount depends on facts that are unknown at the time the payment is made, the withholding agent must withhold an amount "based on the entire amount paid that is necessary to assure that the tax withheld is not less than 30 percent (or other applicable percentage) of the amount that will subsequently be determined to be from sources within the United States or be income subject to tax." As an alternative, the withholding agent may make a reasonable estimate of the taxable amount and set aside a corresponding portion of the amount due in escrow until the amount of withholding can be determined. Treas. Reg. § 1.1441-3(d)(1).

[19] Final Regulations Preamble at 5.

[20] Prop. Reg. § 1.871-15(d)(2).

[21] Prop. Reg. § 1.871-15(e).

[22] Prop. Reg. § 1.871-15(c).

[23] For purposes of section 871(m), an NPC is defined as set forth in Treas. Reg. § 1.446-3(c).

[24] Prop. Reg. § 1.871-15(b)(1) of the Prior Proposed Regulations also expanded section 871(m) to apply to non-swap derivatives.

- providing certain exceptions for transactions that have limited potential for tax avoidance, such as when the long party is a dealer; and
- providing no exception for instruments that take into account estimated (rather than actual) dividends on the underlying security.

These changes represent a dramatic shift from the approach taken in the Prior Proposed Regulations and, if finalized, will significantly expand the number of transactions subject to section 871(m). While we expect there to be substantial comments to the specific technical provisions in the Proposed Regulations, high level issues that should be considered include:

- the potentially significant market effects of imposing withholding tax on nearly all cross-border derivatives on US equities;
- the appropriateness of using a delta threshold of 0.7, as opposed to a significantly higher threshold;
- the feasibility of requiring brokers and dealers to provide delta calculations every time a non-US investor acquires a US-equity linked instrument;
- the rationale (and statutory basis) for subjecting to withholding tax derivative payments that are neither contingent on nor determined by reference to US source dividends; and
- the ways in which taxpayers and broker/dealers may perform delta calculations.

Specified NPCs

As explained in the preamble to the Proposed Regulations (the "Proposed Regulations Preamble"), the Treasury Department and the IRS determined that, after considering the comments on the Prior Proposed Regulations, the seven category approach for specified NPC treatment did not provide the best framework for identifying NPCs that had the potential for tax avoidance.[25] As a result, the Proposed Regulations eliminate the previous seven categories of specified NPCs to identify specified NPCs based on an objective measurement of the correlation of the fair market value of the NPC and the fair market value of the underlying security referenced by the NPC.[26] This fair market value correlation concept is referred to as the "delta" of the NPC to the underlying security.[27]

A specified NPC is an NPC with a delta of 0.70 or greater with respect to an underlying security at the time that the long party acquires the NPC.[28] A "long party" is defined as "the party to a potential section 871(m) transaction with respect to

[25] Proposed Regulations Preamble at 15.

[26] Prop. Reg. § 1.871-15(d)(2) and (g); Proposed Regulations Preamble at 15-16. For purposes of the Proposed Regulations, the term "underlying security" is defined as "any interest in an entity taxable as a C corporation (within the meaning of section 1361(a)(2)) if a payment with respect to that interest could give rise to a US source dividend pursuant to §1.861-3." If the NPC references an interest in more than one entity or different interests in the same entity, "each referenced interest is a separate underlying security." Prop. Reg. § 1.871-15(a)(11). "Reference" means to be contingent upon or determined by reference to, directly or indirectly, whether in whole or in part. Prop. Reg. § 1.871-15(h)(8).

[27] Prop. Reg. § 1.871-15(d)(g).

[28] Prop. Reg. § 1.871-15(d)(2). If an NPC references more than one underlying security, the NPC is a specified NPC only with respect to underlying securities for which the NPC has a delta of 0.70 or greater. Prop. Reg. § 1.871-15(d)(2).

an underlying security that is entitled to a dividend equivalent [as described under the Proposed Regulations]."[29] A "section 871(m) transaction" is any securities lending or sale-repurchase transaction, specified NPC or specified ELI, and a "potential section 871(m) transaction" is any securities lending or sale-repurchase transaction, NPC or ELI that references one or more underlying securities.[30] The mechanics for measuring an NPC's delta are discussed in greater detail below.[31]

According to the Proposed Regulations Preamble, the Treasury Department and the IRS believe this delta-based approach to identifying section 871(m) transactions will prevent taxpayers from avoiding US withholding tax by entering into derivative contracts to gain exposure to US equities instead of owning the underlying US equity.[32] The Treasury Department and the IRS also believe that this approach is simpler and more administrable than the previous seven category approach.

