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White Paper

An In-Depth Look at the 2013 IRS Final and Proposed Regulations on Cross-Border Dividend Equivalents Paid on Swaps and in Security Lending Transactions

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An In-Depth Look at the 2013 IRS Final and Proposed Regulations on Cross-Border Dividend Equivalents Paid on Swaps and in Security Lending Transactions

The waiting for the final regulations addressing when US federal income tax withholding would be imposed on dividend equivalent payments made to non-US persons under notional principal contracts ("NPCs" or "swaps") and in security lending transactions bore a strong similarity to the plight of nine-year-old Ralphie in Jean Shepherd's "A Christmas Story." Ralphie suspects that his parents have gotten him a Red Ryder BB gun as a Christmas present, but until Christmas morning arrives, he doesn't know for sure. The anticipation, brilliantly portrayed in both the book[1] and the movie, is palpable. It's fair to say that participants in the swap and securities lending markets exhibited at least the same degree of eagerness for final regulations under Section 871(m) of the Internal Revenue Code of 1986, as amended (the "Code") as Ralphie did for his BB gun. Well, unlike Ralphie, we got our present early this year. On December 4, 2013, final regulations were issued for dividend equivalents paid prior to 2016 and regulations have been proposed for dividend equivalents paid after such date.

I. The Briefest of Backgrounds

In 1991, the IRS promulgated a regulation providing that income from a swap is sourced to the residence of the payee.[2] This rule created the potential for a discontinuity with respect to equity swaps and total return swaps, on the one hand, and actual stock ownership, on the other. Specifically, if a non-US person[3] held a stock directly, unless an income tax treaty provided for a total exemption from US federal income tax, any dividends paid on a US stock would be treated as US-source income and subject to either 15% (most tax treaties) or 30% US federal income tax withholding.[4] In contrast, a dividend equivalent payment[5] made to a non-US person under a swap in respect of a dividend paid on a US stock included in the specified index[6] would be treated as non-US-source income and not be subject to US federal income tax withholding. Congress became dissatisfied with these results.[7] The IRS perceived that banks and non-US taxpayers abused this

disparity through a variety of transactions and initiated an audit campaign to curtail these perceived abuses.[8]

In March 2010, Congress addressed the perceived abuse through the passage of the HIRE Act.[9] Specifically, Section 541 of the HIRE Act enacted Code § 871(m). Code § 871(m)(1) provides that a dividend equivalent "shall be treated as a dividend from sources within the United States." For the period from the effective date of the HIRE Act, dividend equivalents paid or credited on certain swaps and in securities lending transactions could be subject to withholding.[10] Accordingly, Code § 871(m) reverses the rule contained in the 1989 Treasury Regulation for dividend equivalents on certain swaps. As a result, certain dividend equivalents are subject to the same US federal income tax withholding that an actual dividend would be subject to. Indeed, Temporary Regulations amended the 1991 regulation to specifically state that it no longer applied to dividend equivalents and these regulations has now been finalized.[11]

In January 2012, the IRS released three sets of rules. First, a set of rules was provided for payments on swaps made or credited on or after January 23, 2012 and before January 1, 2013.[12] These rules generally followed the rules that had been in effect since 2010. Second, a set of new rules for dividend equivalents were proposed to be effective after final regulations are published.[13] Third, rules were proposed to expand the categories of swaps affected by the dividend equivalent withholding rules (referred to as "specified notional principal contracts" or "specified NPCs") beginning in 2013.[14] The proposed regulations were pulled by the IRS in August 2012[15] and practitioners have been waiting for revised guidance since that time.

II. The 2013 Final Regulations

The 2013 Regulations provide final regulations for dividend equivalents paid before 2016 and address certain technical comments raised by practitioners. First, they provide that the four categories of statute-specified swaps that can give rise to dividend equivalents remain the sole types of equity derivative transactions (apart from securities loans) that can give rise to US-source dividend equivalents. Second, they make payers of dividend equivalents absolutely liable for the correct amount of withholding even if the portion of a distribution that constitutes a dividend cannot be determined at the time that the dividend equivalent is paid.

A. THE EXISTING CATEGORIES OF TRANSACTIONS THAT CAN GIVE RISE TO US-SOURCE DIVIDEND EQUIVALENTS REMAIN UNCHANGED FOR PAYMENTS BEFORE JANUARY 1, 2016

In Code § 871(m)(3)(B), Congress provided the IRS with the right to revise the statutory rules for the withholding of US federal income tax on derivatives referencing US stocks for payments made after March 18, 2012. The applicable tax rules also provide the IRS with the right to extend the withholding rules for dividend equivalents from swaps to financial contracts other than swaps.[16] The legislative history accompanying the enactment of the statute provided, "under this rule, for example, the [IRS] may conclude that payments made under certain forward contracts...that reference stock of US corporation are dividend equivalents."[17] In the new regulation package, the IRS chose not to exercise grants of authority for payments made prior to January 1, 2016.

Specifically, in new final Treasury Regulation § 1.871-15(d), the IRS spells out that only four types of swap transactions can give rise to dividend equivalents when paid or credited to the account of a non-US person prior to January 1, 2016:

1. The non-US person, in connection with entering into the swap, transfers the underlying security to the short party.

2. The short party, in connection with closing or terminating the swap, transfers the underlying security to the non-US person.

