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FEDERAL INCOME TAX UPDATE ON DERIVATIVE ISSUES FOR DEALERS & BANKS

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CLE Question

Who has heard that the rules for withholding US federal income tax on Dividend Equivalents have been delayed yet again?

The IRS has Proposed Multiple Approaches to Addressing Dividend Equivalents

- **Notice 2016-76 – Delta One derivatives subject to withholding beginning in 2017. All other in scope derivatives subject to withholding beginning in 2018**

- **Revenue Procedure 2017-15 – QDD rules wrapped into Qualified Intermediary rules.**

- **2017 Final Regulations – Expanded & refined 2015 regulations.**

- **Notice 2018-72 – Deferred application of Code § 871(m) to non-delta one derivatives issued on or after Jan. 1, 2021. Extended industry-friendly combination rule until 2021 as well.**

The US Withholding Tax Rules for Cross-Border Loans of US Stocks

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Cross-Border Securities Lending

- Code § 871(m) codified the regulations on substitute dividends paid in securities lending transactions, effective in 2010.
- Substitute dividends are sourced based upon the loaned securities.
- Cascading withholding could result – Borrower becomes subject to withholding on actual dividend & lender is then also subject to withholding on substitute (manufactured) dividend.
- IRS addressed cascading withholding in Notice 2010-46 – a "credit forward" approach, presumption rules plus the Qualified Securities Lender ("QSL") regime
- All regimes now end at end of 2020. After 2020, QDD regime will be the only avenue to avoid foreign-to-foreign cascading withholding

The Document-Based Credit Forward System (Ends in 2020)

Notice 2010-46 prescribes a four-part documentation substantiation test to determine if there has been prior withholding in a series:

(1) The lender receives a substitute dividend net of U.S. withholding taxes;

(2) The lender receives a written statement from the immediately prior withholding agent setting out the amount of such taxes (proof that the stock has been on-sold is not evidence of prior withholding);

(3) The borrower identifies the person who withheld such tax and the recipient of the payment against which such tax was withheld; and

(4) The lender does not know or have reason to know that the written statement is unreliable.

The fourth prong is reinforced by an anti-abuse rule. If a withholding agent or Qualified Securities Lender "knows or has reason to know" that a securities lending transaction has a principal purpose of reducing or eliminating withholding tax, it must withhold notwithstanding compliance with the documentation requirements.

The QSL Regime

No withholding is required provided that the stock lender assumes responsibility and liability for proper withholding or the payment of tax. Specifically, the QSL must agree to withhold if it is obligated to make offsetting substitute dividend payments or, if it is not obligated to make offsetting substitute dividend payments, to remit the tax directly to the IRS.

A Qualified Securities Lender is a foreign financial institution only if it satisfies all of the following conditions:

(1) It is a bank, custodian, broker-dealer, or clearing organization that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized;

(2) It is (i) subject to audit by the IRS under Code § 7602 or (ii) is a Qualified Intermediary (a "QI"); and

(3) It files an annual statement on an IRS Form (not yet released) certifying that it satisfies the conditions necessary to be a Qualified Securities Lender.

The Use of the Presumption Rules

Notice 2010-46 provides a set of rules under which a party to a securities lending transaction may presume that there has been sufficient prior withholding in a transaction:

(1) The withholding agent receives a substitute dividend or dividend payment with respect to identical securities that reflects a reduction for withholding of U.S. gross-basis tax;

(2) The withholding agent does "not know or have reason to know" that tax was not withheld and deposited or paid. Reason to know exists that tax was not withheld if the amount of any lending fee or similar fee is increased directly or indirectly, in whole or in part, by the difference between the gross amount of the substitute dividend and the net amount received; and

(3) The withholding agent is a person subject to IRS audit, or in the case of a QI, by an external auditor.

The Final HIRE Act Regulations (Rules Applicable Beginning in 2021)

New HIRE Act Final Regulations - Effective Dates

- New final rules apply as follows:
  - ❑ Non-Statutory Swaps & all Equity-Linked Instruments (ELIs) issued before 2021 – Not subject to new rules. 5-year swaps? 10-year swaps?
  - ❑ Swaps & ELIs before 2021 – Test at issuance & if transaction has a delta of 1.0, it will be subject to dividend equivalent payment withholding.
  - ❑ Swaps & ELIs issued in 2021 & after. Test at issuance & if transaction has a delta or 0.80 or greater, it will be subject to the new rules.

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More on HIRE Act Final Regulations Effective Dates

- Certain specified Exchange-Traded Notes (ETNs) issued pursuant to continuous distribution circulars will not be subject to new rules until 2020.

- These ETNs were first offered prior to September 18, 2015 (when the final Code § 871(m) regulations were issued) & new issuances of the ETNs are indistinguishable from each other.

