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Final Regulations Under Section 871(m) Clarify Withholding Tax Rules for Equity-Linked Derivatives, Yet Many Challenges Remain

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On September 17, 2015, the Treasury Department and the Internal Revenue Service (the "IRS") issued new temporary and final regulations under section 871(m) of the Internal Revenue Code regarding the imposition of US federal withholding tax on certain equity-linked instruments. Under the final regulations, the general framework set forth in regulations proposed in 2013 was retained, including the delta standard for determining whether "simple" contracts relating to US equity securities are subject to US federal withholding tax. The final regulations, however, increased the delta standard from 0.70 to 0.80, requiring a stronger economic correlation between the contract and the underlying securities in order for the contract to be subject to withholding. The final regulations require that a contract's delta be tested only at the contract's issuance, which effectively excludes most convertible debt from being treated as section 871(m) transactions. For "complex" contracts (*e.g.*, those that reference a number of securities that may change over time), the temporary regulations set forth a "substantial equivalence" test for determining whether US federal withholding tax will apply. The final and temporary regulations make a number of other important changes, which are discussed in detail below.

Background

US withholding tax generally is imposed on certain types of US source income, including dividends from a domestic corporation, paid to foreign persons at a 30 percent rate (subject to reduction or elimination pursuant to an applicable income tax treaty).[1] In general, swap payments are not subject to US withholding tax because payments made to a foreign person

[1] I.R.C. §§ 871 and 881.

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.

Section 871(m)

Section 871(m) was enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment ("HIRE") Act.[3] 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.[4] Accordingly, such payments when made to a foreign person are generally subject to US withholding tax at a 30 percent rate (subject to reduction or elimination pursuant to an applicable income tax treaty).

Pursuant to section 871(m)(3)(A) and Treasury regulations that have been in effect since 2012, 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"; or
- 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.[5]

While the categories of specified NPCs enumerated in the statute are relatively narrow, section 871(m) provided for the statutory categories to be temporary measures until the Treasury Department and the IRS determined which transactions lacked tax avoidance potential and thus deserved not to be classified as specified NPCs. The Treasury Department and the IRS worked to establish a more comprehensive method of clarifying transactions as specified NPCs and, on January 19, 2012, issued the first set of proposed regulations under section 871(m). The proposed regulations provided that an NPC would be considered a specified NPC if it fell into one of seven enumerated categories. Temporary regulations, which were issued at the same time and subsequently amended, provided that the statutory definition of a specified NPC under section 871(m)(3)(A) would apply to payments made on or before December 31, 2013.[6]

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

[3] 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).

[4] 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).

[5] Treas. Reg. § 1.871-15(d)(1).

[6] 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.

After numerous commentators expressed concerns that the seven categories in the 2012 proposed regulations were too difficult to implement in practice, the Treasury Department and the IRS withdrew the 2012 proposed regulations and released revised proposed regulations on December 4, 2013 (the "Proposed Regulations").[7]

The Proposed Regulations

The Proposed Regulations made several important changes and clarifications to the existing statutory regime, including:

- broadening the definition of specified NPC to include any NPC[8] 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 acquired the NPC;
- expanding section 871(m) to apply to payments under certain equity-linked instruments ("ELIs," such as futures, forwards and options, referred to as "specified ELIs") to the extent that such derivatives had a delta of 0.70 or greater with respect to an underlying security at the time the long party acquired the ELI;
- providing certain exceptions for transactions that had limited potential for tax avoidance, such as when the long party is a dealer; and
- extending the application of section 871(m) to instruments that take into account estimated or implicit (rather than actual) dividends on the underlying security.

Final and Temporary Regulations

On September 17, 2015, the much anticipated new final regulations (the "Final Regulations") and temporary regulations (the "Temporary Regulations") under section 871(m) were issued. The Final Regulations generally preserve the delta standard and overall framework set forth in the Proposed Regulations, while increasing the delta threshold (as discussed below). The new regulations retain the delta test only for simple contracts, and instead use a "substantial equivalence" test (rather than a delta test) for complex contracts.

Simple Contracts

Like the Proposed Regulations, the Final Regulations define the term "dividend equivalent" to include any payment pursuant to a specified NPC or a specified ELI that references the payment of a dividend from an underlying security (*i.e.*, security payments which may be considered US-source income).[9] Unlike the Proposed Regulations, the Final Regulations divide NPCs and ELIs into "simple" and "complex" instruments and provide different texts for determining whether each type of instrument is a specified NPC or a specified ELI.

In response to concerns from commentators that delta was difficult or impossible to discern with respect to certain complicated derivative contracts (which are referred to as "complex contracts"), the Treasury Department and the IRS,

[7] In addition, the Treasury Department and the IRS released final regulations that continued the existing regime of section 871(m)(3)(A) for any payments made on or prior to December 31, 2015. T.D. 9648, 26 C.F.R. Part 1; REG-120282-10, 26 C.F.R. Part 1. See our prior client publication dated December 6, 2013 entitled "New Proposed Regulations Under Section 871(m) Adopt a Single Factor Test but Delay Effective Date Until 2016" available at www.shearman.com in the Tax practice area.

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

[9] Treas. Reg. § 1.871-15(c)(1).

based upon suggestions from certain financial institutions, developed a standard for determining when such complex contracts are subject to section 871(m).