3. The underlying security is not readily tradable on an established securities exchange.

4. In connection with the opening of the swap, the short party posted the underlying security to the non-US person.

These four transactions, known as "specified notional principal contracts," dovetail with the four Congressional-specified transactions that give rise to dividend equivalents subject to withholding when paid or credited to a non-US person for periods prior to March 18, 2012.[18]

B. OTHER TECHNICAL ASPECTS OF THE FINAL DIVIDEND EQUIVALENT REGULATIONS

The final 2013 dividend equivalent regulations make a number of technical changes and clarifications. First, the regulations regarding the impact of tax treaties on the amount to be withheld have been amended to specifically provide

that dividend equivalents are eligible for a reduced rate of withholding in those cases in which a tax treaty provides for a lower withholding rate on actual dividends.[19] Second, foreign sovereign entities who can receive dividends exempt from US withholding tax may receive dividend equivalents free from US withholding tax.[20]

Code § 871(m)(5) provides that the word "payment" as used in Code § 871(m) includes any gross amount used to compute any net amount payable to or by a taxpayer. This rule ensures that a dividend equivalent subsumed in another payment retains its character as a US-source income item, potentially subject to withholding. For example, assume that in a single stock equity swap over a US stock, the bank counterparty ("ShortCo") has an obligation to make dividend equivalents payments to a non-US person ("LongCo"). LongCo has an obligation to make so-called funding payments to ShortCo. The funding payments equal the product of the value of the stock included in the specified index and an objective interest rate index. On a payment date, ShortCo's obligation to make a dividend equivalent payment to LongCo is $500 and LongCo's obligation to make a funding payment to ShortCo is also $500. As a result, no money passes hands between the counterparties. On these facts, ShortCo is considered to have made a $500 dividend equivalent payment to LongCo. The final withholding regulations specifically impose a withholding requirement on ShortCo in this situation.[21]

The preamble to the final regulations makes clear that any person that is treated as a withholding agent (including custodians and financial intermediaries) can be treated as withholding agents on dividend equivalents. Interestingly, the same issue arose under the Foreign Account Tax Compliance Act ("FATCA") and the IRS ultimately limited withholding responsibility to only those persons who had knowledge that the payment was a withholdable payment. The initial IRS proposed FATCA regulations provided that "when multiple withholding agents that are brokers are involved in effecting a sale, each broker must determine whether it is required to withhold on its payment of gross proceeds by reference to the chapter 4 [FATCA] status of its payee."[22] This language was interpreted by the banking community as imposing FATCA withholding responsibility both on executing brokers and Clearing Organizations.[23]

In January 2013, the IRS released final FATCA regulations that superseded and replaced the proposed regulations.[24] The final regulations deleted what had been Proposed Treasury Regulation § 1.1471-2(a)(2)(v). Instead, a regulation with the same title ("Payments of gross proceeds") was left as a placeholder and was

reserved.[25] While the rule that provided for cascading broker responsibility was deleted, the final regulation addressing when a person acting as an agent is a FATCA withholding agent was expanded. Under the expanded FATCA agency rule, a person treated as a withholding agent has an obligation to withhold only to the extent that "it has control over or custody of money or property owned by the payee or beneficial owner from to which to withhold an amount and has knowledge of the facts that give rise to the payments."[26] Unfortunately, the final dividend equivalent payment rules do not contain a similar standard.

It is often unclear as to whether an extraordinary distribution made with respect to stock will be fully taxable as a dividend or whether some portion of the distribution will exceed earnings and profits and be taxable as a return of capital.[27] Commentators had requested that payers be able to use an issuer's estimate of the taxable portion of the distribution in determining their withholding responsibility. The IRS refused this request. As a result, it is likely that payers of dividend equivalents will withhold against the full amount of a dividend equivalent even if issuer has indicated that the full amount may not be taxable.

C. ANTI-ABUSE ENFORCEMENT

The preamble to the final regulations specifically states that the IRS will continue to pursue ("scrutinize") transactions that skirt the literal dividend equivalent withholding rules but present abusive circumstances. While not specifically mentioned, the directive is likely a reference to the IRS Large Scale and Midsize Business ("LMSB") "Industry Directive on Total Return Swaps ('TRSs') Used to Avoid Dividend Withholding Tax" (the "Swap Audit Guidelines").[28] The Swap Audit Guidelines assist IRS agents in "uncovering and developing cases related to [total return swap] TRS transactions that may have been executed in order to avoid tax with respect to US source dividend income" paid to non-US persons. The Swap Audit Guidelines then posit four different transaction structures involving equity swaps. If an IRS agent uncovers one of these fact patterns, he is encouraged to "develop facts supporting a legal conclusion that the Foreign Person retained ownership of the reference securities." Auditors are also advised to look for elements of the facts described in each of the fact patterns. In this way, the IRS can attack transactions that don't neatly fit into the transactions that it has identified.

III. The Proposed Regulations for Dividend Equivalents Paid on or After January 1, 2016

The proposed regulations treating amounts as dividend equivalents extend far beyond equity swaps. Specifically, the regulations impose US federal income tax on dividend equivalents found in financial instruments now classified as "specified equity-linked instruments" ("specified ELIs"). ELIs include financial products (other than NPCs and sale-repurchase transactions) "that reference one or more underlying securities."[29] An "underlying security" is "any interest in an entity taxable as a C Corporation if a payment with respect to that interest could give rise to a US source dividend."[30] The proposed regulations do not carve out exchange-traded instruments and, as a result, futures and exchange-traded options are encompassed by definition of ELIs. As more fully described below, an ELI will be a specified ELI if the correlation between the ELI and the underlying security equals or exceeds 0.70 at the time that the ELI is acquired by the non-US person.[31]

A. EFFECTIVE DATES

The new rules described below are effective beginning in 2016. At the outset, it is worth noting that the proposed rules described below do not "grandfather" swaps or other affected transactions entered into before January 1, 2016. The proposed rules are scheduled to apply to swaps and other transaction payments made after such date. Accordingly, if a swap is executed prior to January 1, 2016 but is outstanding on such date, payments made under the swap after January 1, 2016 are proposed to be subject to withholding if encompassed by the proposed rules and the swap or other transaction will not be grandfathered. In contrast to the 2012 proposed regulations, however, payments made prior to the effective date of the new rules cannot be recharacterized as dividend equivalents subject to withholding.

Special effective date rules apply to specified ELIs. Specifically, withholding is required with respect to specified ELIs issued before March 5, 2014 only if it is acquired by a non-US person after such date.[32] For example, assume that a financial institution issues a 7-year forward contract over a US stock prior to March 5, 2014 to a non-US person and the forward contract has a delta (described below) of .070 or greater. Notwithstanding the general effective date of the proposed regulations for payments made in 2016 and thereafter, no US federal income tax is imposed on the non-US holder with respect to dividend

equivalent payments made in 2016 and thereafter. If, however, the original holder transfers the specified ELI to another non-US holder after March 5, 2015 withholding will be required with respect to dividend equivalent payments made in 2016 and thereafter. The specified ELI will have grandfathered status only in the hands of the original holder.