- This poses a "fungibility" problem – custodians and issuers won't be able to distinguish ETNs issued before regulations and those issued after regulations are effective.

- Accordingly, the IRS gave these issuer until 2020 to develop systems to distinguish ETNs issued prior to and after such time.

SPECIFIED NPCS AND SPECIFIED ELIS

- Potential specified NPC is any swap that references one or more US securities or equity-linked debt instruments
- Potential specified ELI – any transaction not a swap or securities lending transaction that references one or more US securities or equity-linked debt instruments
- Simple contract - Simple contracts provide for payments based on a single fixed number of shares of the underlying securities that can be ascertained at the time the contract is issued.
  - Examples
    - ❑Single maturity or exercise date; acceleration provision OK
    - ❑Single date on which all amounts payable are calculated.
- Any other contract is a complex contract
  - Examples
    - ❑Best of/Worst of Structured Notes, multipliers on either appreciation or depreciation, binary pay-outs

UNDERSTANDING THE "DELTA" CONCEPT IS KEY TO THE NEW RULES

- Delta is the ratio of change in the fair market value of a specified NPC or Equity-Linked Instrument ("ELI") to a small change in the fair market value of the number of shares of the underlying scurity referenced in the swap or ELI.

- Example: A total return swap ("TRS") with respect to a single US stock entered into at the market price of the stock when the swap is opened will have a delta of 1.0. This is because any change in the price of the referenced equity will be reflected in the change in value of the TRS.

- Example: A swap that provides for 70% of the total return performance of the referenced stock should have a delta of 0.70.

SIMPLE CONTRACTS ARE DELTA TESTED

- A simple contract is tested as to whether it will be subject to HIRE Act withholding by determining the ratio of a small change in the fair market value of the contract to a change in the value of the contract.
- If the delta is 0.80 or greater, the contract is subject to HIRE Act withholding when a dividend equivalent is "paid." If a fractional multiplier is used, notional amount is scaled down until 0.80 delta is reached.
  - For example, structured product providing credit for 50% of all dividends on 100 shares would be treated as an ELI providing for 100% credit on 50 shares.
- Testing occurs only when the contract is issued. Re-testing is required only if the contract undergoes a significant modification.
- If contract references 10 or more US securities & is hedged with an exchange-traded security, delta may be tested by comparing the index to the hedge.
- In all other basket transactions, the basket is disaggregated.

Complex Contracts Are Tested for Substantial Equivalence

- Substantial equivalence testing assesses whether the complex contract substantially replicates the economic performance of the US security.

- Test at contract pricing, one standard deviation above & one standard deviation below (more testing prices may be required)

- Short party tests against the number of shares that it holds as a hedge of its economic exposure

- Determine the simple contract(s) with a delta of 0.80 that most accurately replicate the exposure to the complex contract.

- If comparison of exposure to complex contract to simple contract reveals that complex contract is at least as sensitive, then complex contract is subject to HIRE Act withholding.

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Dividend Equivalents Subject to Withholding

- The dividend equivalent is the gross amount of the dividend used to determine a payment multiplied by the initial delta.
- Even if net payment is zero, a dividend equivalent is subject to HIRE Act withholding
- Implicit dividends are subject to withholding.
- Estimated dividend payments are dividend equivalents & can be used in lieu of the actual dividend for withholding tax purposes if the short party designates the amount of the estimate at contract opening
  - Examples
    - ❑ Price return swaps
    - ❑ Single Stock Future 1-C contracts
- Dividend equivalent is considered paid on earlier of (1) record date & day prior to ex-dividend date and (2) date payment is made under the ELI.

Futures, Options & Worthless Contracts

- The dividend equivalent withholding rules apply to exchange-traded contracts.

- Options and futures traded that have deltas of 0.80 or greater at issuance. Options & futures with the same CUSIP can have different deltas depending upon when they are issued.

- Adjustments for dividends (e.g., extraordinary dividends) will cause contract to pay a dividend equivalent.

- Even if the contract expires worthless, if it had a delta of ≥ .080 at issuance, the short party has a withholding tax obligation

  - ❑ Both exchange and clearing broker are liable to withhold.

  - ❑ Withholding rule is likely to cause an increase in the amount of margin that must be posted.

  - ❑ Final regulations repeal proposed exception for options that expire worthless.

