Report 1306

New York State Bar Association Tax Section

Report on Proposed Regulations under Section 871(m)

May 20, 2014

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New York State Bar Association Tax Section Report on

Proposed Regulations under Section 871(m)

This Report[1] addresses issues arising under proposed regulations under section[2] 871(m) and, to a more limited extent, final regulations under section 871(m).[3]

I. Introduction

Section 871(m) was added to the Code as part of the HIRE Act[4] to address concerns about the avoidance of withholding tax on U.S. source dividends through derivative transactions. Section 871(m)(1) alters the usual rule of recipient-based sourcing on certain notional principal contracts ("NPCs") contained in Treasury Regulations section 1.863-7(b)(1) for "dividend equivalent" payments, and provides that a dividend equivalent payment is treated as if it were a U.S. source dividend for withholding tax purposes. As a result, dividend equivalent payments are subject to U.S. withholding tax when paid to a non-U.S. recipient.

Section 871(m) treats as a dividend equivalent three categories of payments: (a) substitute dividend payments made pursuant to securities lending or sale-repurchase agreements;[5] (b) payments made pursuant to "specified notional principal contracts" that are directly or indirectly contingent upon or determined by reference to the payment of a dividend

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1 The principal drafters of this Report were Peter J. Connors and Erika Nijenhuis. Substantial contributions were made by Michael Farber, Edward Gonzalez, Stephen Land, David Miller, Michael Schler, David Schnabel and Stephen Shay. Helpful comments were received from Micah Bloomfield, Andrew Chalnick, Allen Friedman, Robert Kantrowitz and Kirk Wallace. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates. The substantial assistance of Stephen Lessard and Jonas Robison is gratefully acknowledged.

2 Unless otherwise indicated, all references in this Report to "section" and "sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" (or "Prop. Reg. §") are to regulations (or proposed regulations) issued thereunder ("Regulations"). References to the "Service" and the "IRS" are to the Internal Revenue Service, references to "Treasury" are to the United States Department of the Treasury and references to the "Secretary" are to the Secretary of the Treasury.

3 This is the third report the NYSBA has prepared on this provision. See "Report on Section 871(m)," 2011 TNT 47-16 (Mar. 8, 2011); "Report on Proposed and Temporary Regulations under Section 871(m)" 2012 TNT 13-6 (Apr. 25, 2012) (the "2012 Report").

4 P.L. 111-147 (124 Stat. 71).

5 Payments on substitute dividend payments made pursuant to securities lending or sale-repurchase agreements are already subject to withholding under Treasury Regulations section 1.861-3(c)(6).

from sources within the United States; and (c) any other payment determined by the Secretary to be substantially similar to a payment described in (a) or (b).

Proposed regulations issued on January 23, 2012 (the "2012 Proposed Regulations"), previously provided guidance using a seven-factor test to identify when a transaction was a specified NPC. The 2012 Proposed Regulations also created a new category of transactions "equity-linked instruments" ("ELIs"). ELIs would be treated as "specified equity-linked instruments," and thus subject to section 871(m), if they met one of seven factors. New proposed regulations issued on December 5, 2013 (the "Proposed Regulations"), adopt a 70% delta test to determine whether a transaction is a specified NPC or a specified ELI. Very generally, once a transaction meets the delta threshold, implied dividends would be subject to taxation and withholding.

II. Recommendations

Our principal recommendations are as follows:

A. *Dividend estimates*. We recommend that section 871(m) apply to dividend "estimates" only for transactions involving preferred shares, and, possibly, short-term transactions or a series of short-term transactions. Transactions that expressly provide for a payment made by reference to a dividend, or for an adjustment to the terms of the instrument if a dividend changes, should be treated as transactions providing for actual dividend equivalent payments.

B. *Delta test.* We are concerned that a delta threshold of 0.70 is too low. For the reasons discussed below, we believe that a threshold of at least 0.80 is more appropriate.

We also recommend that the delta test not be applied to certain "exotic" instruments, such as digital options; that a disaggregation method be considered for determining whether instruments that provide for exposure to varying amounts of shares are subject to section 871(m); and that, in the case of exchange-traded instruments, a surrogate method be considered for determining whether the instrument is subject to section 871(m).

C. *Convertible debt and other issuer securities.* We recommend that convertible debt obligations and other securities issued by the issuer of the underlying stock be excluded from section 871(m). We also recommend changes to the reporting rules for "deemed" dividends under section 305 to make the regime more effective so that deemed dividends arising under section 305 are consistently reported to taxpayers and are taken into account for net income and withholding tax purposes.

D. *Indices*. We recommend that the determination of whether an index is "qualified" be made by reference to whether modifications or rebalancings of the index are conducted using publicly stated objective criteria and objective goals, even if the index is not created pursuant to a formulaic rule and some discretion is involved in determining whether the criteria are satisfied. Those objective criteria should not take into account any positions or costs (for example, hedging costs) of any party to the transaction or the compiler of the index. We also recommend that the exclusion for certain indices in which U.S. dividend-paying stocks represent less than 10% of the index be narrowed to exclude indices created for the purpose of avoiding dividend withholding tax.

E. *Variable withholding amounts, and withholding on prepayments*. Some members of the Executive Committee believe that consideration should be given to imposing withholding tax on a basis that would simplify the tax calculation on each dividend payment date. Under this approach, tax would be withheld on an instrument subject to section 871(m) as if the delta were 1.0 when the delta on the relevant testing date (that is, the ex-dividend or record date for the relevant dividend) is equal to or greater than the threshold that causes the instrument to be subject to section 871(m), and no tax would not be withheld when it is below that threshold on that date.

We recommend that Treasury and the IRS reconsider the requirement that a short party must withhold on dividend equivalents to the extent that it has received a "prepayment," except in limited circumstances.

F. *M&A transactions*. We recommend that the exclusion for M&A transactions be broadened to apply to transactions involving 20%, rather than 50%, of the stock of a company.

G. *Short-term exception*. We believe that the short-term exception, which requires that the determination of whether withholding is required be made at maturity or other termination of a short-term instrument, is useful. We recommend that the short-term rule be limited to instruments that do not actually pay or credit dividend equivalent amounts during their term, and that the determination of whether an instrument is short-term be made based on its term at issuance, rather than when it is acquired.

H. *Testing at issuance versus acquisition*. Some members believe that section 871(m) testing should take place only upon issuance of an instrument, rather than upon any investor's acquisition.

I. *Compensation-related option*. We recommend that compensation-related positions be excluded from the rules.

J. *Cascading withholding tax.* We recommend that a cascading rule, similar to that in Notice 2010-46, be implemented generally to avoid multiple withholdings with respect to a single chain of derivatives. In the alternative, we recommend modifications to the qualified dealer exception.

K. *The "in connection with" rule*. We recommend that changes be made to the rules for determining whether a position is held "in connection with" another position and that examples be added to clarify the application of these rules. We also recommend that taxpayers be permitted to seek a refund if they can demonstrate that their net long position is below the applicable delta threshold.

L. *Partnerships and trusts*. We recommend that, in determining the application of the provisions to partnerships and trusts, taxpayers be allowed to use recent audited financial statements to determine whether the 10% threshold has been met, absent actual knowledge that the threshold is met at the time of an acquisition.

M. *Anti-abuse rule*. We support the inclusion of an anti-abuse rule. We recommend that the anti-abuse rule specify that it applies to transactions that are the substantial economic equivalent of an investment in the stock of a U.S. corporation and that have been structured with a principal purpose of avoiding the application of section 871(m). If this recommendation is not adopted, then we urge that the final regulationss clearly state an alternative standard. We also recommend that examples be included to illustrate when the anti-abuse rule would be invoked.

N. *Other issues.* We address due bills, reporting by issuers, and the Proposed Regulations' effective date. It appears appropriate to subject non-U.S. investors to section 871(m) to extent they receive dividend equivalent amounts as a result of due bill procedures, but we are concerned about the impact that this could have on the orderly functioning of stock exchanges. We recommend that issuers be required to report their determinations of delta contemporaneously with issuances, and on a frequent basis thereafter, and that investors be permitted to rely on the most recent information provided by an issuer. We recommend that specified NPCs that hedge grandfathered specified ELIs should be grandfathered, regardless of when they are issued.

III. Background

A. Section 871(m)

Section 871(m) was added to the Code as part of the HIRE Act[6] to address concerns about the avoidance of withholding tax on U.S. source dividends through derivative transactions. Section 871(m)(1) alters the usual rule of recipient-based sourcing on certain NPCs contained in Treasury Regulations section 1.863-7(b)(1) for "dividend equivalent" payments, and provides that a dividend equivalent payment is treated as if it were a U.S. source dividend for withholding tax purposes. As a result, dividend equivalent payments are subject to U.S. withholding tax when paid to a non-U.S. recipient.

[6] P.L. 111-147 (124 Stat. 71).

Section 871(m) treats as a dividend equivalent three categories of payments: (a) substitute dividend payments made pursuant to securities lending or sale-repurchase agreements;[7] (b) payments made pursuant to "specified notional principal contracts" that are directly or indirectly contingent upon or determined by reference to the payment of a dividend from sources within the United States; and (c) any other payment determined by the Secretary to be substantially similar to a payment described in (a) or (b).

Section 871(m)(3) defines an NPC to be a "specified NPC" if (i) in connection with entering into such contract, any long party to the contract transfers the "underlying security"—that is, shares of a U.S. corporation—to any short party to the contract, (ii) in connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract, (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract, or (v) such contract is identified by the Secretary as a specified NPC.

An important feature of section 871(m) is its staggered effective date. The provision was enacted on March 18, 2010, but it had a 180-day delayed effective date, applying only to the transactions described in the preceding paragraph. After March 18, 2012, section 871(m) applies to payments made on any NPC unless the Secretary has made a determination that such contract is of a type which does not have the potential for tax avoidance. It is this regulatory authority that is the subject of two sets of proposed regulations.