B. THE IMPORTANCE OF DELTA

The proposed regulations discard the seven filters that had been proposed under the 2012 proposed regulations and replace those filters with a single standard using the delta of the transaction. Specifically, a payment made on a swap or an ELI that has a "delta of 0.70 or greater"[33] with respect to a US stock at the time that the long party acquires the swap or ELI[34] is treated as a dividend equivalent subject to withholding when the payment is made to a non-US person not connected with the conduct of a US trade or business.[35] Delta is defined as the relationship of the change in fair market value of the swap or ELI to the change in the fair market value of referenced security.[36] For example, if a $.01 change in the value of the referenced stock results in a $.01 change in the value of the swap or ELI, the swap or ELI has a delta of 1.0. If the swap or ELI references more than one stock, the transaction is disaggregated and delta is determined with reference to each underlying security.[37] If delta is determined for non-tax purposes, that delta must be used to determine whether the 0.70 delta standard is met.

A swap or an ELI that has a constant delta with respect to an underlying security is treated as having a delta of 1.0. If a constant delta transaction has a delta of less than 1.0, the number of underlying shares is adjusted so that the transaction has an underlying delta of 1.0 with respect to a specified number of shares. This retesting (and overlap standard) is substantially similar to the retesting (and overlap standard) required by the substantial overlap rule for determining if a position in a basket of stocks reduces the dividend-received deduction with respect to a specific long stock holding.[38] This rule is illustrated by a swap that provides for 50% of the appreciation and dividends to be paid on 100 shares of US stock (which would be a delta of 0.50). The example concludes that the swap has a delta of 1.0 with respect to 50 shares of the stock.[39]

The fact that delta is tested when the non-US person acquires an interest in an ELI can result in disparate treatment of the same financial product. This is likely to be especially challenging for exchange-traded products with the same CUSIP (Committee on Uniform Security Identification Procedures Identification

Number). For example, a LEAP call option, that is, a long-dated exchange traded option, may have an initial delta of less than 0.70. If the value of the reference security increases, however, the long LEAP position could easily have a delta of 0.70 or greater. If a non-US person acquires the LEAP after the value of the underlying security has increased sufficiently to cause the LEAP to have a delta of 0.70 or greater when the issuer of the referenced security declared and paid a dividend, a non-US holder would incur a US tax liability that must be enforced through withholding. In contrast, no dividend equivalent would be considered to have been paid to a non-US person on the same dividend who acquired the LEAP at a time when its delta was less than 0.70.

If the delta of a section 871(m) transaction falls after the acquisition of the instrument by a non-US holder, the instrument continues to be treated as a section 871(m) transaction even if the delta falls below 0.70. While such an occurrence is unlikely for most ELIs, it is certainly a possibility for options such as LEAPs. Accordingly, a close-out of a derivative position with a low delta could have withholding tax implications for non-US persons even if the delta has fallen below the 0.70 threshold.

C. THE AMOUNT OF THE DIVIDEND EQUIVALENT

The proposed regulations treat the full amount of the dividend paid on the underlying shares as a dividend equivalent in sale-repurchase transactions and securities lending transactions.[40] In specified NPCs and ELIs, however, the amount of the dividend equivalent is adjusted for the delta of the transaction.[41] For example, if an ELI transaction has a delta of 0.80 (greater than the 0.70 threshold), the amount of the dividend equivalent would be the full dividend paid on underlying stock, multiplied by 80%. If the delta remains constant over the life of the transaction, then the initial delta would be used. If the delta changes over the life of the transaction, however, the delta applicable to the time that the dividend equivalent entitlement is determined is used.[42] If the transaction has a term of one year or less, however, the delta at the termination of the transaction is applied.[43]

D. CERTAIN AFFECTED TRANSACTIONS

The proposed regulations would impose withholding on dividend equivalents on a wide range of instruments, included equity-linked debt, futures contracts and

potentially on option transactions as well. Option and other transactions are proposed to be subject to withholding even if such positions are exchange-traded.

1. *Price Return Swaps*

A price return swap is a swap in which one party (the short party) pays any price appreciation in the referenced equities to the other and the other party (the long party) pays any price depreciation to the short party. The short party is not required to make any payments that are determined with reference to dividends paid on the reference stocks. Facially, a price return swap does not appear to provide for any dividend equivalent payments that could be subject to US federal income tax under Code § 871(m). Nonetheless, the proposed regulations would treat price return swaps as generating dividend equivalents "because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC."[44] In an example included in the proposed regulations, the long party is presumed to enjoy an obligation to make lower funding payments because the short party is not making dividend-equivalent payments to the long party. The example concludes that the lower funding payments include an "implicit dividend."[45]

2. *Equity-Linked Indebtedness*

If a debt instrument bears interest that is linked to the dividends paid on one or more US stocks, such debt instrument could be used as a host instrument to avoid the application of the withholding rules on dividend equivalents. Accordingly, the proposed regulations deny portfolio interest treatment to any yield payment that is a dividend equivalent.[46] The preamble to the proposed regulations suggests that a debt instrument would not be treated as paying dividend equivalent interest if it had a delta of less than 0.70. The cross-references between the proposed regulation denying portfolio interest treatment for equity-linked indebtedness and the rules defining a dividend equivalent, however, do not incorporate this limitation.[47] Hopefully, this ambiguity will be cleared up before the proposed regulations are finalized.

The more interesting question, assuming that the delta of the host debt instrument must equal or exceed 0.70 before portfolio interest status is denied to the equity-linked payment, is how the delta should be determined. One method would be to test whether the equity-linked debt instrument itself has a delta of 0.70 or greater. A second method, however, would be to require testing of the embedded derivative apart from the host debt instrument. Use of the second

method makes it more likely that the required correlation of 0.70 or greater will be met. For example, assume that a debt instrument provides for annual interest payments of 2% plus a payment at maturity of $100 plus or minus the total return (dividends plus price changes) of a share of US stock from the time of issuance of the debt instrument until its maturity. Such an instrument could easily have a delta of less than 0.70, especially if the initial price of the stock is low in relation to the principal amount of the debt instrument. If the embedded forward contract were stripped out of the host instrument and tested on a stand-alone basis, however, it is likely that the forward contract would have a delta approaching 1.0. Conversations with the drafters of the regulations support the conclusion that disaggregated testing is the favored approach. More significant guidance on the application of this rule would be helpful.