As an initial matter, the Treasury Department and the IRS defined a “simple contract” (to which the delta standard applies) as an NPC or ELI that references a single, fixed number of shares of the underlying security and has a single maturity or exercise date when amounts due under the contract are required to be calculated.[10] A “complex contract” (to which the delta standard does not apply) is defined as any NPC or ELI that is not a simple contract.[11] Complex contracts are subject to the “substantial equivalence” test, discussed in detail below, rather than the delta test.

A simple contract that has a delta of 0.80 or greater with respect to an underlying security when the NPC is issued is a specified NPC or specified ELI.[12]

It is important to note that the definition of specified NPC and specified ELI described above apply only with respect to transactions and payments that occur after the dates specified in the detailed effective date provision of the Final Regulations or Temporary Regulations (which are described below). All other instruments are subject to the existing statutory framework under section 871(m).

Calculation of Delta

The Final Regulations, like the Proposed Regulations, define the delta of a contract generally as the ratio of the change in the fair market value of the contract to the change in the fair market value of the property referenced by the contract.[13]

The Final Regulations clarify, however, that the delta ratio is intended to measure the change in the fair market value of the contract to a *small* change in the fair market value of the underlying property referenced by the contract,[14] and the preamble to the Final Regulations (the “Preamble”) explains that a small change is typically a change of less than 1 percent.[15]

Delta Threshold

As noted above, the Final Regulations increase the delta threshold for specified NPC or specified ELI treatment to 0.80 from 0.70, thereby requiring closer economic correlation between the contract and the underlying securities than the Proposed Regulations.[16] The Preamble explains that the Treasury Department and the IRS recognized that a delta threshold of 0.70 could cause section 871(m) to apply to contracts that are not economically similar enough to the underlying security.[17] Although some commentators had suggested a delta threshold of 0.90, the Treasury Department

[10] Treas. Reg. § 1.871-15(a)(14)(i).

[11] Treas. Reg. § 1.871-15(a)(14)(ii)(A).

[12] Treas. Reg. § 1.871-15(d)(1); -15(e)(1).

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

[14] Treas. Reg. § 1.871-15(g)(1).

[15] Preamble at 9.

[16] Treas. Reg. §§ 1.871-15(d)(2)(i), (e)(1).

[17] Preamble at 8.

and the IRS believed that such a high delta threshold would allow certain contracts that are "surrogates" for owning the underlying security, such as deep-in-the-money options, to escape withholding tax under section 871(m).[18]

Time for Testing Delta

Unlike the Proposed Regulations (which would have tested delta each time an instrument was acquired and each time a dividend on an underlying security was paid), the Final Regulations provide that the delta of a contract is tested only at the issuance of the contract.[19] This change responded to comments on the difficulty associated with determining a contract's delta every time the contract is purchased or otherwise acquired in the secondary market.[20] A contract is considered "issued" at inception, original issuance or at the time of an issuance pursuant to a section 1001 deemed exchange.[21]

While this change is a welcome simplification, we note that given the manner in which listed options are traded, each acquisition of a listed option appears to be considered a separate "issuance" for this purpose, such that the delta for a listed option may need to be calculated each time the option is acquired. It is unclear whether the disparate treatment of listed options and other types of derivatives was intended.

One issue that arises with respect to the issuance date rule is how to apply the issuance date rule to a basket contract that is issued prior to January 1, 2016, but provides the holder of the contract the right to change the components of the basket during its term. While not entirely clear, there is some risk that a deemed exchange of such contract for a new contract will be deemed to occur each time the holder changes one or more assets in the basket. If a deemed exchange were to occur, the contract would be treated as reissued for purposes of determining the delta of the contract. Any such deemed exchange would also be relevant for purposes of determining how the effective date rule applies.

A similar issue may arise in the context of certain issuances of structured notes. For example, assume that an issuer creates a class of structured notes, but issues less than all of the notes and retains the rest of such class. If the issuer later issues more notes from such class, the delta of such notes (or, if such notes are complex contracts, the application of the substantial equivalence test to the notes) would presumably need to be re-tested. Further, if subsequently issued notes had different consequences under section 871(m) than the originally issued notes, then the subsequently issued notes would likely need to be given a different CUSIP or identifying number.

Shorthand Method for Testing Delta

In response to comments requesting a simplified method for determining delta in certain circumstances, the Final Regulations provide that if:

- a short party issues a simple contract that references a basket of ten or more securities,
- the short party uses an exchange-traded security (such as the stock of an exchange-traded fund) to hedge its exposure under the contract, and

[18] Preamble at 8-9.

[19] Treas. Reg. § 1.871-15(g)(2).

[20] Preamble at 10.

[21] Treas. Reg. § 1.871-15(a)(6).

- the exchange-traded security references substantially the same securities that are referenced in the contract,

then the short party may determine the contract's delta using the exchange-traded security.[22]

Complex Contracts — Substantial Equivalence Test

As discussed above, the Final Regulations set forth two basic categories of contracts that may be subject to section 871(m): simple contracts and complex contracts. While simple contracts are subject to the delta test, complex contracts are subject to the substantial equivalence test, which is set forth in the Temporary Regulations.