Expanded Definition of Dividend Equivalent

Significantly, the Proposed Regulations expand the definition of "dividend equivalent" for purposes of section 871(m) by including payments on specified ELIs and "other substantially similar payments," thereby treating as US source income payments made under certain futures contracts, forward contracts and options as well as certain gross-up payments.

An ELI is a financial transaction (other than a securities lending or a sale-repurchase transaction or an NPC) that references the value of one or more underlying securities, such as a futures contract, forward contract, option, debt instrument or other contractual arrangement that references the value of one or more underlying securities.[33] A specified ELI is any ELI acquired by the long party on or after March 5, 2014 that has a delta of 0.70 or greater with respect to an underlying security at the time that the long party acquires the ELI.[34]

The Proposed Regulations provide that the category of "other substantially similar payments" in the dividend equivalent definition includes any payment in satisfaction of a tax liability with respect to a dividend equivalent made by a withholding agent to a long party in an amount determined under the gross-up formula provided in Treas. Reg. § 1.1441-3(f)(1).[35] The Treasury Department and the IRS have requested comments on whether other payments should be included within the other substantially similar payments category, such as a payment made by a

[29] Prop. Reg. § 1.871-15(a)(7)(i). A "short party" is defined as "the party to a potential section 871(m) transaction with respect to an underlying security that is liable for a dividend equivalent described in [the Proposed Regulations]." Prop. Reg. § 1.871-15(a)(7)(ii).

[30] Prop. Reg. § 1.871-15(a)(9).

[31] Notably, because the determination of whether an NPC is a specified NPC is made when the long party acquires the NPC, the "look-back" rule in the Prior Proposed Regulations is unnecessary. The look-back rule provided that if an NPC was not considered a specified NPC on the date the parties entered into the NPC, but later became a specified NPC, any payment made during the term of the NPC that was made by reference to a US source dividend was considered a dividend equivalent. See Prop. Reg. § 1.871-16(d) of the Prior Proposed Regulations.

[32] Proposed Regulations Preamble at 16.

[33] Prop. Reg. § 1.871-15(a)(4).

[34] Prop. Reg. § 1.871-15(e). If the ELI references more than one security, "the ELI is a specified ELI only with respect to underlying securities for which the ELI has a delta of 0.70 or greater at the time that the long party acquires the ELI." *Id.*

[35] Prop. Reg. § 1.871-15(f)(1). This is consistent with the approach taken in the Prior Proposed Regulations. The gross-up formula in Treas. Reg. § 1.1441-3(f)(1) is as follows: Payment = Gross payment without withholding / (1 – (tax rate)).

seller of stock to a purchaser pursuant to an agreement to deliver a pending US source dividend after the record date (*e.g.*, a due bill).[36]

The definition of dividend equivalent provides exceptions for: (1) payments that reference a distribution on an underlying security to the extent that the distribution would not be subject to tax under section 871 or section 881 if the long party owned the underlying security,[37] and (2) payments that are treated as distributions taxable as dividends pursuant to section 305.[38]

Exceptions

The Proposed Regulations contain two exceptions for transactions deemed to have limited potential for tax avoidance: (1) the qualified dealer exception and (2) the corporate acquisition exception.

The Qualified Dealer Exception

The first exception applies to a qualified dealer that enters into a transaction in its capacity as a dealer in securities and the dealer is the long party with respect to the underlying security.[39] A qualified dealer is any dealer that:

- is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized; and
- provides written certification to the short party confirming that:
  - the dealer is a qualified dealer acting in its capacity as a dealer in securities; and
  - the dealer will withhold and deposit any tax imposed under section 871(m) with respect to any section 871(m) transactions that the dealer enters into as a short party in its capacity as a dealer.[40]

Notably this exception does not apply with respect to any proprietary position held by a dealer. [41]

The Corporate Acquisition Exception

The second exception applies to transactions that obligate the long party to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the long party) are obligated to acquire underlying securities representing more than 50 percent of the issuing entity's value.[42] The long party must provide written certification (under penalties of perjury) to the short party that it satisfies the requirements for the exception.[43]

[36] Proposed Regulations Preamble at 18.