On January 23, 2012, Treasury and the IRS issued the 2012 Proposed Regulations and temporary regulations.[8] The temporary regulations effectively postponed the effective date of withholding on those NPCs not specifically identified in the statute until January 1, 2014. The 2012 Proposed Regulations, which were proposed to apply to NPC payments made on or after

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7 Payments on substitute dividend payments made pursuant to securities lending or sale-repurchase agreements are already subject to withholding under Treasury Regulations section 1.861-3(c)(6).

8 T.D. 9572; REG-120282-10.

January 1, 2014, contained a seven-factor test[9] to determine whether an NPC is a specified NPC and created a new category of instruments referred to as an "equity-linked instrument."[10] An ELI was defined as a financial instrument or combination of financial instruments that references one or more underlying securities to determine its value, including a futures contract, forward contract, option or other contractual arrangement.

On December 5, 2013, Treasury and the IRS issued final regulations (the "Final Regulations"), withdrew the 2012 Proposed Regulations, and issued a new set of proposed regulations (which we refer to as the Proposed Regulations).[11]

B. The Final Regulations

The Final Regulations are limited to specified NPCs. For payments made after March 18, 2012, but before January 1, 2016, a specified NPC is any NPC if (1) in connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract, (2) in connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract, (3) the underlying security is not readily tradable on an established securities market, or (4) in connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

The Final Regulations also provide that a dividend equivalent under section 871(m) is treated as a dividend for purposes of tax treaties and is treated as income from investments in stock for purposes of section 892.[12] The Final Regulations also made a number of coordinating changes to the regulations under section 1441.

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9 The seven factors were as follows: (1) a contemporaneous transfer of the underlying security is made on the day or days that parties price the NPC or day or dates when the NPC terminates; (2) the underlying security is not regularly traded; (3) the underlying security is posted as collateral; (4) the NPC has a term of fewer than 90 days; (5) the NPC long party controls the short party's hedge; (6) the notional principal amount represents a significant percentage of trading volume; and (7) the NPC provides for a payment of a special dividend. Former Prop. Reg. § 1.871-16(c) (2012).

10 Former Prop. Reg. § 1.871-15(d)(2)(i) (2012).

11 T.D. 9648; REG-120282-10.

12 Treas. Reg. § 1.892-3(a)(6).

C. The Proposed Regulations

The approach of the Proposed Regulations is fundamentally different from the approach of the 2012 Proposed Regulations in a number of respects. The Proposed Regulations discard the seven-factor test in favor of a bright-line "delta" based test. In addition, the Proposed Regulations would tax estimated dividends.

1. Specified NPCs and Specified ELIs

The Proposed Regulations address both specified NPCs and specified ELIs. An ELI "is a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC that references the value of one or more underlying securities. For example, a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one or more underlying securities is an ELI."[13]

Both specified NPCs and specified ELIs are those contracts for which there is a delta (defined below) of 0.70 or greater at the time that the long party enters into or acquires the NPC or ELI. Thus, the delta must be determined each time there is a transfer.

2. Delta

Delta is defined as the ratio of the change in the fair market value of the contract relative to the change in the fair market value of the referenced equity.[14] If an NPC or ELI references more than one underlying security, a separate delta must be determined with respect to each "underlying security" without taking into account any other underlying security, other property or liability. The delta is determined at the time of acquisition for purposes of determining whether an NPC or ELI is a specified NPC or specified ELI.[15] If the contract has a delta of 0.70 or greater with respect to the underlying security, the instrument is either a specified NPC or a specified ELI.

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[13] Prop. Reg. § 1.871-15(a)(4).

[14] Prop. Reg. § 1.871-15(g)(2).

[15] Prop. Reg. § 1.871-15(d)(2) and (e).

If the delta is considered "constant" at the time it is acquired, the delta is treated as 1.0. An NPC or ELI has a constant delta with respect to an underlying security if the NPC or ELI has a delta that is not reasonably expected to vary during the term of the transaction with respect to changes in the underlying security.[16]

3. Qualified Indices

For baskets of securities, it is necessary to analyze each underlying security and determine the delta with reference to the underlying securities. There is no withholding if the instrument references a qualified index. A qualified index is 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;

(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; and

(vi) as to which futures contracts or option contracts on 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.[17]

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16 Prop. Reg. § 1.871-15(j)(2).

17 Prop. Reg. § 1.871-15(k)(2).

Under a safe harbor, an index is also a qualified index if the index is comprised solely of long positions in assets, and the referenced component underlying securities (*i.e.*, shares of U.S. corporations) in the aggregate comprise 10% or less of the index's weighting.[18]

If a potential section 871(m) transaction references a qualified index and one or more underlying securities or indices, the qualified index will remain a qualified index only if the potential section 871(m) transaction does not reference a short position in any referenced component underlying security of the qualified index, other than a short position with respect to the entire qualified index (for example, a cap or floor). According to the Proposed Regulations, if, in connection with a potential section 871(m) transaction that references a qualified index, a taxpayer (or a related person within the meaning of sections 267(b) or 707(b)) enters into one or more transactions that reduce exposure to any referenced component underlying security of the index, other than transactions that reduce exposure to the entire index, then the potential section 871(m) transaction is not treated as referencing a qualified index.[19]

4. <u>Combination Rules</u>

Two or more potential section 871(m) transactions are treated as a single transaction with respect to an underlying security and subject to section 871(m) when (i) a person (or a related person within the meaning of sections 267(b) or 707(b)) is the long party with respect to the underlying security for each potential section 871(m) transaction; (ii) the potential section 871(m) transactions reference the same underlying security; and (iii) the potential section 871(m) transactions are entered into "in connection with each other" (regardless of whether the transactions are entered into simultaneously or with the same counterparty).[20] The Proposed Regulations do not provide any guidance on how the "in connection with" determination is to be made.

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[18] Prop. Reg. § 1.871-15(k)(3).

[19] Prop. Reg. § 1.871-15(k)(6).

[20] Prop. Reg. § 1.871-15(l)(1).

If a potential section 871(m) transaction is a section 871(m) transaction solely as a result of applying the combination rule and the withholding agent 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) transaction, the potential section 871(m) transaction is exempt from withholding under section 1441(a).[21] This relieves the withholding agent of responsibility for withholding, but does not eliminate the tax imposed by section 871(m) on the recipient, who would be obligated to file a U.S. tax return in order to pay the tax.

5. Estimated Dividends

The Proposed Regulations provide rules for identifying a payment of a dividend equivalent.[22] In perhaps the most important change from the 2012 Proposed Regulations, withholding is required on estimated dividend amounts used in pricing a derivative. A "payment" includes an actual or estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction, including interest rate, notional amount, purchase price, premium, up-front payment, strike price, or any other amount paid or received pursuant to the potential section 871(m) transaction. A simple option on stock will have one or more implied dividend estimates within the meaning of the Proposed Regulations, because expected interim dividend payments will be reflected in the pricing of the option (which typically has an adjustment mechanism to account for "special" dividends but not "ordinary" interim dividends). Similarly, a convertible debt instrument would have an implied estimated dividend if it did not provide for adjustments to its conversion ratio to account for dividends (or deviations from expected dividends) on the underlying stock. More generally, virtually any derivative instrument linked to U.S. equities will be a potential ELI under the Proposed Regulations, because if the terms of the instrument do not reflect adjustments to account for the full amount of actual dividends, then the pricing of the instrument will

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

[22] Prop. Reg. § 1.871-15(h).

necessarily take into account expected interim dividends. This concept of implied estimated dividends expands the concept of "income" beyond that commonly accepted today. It also creates many complications in applying the Proposed Regulations. The statutory authority for this provision is presumably section 871(m)(5), which provides that the term "payment" includes any gross amount used in computing any net amount that is transferred to or from the taxpayer.

6. The Amount of the Dividend Equivalent

For a securities lending or sale-repurchase transaction, the amount of the dividend equivalent for each underlying security equals the amount of the actual per-share dividend paid on the underlying security multiplied by the number of shares of the underlying security transferred pursuant to the securities lending or sale-repurchase transaction. For a specified NPC or a specified ELI, the amount of the dividend equivalent for each underlying security equals: (1) the amount of the per-share dividend with respect to the underlying security multiplied by (2) the number of shares of the underlying security multiplied by (3) the delta of the section 871(m) transaction with respect to the underlying security at the time that the amount of the dividend equivalent is determined. This delta is used solely for purposes of determining the amount of the dividend equivalent at that time, and the transaction is not retested to determine if it is a section 871(m) transaction.[23] The purpose of using the delta at the time of the dividend payment appears to be to allow for adjustments in the underlying hedge maintained by the short party. That is, if the short party to an equity-linked derivative transaction is a dealer, it ordinarily will increase or decrease the amount of stock that it holds during the term of the derivative by reference to increases or decreases in delta, and therefore can be expected to receive more or less dividend income from its position in that stock as a result.

The amount of the dividend equivalent is determined on the earlier of the ex-dividend date and the record date for the relevant dividend.[24] If the section 871(m) transaction has a term

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23 Prop. Reg. § 1.871-15(i)(1)(ii).