Payments on a complex contract are subject to withholding under section 871(m) only if the contract satisfies the substantial equivalence test. The substantial equivalence test is meant to assess whether a complex contract substantially replicates the economics of an underlying security by comparing, at various testing prices, the differences between the expected changes in value of the complex contract and its initial hedge and the differences between the expected changes in value of a "benchmark" simple contract and its initial hedge.[23] The simple contract that is used as a benchmark (referred to as the "simple contract benchmark") is a closely comparable simple contract that has a delta of 0.80 at the time the complex contract is issued, references the underlying security referenced by the complex contract and has the same maturity as the complex contract with respect to the underlying security.[24]

A complex contract is considered substantially equivalent (such that it is a section 871(m) transaction with respect to the underlying security) if the "complex contract calculation" results in an amount that is equal to or less than the amount of the "benchmark calculation."[25] The "complex contract calculation" is computed as follows with respect to an underlying security:

(1) determining the change in value of the complex contract with respect to the underlying security at each testing price;[26]

(2) determining the change in value of the initial hedge for the complex contract at each testing price;[27]

[22] Treas. Reg. § 1.871-15(g)(3).

[23] Temp. Reg. § 1.871-15T(h)(1). An initial hedge is the number of underlying security shares that a short party would need to fully hedge an NPC or ELI with respect to an underlying security at the time the NPC or ELI is issued. Treas. Reg. § 1.871-15T(a)(5).

[24] Temp. Reg. § 1.871-15T(h)(2).

[25] Temp. Reg. § 1.871-15T(h)(3).

[26] The change in value of a complex contract is the difference between the value of the complex contract with respect to the underlying security at the time the complex contract is issued and the value of the complex contract with respect to the underlying security if the price of the underlying security were equal to the testing price at the time the complex contract is issued. Temp. Reg. § 1.871-15T(h)(4)(ii). The testing prices must include the prices of the underlying security if the price of the underlying security at the time the complex contract is issued were alternatively increased by one standard deviation and decreased by one standard deviation. Temp. Reg. § 1.871-15T(h)(4)(iii).

[27] The change in value of the initial hedge of a complex contract with respect to the underlying security is the difference between the value of the initial hedge at the time the complex contract is issued an the value of the initial hedge if the price of the underlying security were equal to the testing price at the time the complex contract is issued. Temp. Reg. § 1.871-15T(h)(4)(ii).

(3) determining the absolute value of the difference between the change in value determined in (1) and the change in value determined in (2) at each testing price;

(4) determining the probability associated with each testing price;[28]

(5) multiplying the absolute value in (3) by the corresponding probability for that testing price in (4);

(6) adding the product of each calculation determined in (5); and

(7) dividing the sum in (6) by the initial hedge for the complex contract.[29]

The "benchmark calculation" with respect to an underlying security is determined by using the complex contract calculation method with respect to a simple contract benchmark for the underlying security. The "testing prices" to be used in the steps above are the prices of the underlying security if its price at the time the complex contract is issued were alternatively increased by one standard deviation and decreased by one standard deviation. The Temporary Regulations provide little detail on certain aspects of how the substantial equivalence test should be applied. For example, while the calculation of standard deviation is a function of the period of time over which it is measured, the Temporary Regulations provide no detail on what time period should be used for this purpose (perhaps suggesting that the relevant time period is the term of the complex contract).

If the substantial equivalence test cannot be applied to a complex contract, the Final Regulations provide that the taxpayer must use the principles of the substantial equivalence test to determine if the contract is a section 871(m) transaction.[30]

Payments of Dividend Equivalents

As in the Proposed Regulations, the Final Regulations provide that a payment of a dividend equivalent includes any gross amount that references an actual or estimated payment of a US-source dividend, whether the reference is explicit or implicit.[31] Thus, unlike the statutory framework, which only applies to instruments where payments are contingent on or determined by reference to US-source dividends, the Final Regulations (like the Proposed Regulations) do not require that any dividends on the underlying securities be "passed through" to the long party in order for withholding tax to be imposed. Consequently, a contract that does not explicitly reference dividends but instead provides for payments based on the appreciation in the value of the underlying security (*i.e.*, a price return only derivative) generally would be covered by the Final Regulations because of the implicit reference to dividends in such a contract.

Amount of a Dividend Equivalent

The Final Regulations retain the basic approach of the Proposed Regulations for determining the amount of a dividend equivalent, but do not require that the delta of a section 871(m) transaction be recalculated every time the amount of a

[28] The probability of an increase (or decrease) by one standard deviation is the measure of the likelihood that the price of the underlying security will increase (or decrease) by any amount from its price at the time the complex contract is issued. Temp. Reg. § 1.871-15T(h)(4)(iv).

[29] Temp. Reg. § 1.871-15T(h)(4)(i).

[30] Temp. Reg. § 1.871-15T(h)(1).