The same challenge noted above in the *Delta* discussion regarding disparate treatment of the same financial product can occur with respect to equity-linked debt instruments. For example, assume that the debt instrument provides for a contingent payment at maturity determined with reference to the positive performance of a dividend-paying US stock. At issuance, the embedded call option has a delta of 0.50. After some time, the referenced US stock appreciates and the delta of the embedded call option increases to 0.70 or greater. On the facts, after the issuer of the referenced debt instrument declared and paid a dividend, a non-US holder who acquired the debt instrument after the delta increased would be subject to US tax and withholding on the non-portfolio interest yield. On the other hand, a non-US holder who acquired the debt instrument before the delta increased to 0.70 or above would be eligible to treat the yield attributable to the appreciation of the reference stock as portfolio interest.

Brokers holding equity-linked debt instruments on behalf of non-US persons could face significant challenges in determining the amount to withhold on payments made on such instruments and proceeds from the sale of such instruments. The equity-linked feature of a debt instrument is likely to cause that debt instrument to bear original issue discount ("OID").[48] Special rules apply to imposition of tax and withholding on OID instruments held by a non-US person.[49] Under these special rules, US tax is imposed and withholding is required when a non-US holder sells the debt instrument. If a withholding agent cannot determine the taxable amount of OID, it is required to "withhold on the entire amount of original issue discount accrued from the date of issue until the...the date the obligation is sold or exchanged."[50] Thus, withholding agents

will be required to be able to determine the delta of equity-linked debt instruments when non-US holders acquire these instruments and could be required to withhold from gross proceeds when they sold.

3. Option Transactions

At-the-money long option transactions, on a stand alone basis, should not have a delta of 0.70 or greater because an at-the-money long option position does not provide downside risk (purchased call option) or upside potential (sold put option) in excess of the option premium. When such put and call options are acquired as a package, however, they replicate a forward contract over the referenced stock and can have a delta as high as 1.0. The proposed regulations aggregate two or more transactions, even if not entered into together or with the same counterparty, when the multiple transactions (i) are entered into by the same or related persons, (ii) reference the same stock, and (iii) are entered into "in connection with each other."[51] If the aggregated transactions have a delta in excess of 0.70, the combined transactions and dividend equivalents paid or credited in connection with the transaction will be subject to US federal income tax.[52]

In general, exchange-traded options do not provide for dividend equivalent payments. Such options do, however, often provide for adjustments to the strike prices for extraordinary dividends. (If a stock has not previously paid a dividend, frequently, any dividend in excess of zero is within the definition of an extraordinary dividend.) Thus, the adjustments to the strike prices of the options to reflect the dividend would be subject to withholding. A withholding agent is relieved of the obligation to withhold on combined transactions, provided that it "did not know that the long party (or a related person) entered into the potential section 871(m) transaction in connection with any other potential section 871(m) transactions."[53]

It is worth noting that in-the-money option transactions can have deltas in excess of 0.70. If a non-US person buys an outstanding exchange-traded option, such as a LEAPS option, that is in-the-money, it is possible that the broker holding such option for a non-US person will become a withholding agent if there is an adjustment to the strike price of the option (or as described below, even if there isn't an adjustment) as a result of a dividend because whether the option would be treated as a specified ELI must be tested "at the time that the long party acquires the ELI"[54], not at the time that the option is issued. Accordingly, brokers

will be required to undertake delta testing when non-US persons buy outstanding options.

4. Single Stock Futures

Certain single stock futures contracts provide for an adjustment to the futures price that is based upon an anticipated dividend but is not trued up for any difference between such assumed dividend and the actual dividend. Under the prior proposed regulations, provided that the futures contract was not entered into after such dividend had been announced, the price adjustment for the anticipated dividend would not have been treated as a dividend equivalent potentially subject to withholding. The new proposed regulations reverse this rule.

Under the proposed regulations, a payment based upon an estimated dividend or any contractual term that is based upon an actual or estimated dividend is treated as the payment of a dividend equivalent.[55] Accordingly, given the facts that (i) exchange-traded instruments are not carved out of the rules for the payments of dividend equivalents (indeed, such instruments are explicitly included) and (ii) there is no exception for anticipated dividends, it appears that all single-stock futures contracts over US equities that span a dividend record date after 2015 could have withholding tax implications for non-US persons who do not hold such contracts in connection with the conduct of a US trade or business. The fact that no dividend passes under the contract (the futures prices are adjusted for the dividend) does not provide a basis for avoiding the finding of a dividend equivalent. Neither does the fact that there is no counterparty and the contract is exchange-traded provide a basis for not finding the payment of a dividend equivalent.

E. THE COMBINATION (INTEGRATION) RULE

As noted above, the Proposed Regulations contain what is, essentially, an anti-abuse rule that treats two or more potential section 871(m) transactions as a "section 871 transaction" if (i) they are entered into by the same (or related) persons, (ii) they reference the same US stock, (iii) the taxpayer is the long party on each potential section 871(m) transaction, and (iv) they are entered into in connection with each other.[56] It appears that the drafters of the proposed regulations were thinking about "put-call combos," a frequently encountered set of option transactions.[57] In a typical put-call combo, a taxpayer will purchase a call option enabling it to purchase a stock at its current trading price.

Simultaneously, the taxpayer will sell a put option allowing the counterparty to sell the stock to the taxpayer at the same price. For purposes of illustration, we'll assume that both options are European style; that is, they are exercisable at a single date in the future and the expiration date of both options is the same.