[37] Prop. Reg. § 1.871-15(c)(2)(i). For example, if a specified NPC referenced regulated investment company stock that pays a capital gains dividend under section 852(b)(3)(C) which would not be subject to withholding tax if paid directly to the long party, an NPC payment determined by reference to such dividend would not be a dividend equivalent. *Id.*

[38] Prop. Reg. § 1.871-15(c)(2)(ii).

[39] Prop. Reg. § 1.871-15(j)(1)(i).

[40] Prop. Reg. § 1.871-15(j)(1)(ii)(A) and (B).

[41] Prop. Reg. § 1.871-15(j)(1)(i).

[42] Prop. Reg. § 1.871-15(j)(2).

[43] *Id.*

Determination of an Instrument's Delta

As noted above, the Proposed Regulations adopt a single factor test of a specified NPC or specified ELI: whether it has a delta of 0.70 or greater with respect to an underlying security when the long party acquires its position.[44] The delta of an NPC or ELI is generally the ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of the property referenced by the NPC or ELI.[45] The delta of an NPC or ELI is deemed to be 1.0 if the ratio set forth in the general rule is not reasonably expected to vary during the term of the transaction (such transactions, "constant delta" transactions).[46]

The ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of the property referenced by the NPC or ELI must be determined in a commercially reasonable manner. If a taxpayer calculates that ratio for non-tax business purposes, then the ratio calculated by the taxpayer is generally treated as the delta (subject to the rules regarding constant delta transactions).[47] Thus, if an options dealer calculates that ratio to determine the number of shares needed to balance its position on certain options (or for other risk management purposes), the dealer may use the ratio so calculated to determine whether such options are specified NPCs or ELIs (regardless of whether that number of shares corresponds to the dealer's actual hedge).

If a transaction would not have a delta of 1.0 based on the number of shares referenced, the number of shares of the underlying security is adjusted to reflect the constant delta of 1.0. This rule is intended 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, an NPC that provides the long party with 50 percent of the appreciation, dividends, and depreciation on 100 shares of stock X throughout the term of the NPC will be a specified NPC with a delta of 1.0[48] that is treated for purposes of Regulations Section 1.871-15 as providing 100 percent of the same exposure on 50 shares of stock X.[49]

Combined Transactions

To prevent taxpayers from avoiding section 871(m) by entering into multiple transactions referencing the same underlying security, the Proposed Regulations treat multiple transactions as a single transaction for purposes of determining if the transactions are a section 871(m) transaction in cases where a long party (or a related person) enters

[44] Prop. Reg. §§ 1.871-15(d)(2); 1.871-15(e). If an NPC or ELI references more than one underlying security, such NPC or ELI will have a separate delta with respect to each underlying security, determined without taking into account any other underlying security or other property or liability referenced in the transaction, and will be a specified NPC or specified ELI only with respect to the underlying securities for which it has a delta of 0.70 or greater at the time the long party acquires its position. Prop. Reg. § 1.871-15(g)(1).

[45] Prop. Reg. § 1.871-15(g)(1). If an NPC or ELI contains more than one reference to a single underlying security, all references to that underlying security are taken into account in determining the instrument's delta.

[46] Prop. Reg. § 1.871-15(g)(2).

[47] Prop. Reg. § 1.871-15(g)(1).

[48] Prop. Reg. § 1.871-15(g)(3), Ex. 3.

