

Comeback Victory: The IRS Issues Final Dividend Equivalent Regulations

By Mark Leeds¹

Chuck Tanner, the unsinkable manager of the Pittsburgh Pirates baseball team, said he had three secrets to managing the 1979 World Series championship team, after staring down a three-games-to-one deficit. The first was patience. The second was to be patient. And the third most important secret was patience. There is no doubt that the Internal Revenue Service (the “IRS”) took a page from Chuck’s playbook in developing final and temporary regulations implementing the dividend equivalent rules for Section 871(m) of the Internal Revenue Code of 1986, as amended (the “Code”). This Code section treats dividend equivalents paid to a non-US person in the same manner as actual dividends in such a person’s hands. After two attempts at drafting regulations and listening to significant industry blowback, on September 16, 2015, the IRS promulgated the most thoughtful set of rules yet.² And as anyone who has been following this saga knows, it has taken more than a dollop of patience. After a brief background discussion, this article summarizes, in decision-tree format, when the final regulations will apply and provides some observations about their operation.

The Briefest of Backgrounds

In 1991, the IRS promulgated a regulation providing that income from a swap (notional principal contract, or NPC, in tax parlance) is sourced to the residence of the payee.³ This rule

created the potential for a discontinuity with respect to equity swaps and total return swaps, on one hand, and actual stock ownership, on the other. Specifically, if a non-US person⁴ held a US stock directly, dividends paid on the stock would be treated as US-source income. Unless an income tax treaty provided for a total exemption from US federal income tax, the non-US holder would be subject to either 15 percent (most tax treaties) or 30 percent US (non-treaty rate) federal income tax withholding.⁵ In contrast, a dividend equivalent payment⁶ made to a non-US person under a swap in respect of a dividend paid on a US stock included in the specified index⁷ would be treated as non-US-source income and not be subject to US federal income tax withholding. Congress became dissatisfied with these results.⁸ 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.⁹

In March 2010, Congress addressed the perceived abuse through the passage of the HIRE Act.¹⁰ 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.¹¹ 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 to which an actual dividend would be subject. Indeed, Temporary Regulations amended the 1991 regulation to specify that it no longer applied to dividend equivalents, and these regulations have now been finalized.¹²

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, 2013.¹³ These rules generally followed the rules that had been in effect since 2010. Second, a set of new rules for dividend equivalents was proposed, to be effective after final regulations were published.¹⁴ 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 2013.¹⁵ These proposed regulations were pulled by the IRS in August 2012.¹⁶

The 2013 Final Regulations (Now Applicable Until 2017)

In 2013, the IRS released final regulations for dividend equivalents paid before 2016.¹⁷ These regulations 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. In the latest release of regulations, the IRS extended these regulations through 2016.¹⁸

Specifically, the IRS has extended Treasury Regulation § 1.871-15(d) through the end of 2016

so as to treat swap transactions as giving rise to taxable dividend equivalents when paid or credited to the account of a non-US person in the following instances:

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; or
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, 2012.¹⁹

A number of issues were clarified for pre-2017 dividend equivalents in the 2013 regulations. First, dividend equivalents are eligible for a reduced rate of withholding in cases in which a tax treaty provides for a lower withholding rate on actual dividends.²⁰ Second, foreign sovereign entities that can receive dividends exempt from US withholding tax may receive dividend equivalents free from US withholding tax.²¹ The IRS also issued new proposed regulations in 2013, but these regulations have also been withdrawn and replaced by new final and temporary regulations.

Transactions That Can Give Rise to Dividend Equivalents

A good place to begin in analyzing the 2015 final and temporary regulations is with the type of transactions that can give rise to dividend equivalent that can be subject to federal income tax withholding when paid to a non-US person.

At the broadest level, there are two types of such transactions: equity-linked instruments (each, an “ELI”)²² and notional principal contracts (each, a “swap”).²³ An ELI includes a financial transaction that references one or more dividend-paying US securities or a convertible or equity-linked debt instrument. Examples of such transactions include futures contracts, forward contracts, options and debt instruments. Swaps for this purpose are transactions treated as swaps under general tax rules and reference a dividend-paying US stock or an equity-linked or convertible debt instrument.²⁴

The final regulations refer to swaps and ELIs that reference US stocks and convertible debt instruments and equity-linked debt instruments as potential section 871(m) transactions.²⁵ If the transaction is captured by the final dividend equivalent rules, it is referred to as a “section 871(m) transaction.”²⁶ Thus, if a swap or an ELI is a potential section 871(m) transaction, the next step in the analysis as to whether payments to a non-US counterparty are subject to withholding under the dividend equivalent rules is to determine whether the instrument has referenced a payment that is treated as a US dividend for these purposes.

