New Proposed and Final Regulations Address Withholding on “Dividend Equivalents”

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Section 871(m) of the Internal Revenue Code, enacted in 2010, treats “dividend equivalents” as U.S.-source dividends for withholding tax purposes. On December 4, 2013, the Treasury Department and the Internal Revenue Service (the “**IRS**”) released new proposed regulations (the “**2013 Proposed Regulations**”) and final regulations (the “**2013 Final Regulations**”) interpreting Section 871(m).

The 2013 Proposed Regulations

Overview and Effective Dates

While the 2013 Final Regulations generally extend the applicability of “current law” regarding dividend equivalents until December 31, 2015, the 2013 Proposed Regulations represent a dramatic departure from the proposed regulations published in 2012 (the “**Prior Regulations**”). Most notably, the 2013 Proposed Regulations generally use a derivative’s delta as the exclusive determinant of whether it is subject to tax under Section 871(m) as a “specified notional principal contract” (a “**specified NPC**”) or “specified equity-linked instrument” (a “**specified ELI**”).

Under the 2013 Proposed Regulations, “payments” made after December 31, 2015 on a specified ELI acquired by a “long party” on or after March 5, 2014, and payments on a specified NPC, whenever acquired, generally will be “dividend equivalents” if the relevant instrument (1) has a “delta” at the time of acquisition by a long party of 0.70 or greater and (2) “references” a U.S.-source dividend, subject to relatively narrow exceptions. Because an instrument is tested when acquired by a long party, the ELI “grandfathering” rule, while administrable for instruments always held by the same long party, does not protect against onerous administrative burdens when it comes to, for instance, currently outstanding traded convertible debt and ETNs that mature after December 31, 2015. Additionally, as discussed below, the new rules will apply to instruments linked to U.S. equities even if the instruments do not explicitly provide for payments determined by reference to dividends.

The Delta-based Approach

The 2013 Proposed Regulations use a delta-based approach to determine if an NPC or ELI is subject to tax under Section 871(m). In general, if an NPC or ELI has a delta of 0.70 or greater with respect to an underlying security at the time acquired by the long party, it is a specified NPC or specified ELI. Consequently, an ELI can become subject to Section 871(m) when acquired by a long party on a secondary market (if its delta with respect to an underlying security is then 0.70 or higher) — even if its delta was less than 0.70 when issued by the short party, and even if the short party does not know the relevant acquisition has occurred (or what the “delta” is at that time). As discussed below, the short party (*i.e.*, the issuer) can have material information reporting obligations once an acquisition occurs (which for a very liquid instrument could be daily), and can also become a withholding agent. Under these circumstances, the short party or another withholding agent (*e.g.*, a broker or custodian) will need to ascertain the particular long party’s purchase date as well as the delta on that date. It is difficult to understand how issuers (including option and other derivative exchanges) and certain other withholding agents will satisfy these requirements.

If an instrument is linked to multiple underlying securities, the delta must be determined with respect to each underlying security “without taking into account any other underlying security or other property or liability.” “Property” may be intended to refer to “long” exposures within the derivative to assets other than

dividend-paying U.S.-stocks, and "liability" may be intended to refer to a "short" exposure within the derivative. Be that as it may, for basket-linked instruments with a "basket delta" that is high but less than one, it is not clear how the delta with respect to each underlying security should be determined for purposes of these regulations. One approach would be to determine the delta of a "portion" of the instrument (equal to the weighting of the relevant underlying "long" stock) with respect to that stock, holding other inputs constant. Using the delta of the basket seems simpler and closer to the economics of the investment, but this approach is inconsistent with the language of the rules.

Combinations of instruments held by the long party or its related parties with respect to a single underlying security are aggregated to determine if their "delta" is potentially 0.70 or greater on the date of acquisition of each instrument entered into "in connection with" another.[1] A withholding agent with respect to any one of these positions, the delta of which at inception was less than 0.70, would not be subject to liability for failure to withhold, however, unless it knew the long party or a related person had entered into the instruments in connection with one another.

"Dividend Equivalents"

The 2013 Proposed Regulations depart significantly from the approach of the Prior Regulations by bringing within the scope of "dividend equivalents" amounts that are estimated, whether explicitly or implicitly.[2] Unless estimated dividend amounts are set out in writing at inception by the short party, there is a presumption that the "per share" dividend equivalent with respect to each dividend on an underlying security during the term of the instrument is equal to the actual per-share dividend with respect to that underlying security. The apparent effect of this provision is that any "high delta" instrument linked to a U.S. dividend-paying stock for a period that includes an expected dividend (unless the instrument is a "grandfathered" ELI, as described above, or the index exception discussed below or some other exception applies) will give rise to dividend equivalents after December 31, 2015, even if the instrument involves no explicit adjustments for dividends but is, for example, "price return only." The 2013 Proposed Regulations generally provide that if reasonable estimated dividends are set forth in the instrument, the lesser of the estimated and the actual amount of the relevant dividend is the "per share" dividend amount. To determine the dividend equivalent amount, this "per share" dividend amount is multiplied by the delta of the instrument with respect to the relevant underlying stock on the earlier of the ex-dividend date and the record date for each dividend. This dividend equivalent calculation is required even if on a relevant "payment" date the delta of the contract is below 0.70 with respect to the relevant underlying security.