[49] Prop. Reg. §§ 1.871-15(i)(1)(ii)(B)(*2*); 1.871-15(g)(3), Ex. 3. The Proposed Regulations Preamble requests 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." Proposed Regulations Preamble at 21.

into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other.[50] Transactions that are combined for purposes of determining whether there is a section 871(m) transaction are treated as separate transactions for all other purposes, and (as noted below) withholding agents would not be required to withhold absent knowledge that the long party (or a related person) entered into the combined transactions in connection with each other.[51] The deltas of the combined transactions are tested each time the long party (or a related person) acquires a position that may be combined with other positions. For example, if a taxpayer purchases a call option and sells a put option 9 days later on the same underlying security and the two transactions are entered into in connection with each other, the call option is tested on the day it is purchased to determine whether it is a section 871(m) transaction, and the combined single transaction is tested when the put option is sold based on the deltas of the call option and put option at that time.[52]

Amount of Dividend Equivalent Payment

Under the Proposed Regulations, 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 a 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).[53] A payment occurs when the amount of a dividend equivalent is fixed under the transaction terms, even if otherwise paid or taken into account at a later date.[54] Unlike the Prior Proposed Regulations, the Proposed Regulations do not contain an exception from the dividend equivalent definition for payments that are determined by reference to an estimate of an expected (but not yet announced) dividend.

A payment includes any amount that references actual or estimated dividends (even if the reference is implicit), and the payment is treated as referencing the actual dividend amount if a potential section 871(m) transaction payment references an estimated dividend that adjusts to account for the amount of an actual dividend paid.[55] A payment includes an actual or estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction (including interest rate, notional amount, purchase price, premium, upfront payment, strike price or any other amount paid or received).[56] It is unclear when an NPC or ELI would not be treated as implicitly taking into account dividends on the underlying security (other than in circumstances where such security is expected to pay no dividends).

[50] Prop. Reg. § 1.871-15(l).

[51] Prop. Reg. § 1.1441-1(b)(4)(xxiii).

[52] Prop. Reg. § 1.871-15(l)(2).

[53] Prop. Reg. § 1.871-15(h)(1).

[54] Prop. Reg. § 1.871-15(h)(3).

[55] Prop. Reg. § 1.871-15(h)(2)(i).

[56] Prop. Reg. § 1.871-15(h)(2)(ii). "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 (a price return swap), the [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." Proposed Regulations Preamble at 24.

With respect to estimated dividends, the Proposed Regulations contain a presumption that a section 871 transaction pays a per share dividend amount equal to the actual dividend amount unless the short party to the section 871(m) transaction identifies a reasonable estimated dividend amount in writing when the transaction is entered into.[57] When a section 871(m) transaction provides for payments based on estimated dividends, the per share dividend amount used to calculate the amount of the dividend equivalent is the lesser of the estimated dividend amount and the actual dividend amount paid on the stock while the long party was a party to the transaction.[58] Thus, it should be beneficial in the case of specified NPCs and specified ELIs that do not provide for a pass through of dividends to provide for estimates of dividends on the underlying security in order effectively to "cap" the amount of any dividend equivalent to the estimated amount of such dividend.

The amount of the dividend equivalent is determined on the earlier of the date the underlying security becomes ex-dividend with respect to the dividend and the record date of the dividend.[59]

The Proposed Regulations contain detailed rules addressing the calculation of the amount of a dividend equivalent payment. With respect to a securities lending or sale-repurchase transaction, the amount of a dividend equivalent payment equals the amount of the actual per share dividend paid on the underlying security multiplied by the number of shares of the underlying security transferred under the transaction.[60]

With respect to specified NPCs and specified ELIs, the amount of the dividend equivalent payment equals:

- the amount of the per share dividend with respect to the underlying security, multiplied by;
- the number of shares of the underlying security referenced in the transaction (subject to adjustments), multiplied by;
- the delta of the specified NPC or specified ELI with respect to the underlying security at the time that the amount of the dividend equivalent is determined.[61]

[57] Prop. Reg. § 1.871-15(h)(2)(iii). For this purpose, a reasonable estimated dividend amount stated in an offering document or the document governing the terms of the transaction will establish the written estimated dividend amount. The written estimated dividend amount must separately state the amount estimated for each anticipated dividend or state a formula to allow the dividend to the be determined. *Id.*

[58] Prop. Reg. § 1.871-15(h)(2)(iv). If a section 871(m) transaction provides for any payment determined by reference to a dividend in addition to the estimated dividends (*e.g.*, a special dividend), the actual dividend amount paid on the stock is used for the additional dividend payment. *Id.*

[59] Prop. Reg. § 1.871-15(i)(2)(i).