Qualified Index Exception (No Withholding)

- The "QIX" exception:
  - ❑ Minimum of 25 components
  - ❑ Percent limitation for maximum weighting of single underlying security is increased from 10% to 15%. But no 5 or fewer components can constitute more than 40% of index.
  - ❑ Qualified Index can now hold *de minimis* short positions (5% or less in aggregate of value of long positions).
  - ❑ Dividend yield cannot exceed 150% of S&P500 yield
  - ❑ Index has liquid futures or options market that trades on National Securities exchanges.
  - ❑ Qualified Index can now be periodically rebalanced by a board or committee (S&P 500 should now qualify)

MORE ON QUALIFIED INDICES

- Special QIX rules:
  - ❑ Exchange-traded funds can be treated as qualified indices if the ETFs meet the requirements to be treated as QIXs
  - ❑ If the ELI contains short positions of more than 5% of the components in the QIX, the ELI no longer will be considered to reference an ELI
  - ❑ Although the MSCI World Index does not appear to meet the requirements to be treated as a QIX, the US Sub-Index should qualify as a QIX.
  - ❑ As anticipated, proprietary indices will be not qualify. They will be considered custom indices that will require “look thru” treatment

4 Simplifying Rules for Non-QIX/Basket Trades

- If a swap or ELI references more than 25 securities, the short party may treat all dividend payments as paid at the end of each calendar quarter in which the contract is outstanding. Withholding at the calendar quarter.
- If a swap or ELI references a public non-QIX, the amount of the dividend equivalent is the yield on the index, not the yield on the individual components of the index
- If the short party uses the simplified delta calculation for a transaction referencing 10 or more securities, the dividend yield is set at the yield on the exchange-traded fund or other security used to hedge the transaction.
- If less than 10% of the stocks in aggregate referenced in the basket are US securities, then basket is exempt from HIRE Act.

EXCEPTIONS FROM WITHHOLDING

- Non-Dividend distributions such as capital gain dividends paid by RICs, REITs and return of capital distributions
- ELIs and Swaps referencing partnership interests unless either 25% or more of the partnership's assets consist of securities or the value of securities held by the partnership exceeds USD25 million.
- Section 305(c) adjustments – that is adjustments to conversion ratios that trigger taxable dividends
- Variable annuities & life policies provided that the pay-out to a non-US annuitant or insured is subject to US withholding tax.
- Merger transactions & compensation arrangements. Merger transactions include dividends paid in connection with the acquisition of 50% or more of the stock of the payer.

IRS Enforcement Standards

- Banks that have made a "good faith effort" to comply with the withholding rules will not be penalized for withholding tax failures.
  - Good faith standard applies to delta one transactions prior to 2021.
  - Good faith standard to non-delta one transactions in 2021.
- Banks that elect to be treated as qualified derivative dealers (QDD) will be excused from withholding tax failures provided that the bank made a "good faith effort to comply with the Code § 871(m) regulations.
- Other QDD failures will likewise be excused if the bank made a good faith effort to comply with the qualified intermediary rules.

Combination Rules

- Transactions will only be combined if economics of the combined transaction would be a section 871(m) transaction if tested as a single transaction
  - ❑Two or more long positions are not aggregated
- Transactions will not be subject to combination if either:
  - ❑Are executed in separate accounts OR
  - ❑Are entered into 2 or more days apart
- If Broker has "actual knowledge" that transactions are structured to avoid rules, transactions must be combined.
- Transactions must be aggregated in the way that results in the greatest number of shares being held in a Section 871(m) transaction.

Special Rules for Combinations Pre-2021

- Financial institutions have had implementation challenges for combined transactions
  - Derivatives not held in accounts
  - Transactions entered into by different business units may not centrally coordinated.
- Special pre-2021 transition rule to allow dealers to develop combination systems:
  - Transactions must be OTC. No requirement to look to exchange-traded positions for determining if transactions must be combined.
  - Transactions must be marketed and sold together for combination to be required.
  - If transactions are combined under this "simplified standard," then disposition of one or more legs will not alleviate withholding on remaining legs.
  - Simplified standard only applies to withholding agents.

The QDD Rules

Qualified Derivative Dealer Rules

- The QDD Regime is the only avenue offered for avoiding cascading withholding taxes when dealers hedge their short exposures under swaps and ELIs. Beginning in 2021, it will be the exclusive regime for security lenders as well.

- QDDs include:
  - Banks and security dealers
  - Entities issuing potential Section 871(m) transactions to customers

- A QDD must provide:
  - A qualified intermediary withholding certificate
  - Assume primary obligation to undertake withholding
  - Remain liable for taxes on dividends & dividend equivalents that are not paid out on Section 871(m) transactions
  - Agree to compliance review procedures

Qualified Derivative Dealer Rules

- Original QDD rules provided that there was no withholding on dividends or dividend equivalents paid to QDDs.

- Revised rules (Notice 2018-72) changes the rules and provides that the QDD is subject to both FATCA withholding and regular (ch. 3) withholding on actual dividends beginning in 2021.