When the return on an instrument is calculated using fractions or multipliers (or the amount of a payment is otherwise altered), the number of shares of the underlying security is adjusted in a corresponding manner for the purposes of determining "per share" dividend equivalents. For example, if a total return swap provides the long party with the right to receive 1.5 times the return on 100 shares of Stock X, the swap would be treated as referencing 150 shares of Stock X. It is not clear how this rule will apply in the

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[1] For example, assume that an investor purchases a call option with a term of six months with respect to Stock A, when the delta of the call option is 0.40. Because the delta is less than 0.70, the call option is not a Section 871(m) transaction. However, if after three months the investor writes a three-month put option with respect to Stock A, these options could be treated as entered into in connection with each other and therefore as a combined transaction. Assume that at the time that the investor writes the put option the delta of the call option is 0.60 and the delta of the put option is 0.20. The delta of the combined transaction is 0.80 and the combined transaction is treated as a Section 871(m) transaction. Alternatively, if the delta of the call option on day 1 had been 0.75, it is treated as a Section 871(m) transaction, but the combined transaction is not if its delta when the put is acquired is less than 0.70.

[2] A dividend is treated as implicitly estimated if the estimate is taken into account in computing one or more terms of the transaction, including interest rate, notional amount, purchase price, premium, upfront payment, strike price or any other amount paid or received.

case of instruments with respect to which, for example, the number of underlying shares can vary based on the price of the underlying stock (*e.g.*, because of "amplified" upside and/or downside exposure), or instruments linked to the worse or worst of multiple stocks.

Dividend equivalent "payments" occur even if no cash is paid under the relevant instrument in connection with that dividend. However, the proposed withholding rules provide that withholding is required only on the later of the dividend equivalent determination date and the date the withholding agent is deemed to have control over money or other property of the long party because (1) money or other property is paid to or from the long party, (2) the withholding agent has custody or control over money or other property of the long party at any time on or after the amount of a dividend equivalent is determined or (3) the transaction provides for an upfront payment or prepayment of the purchase price. It is not entirely clear how this withholding rule is intended to work, though it appears intended to require a withholding agent to withhold on dividend equivalents at the time they arise if and perhaps to the extent it has received cash or property from the long party, or otherwise has access to cash or property of the long party.[3]

The "Look Through" Rule

The 2013 Proposed Regulations also impose a "look through" rule under which a derivative linked to an interest in an entity that is not a C corporation references the allocable portion of each underlying share and each "potential Section 871(m) transaction" held, directly or indirectly, by the relevant entity. There is an exception (subject to an anti-abuse rule) if the underlying shares and "potential Section 871(m) transactions" represent in aggregate 10% or less of the value of the interest in the relevant entity at the time the long party acquires the derivative referencing that interest.

The "Qualified Index" Exception

The 2013 Proposed Regulations exempt certain indices from the definition of an "underlying security" and thus from the application of the proposed rules. This exception is, in important respects, a narrowing of the comparable exception contained in the Prior Regulations. A "qualified index" (tested when a long party acquires an instrument, so that an index may be qualified on one day but not on another) is one that:

(1) has 25 or more component underlying securities;

(2) references only long positions in underlying securities;

(3) has no component underlying security representing more than 10% by weight of the index (at the time of the acquisition by the long party);

(4) is modified only according to predefined objective rules at set dates or intervals;

(5) has a yield "from component underlying securities" no greater than 1.5 times the yield of the S&P 500 Index as reported for the month immediately preceding the date that the long party acquires the instrument; and

[3] The 2013 Proposed Regulations include a special rule for "short-term" instruments (those with a term of one year or less when acquired by the long party), under which the amount of an underlying dividend is determined when the long party disposes of the instrument. The purpose of this provision is not clear and its effect seems arbitrary. First, it appears to provide that even if an actual underlying dividend is "paid through" on an instrument, it is not determined (or therefore subject to withholding tax) until the instrument is later disposed of. Second, it suggests the "delta" should be determined when the instrument is disposed of, even if it is then very different from the delta when the relevant dividend was announced/declared/paid. Further guidance on this provision is needed.