[31] Treas. Reg. § 1.871-15(i)(2)(i). The payment is determined on a gross basis even if the long party makes a net payment to the short party or no amount is paid because the net amount is zero.

dividend equivalent is determined. Instead, the amount of a dividend equivalent is determined based upon the delta determined at the contract's issuance. Specifically, for a simple contract, the amount of the dividend equivalent for each underlying security 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 section 871(m) transaction with respect to the underlying security.[32]

For a complex contract, the amount of the dividend equivalent for each underlying security equals:

- the per-share dividend amount with respect to the underlying security, multiplied by
- the initial hedge for the underlying security.[33]

For this purpose, the per-share dividend amount with respect to the underlying security generally is based on the actual dividends paid with respect to such security. If, however, the short party identifies a reasonable estimated dividend amount (which may be zero if the underlying security is not expected to pay a dividend) in writing at the time the transaction is issued, the per-share dividend amount is based upon such estimated dividend amount and not the actual dividend amount (plus any adjustment payment under the contract if the actual dividend exceeds the estimated dividend).[34] This is a change from the Proposed Regulations, which would have based the per-share dividend amount on the lower of the actual dividend and the estimated amount of such dividend. This change, while less favorable in some cases and perhaps questionable from a policy standpoint, should make the dividend equivalent calculation simpler to implement by making the dividend equivalent calculation based either on actual dividends or estimated dividends throughout the life of the contract.

The Final Regulations also contain a simplifying rule for dividend equivalents paid with respect to a basket of more than 25 referenced securities, which allows the short party to treat all of the dividends paid on the securities referenced in the basket as paid on the last day of the calendar quarter.[35]

Exceptions

The Final Regulations retain many of the same exceptions contained in the Proposed Regulations for transactions that the government has determined have limited potential for tax avoidance. Rather than using the qualified dealer exception from the Proposed Regulations, however, the Final Regulations expand the qualified intermediary ("QI") regime to cover certain derivatives dealers, as set forth in the Temporary Regulations. The Final Regulations also depart from the

[32] Treas. Reg. § 1.871-15(j)(1)(ii).

[33] Treas. Reg. § 1.871-15(j)(1)(iii).

[34] Treas. Reg. § 1.871-15(i)(2)(iii).

[35] Treas. Reg. § 1.871-15(i)(3)(i).

Proposed Regulations in that they do not contain an exception for options with a term of one year or less that are not exercised.[36] The exceptions contained in the Final and Temporary Regulations are described below.

Cascading Withholding Relief and QDDs

Rather than permitting taxpayers to rely on the qualified dealer exception set forth in the Proposed Regulations (which generally exempted from withholding tax under section 871(m) payments made to "qualified dealers"), the Final Regulations provide relief from cascading withholding under section 871(m) by broadening the QI regime to cover "qualified derivatives dealers" (referred to as "QDDs"). A QI is an eligible person that enters into a QI agreement with the IRS and acts as a QI under such agreement for purposes of assuming certain withholding and documentation responsibilities. The Treasury Department and the IRS intend to amend the QI agreement to include provisions that will permit an eligible QI to act as a QDD. A QI is eligible to act as a QDD if it is either:

- a securities dealer that is regulated as a dealer in a jurisdiction in which it was organized or operates; or
- a bank that is regulated as a bank in the jurisdiction in which it was organized or operates (or a wholly-owned foreign affiliate of such a bank).[37]

A QI that acts as a QDD will not be subject to withholding on dividend equivalent payments under section 871(m) that the QDD receives in its capacity as a dealer provided that the QDD complies with its obligations under the QI agreement.[38]

In order to act as a QDD, a QI must meet four requirements:

- the QDD must furnish to withholding agents a QI withholding certificate affirming that it is acting as a QDD;
- the QDD must agree to assume primary withholding and reporting responsibilities on payments associated with the withholding certificate and to determine whether payments it makes are dividend equivalents;
- the QDD must agree to remain liable for tax on any dividends and dividend equivalents it receives unless the QDD is obligated to make an offsetting dividend equivalent payment; and
- the QDD must comply with any compliance review procedures applicable to a QI acting as a QDD.[39]

The Preamble provides that the qualified securities lender ("QSL") regime in Notice 2010-46, 2010-24 I.R.B. 757, which provides relief from cascading withholding in the context of securities lending and sale repurchase agreement transactions, will be phased out and replaced with the expanded QI regime. The Preamble also indicates that the credit forwarding system in Notice 2010-46 may not be preserved when the QSL regime is replaced with the expanded QI regime.[40]

[36] The Proposed Regulations provided that a long party that acquired an option with a term of one year or less would not incur withholding tax under section 871(m) if the option lapsed. Prop. Reg. § 1.871-15(i)(2)(ii).

[37] Temp. Reg. § 1.1441-1T(e)(6)(ii).

[38] Temp. Reg. § 1.871-15T(q)(1); Preamble at 47.

[39] Temp. Reg. § 1.1441-1T(e)(6).

[40] Preamble at 49-50.

