SECTION 871(m): WHERE WE ARE, AND WHERE WE ARE GOING

PLI Taxation of Financial Products and Transactions 2024

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Poll: 1. How familiar are you with 871(m)?

Overview of Section 871(m)

- Section 871 imposes a 30% withholding tax on payments of U.S. source dividends.
- Unless Section 871(m) applies, payments on an equity or other derivative (such as an equity swap) are generally not subject to withholding. Swap payments are otherwise sourced to the residence of the payee.
- Congress determined that dividend equivalents with respect to certain derivatives should be taxed in the same manner as actual dividends.
- Section 871(m) generally applies a 30% withholding tax on "dividend equivalent payments," in respect of certain derivatives that reference U.S. stocks.

Overview of Section 871(m)

- The Section 871(m) Regulations provide that the Section 871(m) withholding tax generally applies to long U.S. equity-linked derivative positions that have a “delta” of .8 or greater.
    - As discussed below, for contracts entered into before January 1, 2025, the delta threshold is one.
- Withholding tax applies even if the derivative does not provide for payments of U.S. dividend equivalents.
    - Accordingly, price return swaps, options and structured notes could be subject to the Section 871(m) withholding tax even if they do not provide for a direct pass through of dividends on the underlying stock.
- The withholding tax does not apply to derivatives with respect to a “qualified index.”
- Delta is generally the ratio of the change in the FMV of the contract to a small change in the FMV of the underlying equity.
- Delta is determined when the financial contract is issued.
    - A new delta will need to be computed upon each purchase of a listed option.

Overview of Aggregation Rules

- Transactions entered into "in connection with" one another must be combined to determine whether they satisfy the delta threshold and are thus subject to Section 871(m) withholding.
    - For example, a foreign person could be subject to Section 871(m) if it purchases a call option and it sells a related put option on the same stock with the same strike price, because the combined transactions constitute a delta-one synthetic forward contract.
- Withholding agents may rely on a rebuttable presumption that two transactions are not entered in connection with one another and thus need not be combined if either:
    - The long party holds the transactions in separate accounts or
    - The transactions are entered into more than two business days apart.
- These presumptions are not available if the withholding agent has actual knowledge that the transactions were entered into in connection with one another.

Overview of Qualified Index Rules

- Under the final regulations, a "qualified index" is not treated as an underlying security, and therefore instruments linked to a qualified index are not subject to Section 871(m).
- There are two alternative tests. If an index satisfies at least one of the tests, it is generally treated as a "qualified index."
  - Under both tests, the index must be a "passive index," based on a 'diverse basket of publicly-traded securities,'" that is "widely used by numerous market participants."
- Determination of whether an index is qualified is made on the first business day of the calendar year and applies for the entire year.
  - In the case of a new index, the determination is made on the date that the index is created.
- An index that otherwise constitutes a qualified index will not be a qualified index if a related short position (whether as part of the index or entered into separately) reduces exposure to the component securities in the index by more than 5% of the value of the long positions in the index.
- A transaction that references an ETF that tracks a qualified index is treated as referencing the index for purposes of Section 871(m).

More on Qualified Indices

- Alternative Test 1: An index will constitute a qualified index if:
  - The index references 25 or more component securities;
  - The index references only long securities (subject to a de minimis exception);
  - 5 or fewer "underlying securities" do not represent more than 40% of weighting in index;
  - A single "underlying security" does exceed 15% of weighting of index;
  - The index is modified or rebalanced only according to publicly stated, pre-defined criteria;
  - The index is traded through futures contracts or option contracts on (i) certain national securities exchanges or boards of trade, or (ii) certain foreign exchanges; provided that in the latter case, the referenced component underlying securities (i.e., U.S. equities) constitute less than 50% of the weighted securities in the index; and
  - Component "underlying securities" in the index did not have an aggregate dividend yield in the immediately preceding year that was greater than 1.5 times the dividend yield of S&P 500 index in such year.
- Alternative Test 2: An index will also be qualified if :
  - The referenced component underlying securities (i.e., U.S. equities) in the aggregate comprise 10% or less of the weighting of all components in the index;
  - The index is widely traded; and
  - The index was not formed or availed of with a principal purpose of avoiding U.S. withholding tax.

Section 871(m) Rules for Partnerships

- Section 871(m) imposes withholding on derivatives that reference a partnership interest if the partnership:
    - Is a dealer or trader in securities;
    - Has significant investments in U.S. equities and certain derivatives with respect to U.S. equities (comprising 25% or more of the partnership's assets, or having a value over $25 million);
    - Holds an interest in a lower-tier partnership that engages in either of the above activities.
- Such transactions are treated as referencing the allocable share of U.S. corporate shares that are held by the partnership.
- Many traditional publicly traded partnerships ("PTPs") could be subject to these rules because they may have a significantly large "blocker corporation" that earns income that is "non-qualifying" for PTP purposes.
- If a derivative with respect to a PTP interest or PTP index is subject to Section 871(m), the parties to the derivative likely would not have the information to determine the proper withholding amount.