NON-DIVIDEND AND DEEMED DISTRIBUTIONS, INDICES AND OTHER EXEMPT DISTRIBUTIONS

Non-dividend distributions. If an ELI or a swap references a distribution on a US security that would not be subject to withholding if paid directly to a non-US person, it will not be considered to have paid a dividend equivalent.²⁷ The final regulations include an example of a transaction that references a capital gain dividend paid by a regulated investment company (a “RIC” or mutual fund) as not being treated as a dividend equivalent. Although not explicit, it appears that a transaction that references an interest payment on a debt instrument that is not exempt from withholding (under the portfolio interest exception or otherwise) is treated as a dividend equivalent.

While this is counterintuitive, it follows from the rules described below that deny portfolio interest treatment on equity-linked debt instruments.

Indices. To the extent that an ELI or swap provides payments with respect to a “qualified index,” it does not give rise to dividend equivalents.²⁸ While the basic structure of the qualified index rules from the 2013 proposed regulations has been retained, the final regulations make these rules much more user-friendly. Customized indices and indices that target special dividends are not qualified indices.²⁹

A qualified index means an index that, as of the first day of the calendar year in which the transaction is opened, meets the following requirements:³⁰

- i. It references 25 or more component securities;
- ii. 95 percent or more of the value of the index is attributable to long positions in component securities;
- iii. It contains no component security that represents more than 15 percent of the weighting of the underlying securities in the index;
- iv. It does not reference five or fewer components that together represent more than 40 percent of the weighting of the component securities;
- v. It is modified or rebalanced only according to publicly stated, predefined criteria (which may require interpretation by the index provider or a board);
- vi. It does not provide a dividend yield in the immediately preceding year that is greater than 1.5 times the dividend yield of the S&P 500 Index for the preceding year; and
- vii. Futures contracts or option contracts on the index (whether the contracts provide price only or total return exposure to the index) trade on (A) 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 or (B) a foreign exchange that the IRS has designated as a qualifying board of exchange for the mark-to-market rules of Code § 1256 and US securities constitute less than 50 percent of the weighting of the components.³¹

A transaction may short positions in the index provided that the aggregate of the short positions in the index itself and the outside short positions do not exceed five percent of the index components.³² In addition, long-only indices that have less than 10 percent of their assets in securities are not looked through to find dividend equivalents.³³

Partnership (Hedge Fund) Transactions.

A swap or an ELI payment that references a payment on a partnership interest will be considered to pay dividend equivalents only if the partnership is a dealer or trader in securities or holds significant investments in securities (each, a “covered partnership”).³⁴ A partnership is considered to have significant investments in securities if either 25 percent or more of the partnership’s assets consist of securities or the value of the US securities held by the partnership exceeds \$25 million.³⁵ Value is determined as of the last day of the partnership’s preceding tax year, unless the short party has actual knowledge that a transaction since such date caused the partnership to breach either threshold.³⁶ If a partnership is a covered partnership, dividend equivalents are determined by looking through the partnership to the partnership’s underlying assets.

Taxable Conversion Adjustments.

Convertible debt instruments and other equity-linked instruments can give rise to adjustments and payments that are treated as dividends.³⁷ While an analysis of these rules is beyond the scope of this article, this can happen when an adjustment ratio in a convertible debt

instrument provides for an adjustment that increases the holder’s proportionate interest in the corporation. For example, if a corporation with convertible debt outstanding splits its stock in a 2-for-1 stock split but increases the number of shares into which its outstanding debt can be converted into stock by a ratio of 2.5-to-1, the holders of the convertible debt are treated as having received a taxable dividend distribution of .5 shares (multiplied by the number of shares into which the debt is convertible). The final regulations exclude payments with respect to such deemed dividends from the definition of dividend equivalents.³⁸

Due Bills. A due bill payment is also excluded from the definition of dividend equivalent. A due bill transaction occurs when a seller of stock agrees to deliver the amount of a pending US dividend after the record date to the stock purchaser. In order for a due bill transaction not to be treated as dividend equivalent, the following conditions must be met:

1. The due bill obligation must arise from the actions of a securities exchange that applies to all transactions in the stock; and
2. The ex-dividend date must fall after the record date.³⁹

Variable Annuities & Life Policies.