Underlying Dividend Not Subject to Withholding Tax

As in the Proposed Regulations, payments that reference a distribution on an underlying security are excepted from the application of section 871(m) 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.[41] As an example of such a distribution, the Final Regulations describe a swap with respect to shares of a regulated investment company ("RIC") to the extent that a distribution by the RIC would constitute a capital gains dividend, and thus would not be subject to withholding tax if paid to the long party by the RIC.[42]

Coordination with Section 305

While the Proposed Regulations provided that a payment pursuant to a section 871(m) transaction would not be a dividend equivalent to the extent it is treated as a distribution taxable as a dividend under section 305, the Final Regulations provide that a dividend equivalent in a section 871(m) transaction is reduced by any amount treated as a dividend with respect to the underlying security pursuant to section 305(b) and (c).[43]

Corporate Acquisition Transactions

Like the Proposed Regulations, the Final Regulations contain an exception for corporate acquisition transactions where a taxpayer enters into a transaction as part of a plan pursuant to which one or more persons (including the taxpayer) is obligated to acquire more than 50 percent of the entity issuing the underlying securities.[44]

Due Bills

The Proposed Regulations reserved on whether a payment made by a seller of stock to the purchaser pursuant to an agreement to deliver a pending US-source dividend after the record date (*e.g.*, a due bill) should be excepted from section 871(m). The Final Regulations, however, provide that a dividend equivalent does not include a payment made pursuant to a due bill that arises from the actions of a securities exchange if such actions apply to all transactions in the stock and the relevant exchange has set an ex-dividend date with respect to the dividend that occurs after the record date.[45]

Employee Compensation

The Final Regulations also generally except from section 871(m) treatment employee compensation that is subject to withholding or is eligible for an exclusion from withholding (*e.g.*, where the services relating to such compensation are performed outside of the United States).[46] Thus, where an employee receives restricted stock, the dividends relating to such restricted stock generally are not subject to withholding tax under section 871(m) until the employee is treated as receiving such stock for tax purposes.

[41] Treas. Reg. § 1.871-15(c)(2)(i).

[42] Treas. Reg. § 1.871-15(c)(2)(i).

[43] Treas. Reg. § 1.871-15(c)(2)(ii).

[44] Treas. Reg. § 1.871-15(k).

[45] Treas. Reg. § 1.871-15(c)(2)(iii).

[46] Treas. Reg. § 1.871-15(c)(v).

Insurance Contracts

The Temporary Regulations generally carve-out payments made pursuant to certain insurance contracts—including annuities, endowments or life insurance contracts—from dividend equivalent treatment under section 871(m).[47]

Convertible Debt Instruments

The Final Regulations do not provide an exemption for convertible debt instruments, as had been sought by numerous industry participants. Nevertheless, because the Final Regulations provide that the time for testing delta is only at issuance of the contract, section 871(m) is unlikely to apply to most convertible debt instruments (unless a deemed exchange of such an instrument occurs under Treas. Reg. § 1.1001-3) because such instruments are typically issued with an embedded option that has a delta of less than 0.80.[48] However, a derivative with respect to a convertible debt instrument (rather than the convertible debt instrument itself) generally would be subject to section 871(m) if the underlying instrument has a delta of 0.80 or more when the derivative is issued. Thus, where a non-US investor is interested in gaining exposure to an outstanding convertible debt instrument that was originally issued with a delta of less than 0.80 but has a current delta of at least 0.80, the investor generally would be able to avoid withholding tax under section 871(m) only by acquiring the convertible debt instrument rather than entering into a derivative with respect to such instrument.

Application to Index-Linked Instruments

The Proposed Regulations provided that a "qualified index" was not treated as an underlying security, thus exempting contracts that reference qualified indices from the application of section 871(m).[49] The Proposed Regulations defined "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.[50]

[47] Temp. Reg. § 1.871-15T(c)(iv).

[48] The Final Regulations also clarify that, for purposes of the section 871(m) calculations, the delta of the convertible feature is tested separately from the delta of the debt instrument. Treas. Reg. § 1.871-15(g)(1).

[49] Prop. Reg. § 1.871-15(k)(1).

[50] Prop. Reg. § 1.871-15(k)(2).

The Proposed Regulations provided a safe harbor under which an index would be a "qualified index," even if it did not meet the definition of "qualified index," if the index was comprised solely of long positions in assets and the referenced underlying securities in the aggregate comprised 10 percent or less of the index's weighting.[51] Outside of this safe harbor, any component of an index that was not an underlying security was not taken into account for purposes of determining whether an index was a qualified index.

The qualified index exception, as contained in the Proposed Regulations, was criticized widely for being too narrow and defined in a manner that would exclude many of the most widely-used indices.

The Final Regulations generally adopt the qualified index safe harbor contained in the Proposed Regulations, with certain modifications intended to be responsive to industry concerns. These modifications include:

- allowing securities other than underlying securities to count toward the 25 or more component security requirement;[52]
- increasing the maximum weighting of any single component underlying security from 10 percent to 15 percent , but limiting the weighting of any 5 or fewer component underlying securities to 40 percent;
- providing that the determination of whether an index is a qualified index needs to be made only at the beginning of each calendar year (as opposed to on each date that a long party enters into the transaction, as provided under the Proposed Regulations);
- determining the dividend yield of the index by reference to the immediately preceding calendar year (rather than the immediately preceding month);
- allowing the modification or rebalancing of the index to involve interpretation by the index provider or a board or committee responsible for maintaining the index, so long as the criteria are publicly stated and predefined; and
- permitting a *de minimis* amount of short positions in a qualified index.

In addition to these modifications, the Final Regulations provide that the purpose of the qualified index exception is to provide a safe harbor for transactions on passive indices that reference a diverse basket of securities and that are widely used by market participants, and an index is not considered a qualified index to the extent such treatment would be contrary to this purpose.[53]

Under the Final Regulations, notwithstanding the safe harbor criteria for a qualified index, an index is considered a qualified index if the referenced component underlying securities comprise 10 percent or less of the weighting of the component securities in the index.[54]

[51] Prop. Reg. § 1.871-15(k)(3).