- Example: in 2019, Bank (QDD) issues a structured note referencing 100 shares of a single US stock. The structured note is a complex contract and Bank buys 70 shares of stock as a hedge. Assume that full dividends paid all 70 shares are subject to Code § 871(m) withholding.

- Issuer/custodian will withhold on dividends paid on hedge shares and Bank will also have a withholding obligation on structured product. Only solution will be to hedge with derivatives.

The QDD Tax Liability

- A QDD has a QDD tax liability to the extent that it receives dividends and dividend equivalents in excess of the amount of dividend equivalents that it pays.
- The tax liability is computed on the "Section 871(m) amount."
- If a QDD hedges a qualified index or an ELI with a delta of less than 0.80 by holding the underlying shares, the QDD will have a "Section 871(m) tax liability" (self-assessment) on dividends paid on the hedges.
- 2 Solutions for QIX and low delta transactions:
  - Issue transaction through a US Branch. BUT booking alone is not sufficient for a transaction to be treated as a Branch transaction. US personnel must actively and materially participate in transaction.
  - If non-US issuer is located in a Treaty jurisdiction, Issuer can issue ELI or swap, US Branch can acquire hedge & issue back-to-back transaction with non-US Branch.

The New Net Delta Exposure Test for QDD

- Net Delta Exposure is determined by aggregating the delta of all physical positions & potential section 871(m) transactions with respect to an underlying security.
- If net delta is calculated for non-tax purposes, this figure will "ordinarily" be used.
- Net delta is not mandatory until 2021.

New Withholding Obligations on the Disposition of Partnership and MLP Interests

A Brief History of US Tax on Dispositions of Partnership Interests

- Revenue Ruling 91-32 – IRS rules that gain from dispositions of interests in partnerships conducting a US trade or business should be treated US effectively connected income ("ECI")
- Many practitioners advised clients that Revenue Ruling 91-32 was not a valid interpretation of the law, mainly because Code § 741 treats partnership interests as capital assets.
- Dispute could be framed as to whether a partnership was an entity or an aggregate for purposes of the ECI rules.
- In *Grecian Magnesite*, Tax Court (July 2017), the Tax Court held that Revenue Ruling 91-32 was wrong & gains from the dispositions of partnership interests in partnerships with US trades or businesses was not ECI.
- Congress overruled *Grecian Magnesite* in the Tax Cut and Jobs Act, for dispositions of partnership interests on or after December 27, 2017.

Operation of Code § 864(c)(8)

- Gain or loss on the disposition of an interest in a partnership that conducts a US trade or business is ECI.
- Amount of ECI is determined on a look-thru basis. Non-US person must determine his share of partnership ECI gain and loss if partnership had disposed of all of its assets at fair market value.
- Amount of ECI gain is reduced by the amount taxable under FIRPTA.
- Dispositions include taxable and non-taxable dispositions.
- Code § 1446(f)(1) now requires purchaser to withhold 10% of gross proceeds when seller is a non-US person for dispositions after 2017.
- Seller can provide an affidavit of US status. Hopefully, this means receipt of a Form W-9.
- If the transferee fails to withhold, the partnership is required to reduce distributions to the purchaser by the amount the transferee failed to withhold (plus interest).

IRS has postponed Application Code § 1441(f) to PTPs

- Notice 2018-8 suspends the application of Code § 1446(f) until "regulations or other guidance have been issued."
- The buyer's broker would likely be treated as a withholding agent in the absence of guidance to the contrary
  - Neither buyer nor his broker will have any ability to discern the identity of the seller.
  - Legislative history recognizes that seller's broker may be in the best position to withhold.
- Should distributions in excess of basis (treated as sales) be subject to PTP withholding?
- End of preceding month convention for determining share of PTP liabilities?
- Is a *de minimis* exception warranted?
  - Is *de minimis* to be determined by percentage ownership? Amount sold?
  - Is *de minimis* to be determined by the amount of ECI gain? (Notice 208-29 approach)

Notice 2018-29 addresses Preliminary Issues on non-PTPs

- A certification that the transferee is a US person must be provided under penalties of perjury and include a TIN. A Form W-9, even one already on file, may be used for this purpose.
- Until further guidance is issued, the FIRPTA withholding rules in Code § 1445 must be used for reporting and paying over the tax due.
- Transferor may provide a certification that no gain was recognized in the transfer.
- Transferor may provide a certification, no earlier than 30 days prior to the transfer, that for the 3 immediately preceding years, less than 25% of share of income was ECI. Schedule K-1s must have been issued.
- Partnership may certify that less than 25% of the total gain recognized on the disposition of its assets would be ECI
- Until guidance is issued, no withholding is required on nonrecognition transfers.
- Non-controlling partners may use Schedule K-1 liability shares for most recent year as their share of partnership liabilities.