Universal and whole life insurance policies and annuities frequently reference US stocks and can provide for distributions that are determined with reference to dividends paid on such stocks. Under Temporary Regulations issued in connection with the final dividend equivalent regulations, such payments are not treated as dividend equivalents if the distribution to the policy holder is otherwise subject to withholding tax.⁴⁰ The regulations exempt all payments by non-US insurance companies from being treated as dividend equivalents, extending the existing rules that discourage non-US persons from purchasing insurance policies and annuities from US carriers.⁴¹

Compensation & Merger Transactions.

The final regulations provide two other exclusions from the definition of a dividend equivalent. First, dividends paid on unvested stock granted to a non-US person as compensation is excluded from the definition of a dividend equivalent.⁴² Once the transaction vests in the hands of the non-US employee, however, dividend equivalents are subject to the new withholding rules. Second, transactions (merger arbitrage transactions) that reference dividends paid pursuant to a plan on the part of one or more persons to acquire more than 50 percent of the outstanding stock of a corporation are not dividend equivalents for purposes of the withholding tax rules.⁴³

EFFECTIVE DATES

If a payment on a swap or ELI does not qualify for one of the eight types of exemptions specified above, it still may not be treated as a dividend equivalent if the instrument was issued prior to the effective date of the new rules or if the payment itself was made prior to a grandfather date. Here is a run-down of avoiding the application of dividend equivalent rules based on the effective date rules:⁴⁴

Pre-2016 Swaps Not Described in the Code Itself. As noted above, a swap that does not meet one of the four criteria specified in Code § 871(m)(3)(A)(i)-(iv) (described above in Section II) that is issued prior to 2016 is not subject to the dividend equivalent rules.

Pre-2016 ELIs (Non-Swap Transactions). These transactions, unless treated as securities lending transactions, are not subject to the dividend equivalent rules.

Swaps Not Described in the Code & ELIs Issued in 2016. A swap issued in 2016 that does not meet one of the four criteria specified in Code § 871(m)(3)(A)(i)-(iv) and an ELI issued in 2016 is not subject to testing under the dividend equivalent rules until 2018.

Swaps and ELIs Issued after 2016. A swap issued in 2017 or later that does not meet one of the four criteria specified in Code § 871(m)(3)(A)(i)-(iv) and an ELI issued in 2017 is to testing under the dividend equivalent rules.

If a swap or an ELI is modified after it is issued and the modification results in deemed reissuance of the contract, the contract is retested on the date of the significant modification.

CORRELATION TESTING

If a payment on a swap or an ELI is not exempt from the dividend equivalent rules under one of the eight exceptions discussed above, or based upon the date on which the contract is issued or the date on which the payment is made, the next step in determining whether the financial contract has paid a dividend equivalent is to determine whether the swap or ELI is sufficiently correlated with the referenced US security so that the final regulations impose withholding on the payment. In order to determine the appropriate test to be applied, the final regulations distinguish between simple contracts and complex contracts.

Simple Contracts. A swap or an ELI is a simple contract if the following requirements are met:⁴⁵

1. All amounts paid on the contract are determined with reference to a single, fixed number of shares of the underlying security, provided that the number of shares can be ascertained when the contract is issued; and
2. The contract has a single maturity or exercise date with respect to which all amounts are required to be calculated with respect to the reference security, even if that date can be accelerated. If the amount paid or received is discontinuously increased or decreased, the contract is not a simple contract.

Complex Contracts. Any swap or ELI that is not a simple contract is a complex contract. The regulations contain two examples of complex contracts: a digital option that provides a single pay-out (or terminates) when a target price is reached and a swap in which the long party receives the return on 200 shares of a stock, but bears losses on only 100 shares of the same stock. The preamble to the final regulations also note that path-dependent contracts, such as best of and worst of structured notes, and other structured notes are complex contracts.

DELTA TESTING AND REPORTING FOR SIMPLE CONTRACTS

If a swap or an ELI is a simple contract, a payment with respect to a dividend paid on a referenced US stock will be treated as a dividend equivalent if the delta of the contract is 0.80 or greater, *determined solely at the date that the contract was issued*.⁴⁶ In contrast to the 2013 proposed regulations, no re-testing of the contract is required even if it is initially issued to a domestic person and is later acquired by a non-US person. If a contract is re-issued, however, due to a material modification or otherwise, testing is required on the re-issuance date.