[52] Thus, equity securities of non-US issuers and debt securities of any issuer will be taken into account in determining whether an index has 25 or more components.

[53] Treas. Reg. § 1.871-15(l)(1). This provision was not contained in the Proposed Regulations, and it is unclear what circumstances the provision was intended to address.

[54] Treas. Reg. § 1.871-15(l)(4).

The Final Regulations retain the rule in the Proposed Regulations that provided that if, in connection with a transaction that references a qualified index, the taxpayer or a related person enters into one or more transactions that reduce exposure to any referenced component security (other than transactions that reduce exposure to the entire index), the transaction is not treated as referencing a qualified index.[55] The Final Regulations, however, permit the qualified index exception to apply where such transactions reduce exposure to referenced component securities by 5 percent or less of the value of the long positions in the qualified index.[56] The Final Regulations also expand the types of exchanges or boards of trade on which such futures or options must trade to include certain foreign exchanges and boards of trade, but only if "underlying securities" (generally, securities in US entities) comprise less than 50 percent of the index's weighting.[57] Perhaps most concerning to industry participants is that the Final Regulations continue to require that futures or options contracts on the index must be traded on a specified exchange or board of trade for an index to constitute a qualified index under the general rule.

Combined Transactions

To prevent taxpayers from avoiding section 871(m)'s delta threshold by entering into multiple transactions referencing the same underlying security, multiple transactions can be combined into a single transaction for purposes of determining the application of section 871(m) where 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.[58]

The Final Regulations set forth the same combined transactions rule as in the Proposed Regulations, but add certain presumptions (discussed below) for determining when multiple transactions will be treated as a single transaction. While the Final Regulations provide some additional guidance on how multiple transactions should be aggregated under the combined transaction rule, many complex issues remain unresolved.

Presumptions Available to Brokers Acting as Short Parties

Brokers acting as short parties may use the following two presumptions when determining if transactions should be combined:

- transactions are presumed not to be entered into in connection with each other if the long party holds the transactions in separate accounts; and
- transactions entered into two or more business days apart are presumed not to be entered into in connection with each other.[59]

In each case, however, the presumption will not apply if the short party has actual knowledge that the transactions were entered into in connection with each other. While the presumptions provide some relief to brokers regarding the combined transaction rule, it is expected to be challenging for brokers to track transactions in the same account within the two day period to which the presumption does not apply.

[55] Treas. Reg. § 1.871-15(l)(6).

[56] Treas. Reg. § 1.871-15(l)(6)(ii).

[57] Treas. Reg. § 1.871-15(l)(3)(vii)(B).

[58] Prop. Reg. § 1.871-15(l).

[59] Treas. Reg. § 1.871-15(n)(3).

Presumptions Commissioner Will Apply to the Long Party

The Final Regulations further provide that the IRS will apply similar rebuttable presumptions to the long party:

- transactions are presumed not to be entered into in connection with each other if the transactions are properly reflected on separate trading books;[60]
- transactions entered into two or more business days apart are presumed not to be entered into in connection with each other;[61] and
- transactions are presumed to be entered into in connection with each other if:
  - the transactions are entered into within two business days of each other; and
  - reflected on the same trading book.[62]

These presumptions are not available to a long party to the transaction; as a result, the long party must treat two or more transactions as combined transactions where they reference the same underlying security and are entered into in connection with each other.

Derivatives That Reference Partnership Interests

The Proposed Regulations treated 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 by that entity (except generally where such interests represented 10 percent or less of the value of the interests in the referenced entity); and
- referencing the payment of any dividends from those underlying securities and having a dividend equivalent equal to the allocable portion of any dividend or dividend equivalent received, directly or indirectly, by the referenced entity.[63]

The Final Regulations substantially modify this look-through rule for non-corporate entities. Under the Final Regulations, section 871(m) applies to treat derivatives that reference a partnership interest as referencing the assets of the partnership only if the partnership:

- carries on a trade or business of dealing or trading in securities;
- holds significant investments in securities; or

[60] Treas. Reg. § 1.871-15(n)(4)(i). The IRS may rebut this presumption by showing that either (i) the transactions reflected on separate trading books were entered into in connection with each other or (ii) separate trading books were created or used to avoid section 871(m).

[61] Treas. Reg. § 1.871-15(n)(4)(ii). The IRS may rebut this presumption by showing that the transactions were entered into in connection with each other.

[62] Treas. Reg. § 1.871-15(n)(4)(iii). A long party may rebut this presumption by showing that the transactions were not entered into in connection with each other.

[63] Prop. Reg. § 1.871-15(m)(1).