24 Prop. Reg. § 1.871-15(i)(2)(i).

of one year or less, the amount of the dividend equivalent is determined when the long party disposes of the transaction.[25]

A section 871(m) transaction is treated as paying a per-share dividend amount equal to the actual dividend amount unless the short party to the section 871(m) transaction identifies a reasonable estimated dividend amount in writing at the inception of the transaction. A reasonable estimated dividend amount stated in an offering document or the documents governing the terms of the transaction will establish the estimated dividend amount in writing at the inception of the transaction. To qualify as an estimated dividend amount, the written estimated dividend amount must separately state the amount estimated for each anticipated dividend or state a formula that allows each dividend to be determined.[26]

A payment occurs when the amount of a dividend equivalent is fixed pursuant to the terms of the transaction, even if paid or otherwise taken into account on a later date.[27]

7. Application to Pass-Through Entities

If a transaction references an entity that is not a corporation, then the transaction references the allocable portion of any underlying security or potential section 871(m) transaction held, directly or indirectly (including through one or more other entities that are not C corporations), by the referenced entity. When a transaction references any underlying security under this provision, the transaction also references the payment of any dividends from those underlying securities and has a dividend equivalent equal to the allocable portion of any dividend or dividend equivalent received, directly or indirectly (including through one or more other entities that are not C corporations), by the referenced entity.

A transaction is not treated as referencing underlying securities if the underlying securities held, directly or indirectly. by the referenced entity and the underlying securities referenced by any potential section 871(m) transaction held, directly or indirectly, by the

25 Prop. Reg. § 1.871-15(i)(2)(ii).

26 Prop. Reg. § 1.871-15(h)(2)(iii).

27 Prop. Reg. § 1.871-15(h)(3).

referenced entity represent, in the aggregate, 10% or less of the value of the referenced interest in the entity at the time the long party acquires the transaction and there is "no plan or intention for acquisitions or dispositions" that would cause underlying securities to represent more than 10% of the value of the referenced interest.

This is illustrated by an example in which an actively-traded Partnership A owns a pro rata interest in Partnership B that represents 10% of the value of an interest in Partnership A, and Partnership B owns an interest in Underlying Security X that represents 20% of the value of an interest in Partnership B. Consequently, Underlying Security X represents 2% of the value of a pro rata interest in Partnership A. Accordingly, a pro rata interest in Partnership A qualifies for the 10% value exception and Underlying Security X is not treated as referenced by a transaction that references a pro rata interest in Partnership A.

8. Anti-Abuse Rule

Like the 2012 Proposed Regulations,[28] the Proposed Regulations contain a broad anti-abuse rule. The anti-abuse rule allows the Commissioner to treat any payment made with respect to a transaction as a dividend equivalent if the taxpayer acquires a transaction with a principal purpose of avoiding the application of these rules. The Commissioner may adjust the delta of a transaction; change the number of shares; adjust an estimated dividend amount; adjust the timing of payments; combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions; or otherwise depart from the rules as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent.[29] The Proposed Regulations do not provide any examples of transactions that may be treated as acquired with a principal purpose of avoiding these rules.

[28] Former Prop. Reg. § 1.871-15(e) (applicable where a taxpayer has a principal purpose of avoiding the application of the Treasury Regulations sections 1.871-15 or 1.871-16).

[29] Prop. Reg. § 1.871-15(n).

9. Section 305

The Proposed Regulations provide that a payment pursuant to a section 871(m) transaction is not a dividend equivalent to the extent that the payment is treated as a distribution taxable as a dividend pursuant to section 305.[30] The application of this rule raises may questions, as the circumstances giving rise to a deemed dividend under sections 305 and 871(m) are not the same. Among other matters, a section 305 dividend is equal to the value of the deemed distribution and is not determined by reference to delta; and in the case of a convertible bond or option with dividend adjustment provisions, a section 305 dividend arises at the time of an adjustement to the instrument's conversion ration to reflect the payment of a dividend on the issuer's common stock, rather than on the record or ex-dividend date for the related dividend.

The interaction between sections 871(m) and 305 is discussed in detail in Part IV.C below.

10. M&A Transactions

The Proposed Regulations also carve out from the scope of section 871(m) transactions where an investor has an obligation to acquire underlying securities representing more than 50% or greater of the value of the entity issuing the underlying securities.[31] This exception is intended to ensure that section 871(m) does not apply to M&A transactions involving the acquisition of a company's stock. As discussed below in Part IV.F, however, the Proposed Regulations would still apply to some M&A transactions.

11. Effective Date

The Proposed Regulations would be effective for payments made after January 1, 2016. For specified ELIs, the Proposed Regulations provide that they would apply to payments made on or after January 1, 2016, but only with respect to an ELI that was acquired by the long party on or after March 5, 2014. In Notice 2014-4,[32] Treasury and the IRS revised the effective date

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[30] Prop. Reg. § 1.871-15(c)(2)(ii).

[31] Prop. Reg. § 1.871-15(j)(2).

[32] 2014-13 I.R.B. 881.

for ELIs so that the regulations under section 871(m) would apply to ELIs issued on or after 90 days after the date of publication of the final regulations.

12. Reporting and Withholding

Brokers and dealers that are parties to potential section 871(m) transactions must determine whether a transaction is a section 871(m) transaction and provide that information to the counterparty. If no broker or dealer is a party, the short party must provide this information. The party to the transaction that is required to determine whether a transaction is a section 871(m) transaction must also determine and report any dividend equivalents to the counterparty or customer under the payment reporting rules of section 1461 (Chapter 3 reporting) and 1474 (FATCA).[33]

In addition, upon request by any other party to the transaction or any broker or other reporting agent, the party required to provide information must provide the requester with information regarding the amount of each dividend equivalent, the delta of the potential section 871(m) transaction, the amount of any tax withheld and deposited, the estimated dividend amount if specified, and any other information necessary to apply the rules of the regulations under section 871(m). With respect to the delta, the party must provide the delta when the transaction is acquired, at the time the amount of each dividend equivalent is determined, and at any other time delta information is necessary to apply the rules of the regulations under section 871(m). The information requested must be provided within a reasonable time, not to exceed 14 calendar days.[34]

A withholding agent is not obligated to withhold until the later of (i) the time that the amount of a dividend equivalent is determined and (ii) the time that the withholding agent is deemed to have control over money or other property of the long party.[35] For purposes of determining whether a payment is a dividend equivalent and the amount of the dividend

33 Prop. Reg. § 1.871-15(o)(2).

34 Prop. Reg. § 1.871-15(o)(3).

35 Prop. Reg. § 1.1441-2(d)(5).

equivalent, a withholding agent may rely on the information received from the party to the transaction that is required to determine whether a transaction is a section 871(m) transaction as provided above, unless the withholding agent has actual knowledge or reason to know that the information received is incorrect.[36]

A withholding agent is also not obligated to withhold on payments made to a qualified dealer. A non-U.S. 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-U.S. persons.[37]

13. Specific Requests for Comments in the Preamble

In the Preamble to the Proposed Regulations, Treasury and the IRS asked for guidance on a number of specific issues, including:

(i) What are substantially similar payments: whether other payments should be treated as substantially similar payments, such as a payment made by a seller of stock to the purchaser of the stock pursuant to an agreement to deliver a pending U.S.-source dividend after the record date (for example, a due bill).

(ii) The constant delta rule: whether taxpayers could avoid the constant delta rule by structuring transactions with the potential for *de minimis* delta variability and whether such transactions should be deemed to have a constant delta.

(iii) The combination rules: whether (and, if applicable, how) the rules for combining separate transactions to determine if the transactions are a section 871(m) transaction should apply in other situations, such as when a taxpayer holds both long and short positions with respect to the same underlying security and whether (and, if applicable, how) the remaining

36 Prop. Reg. § 1.1441-3(h)(2).

37 Prop. Reg. § 1.871-15(j)(1).

transaction (or transactions) should be retested when a long party terminates one or more, but not all, of the transactions that make up a combined position.

(iv) The reporting rules: which parties should be required to report and what is the appropriate extent of reportable information.

IV. Discussion of Specific Issues

A. Dividend Estimates

1. Background

At the heart of the Proposed Regulations is a requirement that withholding be based on the estimated dividends (whether explicit or implicit) used in pricing a derivative contract. The 2012 Proposed Regulations were explicit in indicating that estimated dividends would not be subject to withholding.[38] By contrast, the Proposed Regulations state that a "dividend equivalent payment" includes not only an explicit amount paid or credited \ during the instrument's term but also any "estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction."[39] Indeed, the Proposed Regulations provide that if an estimate of an interim dividend is not made explicit by the short party in the documentation at the time of issuance of the instrument, the amount of the dividend equivalent will be deemed to be the actual dividend amount, even if that is higher or lower than what was, in fact, estimated.

The Preamble explains the change in policy as follows:

> The 2012 proposed regulations provided that estimates of expected dividends were not dividend equivalents unless the estimate was adjusted to reflect actual dividend payments. The 2013 proposed regulations eliminate this exception and explicitly treat estimated dividend payments as dividend equivalents because the economic benefit of a dividend is present in contracts that use estimated dividends in much the same way as a contract that adjusts for

[38] Former Prop. Reg. § 1.871-15(b)(2)(i) (2012) (providing that a dividend equivalent does not include any payment that is considered an estimate of expected dividends if such payment is contingent upon or determined by reference to an estimate of expected dividends and the estimate of expected dividends is not adjusted in any way for an actual dividend).

[39] Prop. Reg. § 1.871-15(h)(2)(ii).

> actual dividends. Moreover, the Treasury Department and the IRS are concerned that taxpayers may inappropriately avoid section 871(m) if estimated dividends are not treated as dividend equivalents.

This concept is illustrated in an example where a foreign investor enters into a price-return swap contract that entitles the foreign investor to receive payments based on the appreciation in the value of 100 shares of Stock X and requires the foreign investor to pay an amount based on LIBOR plus any depreciation in the value of Stock X. The swap contract does not entitle the foreign investor to payments based on dividends paid on Stock X during the term of the contract and the swap contract does not contain any reference to an estimated dividend amount. The LIBOR rate on the swap contract, however, is reduced to reflect expected annual dividends on Stock X. Because the LIBOR leg of the swap is reduced to reflect estimated dividends and the estimated dividend amount is not specified, the example concludes that the foreign investor is treated as receiving the actual dividend amount.[40]

2. <u>Discussion</u>

It is far from clear that any dividend estimate is a "dividend equivalent" within the meaning of section 871(m)(2), which defines a "dividend equivalent" as something that is "contingent upon, or determined by reference to, the payment of a dividend from sources within the United States." Dividend estimates are calculated ***prior to*** the payment of a dividend, so they cannot be contingent upon or determined by reference to that payment. Of course, if the dividend has been declared, one can argue that the "estimate" is an estimate in name only, although it remains the case that, even then, the estimate is not contingent upon or determined by reference to the ***payment*** of the relevant dividend.