The put-call combo described in the preceding paragraph operates as a synthetic (fixed price) forward contract. If the value of the referenced stock rises, the taxpayer will capture that full benefit because the closing value of the call option will be equal to the then fair market value of the stock over the call option strike price. The put option should expire worthless. Conversely, if the referenced stock has fallen in value, the taxpayer will suffer the full diminution in value because the counterparty will exercise the put option and the call option will expire worthless. Since this typical put-call combo exposes the taxpayer to the full price performance on the stock, the combo likely has a delta approaching (if not equal to) 1.0. As a result, the embedded dividend equivalent within the options would be subject to withholding under the proposed regulations. This treatment poses myriad challenges.

If we assume that any dividend on the referenced stock is an "extraordinary dividend" that requires an adjustment to the strike price of the options, when the dividend is paid the strike prices of the put and call options will be decreased by the amount of the dividend. Proposed Treasury Regulation § 1.1441-2(d)(5) addresses the timing of the withholding. Under this regulation, withholding is required at the later of the date on which the dividend equivalent is determined or the time that the withholding agent is deemed to have control over money or other property of the taxpayer. If the term of the options is more than one year, the dividend equivalent is determined at the time that the underlying security becomes ex-dividend.[58] If the term of the options is one year or less, the dividend equivalent is determined at the time that the transactions are terminated.[59] Assuming that the taxpayer has a margin deposit on account with the exchange or put-call combo counterparty, the counterparty would be considered to have control over money or other property of the taxpayer at the same time.[60]

One significant challenge is the scope of the combination rule. Suppose the taxpayer acquires two calls over 100 shares of US stock and sells a single put option over 100 shares of US stock, all on the same date. Assume that all options are European-style, have the same strike price and the delta of the call options is 0.50 and the delta of the put option is 0.45. On a stand alone basis, each of the options is a "potential section 871(m) transaction."[61] If the three options were

combined, the dividend equivalent amount should be determined based upon 200 shares of the US stock because the effect of the double long position on the combined transaction is that of a 2x multiplier on the number of shares.[62] On the other hand, it seems to make more sense to combine one call with the put option to find a synthetic forward contract with a delta of .95 over 100 shares, but a conservative reading of the regulations does not seem to support this answer.

The scope of the combination rule is further muddied if the positions are not acquired on the same date. If we use the same example as in the prior paragraph but assume that one call option is acquired on the day following the acquisition of the other call option and the writing of the put option, arguably the contrary result occurs. The combination rule requires combination of two or more "potential section 871 transactions."[63] When the taxpayer acquired the initial call option and wrote the put option, these transactions should have been combined under the combination rules. When the second call option is acquired on the next day, at that point the taxpayer should be considered have a "section 871(m) transaction," specifically, a "specified ELI," and a "potential 871(m) transaction."[64] The combination rule does not require a combination of an [actual] section 871(m) transaction with a potential section 871(m) transaction. (Further inquiry into whether the second call option should be considered to have been acquired "in connection with" the original positions.) A related rule, however, requires testing each time a taxpayer acquires a potential section 871(m) transaction.[65] It is possible that the IRS could interpret these rules to disaggregate previously combined potential section 871(m) transactions each time a new potential section 871(m) transaction is acquired and retested. In that case, the recombined instrument would be providing dividend equivalents on 200 shares of US stock.

The difficulty of applying the combination rule is further illustrated if a leg of a combined transaction is terminated. Using the facts in the preceding paragraph, suppose that the initially purchased call option is sold after two months, leaving the taxpayer with the put option written on the first day and the call option purchased on the second day. Assume further that the correct analysis is that the call option acquired after the initial option pair were acquired is not combined with the original synthetic forward transaction. If this is right, even though the positions held by the taxpayer together have a delta greater than 0.70, the taxpayer could reasonably take the position that the two remaining options should not be combined. A taxpayer is required to retest potential section 871(m) transactions when it acquires a position.[66] The disposition of the originally

purchased call option is not an acquisition. The IRS could take the position that when the synthetic forward is broken by the disposition of the originally purchased call option the taxpayer should be considered to have "acquired" the put option. In addition, it is not clear the put option was acquired "in connection with" the second call option. This position, however, seems beyond the scope of the regulations as written.

Trades that increase exposure to a US stock position further test the limits of the combination rule. Suppose that a non-US person acquires an at-the-money option to acquire US stock. At the time of the acquisition of the option, it has a delta of .0.50. The referenced stock appreciates in value and the option delta increases to 0.80. At that time, the taxpayer acquires another call option with a delta of 0.50. The delta of the two options together is 0.70. Taken literally, the proposed combination regulations would require withholding on dividend equivalents paid on both options from and after the time that the second option is acquired. This result, however, seems beyond the scope of the combination rules.

The combination rules pose significant reporting issues with respect to exchange-traded options and other positions. These challenges are highlighted by the role of the executing broker in "delivery-versus-payment" ("DVP") transactions. In DVP transactions, the executing broker executes the transactions on an exchange, but the transactions are posted in accounts maintained by the customer with a custodian. If an executing broker acquires a put-call combo transaction (or other potential section 871(m) transaction) for a non-US client, the reporting rules do not require the executing broker to notify the custodian that the transactions should be treated as a section 871(m) transaction. Reporting is required only when the broker-dealer is a party to the transaction,[67] which is not the case here. The proposed regulations make clear, however, that the custodian is a withholding agent.[68] Thus the custodian would be required to monitor the client's account and make independent determinations as to whether the positions it sees in such account should be treated as section 871(m) transactions.

The combination rule cannot be used to lower the delta of a transaction. For example, assume that a taxpayer holds an ELI with a delta of 0.70 or greater and then acquires a potential section 871(m) transaction with a low delta. The two transactions, if combined, would have a delta of less than 0.70. A taxpayer may apply the combination rule to reduce the delta of the first transaction to take the position that it no longer has a section 871(m) transaction.