- holds (directly or indirectly) an interest in a lower-tier partnership described in either of the prior two bullet points.[64]

For this purpose, a partnership is treated as holding significant investments in securities if either:

- 25 percent or more of the partnership's assets consist of underlying securities; or
- the value of the underlying securities equals or exceeds $25 million.[65]

As set forth in the Final Regulations, a security is as defined in section 475(c); thus, section 1256 contracts are not treated as securities for purposes of this rule.[66]

This rule for applying section 871(m) to derivatives involving partnership interests may prove to be problematic for taxpayers and withholding agents, particularly as it relates to derivatives on interests in master limited partnerships and other publicly traded partnerships ("MLPs"). In particular, while the rule appears to be targeted at derivatives on financial MLPs (*e.g.*¸ Blackstone Group and Fortress Investment Group), which typically allocate to their partners a significant amount of US-source dividend income, it may also impact derivatives on natural resource MLPs. Natural resource MLPs often hold all of the stock of a subsidiary corporation, which acts as a blocker to protect the MLP from recognizing certain types of non-qualifying income, such as fees for services. For this purpose, the stock of such a blocker corporation held by an MLP is considered a security, such that a derivative on the MLP would potentially trigger withholding under section 871(m) if the value of the blocker corporation's stock was at least $25 million. It is not clear that this result was intended. It is also not clear how the parties to a derivative over an MLP are to determine whether the MLP assets or activities will result in such derivative being subject to the application of section 871(m).

An additional complication is that where section 871(m) applies to a derivative on a partnership interest, such that a dividend on an underlying security would potentially be subject to US withholding tax, the parties will need to determine the amount of such dividends but may not be able to access the relevant information when withholding is required to be collected. In the case of an MLP, it is not apparent how information on the amount of dividends paid with respect to an MLP unit can be determined prior to the issuance of a Schedule K-1 after the close of the taxable year in which the dividends are paid. When a derivative on a partnership interest is terminated, it is unclear how the withholding agent should determine the amount of withholding tax due under section 871(m) if it does not have access to information regarding the amount of dividends allocated with respect to such interest for the year in which the derivative is terminated.

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."[67] The Final Regulations (like the Proposed Regulations) 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

[64] Treas. Reg. § 1.871-15(m)(1).

[65] Treas. Reg. § 1.871-15(m)(2)(i).

[66] *See* section 475(c)(2) (flush language).

[67] I.R.C. §§ 871(h)(4) and 881(c).

within the meaning of section 871(m).[68] The portion of any contingent interest payment that does not qualify for the portfolio interest exemption equals the amount of the dividend equivalent determined under the rules described above. Any interest that is not characterized as a dividend equivalent under such rule may still qualify for the portfolio interest exemption.[69]

Issues for Withholding Agents

The Final Regulations change the timing of the withholding requirement on dividend equivalent payments, such that withholding is required only when an actual payment of a dividend equivalent is made. In particular, the Final Regulations generally consider a payment of a dividend equivalent not to be made for purposes of imposing withholding tax until the later of when:

- the amount of a dividend equivalent is determined; and
- a payment occurs with respect to the section 817(m) transaction.

The effect of this rule is that withholding is required only when money or other property is paid to or by the long party or the long party sells, exchanges, transfers or otherwise disposes of the section 871(m) transaction (*e.g.*, at final settlement of the contract).[70] Despite the general requirement in the Final Regulations that withholding is only required when an actual payment of a dividend equivalent is made, a withholding agent may still be required to withhold from its own funds in certain situations, such as upon the lapse of an option or if the contract is sold (as it is not clear if the purchaser or the short party would be required to withhold upon the sale). In addition, this rule can create challenges for a withholding agent where a fixed coupon payment is made on a section 871(m) transaction and there is a subsequent dividend equivalent with respect to such transaction. In such a case, a withholding agent may be required to remit withholding tax under section 871(m) when the dividend equivalent occurs even though it will be making no cash payment at such time.

In general, withholding agents will be able to determine whether a contract is a specified NPC or a specified ELI (and thus subject to withholding tax under section 871(m)). There are at least three circumstances, however, where that will not necessarily be the case:

- Situations in which the long party enters into two or more transactions that are viewed together under the combined transactions rule. In this circumstance, the withholding agent generally can rely on the presumption allowing it not to combine separately executed transactions unless (i) such transactions are executed within two days in the same account or (ii) the withholding agent knows that the transactions were executed in connection with each other.
- Situations in which the long party engages in other transactions or activities that result in the transaction being subject to withholding tax under the anti-abuse rule. In this circumstance, the withholding agent is not required to withhold unless it knows that the transaction is subject to the anti-abuse rule.

[68] Treas. Reg. § 1.871-14(h).

[69] *Id*.

[70] Treas. Reg. § 1.1441-2(e)(8)(ii). In contrast, the Proposed Regulations treated upfront payments or prepayments of purchase price as payments that could be subject to withholding tax under section 871(m), and provided for withholding to be imposed on money or other property within the custody or control of the withholding agent.

- Situations in which the long party enters into a derivative with respect to a qualified index, but enters into one or more transactions that reduce its risk of loss with respect to the qualified index by more than five percent. In this circumstance, because the presumptions applicable in the context of the combined transaction rule appear not to apply for this purpose, it is not clear whether the withholding agent could be liable for failure to withhold even if it did not have sufficient information for it to determine that withholding is required.