Nonetheless, we think it appropriate as an anti-abuse matter to treat as dividend equivalents estimates of "virtually certain" amounts, even if not yet paid, including declared dividends, dividends on preferred stock, and perhaps (as further discussed below) dividends

[40] Prop. Reg. § 1.871-15(h)(4), Example (2).

actually paid during the duration of "short-term instruments." Transactions that expressly provide for a payment made by reference to a dividend, or an adjustment to the terms of the instrument if a dividend deviates from the parties' expectations, should be treated as transactions providing for actual dividend amounts. Beyond that, we do not believe it is within the intent or language of the statute to tax as dividend equivalents (whether on NPCs or on ELIs) "estimates" of future dividend amounts (for which no adjustment is made to account for actual dividends).

We note further that an implied dividend estimate, which is an amount that is never paid or credited under the relevant instrument but is in effect used to reduce the price of the instrument, is not even ***income***. These amounts, in effect, reflect the (perhaps negotiated, but in any event contractually unstated) determinants of a "discount" to account for an income stream that may or may not be paid in the future on the underlying stock and that the "long party" did ***not*** acquire. Moreover, it is troubling to us that these items would be taxed ***only*** in the hands of non-U.S. persons. Treaties typically provide a non-discrimination article under which a tax may not be imposed on residents of a contracting state that is more burdensome than that imposed on residents of the other contracting state.[41] The Proposed Regulations appear to a number of the members of the Executive Committee to be contrary to this provision.

As discussed above, we would not object to applying the regime to estimated dividends with respect to transactions that have a relatively short term, or a series of such transactions, on the theory that these might be viewed as "substantially similar" to amounts contingent upon or determined by reference to a payment of a dividend. While it is still true that there may be no income in these situations, there are countervailing concerns in these limited cases. Imposing withholding tax may be appropriate because a taxpayer's risk that dividend expectations will change during the term of a "short-term" transaction is lower than in the case of longer-term transactions, where expectations are necessarily more speculative and less certain. Short-term transactions might also give rise to greater potential for abuse because a series of short-term

[41] U.S. Model Income Tax Convention, Art. 24 (Nov. 15, 2006).

transactions could be structured to allow a taxpayer to obtain returns that are very close to what the taxpayer would receive in a longer-term transaction with dividend adjustment provisions.

We have considered what should qualify as "short-term" for this purpose and did not reach agreement. Possible alternatives include 90 days (because most dividends on U.S. stocks are paid quarterly) or one year (because that is the typical time horizon for a "short-term" transaction).

B. The Delta Test

1. <u>Background</u>

Section 871(m) defines a "dividend equivalent" to include, *inter alia*: (i) any payment made pursuant to a specified NPC that (direct or indirectly) is contingent upon or determined by reference to the payment of a dividend from sources within the United States; and (ii) any other payment that the Secretary determines is "substantially similar" to a specified NPC payment or substitute dividend payment. In turn, the Proposed Regulations, define a "dividend equivalent" to include, *inter alia*: (i) any payment (as further described in the proposed rules) pursuant to a "specified NPC" that references the payment of a dividend from an underlying security; and (ii) any payment (as further described in the proposed rules) pursuant to a "specified ELI" that references the payment of a dividend from an underlying security.[42]

Section 1.871-15(g)(1) of the Proposed Regulations provides that the delta of an NPC or an ELI is the ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of "the property referenced by the NPC or ELI." The delta of a transaction must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is treated as the delta for purposes of section 871(m). For example, to determine whether an option is a specified ELI, the Preamble states that a dealer may use the delta that it calculates to determine the number of shares needed to balance its position on the option (even though that number of shares may not correspond to the dealer's

[42] Prop. Reg. § 1.871-15(b).

actual hedge). If an NPC or ELI contains more than one reference to a single underlying security, all references to that underlying security are taken into account in determining the delta.[43] If an NPC or ELI references more than one underlying security, a separate delta must be determined with respect to each underlying security without taking into account any other underlying security or other property or liability.[44]

The Preamble notes that Treasury and the IRS believe the seven-factor test set forth in the 2012 Proposed Regulations does not provide the best framework for evaluating whether an NPC "is of a type which does not have the potential for tax avoidance," the statutory benchmark for the exercise of regulatory authority, and that the seven-factor approach would be difficult to administer, both for the IRS and withholding agents. In addition, the Preamble notes that Treasury and the IRS believe that the delta-based standard of the Proposed Regulations provides a simpler and more administrable framework than the seven-factor test of the 2012 Proposed Regulations. Our 2012 Report recommended the use of delta as an alternative to the seven-factor test. We commend the government for moving away from the seven-factor test and adopting a delta-based approach, which we think as a starting point is a substantial step forward.

The Preamble states that a transaction has the "potential for tax avoidance" if it approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security. It also states that in many cases, a long party is indifferent as to whether to invest in a derivative or a physical position because the derivative and the physical position provide comparable economic returns. The Preamble states further that a delta approach that objectively identifies transactions in which the long party is able to approximate sufficiently the economic returns associated with an underlying security is favored.

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[43] Prop. Reg. § 1.871-15(g)(1).

[44] Id.

2. Comments

Two primary questions are raised by the delta standard of the Proposed Regulations: (i) whether the 0.70 threshold is the appropriate threshold to objectively distinguish between transactions that approximate the economic returns of investing in the underlying stock, and (ii) whether it is appropriate to apply the delta test to all types of derivative transactions that are within the scope of the Proposed Regulations.

a. *Whether a delta of 0.70 is the correct threshold to apply*. It is appropriate that any instrument that provides substantially all of the economic exposure to a U.S. dividend-paying stock should fall within the scope of section 871(m). In connection with the Proposed Regulations, government officials have informally indicated their belief that an option with a 0.70 delta is likely to be exercised. However, it is not clear why "likelihood of exercise" is relevant to a determination of whether the long party is economically earning interim dividend equivalents or substantially similar amounts. We believe that parties attempting to earn dividend equivalents will not find it efficient to do so at deltas as low as 0.70 because, at that level, the transaction will not approximate the economic returns associated with the underlying security, which we think is the "avoidance" at which the statute is directed. Perhaps most notably, low-delta transactions have materially higher transaction costs than high-delta transactions (we understand that "delta one" transactions involve extremely thin "spreads" for the short party, aside from the short party's cost of "carrying" the underlying security, and indeed trade very much like the underlying stock). We do not believe that taxpayers wishing to avoid withholding tax would engage in low delta (high transaction cost) transactions in order to do so.

We are not aware of any other rule of law, including tax law, that treats a position with a 0.70 delta as approximating exposure to the underlying asset. For example, a 0.80 delta standard is used by most practitioners in applying the constructive ownership rules of section 1260 to determine whether substantially all of the economic return with respect to a financial asset has been conveyed through a forward contract, based on a specific carve-out in section 1259 for forward contracts where the amount of cash or stock to be delivered is subject to significant variability.[45] We are not aware of any ruling or public statement adopted by the IRS that is contrary to this market practice. If the delta test is retained, it is hard to see why the standard should be lower for purposes of section 871(m) than for purposes of constructive ownership.[46] We expect that others will make more informed suggestions regarding the appropriate threshold.

b. *Application of "delta" standard*. The Proposed Regulations define "delta" as the ratio of the change in value of the instrument or transaction to the change in value of the underlying shares of stock that the instrument or transaction references. The Proposed Regulations offer no guidance, however, as to how many shares of stock an instrument or transaction is deemed to reference in any given case; that is, how many shares should be deemed referenced in the denominator of the delta test. In many "plain vanilla" cases, it will be clear what the value of the denominator should be. In other cases, the number of shares in the denominator can be reasonably inferred, though it would be useful for the regulations to state so explicitly.

As an example, it is clear that a forward contract with respect to 100 shares of IBM should be tested by putting 100 shares of IBM in the denominator. Similarly, it must be the case that a purchased call and a sold put, each referencing 100 shares with the same strike—two ELIs that together have the same economics as a forward contract—would also be deemed *together* to

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45 Section 1259(d)(1) (a forward contract means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price).

46 The implication under section 1260 is that a contract must provide for substantially all of the economic return of the financial asset to fall within the scope of the constructive ownership rules. For example, forward contracts may trigger application of section 1260, but there is regulatory authority under section 1260(g)(2) to exclude contracts that do not convey "substantially all" of the economic return with respect to a financial asset. Similarly, the regulatory authority under section 871(m)(2)(C) applies to any other payment determined to be "substantially similar to a payment" on a securities lending or a sale-repurchase transaction or with respect to "specified notional principal contracts," which, as discussed above, is a very specific category of notional principal contracts. Just as the "substantially all" language of section 1260 is meant to implicate transactions that replicate ownership of the underlying asset, it would seem the "substantially similar" language is meant to implicate transactions that replicate the receipt of dividends with respect to the underlying stock. Accordingly, in our view, it is first necessary to determine whether a transaction is comparable to one of the transactions described in sections 871(m)(2)(A) and (B) – specifically, whether it is comparable to a securities loan or total return equity swap, which are both "delta one" transactions – and then to determine whether there is a payment substantially similar to a payment on that specified transaction. The first step of this process should, in our view, be subject to a standard no more rigorous than that used for purposes of the constructive ownership rules of section 1260.

reference 100 shares, despite the fact that the taxpayer holds two separate positions, each referencing 100 shares.[47] If this were not the case—that is, if the delta test were applied by putting *200* shares in the denominator—transactions that clearly replicate the economics of a "delta one" position would not be "caught" by section 871(m). This suggests that while the delta test should generally be applied by putting in the denominator all the shares referenced by each of the separate positions that make up an ELI,[48] that should not be the case for ELIs to the extent that they contain overlapping long positions—*e.g.*, long calls and short puts on the same equity. Rather, in such a case, only the maximum number of shares that the long party has exposure to—the 100 shares in the example above—should be put in the denominator of the delta test. While this principle can be inferred from the logic of the Proposed Regulations, it should be so stated explicitly.