Delta is defined as the relationship of the change in fair market value of the swap or ELI to a small change (generally less than one percent) in the fair market value of referenced security.⁴⁷ For example, if a \$.01 change in value of the referenced stock results in a \$.01 change in value of the swap or ELI, the swap or ELI has a delta of 1.0.⁴⁸ In general, if the swap or ELI references more than one stock, the transaction is disaggregated and delta is determined with reference to each underlying security.⁴⁹ If delta is determined for non-tax purposes, that delta is generally required to be used to determine whether the 0.80 delta standard is met.

The preamble to the final regulations states that the delta test was increased from 0.70 in the 2013 proposed regulations to 0.80 in the final

regulations because the regulation drafters found that 0.70 was over-inclusive. A study of a simple exchange-traded option, however, shows that 0.80 may still find dividend equivalents in situations in which one would not expect to find them. Specifically, an exchange-traded option on AT&T with a six-month duration that was issued only 9.08 percent in-the-money has a delta of 0.80.⁵⁰ In addition, the proposed rule exempting transactions with terms of one year or less on which there is no actual payment was deleted from the final regulations.⁵¹ Accordingly, a significant number of exchange-traded options will now be subject to withholding. This is likely to increase the margin requirements for such options.

If one of the parties to a swap or ELI is a broker or a dealer, but the other party is not, the broker or dealer is required to determine the delta of the transaction.⁵² If neither or both parties are dealers or brokers, then the short party must determine the delta of the transaction. The person required to determine the delta of the transaction must report it to the other party or any other withholding agent.⁵³

SUBSTANTIAL EQUIVALENCE TESTING FOR COMPLEX CONTRACTS

If an ELI or a swap is a complex contract, payments on the contract can be considered to be dividend equivalents if the contract satisfies the “substantial equivalence test.”⁵⁴ The substantial equivalence test is contained in Temporary Regulations, and the IRS, in the preamble, has invited comment on this test. Under the Temporary Regulations, the substantial equivalence test “assesses whether a complex contract substantially replicates the economic performance of the under security by comparing, at various testing prices, the differences between expected changes in value of a ‘simple contract benchmark’ and its initial hedge.”⁵⁵ If there are multiple exposures in a single contract, each US security is tested independently. A simple contract benchmark is a

simple contract (as defined above), with a delta of at least 0.80, referencing the underlying security and that has substantially the same terms to the terms of instrument being tested. The simple contract benchmark can be a call option, put option or collar transaction.⁵⁶ The substantial equivalence test is met if the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change of the simple contract benchmark and its initial hedge, determined as of the time at which the contract was issued.⁵⁷

The substantial equivalence test is performed through a seven-part test:⁵⁸

1. Determine the change in value of the complex contract with respect to the reference security at each “testing price;”
2. The minimum two testing prices are the prices obtained by moving the price up and down from the price of the reference security by one standard deviation. If, however, only two testing prices are likely to provide an inaccurate measure, the taxpayer must use additional testing prices.⁵⁹
3. Determine the change in value of the initial hedge at each testing price;⁶⁰
4. The testing values of the hedge are determined by using the same testing prices as are used for the reference security under Step 1. The calculations are performed as of the issuance on the complex contract only.⁶¹
5. Determine the absolute value of the change in value between 1 and 2;
6. Determine the probability associated with each testing price;
7. The probability is the measure of likelihood that the price of the reference security will move by one standard deviation.⁶² This probability is often referred to as volatility.
8. Multiply the absolute value of the change determined in Step 3 by the probability determined in Step 4;

9. Sum the product of each calculation determined in Step 5; and
10. Divide the sum obtained in Step 6 by the number of shares in the initial hedge.

If the amount determined in applying the substantial equivalence test is equal to or less than the “benchmark calculation,” the complex contract is a section 871 contact; that is, dividend equivalent payments on the contract will be treated as US-source income.⁶³ The benchmark calculation is the application of the methodology described above for the simple contract benchmark.

Special Rules for Equity-Linked and Convertible Debt Instruments

If a debt instrument bears interest that is linked to the dividends paid on one or more US stocks, the debt instrument can be used as a host instrument to avoid the application of the withholding rules on dividend equivalents. The final regulations (like their 2013 counterparts) deny portfolio interest treatment to any yield payment that is a dividend equivalent.⁶⁴ The preamble to the final regulations states that an equity-linked or convertible debt instrument will not be treated as paying dividend equivalent interest if it had a delta of less than 0.80 at original issuance. Delta is determined by stripping out the embedded equity position from the host debt instrument and testing whether the embedded position has a delta of 0.80 or greater before portfolio interest status is denied to the equity-linked payment.⁶⁵