(6) has futures contracts or options traded on a U.S. exchange or board of trade (whether the traded contracts provide price or total return exposure).

In general, if an index does not satisfy these criteria, it can nonetheless be "qualified" if it consists only of long exposures, 10% or less (by weight) of the components of which are U.S. stocks. Finally, an index can lose its status as a "qualified index" if the relevant instrument includes a short exposure to any component (but not all) of the index, or if the long party otherwise reduces its exposure to any component (but not all) of the index.

It is not clear whether any index satisfies the qualified index definition. Even the S&P 500 Index, for instance, arguably is not "modified or rebalanced only according to predefined objective rules at set dates or intervals." For example, the index's sponsor has discretion regarding the timing of dropping and adding constituent stocks.[4] In addition, the language of the "yield" prong of this test is ambiguous in several important respects. First, it may mean ***no*** underlying security in the relevant index can have a yield higher than 1.5 times the yield of the S&P 500 Index, or it may (and one hopes does) mean to refer to the ***average*** yield of the index components. Second, it is not clear whether the month preceding the acquisition date means the calendar month or the prior 30-31 days, or exactly what the "reported" yield of the S&P 500 Index is. Moreover, as discussed above, whether an index is qualified must be tested on the date of acquisition by a long party, so that it would appear potentially necessary to test the status of an actively traded instrument linked to an index (*e.g.*, a listed index option) on a daily basis.

Certain Other Exceptions

The 2013 Proposed Regulations include an exception for a long party that is a "qualified dealer" acting in its capacity as a dealer in securities. A qualified dealer is one that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized, and that furnishes a written certification to the short party confirming that it qualifies for this exemption and stating that it will withhold any tax imposed by Section 871(m) with respect to any instrument that the dealer enters into as both a short party and a dealer in securities (presumably relating to the relevant instrument, though the provision does not say so).

The 2013 Proposed Regulations also include an exception for corporate acquisition transactions obligating the long party to acquire ownership of the underlying security as part of a plan under which one or more persons are acquiring more than 50% of the value of the issuer of the underlying securities, provided the long party furnishes a written certification under penalties of perjury to the short party to this effect.

There is no exception for compensatory derivatives.

Section 871(m) Determinations and Information Reporting

If a broker or dealer is a party to a potential Section 871(m) transaction and the other party is not, then the broker or dealer is required to determine whether the transaction is subject to Section 871(m). Otherwise, the short party is required to make the determination. The party required to make that determination is also required to determine (using reasonable diligence) and report to the counterparty or customer and certain withholding agents (in a specified manner) the timing and amount of each dividend equivalent with respect to the instrument. These determinations are binding on the parties and any withholding agents, absent actual knowledge or reason to know the information received is false, but are

[4] *See* S&P Dow Jones Indices, S&P U.S. Indices: Methodology 6-7 (2013), *available at* **http://www.spindices.com/documents/methodologies/methodology-sp-us-indices.pdf**.

not binding on the IRS. There is no stated exception if the long party is not subject to Section 871(m) (*e.g.*, because it is a U.S. person), although one is presumably intended.

The application of this information reporting rule is particularly uncertain because an instrument's status as subject to Section 871(m) may become clear beginning on March 5, 2014, though no payment will become subject to withholding before January 1, 2016. Most critically, a broker or short party could be required to know whether something "acquired" by a long party on any day beginning on March 5, 2014 had a delta of 0.70 or greater ***on that acquisition date***, in order to be able to comply with these information reporting requirements if and when the regulation later becomes final.

Anti-Abuse Rule

The 2013 Proposed Regulations include a broad anti-abuse rule under which, if a taxpayer directly or through affiliates acquired a transaction or transactions with a principal purpose of avoiding the proposed regulations, the Commissioner can treat payments as dividend equivalents to the extent necessary to prevent avoidance of the proposed regulations.

The 2013 Final Regulations

The 2013 Final Regulations generally extend the applicability of "current law" regarding dividend equivalents until December 31, 2015, by extending the statutory four-factor definition of a "specified NPC" to payments made before January 1, 2016. Pursuant to this statutory definition, a specified NPC is any NPC if:

(i) in connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract;

(ii) in connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;

(iii) the underlying security is not readily tradable on an established securities market; or

(iv) in connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

The 2013 Final Regulations also finalize certain rules that were included in the Prior Regulations. Significantly, the 2013 Final Regulations treat dividend equivalents as dividends for tax treaty purposes and for purposes of Section 892, which exempts from U.S. taxation certain payments to foreign governments and international organizations. In addition, Treasury Regulation Section 1.863-7, which provides the general sourcing rules for NPCs, has been finally modified to conform the definition of a "notional principal contract" therein to the definition in Treasury Regulation Section 1.446-3.

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