There are other situations in which the analysis is arguably more complicated, and therefore there is a need to clarify, modify, or replace the delta test. This complexity can arise because (a) there may be uncertainty as to the number of shares being referenced or as to what shares are being referenced and/or (b) because a literal application of the Proposed Regulations would lead to a result that is arguably at odds with congressional intent. Below we give common examples of such cases.

Structured notes issued today often provide investors with a "leveraged" upside return while providing unleveraged exposure to the stock's decrease in value. Thus, the holder might receive the upside on 300 shares, perhaps up to a cap, and the downside exposure on 100 shares. Further, the downside exposure might be "buffered"; that is, it begins only after the underlying stock has declined by some percentage of its initial value. Economically, this is equivalent to buying calls on 300 shares, selling calls on 300 shares with a strike price equal to the cap, and selling puts on 100 shares. The Proposed Regulations, which state that "all references to that

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[47] The text assumes that the put and the call were entered into "in connection with" each other and are therefore to be tested together.

[48] See further discussion of this point immediately below.

underlying security are taken into account in determining the delta" strongly suggest that the denominator of a note of this kind should include 300 shares, notwithstanding the fact that the exposure to that number of shares is bounded, and may be less than meaningful once the referenced security appreciates well above the cap or depreciates well below the strike price on the embedded long call on 300 shares. We believe that this result is mandated by the Proposed Regulations, although it is not clear to us that it is the correct result as a policy matter, as discussed below.

It does seem clear that the numerator of the delta test should reference the entirety of the ELI. In simple terms, that means that the numerator should reflect the change in value of the entire ELI. Economically, that means that the numerator (to use the facts of the example), should reflect not only the purchased calls on 300 shares, but also the sold calls on that same number of shares and the sold puts on 100 shares. It seems clear, in other words, that the value reflected in the numerator should take into account not only the 300 long calls but also (assuming the investor's upside is capped) the embedded short calls. The Proposed Regulations should make this explicit.

There are many cases in which application of the test as laid out in the Proposed Regulations yields results that are at odds with what we believe is the congressional intent. These cases are variations on the theme that (a) the more shares that are referenced in the denominator, the likelier it is—all other things being equal—that the ELI will pass muster under section 871(m) even though (b) an increase in the number of shares in the denominator does not necessarily correspond to an increase in the ELI's optionality. Put differently, an ELI may have a high likelihood of having a payoff very close to that of the referenced equity even if it passes the delta test of the Proposed Regulations.

A simple example illustrates this point. Assume that an ELI with a one year maturity consists of a forward on 100 shares plus an option on an additional 100 shares, where the option's strike is 150% of the spot price at inception. The "referenced property" is 200 shares: the 100 shares referenced by the forward plus the additional 100 shares referenced by the option.

A $1 increase in the value of a referenced share will cause a $200 increase in the denominator but hypothetically (making a series of assumptions as to the key inputs of stock price, typical volatility, interest, and dividend yields) only a $105 increase in the value of the ELI: $100 for the forward component and $5 for the option. If one posits that the option component of the ELI has negligible value, the holder of the ELI has acquired an instrument (a) almost all of whose value and anticipated payoff is highly correlated with 100 shares of the referenced equity yet (b) which will not be subject to section 871(m).

There is also a concern that combining ELIs can work *against* taxpayers by causing an ELI to cross the delta threshold despite the fact that it would not have on its own. For example, assume the same facts just outlined—forward contract plus call option—except that the option has substantial value because its strike price is, say, 100% (rather than 150%) of the current spot, and that it has a delta of 0.5. If that option were tested on a stand-alone basis, it would not meet the threshold under section 871(m). However, if tested together with the forward it would fall under section 871(m), as the combined ELI would have a delta of 0.75. That is, a $1 increase in the value of a referenced share will cause a $200 increase in the value of the 200 shares that are referenced in the denominator (100 for the forward + 100 for the option) and a $150 increase in the value of the ELIs referenced in the numerator ($100 increase in the forward + $50 increase in the option); 150/200 = 0.75.

It might be possible to solve both of the concerns just noted—the artificial inflation of the denominator working against the IRS and the combining of ELIs working against the taxpayer—by disaggregating a transaction into a series of components and then testing each component against the section 871(m) threshold. In order to operate properly, it seems likely that the right approach would first be to aggregate the embedded calls and puts with the largest shared number of shares, using an ordering principle that maximizes the likelihood that the threshold would be met. In the example above, that would mean isolating the forward contract. The remaining components would then be evaluated separately.[49] If this process is unworkable for a particular ELI—that is, one cannot extract an instrument that is forward contract-like—that suggests to us that the instrument may be one to which section 871(m) should not apply.

The approach above could result in applying section 871(m) to part of a transaction and not to another part of it. That could be very complicated to apply in practice. A possible way to address this concern might be to carry out the disaggregation process described above, and then to treat the instrument, as a whole as subject to section 871(m) or not depending on what portion of the instrument's components would "standing alone" be subject to section 871(m). While this would be both over- and under-inclusive compared to the treatment of the components on a stand-alone basis, the effect would be that transactions would be subject to section 871(m) if they primarily provide exposure that would be subject to section 871(m) on a stand-alone basis. If this approach were adopted, disaggregation would be used to address the problems described in the text above in applying the delta test to an instrument that has variable exposure to different numbers of shares, but would not be used to determine the amount of dividend equivalents on the instrument. However, this approach would be both over- and under-inclusive compared to the treatment of the components on a stand-alone basis and thus, would deviate from the economics of the transaction.[50]

An even more difficult problem exists with so-called "digital options" which, despite their exotic name, are common building blocks in structured notes acquired by retail investors.

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[49] This approach is different from the only currently existing disaggregation rule that we are aware of, under Treasury Regulations section 1.246-5, which we do not think would work in this context. Consider the forward-contract-plus-option example described in the text, and assume that under the iterative process required by that regulation, the total number of shares in the denominator would be reduced from 200 to 150. If the numerator is treated as 100% of the forward contract (100 shares) and 50% of the option (50 shares), then a $1 rise in the value of the shares would give rise to a $125 increase in the value of the ELI. The percentage of the instrument's components subject to section 871(m) would therefore be $125/$150, or 83%. As a result, the section 871(m) transaction would consist of the forward *plus approximately half of the option*, which is not the "right" disaggregation result. The reason for this is that the delta one profile of the forward is "infecting" the option component. We have considered alternative ways to apply the rule, but they give rise to even less "right" answers. Accordingly, we believe that a new disaggregation approach would need to be developed.

[50] We expect that market participants will offer meaningful ways of testing complex instruments. We understand that some believe that delta testing should be based on the performance of the hedge over the term of the ELI. We are not in a position to evaluate the merits of this approach.

In such an option, an investor will receive, say, $100, if the price of a referenced security on a given observation date is above, say, $73. The $100 is paid without regard to how far above $73 the referenced security actually closes on that observation date. There is, therefore, no objectively determinable number of shares to be referenced in the denominator.[51] We do not believe digital options raise section 871(m) policy concerns (the "trigger" for the payout on a digital option, as well as the payout itself, could be anything at all, and bears no relation to dividends on the underlying stock), and recommend that they be excluded from the regime unless it can be shown that they are being used to avoid section 871(m).

Another difficulty with using delta as the touchstone for determining whether an ELI is a section 871(m) transaction is that obtaining delta information may not be practical for many exchange-traded positions, where there is no dealer involved and the short party may not have the expertise to calculate delta. For these, we recommend that Treasury and the IRS consider the use of "benchmarks" similar to those contained in the qualified covered call rules.[52] One condition to treatment as a "qualified" covered call is that the strike price of the option is not less than the "applicable stock price" (generally, current fair market value) or a percentage thereof. For over-the-counter options, the applicable strike price increases as the term of the option increases, in recognition of the fact that the forward price for the stock—and, therefore, the true "at the money" strike price for the option—increases over time as a result of the time value of money.

Those rules could be modified in this context to treat the applicable strike price as a percentage of the current fair market value (*e.g.*, 90% or 80%) that is intended roughly to correspond to an option with a 0.70 or other delta. For example, assuming that the percentage is

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[51] A digital option can be approximately represented by a long call struck at "X" and a short call struck at very slightly above "X." For instance, using the facts of the text's example, the digital option can be represented as (1) a purchased call on 10,000 shares with a strike price of $73 and (2) a sold call on 10,000 shares with a strike price of $73.01. The net of those two positions will pay out either (a) $100 (10,000 x .01) if the stock price finishes above $73.01 or (b) $0 if the stock price finishes below $73. Alternatively, it could be represented as (1) a purchased call on 100,000 shares with a strike price of $73 and (2) a sold call on 100,000 shares with a strike price of $73.001. The possibilities are infinite.

[52] See section 1092(c)(4); Treas. Reg. § 1.1092(c)-1 through 1.1092(c)-4.

90%, if an option is originally issued with a strike price of $100 when the value of the underlying stock is $100, it would not be a section 871(m) transaction because the strike price ($100) is above the threshold (*i.e.*, the applicable stock price, here $100, times 0.90, or $90). If the option is acquired at a time when the stock has risen in value to $120, then the strike price of the option ($100) would be below the threshold of $108 ($120 x .90), and it would be a section 871(m) transaction. This test would not be a perfect proxy for delta, but it may be sufficiently similar to be useful, given the potentially enormous complexity involved in applying the delta test to exchange-traded instruments. While we suggest it be considered particularly for exchange-traded options, it could apply to any transaction with options or embedded options.