Reporting Requirements

The Final Regulations generally adopt the approach in the Proposed Regulations with respect to which party or parties are required to determine whether a transaction is a section 871(m) transaction as well as the timing and amounts of the dividend equivalents.[71] Specifically, the Proposed Regulations required a broker or dealer that is a party to a potential section 871(m) transaction to determine:

- whether the transaction is a section 871(m) transaction; and
- if the transaction is a section 871(m) transaction, the timing and amounts of the dividend equivalents.[72]

If both parties to the transaction are brokers or dealers or neither party is a broker or dealer, the Final Regulations require the short party to make the section 871(m) determinations. For this purpose, any person acting as an intermediary with respect to a potential section 871(m) transaction is considered a party to the transaction.[73]

The party required to make the determination is required to exercise reasonable diligence, and the determinations are binding on the parties to the transaction and any withholding agents (but not on the IRS), unless the person has actual knowledge or reason to know that the information is incorrect.[74]

The Final Regulations impose some additional recordkeeping requirements, such as requiring taxpayers to retain documentation and work papers establishing the delta or substantial equivalence calculation.[75] The determinations required to be made are binding on the parties to the transaction and on any person who is a withholding agent with respect to such transaction unless such person knows or has reason to know that the information is incorrect.

Anti-Abuse Rule

The Final Regulations retain the anti-abuse rule contained in the Proposed Regulations, which provides that if a taxpayer (directly or through the use of a related person) acquires or disposes of a transaction or transactions with a principal purpose of avoiding the application of section 871(m) the IRS may treat any payment made with respect to that transaction or transactions as a dividend equivalent.[76] The IRS may, for example, adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, change the maturity, adjust the timing of payments, treat a transaction that references a partnership interest as referencing the assets of the partnership, combine, separate or

[71] *Treas. Reg. § 1.871-15(p)(1).*

[72] *Id.*

[73] Treas. Reg. § 1.871-15(a)(9)(iii).

[74] Treas. Reg. § 1.871-15(p)(1).

[75] Treas. Reg. § 1.871-15(p)(4)(ii).

[76] Treas. Reg. § 1.871-15(o).

disregard transactions, indices or components of indices to reflect the substance of the transaction or transactions or otherwise depart from the rules under section 871(m).[77] The Final Regulations provide, however, that a withholding agent is responsible for withholding tax with respect to a transaction that is subject to withholding solely by virtue of the anti-abuse rule only if the withholding agent knows that the taxpayer acquired or disposed of a transaction or transactions with such a principal purpose.[78]

Given its broad language, the potential reach of the anti-abuse rule is difficult to determine. For example, consider whether the anti-abuse rule would apply to one or more of the following fact patterns:

- a non-US investor enters into a derivative with a delta of 0.79 (rather than acquiring a similar higher-delta derivative) with respect to an underlying security in order to avoid US withholding tax under section 871(m);
- a non-US investor that holds a specified NPC or specified ELI terminates such instrument immediately prior to the day before the ex-dividend date and then enters into the same or similar derivative immediately after the ex-dividend date;[79] and
- a non-US investor that desires exposure to 100 notional of an underlying security enters into a derivative with a delta of 0.50 on a notional of 200.

While strong arguments can be made that all or most of these fact patterns should not implicate the anti-abuse rule, there may not be certainty as to its application in these cases.

Effective Date

The Final and Temporary Regulations contain three separate effective date rules:

- contracts issued before January 1, 2016 are fully grandfathered, such that the existing statutory regime under section 871(m) (rather than the Final and Temporary Regulations) will continue to apply to such contracts throughout their term;
- for contracts issued in 2016, the existing statutory regime under section 871(m) will continue to apply, but payments made on such contracts on or after January 1, 2018 (with respect to dividends paid on or after January 1, 2018) will be subject to the Final and Temporary Regulations; and
- payments made on or after January 1, 2017 with respect to any transaction issued on or after January 1, 2017 will be subject to the Final and Temporary Regulations.[80]

The effective date provisions appear to be intended to provide financial institutions until January 1, 2017 to build systems to determine what transactions are specified NPCs or specified ELIs, and in such cases to provide for appropriate

[77] Treas. Reg. § 1.871-15(o).

[78] *Id*. The Final Regulations also make clear that the IRS may still challenge transactions designed to avoid section 871(m) though the use of all available statutory provisions and judicial doctrines. Preamble at 34.

[79] The amount of a dividend equivalent is determined on the earlier of the date that is the record date and the day prior to the ex-dividend date. Treas. Reg. § 1.871-15(j)(2).

[80] Treas. Reg. § 1.871-15(r)(3).

information reporting and withholding to be done. The effective date rule relating to transactions issued in 2016, however, may be problematic in that institutions will need to be able to capture and record the delta of any transaction issued in 2016 that may continue its existence past December 31, 2017. Delta generally is something that needs to determined contemporaneously with the issuance of the relevant instrument. As a result, while the entire system for an institution to comply with section 871(m) does not need to be completed before the end of 2016, institutions will presumably need to find a method for calculating and recording delta for each transaction done in 2016 to which section 871(m) might apply.

Other Issues

We expect that parties to derivatives will want to update their International Swaps and Derivatives Association ("ISDA") documentation to reflect the Final Regulations before such regulations become effective. This is particularly true where the existing documentation with the counterparty to such derivatives does not shift the risk of withholding tax under section 871(m) to the long party. With respect to derivatives not executed under ISDA documentation, the contracts (where relevant) for derivatives potentially subject to withholding tax under section 871(m) should be revised to provide a mechanism for the short party to collect the section 871(m) tax from the long party where the contract may not provide for a payment to such party from which the tax can be withheld.

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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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