Payments and the Amount of a Dividend Equivalent Payment

Once it has been determined that a payment on an ELI or a swap referencing a US stock is not exempt (i) based upon one of the eight filters discussed above, (ii) based upon the date that the instrument was issued or the date the payment was made or (iii) because the instrument had a delta of less than 0.80 (simple

contracts) or did not meet the substantial equivalence test (complex contacts), the next step is to determine which, when and the amount of payments on the transaction that will be subject to withholding. As to which payments, the Code defines a dividend equivalent payment as the gross amount referencing a US-source dividend that is used to compute the net amount paid.⁶⁶ The 2015 final regulations explicitly state that a short party has paid a dividend equivalent even if there is no net payment to the long party because of a contractual offset.⁶⁷ For example, if, under a swap transaction, the short party owes a \$1 dividend equivalent payment to the long party and the long party owes a \$1 funding payment to the short party, so no payment is made by either party, the short party is nonetheless considered to have paid a \$1 dividend equivalent.

The 2015 final regulations retain the controversial rules for estimated and implicit dividends.⁶⁸ A transaction that makes a payment in respect of an estimated dividend is considered to have a dividend equivalent payment.⁶⁹ In addition, a transaction that makes an allowance for an implicit dividend is considered to have a dividend equivalent payment.⁷⁰ Implicit estimated dividend payments are frequently found in price return swaps and single stock future contracts. 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. On the surface, 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 2015 final regulations 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.”⁷¹ 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.”⁷²

Similarly, single stock futures contracts (including the OneChicago 1-C contract) are priced using implicit estimated dividends.⁷³ The futures price is generally equal to the sum of (i) the current stock price and (ii) a time value of money component minus the anticipated dividends expected to be paid while the futures contract is open. Thus, single stock futures contracts entered into in 2017 will be treated as paying dividend equivalents. Interestingly, the final regulations contain an example of this single stock futures contract with an implicit estimated dividend, but the example casts the transaction as a bilateral forward contract.⁷⁴

Once the dividend equivalent payment (or credit) has been identified, the amount of the payment must be determined. For simple contracts, the amount of the dividend equivalent payment is equal to the number of referenced shares times the actual dividend times the delta for the transaction (determined at the time the contract was issued).⁷⁵ For complex transactions, the dividend equivalent is the actual or estimated dividend multiplied by the number of shares of the reference security held as a hedge.⁷⁶ A transaction that uses an estimated dividend will be considered to have a payment equal to the actual dividend unless, at the time at which the transaction is entered into, the short party designates the amount of the estimated dividend in writing in the transaction documentation.⁷⁷ If the transaction “true up” the estimated dividend (such as the OneChicago 1-D contract), the true-up payment is also treated as a dividend equivalent payment.⁷⁸ If the transaction multiplies the number of reference shares by a factor, the dividend

equivalent must be multiplied by that factor.⁷⁹ The dividend equivalent is considered paid on the earlier of the record date and the day prior to the ex-dividend date, regardless of when the contract gives credit for the dividend.⁸⁰

Three simplifying rules are included for basket transactions, that is, transactions that reference multiple securities. If a swap or ELI references more than 25 securities, the short party may treat all dividend equivalents as paid at the end of each calendar quarter in which the contract is outstanding.⁸¹ If a swap or ELI references a publicly available index, the amount of the dividend equivalent is the yield on the index, not the yield on the individual components of the index.⁸² If a 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-trade fund or other security used to hedge the transaction.⁸³

The 2013 proposed regulations provided a special rule for contracts with a term of one year or less. Under this special rule, the amount of the dividend equivalent was determined at the time that the long party disposed of the contract. This rule allowed a long party to avoid dividend equivalent withholding tax when a long option was worthless at the time of expiration. Since this rule has been repealed, if a dividend is paid during an option term and the option had a delta of 0.80 or greater at issuance, the short party will have a withholding tax obligation even if the option expires worthless. That this result occurs is supported by an example addressing qualified derivative dealer rules, discussed below.⁸⁴ This conundrum is likely to be resolved by requiring holders of long options to post collateral to enable the short party to make the required tax payment. In any event, actual withholding is not required until the later of when payment is made (final settlement in the absence of a payment) or when the dividend equivalent is determined.⁸⁵

Aggregation of Transactions

The final regulations retain rules originally promulgated in the 2013 proposed regulations that require that certain transactions be combined or aggregated in determining whether the aggregated transaction should be treated as a section 871(m) transaction. These regulations, however, were significantly modified in the 2015 final regulations. The modifications make it significantly less likely that a dealer will inadvertently incur a withholding tax liability. First, the final regulations make clear that multiple long positions are not aggregated. A regulation now specifically provides transactions are only combined if the economics of the combined transaction “would be a section 871(m) transaction if the transactions had been entered into as a single transaction.”⁸⁶ In addition, transactions are combined only if they reference the same security and are entered into in connection with each other.⁸⁷