Another possible simplification to make it easier to use the delta test would be to permit the long party to rely on commonly available online tools provided by Bloomberg and others for such positions to calculate delta for exchange-traded ELIs, provided that the taxpayer uses inputs that are within the range of commercially acceptable variation (for example, the interest rate curve and volatility numbers provided by the on-line system in question), uses a consistent methodology, and records its calculations on a contemporaneous basis. This would avoid the need for the short party to provide delta information, which we are confident will prove quite difficult for issuers of many exchange-traded instruments.

C. Convertible Debt and Other Securities Issued by an Issuer of the Underlying Security

Convertible debt is a capital markets instrument that has been used for decades by U.S. publicly traded companies to raise financing at rates potentially lower than would apply to a conventional debt instrument. Convertible debt is ordinarily treated as an "indivisible" debt instrument until conversion, after which (if and to the extent the conversion is into stock) the investment becomes an equity interest.[53] Issuers also issue to the market equity-linked products , including warrants and "mandatorily convertible" units (consisting of a debt instrument and a

[53] For background on convertible debt, see New York State Bar Association Tax Section, Report on the Taxation of Straight and Contingent Convertible Debt, 2002 TNT 226-19 (Nov. 7, 2002).

forward contract to acquire the issuer's stock). These instruments raise unique issues that are not well addressed by the Proposed Regulations.

1. Discussion

a. Interaction of section 871(m) with corporate earnings and profits.

Generally, a distribution is taxable as a dividend to the extent of a corporation's current and accumulated earnings and profits.[54] Thus, an issuer's dividends in any year are limited by its earnings and profits. Otherwise taxable distributions (including "deemed" distributions under section 305) reduce a corporation's earnings and profits.[55] However, section 871(m) dividend equivalents are ***not*** treated as dividends for purposes of sections 312 and 316; so there is no adjustment made to the issuer's earnings and profits for these amounts.[56]

Nonetheless, the Proposed Regulations provide that an amount is not a dividend equivalent "to the extent the distribution would not be subject to tax pursuant to sections 871 or 881, or withholding under chapters 3 or 4, if the long party owned the underlying security. . . ."[57] It is unclear whether and to what extent amounts that are otherwise section 871(m) dividend equivalents and that are paid or deemed paid by the issuer of the underlying security would be subject to tax pursuant to sections 871 or 881 if the long party owned the underlying security because when the issuer of a section 871(m) transaction is also the issuer of the underlying stock, there is no stock "supporting" the section 871(m) transaction on which dividends will actually be paid and any section 871(m) dividend equivalents will increase (for section 871(m) purposes) the aggregate amount of dividends paid or treated as paid by the issuer for the relevant year.

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54 Section 316(a); Treas. Reg. §§ 1.316-1(a), 1.316-2(b).

55 Section 312; Treas. Reg. §§ 1.312-1(d), 1.305-2(b), Ex. 2; Rev. Rul. 76-186, 1976-1 C.B. 86.

56 Section 871(m) only applies for purposes of section 871(a), sections 881 and 4948(a), and chapters 3 and 4. Cf. Treas. Reg. § 1.894-1(c)(2) (regarding application of treaties). Indeed, it would be inconsistent with tax principles underlying the calculation of earnings and profits to have section 871(m) dividend equivalents reduce the issuer's earnings and profits—because they are treated as dividends ***only*** in the hands of non-U.S. persons, unlike all other taxable distributions (including "deemed" section 305 distributions). Among many other problems with such a rule, the issuer will not know when and to what extent publicly traded instruments like convertible debt (and warrants and "mandatory units," all of which raise the same issues) are held by non-U.S. persons on relevant dates.

57 Prop. Reg. § 1.871-15(c)(2)(i).

We believe that this problem arises because in the basic case that section 871(m) was meant to address, a total return swap, the short party receives a dividend that it pays to the long party. There is one distinct dividend and it is a question of who should be treated as receiving the dividend. Of course, the application of section 871(m) does not turn on whether the short party (or anyone else) owns any underlying stock. However, we think it clear that the logic of the regime is that high-delta instruments typically are hedged (ultimately, perhaps through a chain of instruments) by ownership of the underlying stock. This is reflected in the "cascading" rule. Thus, while section 871(m) clearly contemplates increases in aggregate "dividends" for section 871(m) purposes beyond those actually paid or deemed paid by the issuer in any year, in "typical" cases this can be dealt with because "incremental" amounts will result from "chains" of instruments. This is different from the cases described in the text, where incremental amounts are not created by chains of instruments, and indeed where the "underlying security" may not even exist.

For example, assume a corporation that has $100 of earnings and profits makes distributions for a year totaling $90 of "actual" (paid and deemed paid under section 305) distributions and $20 of (actual or deemed) section 871(m) amounts, for a total of $110 of distribution for section 871(m) purposes. How much of the $20 of section 871(m) amounts would be subject to tax pursuant to sections 871 or 881 if the long party owned the underlying security?[58] Do we treat all investors for section 871(m) purposes as receiving *pro rata* amounts of the issuer's earnings and profits (the general rule)? This would result in approximately $18 of the $20 ($20/$110 * $100) of section 871(m) dividends being taxable. But of course, $90 of earnings and profits would in fact be allocated to the "real" dividends (and reduce the issuer's earnings and profits); so treating approximately $18 of the section 871(m) amounts as dividends results in approximately $108 of taxable distributions in the aggregate (for section 871(m)

[58] See section 301(c) (governing taxation of corporate distributions). This treatment must also be harmonized with the rules requiring withholding on amounts specified in regulations even though they are not FDAP income (or even income), as in the case of corporate distributions that exceed earnings and profits. Treas. Reg. § 1.1441-2(a).

purposes), whereas the issuer has only $100 of earnings and profits. Or should only $10 of the $20 of section 871(m) distribution be taxable? But that is not what would happen if the investors in the section 871(m) transactions owned "the underlying security."

This may appear to be a theoretical issue, but we do not believe it is. It highlights a fundamental question, whether and why section 871(m) should apply to instruments issued by an issuer of the underlying securities of such instruments; particularly, where we already have well developed rules for taxing the relevant events (from both the issuer's and the investors' perspective). Treating amounts as dividends, ***only*** in the hands of investors, and only in the hands of ***certain*** (non-U.S.) investors, does not constitute good tax policy. Moreover, as we discuss below, we believe section 305 (when applied properly) should largely accomplish the intended anti-avoidance purpose behind any attempt to apply section 871(m) to these instruments. We do not believe section 871(m) should be applied to instruments issued by the issuer of the underlying security.

b. Coordination with Section 305. Under section 305, a distribution made by a corporation to its shareholders in the form of its stock or in rights to acquire its stock is not included in gross income except as provided in section 305(b) and the regulations promulgated under section 305(c).[59] Under section 305(c), a change in the conversion ratio or conversion price of a convertible security may give rise to a deemed distribution of stock where other shareholders receive a distribution of cash or other property.[60] Thus, an increase in the conversion ratio of a convertible security can be treated as a taxable distribution of stock to the securityholder, before it has converted the security. Withholding is required on these deemed distributions.[61] In addition, the amount of a corporate distribution (whether actually or deemed

[59] Treas. Reg. § 1.305-1(a).

[60] Treas. Reg. § 1.305-7(a).

[61] Treas. Reg. § 1.1441-2(d)(1) (exception regarding payments limited to amount held in custody not applicable in the case of distributions with respect to stock).

paid) to a foreign payee is subject to reporting on Form 1042-S.[62] In practice, it is our understanding that although U.S. federal tax disclosure in a typical convertible debt offering document will indicate that section 305 may apply to changes in the instrument's conversion ratio, brokers and other withholding agents that would be required to do the reporting and withholding with respect to section 305 "deemed" dividends are not made aware of changes that have occurred in the instrument's conversion ratio or the amount of the resulting "deemed" dividend, leading to a lack of actual withholding tax. For the same reason, it appears that section 305 deemed dividends are commonly not reported to domestic investors that are non-exempt recipients, leading to under-taxation of those amounts as well.

Under the Proposed Regulations, a payment pursuant to a section 871(m) transaction is not a dividend equivalent "to the extent that the payment is treated as a distribution taxable as a dividend pursuant to section 305."[63] In connection with a section 305 distribution resulting from a change in an instrument's conversion ratio, there is no actual "payment." The Proposed Regulations, however, define a dividend equivalent "payment" as the number of underlying shares multiplied by the amount of the per-share dividend multiplied by the "delta" of the section 871(m) transaction at the time.[64] It is not entirely clear when and how this "payment" is ***ever*** "treated as a taxable distribution pursuant to section 305," as section 305 has no similar concept—under that section, if it applies, the amount of the conversion ratio adjustment (*e.g.*, the then-current value of the incremental number of shares into which the instrument is convertible) is taxable to the investor (to the extent of the issuer's earnings and profits).

As a result, it is not clear how to apply the section 305 "carveout." Assume a convertible debt instrument has a dividend adjustment above a specified threshold of $0.20 per-share and a $0.30 dividend is paid. This would trigger a change in the convertible debt's conversion ratio

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[62] See Treas. Reg. § 1.1461-1(c)(2)(i). A corporation (or any intermediary described in Treas. Reg. § 1.1441-1(c)(1)) may elect not to withhold on nontaxable distributions of stock and stock rights. Treas. Reg. § 1.1441-3(c)(2)(i)(A).

[63] Prop. Reg. § 1.871-15(c)(2)(ii).

[64] Prop. Reg. § 1.871-15(i)(1)(ii).