[60] Prop. Reg. § 1.871-15(i)(1)(i).

[61] Prop. Reg. § 1.871-15(i)(1)(ii)(A). When a section 871(m) transaction multiplies the number of underlying security shares by a factor or fraction (or otherwise alters the amount of a payment), the number of shares is adjusted to take into account the factor, fraction or other alteration. Prop. Reg. § 1.871-15(i)(1)(ii)(B)(*2*). 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 of an underlying security multiplied by a factor of 1.50, the number of shares of the underlying security is 150 shares. The delta of a section 871(m) transaction for purposes of determining the amount of the dividend equivalent generally is determined on the earlier of the date that the underlying security becomes ex-dividend with respect to the dividend and the record date of the dividend. Prop. Reg. § 1.871-15(i)(2)(i). The delta that is determined is used solely for purposes of determining the amount of the dividend equivalent at that time (and not to retest whether the transaction is a section 871 transaction).

For a specified NPC or specified ELI with a term of one year or less when acquired by the long party, the amount of the dividend equivalent is determined when the long party disposes of the section 871(m) transaction.[62] As a result, a long party that acquires an option with a term of one year or less that is a specified ELI will not incur US withholding tax if the option lapses.[63]

Application to Index-Linked Instruments

The Prior Proposed Regulations provided that certain "qualified indices" referenced by an NPC or an ELI would be exempt from the application of section 871(m). In contrast, each component security of a "customized index" (*i.e.*, (i) a "narrow-based index" (as defined under the Securities Exchange Act of 1934); or (ii) any other index unless futures contracts or options contracts referencing such index traded on a qualified board or exchange) would be treated as an underlying security in a separate NPC or ELI.

The Proposed Regulations provide that a "qualified index" is not treated as an underlying security, thus exempting NPCs and ELIs that reference qualified indices from the application of section 871(m).[64] In response, however, to comments, the Proposed Regulations revise the rules to define a "qualified index" as any index that:

- references 25 or more component underlying securities;
- references only long positions in component underlying securities;
- contains no component underlying security representing more than 10 percent of the index's weighting;
- is modified or rebalanced only based on objective rules at set intervals;
- does not provide for a dividend yield that is greater than 1.5 times the current dividend yield of the S&P 500 Index for the month immediately preceding the date the long party acquires the potential section 871(m) transaction; and
- is referenced by futures or option contracts that trade on a national securities exchange registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission.[65]

Thus, the standard for a "qualified index" generally is more restrictive than under the Prior Proposed Regulations (by adding the first five requirements listed above).[66] The determination of whether an index is a qualified index would be

62 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, cancel, exchange, convert, surrender, forfeit or otherwise dispose of or allow to expire. *Id.* If the transaction does not specify a term, it is treated as having a term of over one year, and if a transaction permits extensions, the term is the maximum term permitted. Prop. Reg. § 1.871-15(i)(2)(iii).

63 Proposed Regulations Preamble at 18. The delta of an option when it lapses is treated as zero, and the delta of an option when it is exercised is treated as one. Prop. Reg. §§ 1.871-15(i)(1)(ii)(*2*) and (*3*).

64 Prop. Reg. § 1.871-15(k)(1).

65 Prop. Reg. § 1.871-15(k)(2).

66 In so doing, the Proposed Regulations rejected the numerous comments requesting that the definition of "customized index" be narrowed. Specifically, the comments had suggested: (i) incorporating exceptions to the definition of narrow-based index from the Securities Exchange Act of 1934; (ii) revising the definition to include only a narrow-based index or an index offered by a publisher that is not a "recognized independent index publisher"; (iii) excluding from customized index any index tracked by an exchange-traded fund, exchanged-traded note or other exchange-

made at the time a long party acquires a potential section 871(m) transaction and is determinative only with respect to that transaction.[67]

The Proposed Regulations provide a safe harbor under which an index will be a "qualified index" if it primarily references assets other than underlying securities. Under this safe harbor, an index will be a qualified index even if it does not the meet the definition of "qualified index" set forth above if the index is comprised solely of long positions in assets and the referenced underlying securities in the aggregate comprise 10 percent or less of the index's weighting.[68] Outside of this safe harbor, any component of an index that is not an underlying security is not taken into account for determining whether an index is a qualified index.