If a long party enters into separate transactions with the same dealer (short party), the short party is not required to aggregate the transactions if they are entered into through separate accounts unless the dealer has actual knowledge that the short party used separate accounts to avoid creating a section 871(m) transaction.⁸⁸ In addition, even if the long party uses the same account at the broker, the short party may presume that the transactions are separate if they are entered into two or more business days apart unless the dealer has actual knowledge to the contrary.⁸⁹ Concomitantly, the IRS will presume for the long party that transactions in separate accounts or entered into two or more days apart will not be aggregated (but the presumption may be rebutted).⁹⁰ If a short party has multiple transactions with a long party (and its affiliates), transactions that are subject to combination must be combined in the way that results in the greater number of shares being part of a section 871(m) transaction.⁹¹

Broker Reporting Requirements and Special Rules

If a broker is a party to a potential section 871(m) transaction with a counterparty that is not a broker or a dealer, the broker must determine whether the transaction is a section 871(m) transaction.⁹² If neither or both parties are brokers, the short party must make that determination. The party required to make the determination must report the dividend equivalent to the counterparty. In a futures contract transaction, the party acquiring the exposure faces an exchange, not a counterparty. Although the regulations are not explicit on who is responsible for reporting on futures transactions, the language of the regulations supports the conclusion that the broker selling the transaction, and not the exchange, must make Code § 871(m) determinations and effect reporting. A definitional regulation treats a party to the transaction to include any person acting as an intermediary with respect to a potential section 871(m) transaction.⁹³ It is worth noting, however, that both the exchange and the clearing broker are withholding agents responsible for collecting and remitting the tax.⁹⁴

In a breakthrough new rule, the IRS has addressed and alleviated most possibilities of cascading withholding taxes. The phenomenon of cascading occurs when tax is collected more than once on the same item of income. For example, assume that a non-US financial institution (“X”) offers an equity-linked instrument that references one or more US stocks in its home market. The ELI provides for payments during its term that are equal to 70 percent 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 percent withholding tax on the actual dividends that it receives on the stocks. Assume further that the ELI has a delta of 0.80 or greater.

On these facts, without relief, there is a cascading withholding tax challenge. X, the financial institution, has been subject to a 30 percent US federal withholding tax on the actual dividend. When X makes a payment in respect of a dividend paid on the referenced portfolio on the ELI, the payment itself would be subject to a withholding tax. Thus, X would be required to withhold 21 percent (70% x 30%) of the actual dividend. On these facts, the proposed regulations result in a 51 percent withholding tax on a single dividend.

Temporary regulations address the cascading withholding problem for electing foreign dealers, banks and related parties that are qualified intermediaries (now defined as “qualified derivatives dealers” or “QDDs”). In order to be a QDD, the non-US dealer must be (i) regulated as a securities dealer, (ii) be regulated as a bank or (iii) issue potential section 871(m) transactions to customers. In all cases, the proposed QDD must be a qualified intermediary.⁹⁵ An eligible QI that desires to act as a QDD must:

1. Furnish a QI withholding statement to withholding agents;
2. Agree to assume primary withholding and reporting responsibilities and agree to determine whether payments are dividend equivalents;
3. Remain liable for tax on dividends and dividend equivalents that are not passed through to counterparties on section 871(m) transactions; and
4. Must agree to comply with compliance review procedures.

Under the temporary regulations, no withholding is required on payments of either dividends or dividend equivalents made to the non-US dealer.⁹⁶ The non-US dealer is required to self-assess and remit tax on proprietary holdings and on amounts received for which the dealer does not have an offsetting liability under a section 871(m) transaction.

Concluding Observations

The final Code § 871(m) represents the best set of rules to address dividend uplift transactions of the three sets that have been promulgated. Nonetheless, the continued inclusion of exchange-traded transactions as section 871(m) transactions far outstrips the legislative intent of the enactment of Code § 871(m) and will impose substantial withholding compliance burdens for what surely will be very little revenue to the Government. In addition, the imposition of withholding on transactions that expire worthless is also going to increase the cost of accessing the United States capital markets for minor revenue. Thus, while the final and temporary regulations do a good job of addressing Congress' decision to shut down dividend arbitrage through the use of derivatives, they overshoot the mark.