F. THE IMPLICIT PAYMENT RULE

The preamble to the proposed regulations states that a dividend equivalent payment "includes any gross amount that references a US source dividend and that is used to compute the net amount transferred."[69] In fact, however, virtually any derivative referencing a US stock will be presumed to have a "payment" associated with it that references a dividend paid on the stock during the life of the derivative.[70] This is because the parties will be presumed to use estimated dividends in pricing the contract "in much the same way as a contract that adjusts for actual dividends."[71]

The proposed regulations provide that a "payment" include an actual or estimated dividend that is implicitly taken into account in computing one or more terms of a potential section 871(m) transaction.[72] The application of this rule can be seen in the case of bilateral negotiated contracts, such as a price return swap. To illustrate, assume that a price return swap relates to one share of US stock with a $100 value and that an expected $8 dividend will be paid during the life of the transaction. If the short party is not required to make a dividend equivalent payment to the long party, the reference price of the share of stock at the termination of the swap should be $92. Assume further that the funding leg to be paid by the long party is at market. In other words, given a $100 price at the swap opening and an $8 dividend during the swap term, the long party should be required to make a depreciation payment to the short party only if the price of the stock at the termination of the swap is below $92. Conversely, in an arm's length transaction, the short party should be required to make an appreciation payment to the long party if the price of the stock at the termination of the swap exceeds $92. Accordingly, it is clear on these facts that even though the price return swap does not reference the dividend, it is implicitly taken into account in determining the payment obligations of the parties and does enable the long party to enjoy the economic benefit of the anticipated dividend. In order for the parties to treat the anticipated dividend as being equal to $8 (as opposed to the amount of any actual dividend), the contract would need to include a specific statement to that effect.[73]

The assumption that the pricing of financial products involving equities reflects an agreed-upon amount of anticipated dividends falls apart for exchange-traded derivatives. For example, assume that a non-US person acquires a LEAP or another outstanding exchange-traded option such as a FLEX option[74] that is deep in the money. Such an option is likely to have a delta of 0.70 or greater, but it is far from clear what portion (if any) of the value is attributable to underlying

dividends. For example, assume that a US stock with a $100 trading price pays quarterly dividends of $2. At this time, a 3-year LEAP call option is issued on the stock with a strike price of $100 and the cost of such option is $10. At this time, the delta of the LEAP call option is 0.50. The stock price later doubles to $200, the delta of the option increases to 0.80 and it is purchased by a non-US person.

In this case, even though the LEAP option would not provide for an adjustment to the strike price each time that the $2 quarterly dividend is paid, the non-US holder is considered to have received a dividend equivalent at each ex-dividend date. In contrast to the price return swap described above, the strike price of the option is not adjusted for the dividend nor can it be reasonably said that the holder of the option position is being compensated by a lower option purchase price for the dividend. In this case, many factors would enter into the price that the LEAP option would sell for, including the cost of hedging, the time value of the option privilege, the cost of funds for the embedded leverage, the volatility of the stock at the time of the purchase, as well as future anticipated dividends. It truly seems beyond the mandate of the statute to find a dividend equivalent in this and similar fact patterns.

Conceptually, the conclusion that there is no dividend equivalent in other non-bilateral arrangements that do not provide for explicit dividend adjustments, such as single stock futures, can be made with equal force. While a buyer of a 1-C single stock future contract may value the position as being equal to the sum of the current value of the stock plus a time value of money factor minus dividends that will reasonably be anticipated to be made during the life of the contract, the futures market does not operate in this manner. When the person seeking the long exposure looks to acquire the log futures position, it will only see a list of prices for the contract. These prices reflect all of the factors listed above and it would only be fortuitous if an actually offered price fitted the buyer's model. Again, it seems like a stretch to find a dividend equivalent on an exchange-traded product when there is no adjustment on the contract itself.

The proposed regulations answer the question as to who is considered to have paid this dividend equivalent.[75] Liability for the withholding is placed with the clearing organization (the CBOE in our example) and the clearing broker who maintains the account for the non-US person.

G. RULES ADDRESSING THE LACK OF A PAYMENT ON WHICH TO WITHHOLD

As can readily be discerned from the discussion above, many dividend equivalents will arise from contract adjustments and net payments instead of actual payments. If withholding agents were required to withhold on such items, the withholding agents would have to either pay the tax from their own funds or demand that the counterparties pay over their tax liability to the withholding agent. The withholding agent would then remit the appropriate amount of tax to the IRS. The proposed regulations, however, provide a saving rule. Under this saving rule, withholding is not required until the latest of (i) the time that the dividend equivalent is considered to have been made or (ii) the time that the withholding agent has cash or property (A) that it has to pay to the non-US person, (B) that constitutes collateral belonging to the non-US person, or (C) that was received as an up-front payment on the transaction from the counterparty.[76]

H. THE CASCADING PROBLEM

The phenomenon of cascading occurs when tax is collected more than once on the same item of income. Cascading can be expected to be a significant challenge under the proposed regulations. For example, assume that a non-US financial institution ("X") offers a equity-linked instrument that references one or more US stocks in its home market after March 5, 2014. The ELI provides for payments during its term that are equal to 70% of the dividends paid on the reference portfolio. Assume that X holds the reference stocks as a hedge of its obligations on the ELI and X is subject to a 30% withholding tax on the actual dividends that it receives on the stocks. Assume further that the ELI has a delta of 0.70 or greater.

On these facts, there is a cascading withholding tax challenge. X, the financial institution, has been subject to a 30% US federal income tax withholding tax on the actual dividend. The "qualified dealer rule" (described below) is not written in a way that would allow X to claim a withholding tax exemption on the actual dividend. When X makes a payment in respect of a dividend paid on the referenced portfolio on the ELI, such payment itself would be subject to a withholding tax. Thus, X would be required to withhold 21% (70% x 30%) of the actual dividend. On these facts, the proposed regulations result in a 51% withholding tax on a single dividend. Curiously, if the transaction giving rise to

the cascading withholding tax challenge was a securities lending transaction, the IRS would provide a credit for the withholding made on the actual dividend.[77]

I. THE QUALIFIED DEALER EXCEPTION

The proposed regulations address the problem described in the *Cascading* discussion above if the party suffering the initial withholding tax is a non-US securities dealer that holds a derivative, either an ELI or a swap, instead of the actual stock referenced in the ELI that it issued. No relief is offered for entities other than securities dealers. Again, interestingly, in contrast, this limitation would not apply if the transaction giving rise to the dividend equivalent was a securities lending transaction instead of a specified ELI or swap.[78]

The proposed regulations will not require withholding on dividend equivalents paid or accrued to non-US persons who are "qualified dealers" and have not entered into the potential section 871(m) transaction for their own account.[79] A non-US person is a qualified dealer if it is subject to supervision by a governmental authority in the jurisdiction of its organization and it furnishes a written statement to the payer of the dividend equivalent (or other withholding agent) that it is acting in its capacity as a dealer in securities and will withhold on dividend equivalents paid or credited to the account of other non-US persons.[80] Importantly, the certification is not limited to the transaction in which the dividend equivalent is paid or credited to the account of the non-US dealer. It appears that in order for the non-US dealer to be treated as a qualified dealer, it must make such representation with respect to all US dividend equivalents that it will pay or credit to other non-US persons.