($0.10) to which section 305 would apply. If a non-U.S. person acquired the convertible debt described above when it had a delta of 0.70, how should it account for the section 305 deemed dividend resulting from a change in the conversion ratio in calculating its taxable section 871(m) dividend equivalent? One possibility is that the section 305 taxable dividend ($0.10, in our example) could be subtracted from the total distribution amount of $0.30 ***before*** the section 871(m) dividend amount is calculated (($0.30 – $0.10) * 0.70 = $0.14). Alternatively, the section 871(m) dividend amount could be determined ***first***, and ***then*** the section 305 taxable amount could be subtracted to produce the amount subject to tax under section 871(m) ((0.70 * $0.30) – $0.10 = $0.11). A literal reading of the Proposed Regulations might suggest the latter result, because it provides that a "payment" (as defined in the Proposed Regulations, which is $0.21 in this example) is not a dividend equivalent "to the extent" section 305 applies, suggesting it would be appropriate to calculate the "payment" first and then subtract the section 305 deemed dividend. However, we are not sure this result was intended (or indeed that this issue was considered).

The issue arises because section 305 dividends are not adjusted for delta, and the policy question is whether it is viewed as desirable when both provisions apply to "cap" the aggregate tax at the amount of the section 871(m) "payment" (the latter approach) or to continue the effect of section 305 as well (resulting generally in more tax than would be due under section 871(m) alone). We have no strong view on this issue and, indeed, do not believe there is a clearly "right" answer; but we emphasize that this is further evidence of the inappropriateness of applying both section 871(m) and section 305 to the same amount.

c. <u>Potential for Avoidance of Withholding Tax with Respect to Convertible Debt and Similar Instruments</u>. Convertible debt and issuer warrants can in theory be used (opportunistically, in the "aftermarkets") to attempt to avoid withholding on dividend equivalent amounts.[65] We do note our understanding is that most non-U.S. investors in

[65] We note that "mandatory" convertible units of the type noted in Revenue Ruling 2003-97, 2003-2 C.B. 380, are not withholding tax efficient, as they typically involve significant "contract payments" (often at least

convertible debt are in fact "arbitrage funds" that routinely "short" the delta of the underlying stock (including interim dividend amounts), so they are taking essentially (ideally) ***no*** net exposure to the underlying securities (including dividends) and are not economically receiving underlying dividends at all. However, it is possible that these instruments could be used (by investors other than arbitrage funds) to accomplish dividend tax avoidance. Nonetheless, we think for the reasons discussed above that it is inadvisable as a policy matter to apply section 871(m) to these instruments.

We also observe that, as a practical matter, it may not be necessary to do so in order to eliminate the potential for tax avoidance. When a convertible debt instrument or warrant is "deep in the money" (so that an investor might try to take advantage of it to "earn" amounts equivalent to dividends without withholding tax), the issuer may have increased its dividend, to keep pace with its significantly increased stock price. If the issuer does so, there will be conversion rate adjustments whenever a dividend is paid, under the terms of a convertible bond. This increase is taxable under section 305, which (if that section is properly enforced) should be a very significant deterrent to the use of these instruments to receive dividend amounts without withholding tax. We think the existence of section 305 largely eliminates the need to apply section 871(m) to instruments issued by the issuer of the underlying securities of such instruments.

With regard to the application of section 305, issuers of convertible debt and similar instruments will be required, starting in 2016, to report certain corporate organizational actions that affect basis to the IRS within 45 days of the action, and to investors annually.[66] This would appear to include taxable section 305 distributions, as they (among other things) increase the

partially attributable to estimated dividends) that are typically treated by the market as withholdable ordinary income. Thus, in any event, we do not believe they represent a "tax avoidance" risk.

[66] Treas. Reg. §§ 1.6045B-1(a)(1), (j)(4); 1.6045-1(n)(3) (an issuer of a convertible debt instrument that takes an "organizational action" that affects the basis of the instrument must file an issuer return under new "cost basis reporting" rules).

investors' basis in the instruments affected by the operation of that section.[67] Otherwise, as indicated above, our understanding is that the lack of communication from issuers to brokers and other market participants regarding the timing and amount of section 305 deemed dividends may be resulting in effective non-compliance with that section. Indeed, even section 6045B will not "help" with this lack of communication, as its reporting is required a considerable period of time ***after*** the relevant deemed distribution occurs. A procedure by which withholding and reporting agents are made aware in "real time" of the timing and amounts of section 305 deemed dividends would, we expect, largely eliminate the opportunity for "avoidance" perceived to be represented by instruments like deep-in-the-money convertible debt. Enforcement of section 305 is also a more appropriate vehicle for addressing concerns about convertible debt, as section 305 is unquestionably an expression of congressional intent intended to apply to convertible bonds, and it applies to both domestic and foreign taxpayers and thus does not raise concerns about discriminatory treatment.

2. Recommendation

For the reasons discussed above, we recommend that final regulations exempt convertible debt and other issuer securities[68] from the scope of 871(m) and, instead, modify the rules under sections 6042 and/or 6045B to provide for increased compliance through reporting, particularly where it relates to section 305 distributions arising from conversion ratio changes.[69]

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[67] There is perhaps a question whether a conversion ratio or other adjustment that occurs by operation of the terms of an instrument is an "organizational action" that will require reporting under section 6045B. Of course, the relevant action is really the declaration and payment of an ***actual*** dividend to the issuer's ***shareholders***, which directly causes the conversion ratio or other adjustment, so we think this is a reportable event. Nonetheless, it may be advisable to confirm this result.

[68] Our recommendation would not apply to NPCs where the issuer of the underlying stock is the counterparty.

[69] Convertible debt has been excepted from the application of other rules primarily not to disrupt the market for such convertible instruments. For example, under the original issue discount rules a debt convertible into the issuer's stock or exchangeable for the stock of certain related parties is treated as a single integrated instrument for purposes of determining the issue price of an instrument. Treas. Reg. § 1.1275-4(a)(4) (a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument); Treas. Reg. § 1.1273-2(j) (issue price of a debt instrument includes any amount paid for an option to convert the instrument into stock). This represented the abandonment by Treasury of a prior regulatory proposal effectively to bifurcate a convertible debt instrument into a "straight" debt instrument and a warrant. Former Prop. Reg. § 1.1275-4(g) (1991). See also Treas. Reg. § 1.1272-1(e) (for purposes of amortizing OID, options to convert are ignored). In addition, typical convertible debt is not subject to section 163(*l*)).

If Treasury and the IRS determine that the current paradigm should be maintained, final regulations should address the questions raised above: (i) how should the earnings and profits of a corporation be adjusted in the case of a section 871(m) dividend equivalent; and (ii) what does the phrase "to the extent that the payment is treated as a distribution taxable as a dividend pursuant to section 305" mean.

D. Index Related Issues

1. Qualified Index Exception

When a transaction references an interest in more than one security, including reference to an index, the Proposed Regulations require an independent analysis of each referenced security.[70] However, a qualified index is treated as a single security that is not an underlying security.[71] Six requirements which must be met in order for an index to be exempt from rules requiring that the underlying securities in a basket be separately analyzed as potential section 871(m) transactions.[72]

The 2012 Proposed Regulations took a different approach. Rather than exempting qualified indices, they would have applied the underlying security rule to "customized indices" which included narrow based indices and any other index unless futures contracts or options contracts referencing the index trade on a qualified board or exchange.[73] The definition of the "narrow-based index" is generally based on the definition of that term in the Securities Exchange Act of 1934, section 3(a)(55)(B).[74]

While the criteria under which an index may be considered a qualified index seem quite liberal, many indices will fail in practice to meet the predefined objective criteria standard. For instance, the S&P 500 is modified as needed (that is, not on a scheduled basis) by operation of a

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70 Prop. Reg. § 1.871-15(a)(11).

71 Prop. Reg. § 1.871-15(k)(1).

72 See Part III.C.3 for a discussion of the criteria.

73 Former Prop. Reg. § 1.871-16(f)(1), (f)(3)(i) (2012).

74 Former Prop. Reg. § 1.871-16(f)(3)(ii) (2012).

committee that takes into account eight published criteria, rather than through an objective rule, and, therefore, is not a qualified index under the Proposed Regulations.[75] Many customized indices contain short positions either as hedging devices or as part of their strategy, thus disqualifying them from qualified index status. We also note that there are many indices on which there is no comparable traded futures contract or options contract, including some widely accepted benchmark indices.[76]

Given this, we recommend that some flexibility be provided in how the term "objective rules" is defined. It should be sufficient if modifications or rebalancings of the index are conducted using publicly stated objective criteria and objective goals, even if the index is not created pursuant to a formulaic rule and some discretion is involved in determining whether the criteria are satisfied. Those objective criteria should not take into account any positions or costs (for example, hedging costs) of any party to the transaction or the compiler of the index. We understand that this is the way the components of the S&P 500 are determined.

Additionally, we believe that some boundaries may need to be put around the 10% carve-out because, without a limitation, taxpayers could create indices that abuse the limitation. For instance, an index could be created specifically to fit within the safe harbor to avoid withholding on high dividend paying U.S. stocks. A foreign holder would escape withholding tax on the dividends of the underlying shares if it were willing to invest in the balance of the basket (we can imagine a situation where an investor could construct a basket where the remaining 90% had little or no risk of loss). Thus, we believe that the index should be required to be one created for purposes other than avoiding dividend withholding tax. "Benchmark" indices widely used in the market such as the FTSE-100 should be presumed to satisfy that standard. Structured

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[75] *See* S&P Dow Jones Indices, *S&P U.S. Indices Methodology* (February 2014) (identifying market capitalization, liquidity, domicile, public float, sector classification, financial viability, treatment of IPOs and eligible securities as criteria for inclusion or exclusion from the Standard and Poor's U.S. indices, and stating that additions or deletions are made on an as-needed basis), *available at http://us.spindices.com/indices/equity/sp-500* (last checked May 18, 2014).