Endnotes

- ¹ Mark Leeds is a tax partner with the New York office of the law firm of Mayer Brown and the editor-in-chief of *Derivatives: Financial Products Report*, an RIA/Thomson monthly magazine. Mark will speak on the new regulations addressed here at the Practising Law Institute Advanced Swaps & Other Derivatives 2015 conference in New York on October 21, 2015. Mark thanks Lisa Chippindale, Managing Director, at the Royal Bank of Canada, for her helpful suggestions and comments. Mistakes remain the sole responsibility of the author.
- ² For readers interested in the previously proposed versions of the regulations, please see my prior articles: Leeds, *New U.S. Tax Regulations Change the Rules for Dividend Equivalents*, Tax Notes (Feb. 12, 2012) and Leeds, *The 2013 IRS Cross-Border Dividend Equivalents Regulations*, Tax Notes (Apr. 7, 2014). The views expressed herein are solely those of the author and should not be imputed to Mayer Brown.
- ³ Treas. Reg. § 1.863-7(b)(1).
- ⁴ All references to non-U.S. persons who are subject to the withholding rules of Code § 871(m) are to non-U.S. persons who did not enter into the swap or other transaction in connection with the conduct of a trade or business in the United States.

- ⁵ See Code § 871(a)(1)(A).
- ⁶ The phrase "dividend equivalent" as used in this article has the meaning assigned to such term in Code § 871(m)(2).
- ⁷ See Treas. Reg. § 1.446-3(c)(2).
- ⁸ See Staff Report, Permanent Subcommittee on Investigations, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*
- ⁹ 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).
- ¹⁰ The Hiring Incentives to Restore Employment Act, P.L. 111-147.
- ¹¹ See Code § 871(m)(2).
- ¹² Temp. Treas. Reg. § 1.871-7T(a)(1); now see Treas. Reg. § 1.873-7(a)(1), effective as of January 23, 2012.
- ¹³ T.D. 9572 (January 19, 2012)
- ¹⁴ See Prop. Treas. Reg. § 1.871-15(f).
- ¹⁵ REG-120282-10 (January 19, 2012)
- ¹⁶ T.D. 9572 (Rev.) (August 30, 2012).
- ¹⁷ T.D. 9648 (De. 4, 2013)
- ¹⁸ T.D. 9734. Par. 3.
- ¹⁹ See Code § 871(m)(3)(A)(i)-(iv).
- ²⁰ Treas. Reg. § 1.894-1(c)(2).
- ²¹ Treas. Reg. § 1.982-3(a)(6).
- ²² Treas. Reg. § 1.871-15(a)(4)
- ²³ Treas. Reg. § 1.871-15(a)(7).
- ²⁴ See Treas. Reg. § 1.871-15(a)(7). Mechanically, debt instruments with equity-linked payments are encompassed by the fact that the final regulations treat the equity-linked payments as payments of dividend equivalents if the embedded host instrument meets the necessary correlation to be treated as a section 871(m) transaction. See Treas. Reg. § 1.871-14(h)(1).
- ²⁵ Treas. Reg. § 1.871-15(a)(12).
- ²⁶ *Id.*
- ²⁷ Treas. Reg. § 1.871-15(c)(2).
- ²⁸ Treas. Reg. § 1.871-15(l)(2).
- ²⁹ T.D. 9734, § II(F); Treas. Reg. § 1.871-15(l)(1).
- ³⁰ Treas. Reg. § 1.871-15(l)(3)
- ³¹ Prop. Treas. Reg. § 1.871-15(k)(2).
- ³² Treas. Reg. § 1.871-15(l)(6)(ii).
- ³³ Treas. Reg. § 1.871-15(l)(4).
- ³⁴ Treas. Reg. § 1.871-15(m)(1).
- ³⁵ Treas. Reg. § 1.871-15(m)(2)(i).

³⁶ Treas. Reg. § 1.871-15(m)(2)(ii).

³⁷ See generally Code § 305(b) and Code § 305(c).

³⁸ Treas. Reg. § 1.871-15(c)(2)(ii).

³⁹ Treas. Reg. § 1.871-15(c)(2)(iii).

⁴⁰ Temp. Treas. Reg. § 1.871-15T(c)(iv)(A).

⁴¹ Temp. Treas. Reg. § 1.871-15T(c)(iv)(B).

⁴² Treas. Reg. § 1.871-15(c)(2)(v).

⁴³ Treas. Reg. § 1.871-15(k).

⁴⁴ Treas. Reg. § 1.871-15(r).

⁴⁵ Treas. Reg. § 1.871-15(a)(14).