J. INDICES

One of the tougher questions involving dividend equivalents is whether financial products linked to equity indices should be treated as paying dividend equivalents when the indices are adjusted for dividends paid on the underlying securities. In other words, when do the dividend equivalent rules look through an index? The proposed regulations provide that a "qualified index" is not disaggregated, with the result that financial products that reference qualified indices will not be looked through to find dividend equivalents. A qualified index means an index that:

(i) References 25 or more component underlying securities.

(ii) References only long positions in component underlying securities.

(iii) Contains no component underlying security that represents more than 10% of the weighting of the underlying securities in the index.

(iv) Is modified or rebalanced only according to predefined objective rules at set dates or intervals.[81]

(v) Does not provide a dividend yield from component underlying securities that is greater than 1.5 times the current dividend yield of the S&P 500 Index as reported for the month immediately preceding the date the long party acquires the potential section 871(m) transaction.

(vi) Futures contracts or option contracts on the index (whether the contracts provide price only or total return exposure to the index) trade on a national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission.[82]

Under an anti-abuse rule, if exposure to the qualified index is coupled with a short position in less than all of the index components, then the index ceases to be a qualified index.[83] In addition, long-only indices that have less than 10% of their assets in securities are not looked through to find dividend equivalents.[84]

K. BROKER-DEALER REPORTING RESPONSIBILITIES

Clearly, the determination as to the delta of a transaction (especially one with multiple reference securities) can be a complex determination that only a financial institution could accurately calculate. As a result, the proposed regulations would subject brokers and dealers (within the meaning of the mark-to-market rules) to substantial reporting and withholding responsibilities when they enter into a "potential section 871(m) transaction" with a person who is not a broker or a dealer.[85] First, the broker or dealer must determine whether the potential section 871(m) transaction should be treated as giving rise to dividend equivalents. Second, if the broker determines that a transaction should be treated as giving rise to dividend equivalents, it must report to the counterparty or customer the timing and amount of any dividend equivalent, as well as the delta number. The dealer's determination of whether the transaction gives rise to dividend equivalents and the amount thereof is binding on withholding agents.

Third, the broker must provide this information to other brokers and persons required to file Form 1042 with respect to the transaction.[86]

It appears that brokers will be required to calculate and provide this information even when facing US persons. For example, a broker could enter into a transaction that gives rise to dividend equivalent payments with a US hedge fund that has one or more non-US partners, such as a master fund. The master fund would be entitled to rely on the broker in determining its withholding tax responsibilities with respect to its non-US partners on dividend equivalents. Thus, the regulation does not limit the broker's obligation to provide this information only to situations in which it is facing a non-US person. ◆

Endnotes

1 The book from which "A Christmas Story" is taken is entitled, *In God We Trust, All Others Pay Cash* (Doubleday 1966). And yes, your author dutifully lined up at the time of publication to have his copy autographed by Mr. Shepherd and the signed first edition remains one of his most prized possessions.

2 Treas. Reg. § 1.863-7(b)(1).

3 All references to non-US persons who are subject to the withholding rules of Section 871(m) of the Internal Revenue Code of 1986, as amended (the "Code") are to non-US persons who did not enter into the swap or other transaction in connection with the conduct of a trade or business.

4 See Code § 871(a)(1)(A).

5 The phrase "dividend equivalent" as used in this article has the meaning assigned to such term in Code § 871(m)(2).

6 *See* Treas. Reg. § 1.446-3(c)(2).

7 *See* Staff Report, Permanent Subcommittee on Investigations, Dividend Tax *Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*

8 LMSB Control No. LMSB-4-1209-044 Impacted IRM 4.51.5 (January 14, 2010). Your trusty author reported on the IRS audit guidelines in Leeds, *New IRS Guidelines Target Equity Swaps with Non-U.S. Counterparties* (January 2010).

9 The Hiring Incentives to Restore Employment Act, P.L. 111-147.

10 See Code § 871(m)(2).

11 Temp. Treas. Reg. § 1.871-7T(a)(1); now see Treas. Reg. § 1.873-7(a)(1), effective as of January 23, 2012.

12 T.D. 9572 (January 19, 2012).

13 See Prop. Treas. Reg. § 1.871-15(f).

14 REG-120282-10 (January 19, 2012)

15 T.D. 9572 (Rev.) (August 30, 2012).

16 Code § 871(m)(3)(A)(v).

[17] Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, *The Hiring Incentives to Restore Employment Act Under Consideration by the Senate*, JCX-4-10 (February 23, 2010).

[18] See Code § 871(m)(3)(A)(i)-(iv).

[19] Treas. Reg. § 1.894-1(c)(2).

[20] Treas. Reg. § 1.982-3(a)(6).

[21] Treas. Reg. § 1.1441-2(b)(6); Treas. Reg. § 1.1441-3(h)(1).

[22] Prop. Treas. Reg. § 1.1471-2(a)(2)(v).

[23] *See* Letter from Herb Green of Pershing to Mr. John Sweeney, Internal Revenue Service, *re: Comments on Internal Revenue Service Notice 2011-34 regarding the Foreign Account Tax Compliance Act* (May 16, 2011); Letter from Securities Industry and Financial Markets Association ("SIFMA") to the Internal Revenue Service, *re: SIFMA Comments on the Proposed FATCA Regulations* (April 30, 2012).

[24] T.D. 9610 (Jan. 2013).

[25] See Treas. Reg. § 1.1471-2(a)(2)(vi).

