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# Advanced Swaps & Other Derivatives 2023 Derivatives Taxation

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# Latest Update on Cryptocurrency Tax Reporting

- **2021 US tax legislation required the IRS to promulgate rules for expanded tax reporting for “brokers” who facilitate cryptocurrency transactions in 2023 and after.**
  - **The question as to who constitutes a broker for this purpose has generated considerable Congressional and industry attention**
- **At the end of August 2023, the IRS released 288 pages of proposed regulations. The proposed regulations leverage existing regulations for the reporting of securities transactions.**
- **The proposed regulations are scheduled to become effective in 2025, but certain information must be gathered in 2023.**

# Transactions That Will Be Subject to Information Reporting

- **Dispositions of digital assets will be subject to information reporting:**
  - **Cash**
  - **Digital assets for other digital assets that “differ materially in kind or extent”**
  - **Stored value cards**
  - **Broker services (including gas fees)**
  - **Property that itself is subject to information reporting (securities and real estate)**

# Transactions Exempt From Information Reporting

- **The direct purchase of goods (other than securities & real estate) and services with digital assets will not be subject to information reporting.**
  - **Exempt transactions processed by an intermediary, however, are subject to reporting by the intermediary (called a digital asset middleman).**
- **Cryptocurrency received in airdrops and hard forks will not be subject to reporting.**
- **Loans of cryptocurrencies will not be subject to information reporting.**

# Rules for Cryptocurrency Derivatives

- **Dual reporting will not be required. Derivatives will be reportable either as a security or a cryptocurrency, but not both.**
- **Derivatives will be characterized crypto if the derivative trades on the blockchain.**
- **Derivatives will be characterized as securities if the derivative itself is not blockchain traded.**
- **The asset subject to the derivative will play no part in the characterization of the derivative.**
- **Derivatives physically settled in crypto will be subject to reporting.**

## More on Cryptocurrency Derivatives

- **Trading on private or permissioned ledgers will be subject to reporting.**
- **Trading subject to reporting will include orders filled from dealer inventory as well as open market transactions.**
- **Digital asset reporting will take precedence over reporting for regulated futures contracts.**
- **Digitized financial assets will be subject to digital asset reporting only.**
- **Digitized real estate transactions will be subject to real estate reporting only.**

# Determining When a Person Is a Digital Asset Broker

- **List of Persons treated as brokers include:**
  - **Digital asset platforms**
  - **Payment processors**
  - **Hosted wallet providers**
  - **Cryptocurrency issuers that regularly offer to redeem their coins (such as stablecoin issuers)**
  - **Digital Asset Middlemen**

# Digital Asset Middlemen

- **Digital asset middlemen will include DAOs, whether or not the DAO is formed as an entity or just a collection of governance tokens.**
- **Any person who provides facilitative services that effect sales of digital assets by customers.**
- **Any person who controls payment asset services.**
- **Persons who facilitate the purchase and sale of securities and real estate with digital assets.**



# Exemptions from Digital Asset Broker Status

- **Merchants that accept digital assets as payment for goods and services.**
- **Miners**
- **Stakers**
- **Hardware sales**
- **Software licensing**

# Exemptions for Foreign Transactions

- **Location of transactions is determined with reference to the residence of the broker and customer.**
  - **Office location is irrelevant**
- **Broker must perform the acts necessary to complete the transaction from outside of the US and the instructions to complete the transaction must emanate from outside of the US.**
- **Any indication that the client is a US person will trigger reporting.**

# Polling Question

- **Staking rewards will be subject to US federal income tax reporting after the proposed regulations are finalized and effective:**

**True**

**False**

# Information to Be Reported

- **Name, address and taxpayer identification number of the payer;**
- **The date and time of disposition using Coordinated Universal Time;**
- **Gross proceeds (dollars or fair market value of goods and services, reduced by one-half of transaction costs);**
- **Transaction ID (if any);**
- **Digital asset address;**
- **Consideration received for the cryptocurrency; and**
- **Information regarding the digital wallet from which payment is received or deposited**

# Dividend Equivalent Payment Withholding

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# Some History

- **Code § 871(m) requires US federal income tax withholding on “dividend equivalent payments” made to non-US persons.**
- **Regulations finalized in 2019 expand dividend equivalent payments to a variety of financial instruments**
  - Swaps
  - Structured Products
  - Securities Lending Transactions
- **IRS Notice 2022-37 continued the pattern of deferring withholding on non-delta one financial instruments issued prior to 2025.**

# Overview of the Withholding Rules to Swaps & Equity-Linked Instruments

- **Dividend equivalent payments on Delta One transactions are currently subject to US federal income tax withholding.**
- **Beginning in 2025, swaps with a delta of 0.80 and greater will be subject to withholding on dividend equivalents.**
- **Dividends and dividend equivalent payments to Qualified Derivatives Dealers (“QDDs”) are not subject to withholding through the end of 2024. QDD status in 2025 and thereafter will be a basis for a withholding tax exemption only for dividend equivalents.**
- **Swaps with varying deltas (like structured products) will be subject to withholding under the “substantial equivalence” test.**

# Contracts that Are Affected

- 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
  - ❑ Best of/Worst of Structured Notes, multipliers on either appreciation or depreciation, binary pay-outs



# Delta Is the Key to Withholding Obligation

- 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 security 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 (Delta Does Not Vary)

- 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.

# Copmplex Contracts (Delta Varies over Life)

- **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 would fully hedge its economic exposure (even if not held)**
- **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.**

# Determining the Amount 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 & Exchange-Traded 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  $\geq .080$  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 Indices

- 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.**

# 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.**

# INFORMATION REPORTING OBLIGATIONS

- **If a broker-dealer is not facing another broker-dealer, the broker-dealer is responsible for reporting and withholding.**
- **If a B/D faces another B/D, or neither party is a B/D, the short party is responsible for reporting and withholding.**
- **If the issuer is a B/D and the agent is a B/D, the short party is responsible for reporting and withholding.**
- **The clearing firm is responsible for reporting and withholding on exchange-traded products.**
- **The issuer of a structured note is responsible for reporting and withholding.**

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