If a potential section 871(m) transaction references a qualified index and one or more underlying securities or indices, the Proposed Regulations provide that the qualified index will remain a qualified index only if the transaction does not reference a short position in any reference component underlying security of the qualified index (other than a short position with respect to the entire qualified index).[69] Furthermore, if in connection with a potential section 871(m) transaction that references a qualified index, a taxpayer (or a related person) enters into one or more transactions that reduce their exposure to any referenced component underlying security of the index (other than transactions that reduce exposure to the entire index), the potential section 871(m) transaction is not treated as referencing a qualified index.[70] These rules are intended to ensure that taxpayers do not circumvent the requirements of a qualified index (*e.g.*, that it references 25 or more component underlying securities and that no component underlying security represents more than 10 percent of the underlying securities in the index) by reducing their exposure with respect to some of the underlying securities in the index through short positions in those securities.

Interests in Non-Corporate Entities

In response to a comment suggesting that an NPC over an interest in a partnership formed to hold a small basket of US equities could be used in the same manner as a customized index (while avoiding the application of section 871(m)), the Proposed Regulations treat transactions that reference interests in an entity that is not a C corporation for US federal income tax purposes as referencing the allocable portion of any underlying securities or potential section 871(m) transaction held, directly or indirectly (including through other entities that are not C corporations) by that entity. Further, a transaction with respect to interests in a non-corporate entity that is treated as referencing underlying securities under this provision also is treated as referencing the payment of any dividends from those underlying securities and has a dividend equivalent equal to the allocable portion of any dividend or dividend equivalent received, directly or indirectly, by the referenced entity.[71]

traded derivative; and (iv) excluding from the definition of customized index any index with respect to which US equity securities comprised less than 20 percent of its notional value.

[67] Prop. Reg. § 1.871-15(k)(1).

[68] Prop. Reg. § 1.871-15(k)(3).

[69] Prop. Reg. § 1.871-15(k)(6).

[70] *Id.*

[71] Prop. Reg. § 1.871-15(m)(1).

An exception is provided for a transaction that references an interest in an entity that is not a C corporation if the underlying securities and potential section 871(m) transactions collectively represent 10 percent or less of the value of the interest in the referenced entity at the time the transaction is entered into and there is no plan or intention for acquisitions or dispositions that would cause the underlying securities to represent more than 10 percent of the value of the referenced interest.[72] This provision raises an issue as to whether NPCs or ELIs that reference interests in a master limited partnership could be subject to withholding under the Proposed Regulations where such partnership has C corporation subsidiaries constituting more than 10 percent of its value.

Treatment of Contingent Interest

Portfolio interest (other than certain types of contingent interest) paid by a US person to an unrelated non-US person is generally exempt from US withholding tax under what is referred to as the "portfolio interest exemption."[73] The Proposed Regulations would revise the regulations addressing the portfolio interest exemption to provide that contingent interest does not qualify for such exemption to the extent that such interest is a dividend equivalent with the meaning of section 871(m).[74] The Proposed Regulations Preamble recognizes that many debt instruments that provide for contingent interest have a delta of less than 0.7 and/or reference a qualified index, but suggests that debt instruments that provide for the payment of interest based on US-source dividend payments have the potential to be used by non-US persons to avoid section 871(m). The portion of any contingent interest payment that will not qualify for the portfolio interest exemption equals the amount of the dividend equivalent determined under the rules described above.

One issue that arises is the extent to which the contingent interest rule might result in convertible debt instruments being treated as specified ELIs, particularly for investors other than original purchasers of such instruments. For example, a typical convertible debt instrument would have a delta of less than 0.7 at the time of its issuance (because a $1 change in the value of the underlying stock would not result in a change of at least $0.70 in the value of the convertible debt instrument). Even if the convertible debt instrument subsequently has a delta of 0.7 or greater due to increases in the value of the underlying stock (assuming that the underlying is stock of a US issuer), a holder who acquired the instrument at original issuance would not be treated as holding a specified ELI because the determination of specified ELI treatment is made at the time of acquisition. Nevertheless, a subsequent non-US purchaser of such a convertible debt instrument at a time when the delta is 0.7 or greater could be treated as acquiring a specified ELI, and could thus be subject to US withholding tax under section 871(m) with respect to dividends on the underlying stock over the remaining term of the debt instrument (and prior to conversion). The application of the Proposed Regulations to convertible debt with a delta of 0.7 or more at the time of acquisition presumably would depend on whether such debt implicitly takes into account the estimated dividends on the underlying shares in computing one or more its terms (such as purchase price).