[26] Treas. Reg. § 1.1471-2(a)(4)(i).

[27] Earnings and profits is "computed as of the close of such year," regardless of the timing of the distribution itself and without reduction for distributions made during the year. Treas. Reg. § 1.316-2(b); Rev. Rul. 74-164, 1974-1 C.B. 74, Situation 1.

[28] LMSB Control No. LMSB-4-1209-044 Impacted IRM 4.51.5 (January 14, 2010). The Audit Swap Guidelines refers to itself as the industry director directive or "IDD."

[29] Treas. Reg. § 1.871-15(a)(4).

[30] Treas. Reg. § 1.871-15(a)(11).

[31] Prop. Treas. Reg. § 1.871-15(e).

[32] *Id.* This date may be pushed forward to a date after March 5, 2014. *See* Sheppard & Parillo, *Dividend Withholding Questions Explored*, Tax Notes (February 3, 2014) (quoting remarks made by Karl Walli, Treasury Office of Tax Legislative Counsel).

[33] One of the drafters of the regulations has been quoted as saying that "after economic analysis, the government understood that transactions as 0.5 delta were generally considered out of the money, while transactions at 0.7 were generally considered substantially in the money." Davis & Elliott, *IRS Defends Delta-Based Standard in Dividend Equivalent Regs*, Tax Notes (December 23, 2013) (quoting Mr. Peter Merkel, IRS branch 5 senior technical reviewer).

[34] Note that retesting is required every time the swap or ELI changes hands.

[35] Prop. Treas. Reg. § 1.871-15(d)(2); Prop. Treas. Reg. § 1.871-15(e).

[36] Prop. Treas. Reg. § 1.871-15(g)(1).

[37] *Id.*

[38] See Treas. Reg. § 1.246-5(c)(1)(iii)(A).

[39] Treas. Reg. § 1.871-15(g)(3)(Ex. 3).

[40] Prop. Treas. Reg. § 1.871-15(i)(1)(i).

[41] Prop. Treas. Reg. § 1.871-15(i)(1)(ii).

[42] Prop. Treas. Reg. § 1.871-15(i)(2)(i).

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

[44] REG-120282-10, p. 24.

[45] Prop. Treas. Reg. § 1.871-15(h)(2)(ii).

[46] Prop. Treas. Reg. § .1871-14(h)(1). Portfolio interest can include contingent interest tied to changes in the value of publicly traded stock (other than stock of the debt issuer). Code § 871(h)(4)(C)(v)(I).

[47] See Prop. Treas. Reg. § 1.871-15(i) (cross-referenced regulation does not contain 0.70 delta limitation, but instead only specifies the amount of a dividend equivalent).

[48] *See* Treas. Reg. § 1.1275-4.

[49] Treas. Reg. § 1.1441-2(b)(3).

[50] Treas. Reg. § 1.1441-2(b)(3)((ii).

[51] Prop. Treas. Reg. § 1.871-15(l)(1).

[52] Prop. Treas. Reg. § 1.871-15(l)(6)(Ex.1).

[53] Prop. Treas. Reg. § 1.1441-1(b)(4)(xxiii).

[54] Prop. Treas. Reg. § 1.871-15(e).

[55] Prop. Treas. Reg. § 1.871-15(h)(2)(i).

[56] Prop. Treas. Reg. § 1.871-15(l)(1).

[57] See Prop. Treas. Reg. § 1.871-15(l)(2).

[58] Prop. Treas. Reg. § 1.871-15(i)(2)(i).

[59] Prop. Treas. Reg. § 1.871-15(i)(2)(ii).

[60] Prop. Treas. Reg. § 1.1441-2(d)(5)(ii)(B).

[61] *See* Prop. Treas. Reg. § 1.871-15(a)(9).

[62] Prop. Treas. Reg. § 1.871-15(i)(1)(ii)(B)(2).

[63] Prop. Treas. Reg. § 1.871-15(l)(1).

[64] See Prop. Treas. Reg. § 1.871-15(a)(9).

[65] Prop. Treas. Reg. § 1.871-15(l)(2).

[66] Prop. Treas. Reg. § 1.871-15(l)(2).

[67] Prop. Treas. Reg. § 1.871-15(o)(1).

[68] Prop. Treas. Reg. § 1.1441-7(a)(3)(Ex. 7).

[69] REG-120282-10, p. 23.

[70] The drafters of the regulations have acknowledged this fact. One of the drafters is quoted as having said that this language was included in the proposed regulations not to act as a limitation but to “distinguish equity derivatives in one case and interest rate derivatives in another.” Davis & Elliott, *IRS Defends Delta-Based Standard, supra* (again quoting Mr. Peter Merkel).

[71] *Id.*

[72] Prop. Treas. Reg. § 1.871-15(h)(2)(ii).

[73] Prop. Treas. Reg. § 1.871-15(h)(2)(iii).

[74] *See* Treas. Reg. § 1.1092-4(a).

[75] Prop. Treas. Reg. § 1.1441-7(a)(3)(Ex. 7).

[76] Prop. Treas. Reg. § 1.1441-2(d)(5).

[77] Notice 2010-46, 2010-24 IRB 757.

[78] *Id.*

[79] Prop. Treas. Reg. § 1.871-15(j)(1)(i).

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

[81] It is worth noting that this limitation would preclude the Standard & Poor's 500 and like indices from constituting qualified indices. The S&P500 and DJIA are rebalanced by Dow Jones both with specific criteria and to "diversify" the stocks included in the indices. *See* Weiner, *Rebalancing of the Dow Jones and S&P 500 Indices: Not So Balanced In Reality*, http://www.benzinga.com/news/13/09/3934011/rebalancing-of-the-dow-jones-and-s-p-500-indices-not-so-balanced-in-reality (Sept 23, 2013).

[82] Prop. Treas. Reg. § 1.871-15(k)(2).

[83] Prop. Treas. Reg. § 1.871-15(k)(6).

[84] Prop. Treas. Reg. § 1.871-15(k)(3).

[85] Prop. Treas. Reg. § 1.871-15(o)(1).

[86] Prop. Treas. Reg. § 1.871-15(o)(3)(ii).

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