⁴⁶ Treas. Reg. § 1.871-15(e)(1).

⁴⁷ Treas. Reg. § 1.871-15(g)(1).

⁴⁸ Treas. Reg. § 1.871-15(g)(4)(Ex. 1).

⁴⁹ Treas. Reg. § 1.871-15(g)(1). Treasury Regulation § 1.871-15(g)(3) allows aggregation if the ELI or swap references 10 or more securities and, at the time the EI or swap is issued, the short party uses an exchange-traded security to hedge the securities .

⁵⁰ The example used in text was provided to the author by Twenty-First Securities Corporation.

⁵¹ T.D. 7734, § II(E)(2).

⁵² Treas. Reg. § 1.871-15(p)(1).

⁵³ Treas. Reg. § 1.871-15(p)(3).

⁵⁴ Treas. Reg. § 1.871-15(e)(2).

⁵⁵ Temp. Treas. Reg. § 1.871-15T(h)(1).

⁵⁶ Temp. Treas. Reg. § 1.871-15T(h)(2).

⁵⁷ Temp. Treas. Reg. § 1.871-15T(h)(1).

⁵⁸ Temp. Treas. Reg. § 1.871-15T(h)(4).

⁵⁹ Temp. Treas. Reg. § 1.871-15T(h)(4)(iii).

⁶⁰ An example in the Temporary Regulations illustrates that the actual number of shares of the reference security (and presumably any other securities) that are acquired by the short party as a hedge of its obligations under the complex contract is used for the hedge. Temp. Treas. Reg. § 1.871-15T(h)(7).

⁶¹ Temp. Treas. Reg. § 1.871-15T(h)(4)(ii).

⁶² Temp. Treas. Reg. § 1.871-15T(h)(4)(iv).

⁶³ Temp. Treas. Reg. § 1.871-15T(h)(3).

⁶⁴ Treas. Reg. § 1.871-14(h)(1). Statutorily, portfolio interest could 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).

⁶⁵ Treas. Reg. § 1.871-15(g)(1).

⁶⁶ Code § 871(m)(5).

⁶⁷ Treas. Reg. § 1.871-15(i)(1).

⁶⁸ Treas. Reg. § 1.871-15(i)(2)(ii).

⁶⁹ Treas. Reg. § 1.871-15(i)(2)(i).

⁷⁰ *Id.*

⁷¹ T.D. 9734, § II(D) [E], quoting REG-120282-10, p. 24.

⁷² Treas. Reg. § 1.871-15(i)(4)(Ex. 2).

⁷³ The OneChicago 1-D contract provides for a true-up for the difference between the estimated dividend and the actual dividend.

⁷⁴ Treas. Reg. § 1.871-15(i)(4)(Ex. 1).

⁷⁵ Treas. Reg. § 1.871-15(j)(1)(i).

⁷⁶ Treas. Reg. § 1.871-15(j)(iii).

⁷⁷ Treas. Reg. § 1.871-15(i)(2)(iii).

⁷⁸ Treas. Reg. § 1.871-15(i)(2)(iv).

⁷⁹ Treas. Reg. § 1.871-15(j)(3).

⁸⁰ Treas. Reg. § 1.871-15(j)(2).

⁸¹ Treas. Reg. § 1.871-15(i)(3)(i).

⁸² Treas. Reg. § 1.871-15(i)(3)(ii).

⁸³ Treas. Reg. § 1.871-15(i)(3)(iii).

⁸⁴ Temp. Treas. Reg. § 1.871-15T(q)(2)(Ex. 3).

⁸⁵ Treas. Reg. § 1.1441-2(e)(8).

⁸⁶ Treas. Reg. § 1.871-15(n)(1)(iii).

⁸⁷ Treas. Reg. § 1.871-15(n)(1)(ii), (iv).

⁸⁸ Treas. Reg. § 1.871-15(n)(3)(i).

⁸⁹ Treas. Reg. § 1.871-15(n)(3)(ii).

⁹⁰ Treas. Reg. § 1.871-15(n)(4)(i), (ii).

⁹¹ Treas. Reg. § 1.871-15(n)(6).

⁹² Treas. Reg. § 1.871-15(p).

⁹³ Treas. Reg. § 1.871-15(a)(9)(iii).

⁹⁴ Treas. Reg. § 1.1441-7(a)(3)(Ex. 7).

⁹⁵ Temp. Treas. Reg. § 1.1441-1T(e)(6).

⁹⁶ Temp. Treas. Reg. § 1.871-15T(q)(1).

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