Reporting Requirements

The Proposed Regulations Preamble asserts that a financial institution is usually in the best position to undertake the responsibility to report the tax consequences of a potential section 871(m) transaction. As a result, the Proposed Regulations require a broker or dealer to determine whether a transaction is a section 871(m) transaction when a broker

[72] Prop. Reg. § 1.871-15(m)(2).

[73] I.R.C. § § 871(h)(4) and 881(c).

[74] Prop. Reg. § 1.871-14(h)(1). The rules addressing contingent interest are proposed to apply to payments made on or after the date the final regulations are published.

or dealer is a party to a potential section 871(m) transaction.[75] If the transaction is a section 871(m) transaction, the broker or dealer is also required to determine the timing and amounts of the dividend equivalents.[76] If both parties to the transaction are brokers or dealers or neither party is a broker or dealer, the short party must make the section 871(m) determination. The party required to make the determination (the "Determining Party") is required to exercise reasonable diligence, and the determinations are binding on the parties to the transaction and any withholding agents, unless the person has actual knowledge or reason to know that the information is incorrect.[77]

Any party to a transaction and certain agents or nominees to a party to the transaction are permitted to request information from the Determining Party when the information is necessary to satisfy their withholding or information reporting obligations, or to determine their tax liability.[78] As discussed below, if a withholding agent reasonably relies on the information received, it will not be liable for underwithholding; rather, the party to the transaction who failed to properly determine the amount will be liable for underwithholding.[79]

The requirement that each broker or dealer must determine whether a transaction is a section 871(m) transaction when such broker or dealer is a party to a potential section 871(m) transaction would impose substantial and quite onerous burdens on those financial institutions. In particular, the fact that such institutions would need to calculate the delta for each equity-linked instrument referencing US-equity on each day on which its non-US client or counterparty acquires such instrument would inflict new burdensome obligations on those institutions. This is particularly true because delta is neither observable in the market nor objectively determinable.

Withholding Agent Matters

Withholding agents generally are liable for their failure to withhold on payments they make that are subject to US withholding tax. The Prior Proposed Regulations provided rules under section 1441 to require a withholding agent to withhold tax owed with respect to a dividend equivalent. Commentators noted that the regime set forth in the Prior Proposed Regulations presented particular problems for withholding agents with respect to swap payments made to foreign persons because an NPC may have been considered a specified NPC due to circumstances that the withholding agent does not know (or have reason to know) exist (*e.g.*, the long party being "in the market" with respect to the underlying security or the NPC being treated as having a term of less than 90 days due to the long party entering into an offsetting position). Others noted that the potential for retroactive withholding obligations created hazards for withholding agents and that it would be difficult for withholding agents to design systems to monitor withholding obligations that may arise after a payment has been made.

The Proposed Regulations address these comments by providing that a withholding agent will not be liable for underwithholding if it reasonably relies on information it receives from the Determining Party, but in such a case the Determining Party will be liable for the underwithholding.[80] The Proposed Regulations further provide that a withholding

[75] Prop. Reg. § 1.871-15(o)(1).

[76] *Id.*

[77] *Id.* The determination, however, is not binding on the IRS.

[78] Prop. Reg. §§ 1.871-15(o)(3)(i) and (ii).

[79] Prop. Reg. § 1.871-15(o)(3)(iii).