Section 871(m) Transition Rule

- Under a special transition rule, the following rules are in effect prior to January 1, 2025:
    - A contract that is issued before January 1, 2025 is only subject to Section 871(m) if the contract has a delta of one.
    - Withholding agents are only required to combine OTC contracts that are "priced, marketed or sold" as part of a single transaction.
    - Withholding agents are not required to combine any listed contracts.
        - The simplified combination rules only apply to withholding agents and do not apply to long parties.
            - What if a withholding agent knows that a long party holds listed options that, when combined, create a delta one contract?
    - "Qualified Derivative Dealers" are not subject to withholding under Section 871(a) on actual dividends or Section 871(m) in respect of their dealer positions.

Consequences When Transition Rule Expires

- Absent further changes to the regime, contracts entered into on or after January 1, 2025 would then be subject to Section 871(m) if they have a delta that is .8 or above.
    - This would cause many more contracts to be subject to Section 871(m), and withholding agents and taxpayers would need to develop systems to identify such contracts.
    - This would be the case notwithstanding that many such contracts have an economic profile that significantly differs from the delta-one contracts that Congress presumably had in mind when it enacted Section 871(m).
- Withholding agents and taxpayers would need to determine the delta of a listed option when it is acquired by a non-US investor.
    - The clearing broker that is the withholding agent generally has limited specific information regarding the execution of the option.
- Many more contracts would be subject to the combination rule.
- Withholding agents would need to combine contracts for withholding tax purposes, including listed options, even if they are not "priced, marketed or sold" together with another contract.
- Withholding agents will often not have the information to determine whether contracts should be combined.
    - This is particularly true in the case of customers that actively trade multiple contracts within the two day presumption period referenced above.

Section 871(m) Anti-Abuse Rule

- The Section 871(m) regulations provide for an anti-abuse rule under which Section 871(m) could apply to a transaction that would otherwise not be subject to Section 871(m) if the transaction has "a principal purpose" of avoiding the application of Section 871(m).
    - Note that the test is "a principal purpose" rather than "the principal purpose."
    - The anti-abuse rule only applies "to the extent necessary to prevent avoidance of" Section 871(m).
- A withholding agent will only be liable for Section 871(m) withholding under the anti-abuse rule if:
    - the withholding agent knows that the taxpayer acquired or disposed of a transaction with a principal purpose of avoiding Section 871(m).

Section 871(m) Anti-Abuse Rule

- Could the anti-abuse rule apply in the following cases?
- A foreign investor that normally invests in delta-one contracts decides to invest in a non-delta-one contract (which could possibly be a listed high delta call option) so that the contract is not subject to Section 871(m) withholding.
  - The IRS has stated that the anti-abuse rule applies for purposes of determining whether a contract has a delta of one.
    - If the .8 delta test applies on January 1, 2025, could the anti-abuse rule apply to a contract with a delta of .79?
- A taxpayer that holds a delta-one swap with respect to a US equity terminates the swap shortly before the ex-dividend date, and then enters into a new swap after the ex-dividend date.
  - Would the result depend on the length of the period between the termination of the first swap and the inception of the second swap?
  - What if the taxpayer acquires a derivative with a delta of .9 between the two swap dates?

Qualified Index -- ETFs

- The Section 871(m) Regulations provide that a contract that references an ETF (such as a delta-one swap over an ETF) that "tracks" the performance of a qualified index will be treated as referencing the qualified index.
- How closely do the ETF and the index need to correlate in order to conclude that the ETF tracks the index?
    - Many index ETFs provide that the ETF will not invest in every component of the index.
    - What if the ETF also holds some cash?
    - What if the ETF holds a leveraged or short position in a qualified index?
- An ETF that invests in a bond or commodities index may qualify as a qualified index under the second qualified index test because the index does not include equities.
- How does the "widely traded" test apply in the case of an ETF that invests in an index? Is it sufficient that the ETF is widely traded even if the index is itself not otherwise widely traded?
- What about the requirement under the first qualified index that there are options or futures that are traded on the index? Is it sufficient if there are options or futures on the ETF even if there are no options or futures on the index itself?

Qualified Index – Related Short Positions

- An index will not constitute a qualified index with respect to a particular contract (even if the index otherwise satisfies the requirements set forth above) if the investor holds a short position with respect to more than 5% of the components of the index (but not all of the index components) and it holds the short position "in connection with" its position under the contract:
  - When should two positions be treated as held "in connection with" each other?
  - This rule does not include the "two day" and "same account" presumptions that withholding agents may apply for purposes of determining whether two positions are related to each other for purposes of the combination rule.
  - Unlike the combination rule, there is no rule that would limit a withholding agent's obligation to apply this rule prior to January 1, 2025, to cases in which the contract and short position are priced, marketed, or sold in connection with each other.
- How should a withholding agent determine whether a long party has entered into a short position with respect to more than 5% of an index?
  - Can a withholding agent assume that the long party has not entered into such a transaction if it has no knowledge to the contrary? Can a withholding agent rely on a representation?
  - What if the withholding agent is an intermediary (e.g., DTC or Euroclear) that has no knowledge of the foreign investor's other positions? Does it have to conduct any diligence?