[80] Prop. Reg. § 1.1441-3(h)(2).

agent is not required to withhold on a dividend equivalent paid pursuant to a transaction that is a section 871(m) transaction only because it 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.[81]

With respect to exchange traded options, an example in the Proposed Regulations makes it clear that both the clearing and settlement exchange and the non-US broker member of such exchange will be treated as withholding agents with respect to a specified ELI transaction executed by the broker member's customer.[82] Specifically, in the example, a non-US corporation ("FC") instructs its non-US broker ("CB," which is a nonqualified intermediary) to purchase a call option that is a specified ELI and CB effects the trade for FC through a US clearing organization ("CO"). The exchange matches FC's order with an offsetting order for a written call option and sends the matched order to CO for clearing. Upon clearing, the option contracts are novated and CO becomes the counterparty to CB and the counterparty to the clearing member representing the call option seller. The example concludes that to the extent there is a dividend equivalent with respect to the call option, both CO and CB will be considered withholding agents.

The Proposed Regulations also provide guidance on how the exception to withholding where no money or property is paid applies to a dividend equivalent. Specifically, the Proposed Regulations provide that a withholding agent is not required to withhold until the later of:

- the time that the amount of the dividend equivalent is determined; and
- the time at which the withholding agent is deemed to have control over money or other property of the long party on account of any of the following having occurred:
  - money or other property is paid to or from the long party,
  - the withholding agent has custody or control of money or other property of the long party at any time on or after the amount of the dividend equivalent is determined, or
  - there is an upfront payment or a prepayment of the purchase price (even though an actual payment has not been made at the time the amount of a dividend equivalent is determined).[83]

Although the withholding agent is relieved of withholding liability when the withholding agent does not have control of money or other property of the long party, the long party still remains liable for US tax on the dividend equivalent pursuant to section 871(m) and Prop. Reg. § 1.871-15.[84]

Anti-Abuse Rule

Similar to the Prior Proposed Regulations, the Proposed Regulations provide that if a taxpayer (directly or through the use of a related person) enters into a transaction or transactions with a principal purpose of avoiding the application of the Proposed Regulations, any payment made with respect to any such transaction may be treated as a dividend

[81] Prop. Reg. § 1.1441-1(b)(4)(xxiii).

[82] Prop. Reg. § 1.1441-7(a)(3) Ex. 7.

[83] Prop. Reg. § 1.1441-2(d)(5).

[84] Proposed Regulations Preamble at 29.

equivalent to the extent necessary to prevent the avoidance of the provisions.[85] The anti-abuse rule further allows the Commissioner to 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 otherwise depart from the Proposed Regulations as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent. While not entirely clear, the Commissioner's authority under the preceding sentence should be exercisable only where a principal purpose of avoidance of the Proposed Regulations is present.

Applicability of Judicial Doctrines to NPCs Other than Specified NPCs

The Proposed Regulations Preamble makes clear that the Proposed Regulations do not supplant common law principles that might otherwise cause payments under an NPC to be subject to US withholding tax. In this regard, the Proposed Regulations Preamble states that, notwithstanding the Proposed Regulations, "[t]he Treasury Department and the IRS will continue to closely scrutinize other transactions that are not covered by section 871(m) and that may be used to avoid US taxation and US withholding. In addition, the IRS may challenge the US 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."[86] As an example of the continued application of judicial doctrines to derivative transactions, the Proposed Regulations Preamble states that section 871(m) does not preclude the IRS from asserting that a transaction that is in form an NPC is in substance an ownership interest in the equity underlying the NPC.

Finalization of Certain Rules

Treatment of Dividend Equivalents Under Tax Treaties

The regulations finalize the portion of the Prior Proposed Regulations that treat dividend equivalents under section 871(m) as dividends for purposes of tax treaties.[87] Accordingly, dividend equivalent payments will be subject to US withholding tax at the rate provided under the dividend article of an applicable tax treaty if the foreign person satisfies the requirements contained in that treaty.

85 Prop. Reg. § 1.871-15(n).

86 Proposed Regulations Preamble at 27-28.

87 Treas. Reg. § 1.894-1(c)(2).

Treatment of Dividend Equivalents Received by Foreign Governments

The regulations also finalize the portion of the Prior Proposed Regulations that treat dividend equivalents under section 871(m) received by foreign governments as income from investments in stocks for purposes of section 892.[88]

Circular 230 Disclosure

Any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties and is not intended to be used or referred to in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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[88] Treas. Reg. § 1.892-3(a)(6).