Qualified Index – Trading Requirement

- As noted above, under the first qualified index test, an index will generally only constitute a qualified index if options or futures on the index are "traded" on certain exchanges or boards of trade.
- Does the requirement that there be traded futures or options require a minimum level of trading? Does "traded" mean available for trading? Is listing for trading sufficient?
    - The Code and Regulations often use the term "regularly traded" to require a minimum level of trading.
- The preamble to the Regulations, in discussing this requirement, states that futures or options must be listed for trading, thereby implying that the "traded" requirement only requires that futures or options be available for trading without requiring a minimum level of trading activity.
- The index would in any case have to be "widely used", but that requirement could arguably be satisfied if there are ETFs that invest in the index, or if there is an active swap market with respect to the index.

Qualified Index Rules -- Netting

- Many contracts (such as outperformance swaps and certain structured notes) provide for a long position with respect to one index or basket and a short position with respect to a second index or basket.
- **Example 1**. Assume that a contract references a long position on Index A that includes Stock A and a short position on Index B that also includes Stock A. Assume that neither index is a qualified index. Can the taxpayer net the long and short positions so that Section 871(m) would only apply to any net long position in Stock A?
- **Example 2**. Assume same as example 1, except that Index A is not a qualified index and Index B is a qualified index. Would the answer be different?
- **Example 3**. Assume same example 1, except that each of Index A and Index B is a qualified index. Assume further that Stock A represents 6% of each of Index A and Index B, and the notional of Index A and Index B under the contract are the same. Would Index A then fail to qualify as a qualified index under the 5% short rule referenced above?

Qualified Index—PTP Indices

- An index will generally constitute a qualified index under the second test if “underlying securities” (the numerator) represent 10% or less (by weighting) of the "component securities" (the denominator) in the index.
- The term “underlying securities” generally refers to “C” corporation stock, which in the case of a covered partnership would include “C” corporation stock that is held by a partnership.
  - The “C” corporation stock that is held by a covered partnership would presumably be included in the numerator for purposes of applying this test.
- The term “component securities” is not defined in the Regulations.
  - If PTP units are not treated as “component securities” for this purpose, then a PTP index could not be a qualified index because the PTP units in the index would not be included in the denominator.
  - By contrast, if PTP units are treated as “component securities” for this purpose, then the value of PTP units could be included in the denominator.
- PTP units are treated as securities for purposes of Section 475 of the Code and for other tax purposes.
  - The Section 475 definition of “securities” is explicitly incorporated into the Section 871(m) definition of “covered partnership”.

Miscellaneous Qualified Index Issues

- What if a contract references a currency adjusted version of a qualified index if the currency adjusted version does not itself satisfy the requirements to be a qualified index?
    - For example, there are indices that are currency adjusted versions of the S&P 500 index that do not independently qualify as a qualified index.
- What if a contract references an index that does not itself satisfy the requirements to be a qualified index but the index includes a qualified index or an investment formula that is the same as a qualified index?
- As noted above, if an index is formed in the middle of a taxable year, then the index will only be a qualified index if it satisfies the relevant requirements on the date that it is created.
    - Does that mean that the index needs to already be widely used by numerous market participants on day one? Under the first test, would there need to be traded futures and options on day one?
        - If so, it would be difficult for a new index to constitute a qualified index in the year that it is created.

Structured Notes – Inventory and Market Making

- Many issuers or their affiliates act as market makers for their structured notes.
- If the issuer of a structured note acquires its own note in its dealer capacity and then resells the note in the secondary market, the sale could be treated as a deemed reissuance for tax purposes.
    - In such a case, an investor that acquires a non-delta one structured note on or after January 1, 2025 could be subject to Section 871(m) even though the note was originally issued before January 1, 2025 (assuming the transition rule is not extended).
    - Notes with the same CUSIP and ISIN number may then not be fungible with each other, depending on whether they were issued in the original issuance or in the deemed reissuance from the dealer's inventory.
- The Section 108 regulations provide for some relief for COD purposes in the case of an issuer of debt that acquires the debt in a dealer capacity and then sells the note in the secondary market.
    - The preamble to the revised Regulations states that the principles of the Section 108 regulations will not apply for Section 871(m) purposes.

Structured Notes – Inventory and Market Making

- Some issuers issue notes to a non-consolidated affiliate that holds the notes in inventory until sold to investors.
  - The affiliate often also acts as a market maker for the notes and sells and acquires the notes in the secondary market.
- If the affiliate hedges its position under the notes with the issuer so that the cash flows under the notes and the hedge offset each other, then the notes may not be treated as outstanding for tax purposes.
- If notes held by the affiliate are not outstanding for tax purposes, then there would be no Section 871(m) tax when the notes are held by the affiliate, but there would be a deemed new issuance (and a potential fungibility issue) when the affiliate sells the notes in the secondary market.
- If notes held by the affiliate are outstanding for tax purposes, then there would be no new Section 871(m) testing when the affiliate sells notes in secondary market, but there would be Section 871(m) withholding when the notes are held by the affiliate if the affiliate is foreign corporation.