[76] For example, until last year the MSCI global equity indices were not traded through futures contracts. MSCI states that its indices are used as a basis for over 650 exchange-traded funds, as of March 2014. *See* http://www.msci.com/products/indexes/ (last checked May 18, 2014).

transactions involving indices with high-dividend paying stocks also might be addressed through an anti-abuse rule.

We also recommend that some *de minimis* level of short positions be allowed to be held in connection with an index, in order to alleviate the cliff effect of inadvertent failure to comply with the rule. For example, no more than 5% of the value of the long positions could be offset by short positions. Where the short position exceeds this threshold, however, the withholding agent should be exempt from withholding unless it has actual knowledge that the short threshold was exceeded.

E. Obligation to Withhold on Varying Amounts and on Prepayments

1. Variable Withholding Amounts

As discussed above, a section 871(m) transaction is treated as paying a per-share dividend amount equal to the actual dividend amount, multiplied by the number of underlying shares, multiplied by the delta at the time of the dividend payment. This means that the amount of tax required to be withheld must be recalculated on each dividend payment date, and withholding agents' systems must be programmed to allow for variable amounts of withholding. We are concerned that these requirements will call for a completely novel and rather complicated approach to withholding tax that is highly dependent on obtaining information about delta in a timely manner, which withholding agents' systems today are not programmed to do.

Some members of the Executive Committee believe that an alternative "all or nothing" rule should apply, pursuant to which (a) if the delta is above 0.70 (or perhaps, above a specified percentage of the applicable stock price), the withholding agent must withhold on an amount equal to the actual dividend multiplied by the number of underlying shares—thus effectively treating the delta as 1.0—and if it is below that threshold, the withholding agent is not obligated to withhold—thus effectively treating the delta as 0. This approach is clearly not consistent with the economics of the transaction, but those members believe it would provide rough justice, would satisfy the policy objectives of section 871(m) and would permit withholding agents to apply a binary yes/no withholding rule rather than one that varies every quarter. Taxpayers' withholding tax obligations should be determined under the same approach, so that withholding will satisfy their tax payment obligations (and will not give rise to refund claims). We note that even this approach may raise challenging issues for withholding agents with respect to ELIs that are traded in the secondary market, because some customers may be subject to withholding tax while others are not.

We note, in any event, that it does not make sense to impose tax on the basis of delta (or any other formula) in the case of actual dividend-equivalent payments or creditings. However these payments or credits are determined, we think it clear that they should be subject to withholding tax in full (if the regime otherwise applies).

2. Withholding on Prepayments

The Proposed Regulations require withholding on dividend equivalent payments.[77] Withholding is not required until the later of (i) the time that the amount of a dividend equivalent is determined and (ii) the time that the withholding agent is deemed to have control over money or other property of the long party because (a) money or other property is paid to or from the long party, (b) the withholding agent has custody or control over money or other property of the long party at any time on or after the amount of a dividend equivalent is determined, or (c) the section 871(m) transaction provides for an upfront payment or pre-payment of the purchase price even though an actual payment has not been made at the time the amount of a dividend equivalent is determined.[78]

We believe that the reference to upfront payments and prepayments of purchase prices should be reexamined. If a premium or upfront payment is paid by the long party, it is not property of the long party. Instead, it is the property of the counterparty (the short party or dealer). We do not believe that withholding should be required on amounts paid by the long party to the short party that are part of the transaction cash flows, rather than merely collateral to

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

[78] Prop. Reg. § 1.1441-2(d)(5).

support the long party's obligations. As an example, if the taxpayer purchases an option and pays a premium, that premium is the property of the option seller. It is paid to compensate the seller of the option for the risks and liability that it is taking on. Requiring the seller to withhold in the future because of a payment it has received for its own account is inconsistent with the concept that withholding is required if the withholding agent has assets of the long party. Requiring withholding on other prepaid amounts raises similar issues.

There is a stronger argument for requiring withholding when the long party has made a prepayment sufficiently large that it is certain, or virtually certain, that the short party will make a payment to the long party when the transaction terminates. In that case, the withholding could be treated as reducing the amount payable at maturity, although market documentation does not currently so provide. The prepayment often is used, however, to fund some or all of the short party's hedge position for the transaction. That means that any withholding that takes place during the term of the transaction is again coming out of the short party's own funds. By contrast, if a long party provides collateral, and the withholding agent uses part of the collateral to pay a withholding tax, the long party ordinarily would be required to top up the collateral, so that the tax would be borne on a current basis by the long party. At a minimum, we do not believe that withholding should be required if the short party holds no assets of the long party but has received a prepayment, unless it is highly likely that the short party will owe a payment to the long party when the transaction terminates that would otherwise exceed the amounts required to be withheld plus an appropriate time value of money return on the withheld tax. Accordingly, we recommend that Treasury and the IRS reconsider this rule.

If this recommendation is not adopted, the final regulations should confirm that, for avoidance of any doubt, any prior withholding should serve as a credit against future withholding.

F. M&A Transactions

The Proposed Regulations contain a carve out from their application transactions with respect to an underlying security if a transaction obligates a taxpayer to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the taxpayer) are obligated to acquire underlying securities representing 50% or more of the value of the entity issuing the underlying securities.[79]

The Proposed Regulations state:

> A potential section 871(m) transaction is not a section 871(m) transaction with respect to an underlying security if the transaction obligates the long party to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the long party) are obligated to acquire underlying securities representing more than 50 percent of the value of the entity issuing the underlying securities. To qualify for the exception provided in this paragraph, the long party must furnish a written certification, provided under penalties of perjury, to the short party that it satisfies the requirements of this paragraph (j)(2).[80]

Our 2012 Report noted the concern that section 871(m) might apply to corporate acquisition transactions:

> Furthermore, many such purchase contracts may be deemed to contain a dividend equivalent payment. For example, it is common for such contracts to include a provision stating that the target must have at closing a minimum amount of working capital and, if it does not, the purchase price is reduced. Since one reason that working capital may have fallen below the specified threshold is that a pre-closing dividend has been paid, it appears that such a contract would arguably contain "an adjustment to the purchase price . . . that is contingent upon a dividend." [Footnotes omitted].[81]

We do not believe that most M&A transactions should be subject to these rules. It is true that when a target pays a pre-closing dividend and the purchase price is reduced accordingly, the purchaser is arguably avoiding a subsequent (potentially withholdable) dividend. However, as this is a mere purchase price adjustment (a clear case of the purchaser ***not buying*** the relevant

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79 Prop. Reg. § 1.871-15(j)(2).

80 Id.

81 2012 Report, Part V.D.1., pg. 39.

cash), we see no reason for taxation at all. Moreover, case law dealing with pre-acquisition dividends more than adequately addresses the issue of how these amounts should be treated.[82] In any event, we see no reason why there should be a 50% threshold; M&A transactions do not appear to us to raise tax avoidance concerns (and if they do, the anti-abuse rule will suffice).

We note that in the context of section 1259, a complete carve out was made for acquisitions of non-publicly traded stock.[83] An exemption like that would solve the problem in the non-public context. However, we do not believe even public transactions should be subject to these rules. For this reason, we propose exempting acquisitions of stock where in the aggregate at least 20% of the total value of all stock is acquired. Erika Nijenhuis

G. Short-Term Exception

As noted, under the Proposed Regulations, the amount of the dividend equivalent generally is determined on the earlier of the ex-dividend date and the record date for the relevant dividend.[84] However, if a section 871(m) transaction has a term of one year or less, the amount of the interim dividend equivalent(s) (including the relevant "delta(s)") is determined when the long party disposes of the transaction.[85] Therefore, as noted in the Preamble, a long party that acquires an option with a term of one year or less that is a specified ELI will not incur a withholding tax if the option lapses. The theory appears to be that no withholding is appropriate, because at the time of the lapse, the seller held no shares to hedge its position.

We believe that the short-term exception is useful. We recommend that the short-term rule be limited to instruments (regardless of whether the instrument is an option) that do not

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82 See Waterman Steamship Corp. v. Comm'r, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (dividend paid in connection with sale had to be characterized as part of the purchase price for the stock); Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (shareholder of target is entitled to capital gain treatment on redemption of remaining shares of stock following stock sale because the combined effect of both transactions was the disposition of her total interest in the corporation).

83 Section 1259(c)(2) (taxpayer shall not be treated as having made a constructive sale solely because the taxpayer enters into a contract for sale of any stock, debt instrument, or partnership interest which is not a marketable security if the contract settles within 1 year after the date such contract is entered into).

84 Prop. Reg. § 1.871-15(i)(2)(i).

85 Prop. Reg. § 1.871-15(i)(2)(ii).

actually pay or expressly credit dividend equivalents amounts during the term. If, for example, a dividend equivalent is actually paid on a short-term instrument prior to its maturity or disposition, we believe that it should be subject to withholding tax.

We further believe that the term of an instrument for this purpose should be determined from the time of its issuance rather than the time of acquisition by a non-U.S. investor, to prevent investors from legging-in to the rule in a manner that might thwart the intended purpose of the rule.

H. Testing at Issuance Versus at Acquisition

Section 871(m) testing under the Proposed Regulations takes place at the time of acquisition. Some members of the Executive Committee believe that testing should occur only at issuance. Those members believe that testing at acquisition is disproportionately complicated and burdensome as an administrative matter relative to what we would expect to be the opportunities for abuse relating to post-issuance acquisitions. Those members believe that if the final regulations are structured as we have proposed, there would be few real-world circumstances in which post-issuance acquisitions would permit abuse, given the proposed carve-outs for convertible debt instruments and long-term instruments with no actual dividend-equivalent payments; what remains (principally structured notes) are likely to be inefficient vehicles for withholding tax avoidance.

Those members who favor this approach believe that the anti-abuse rule should be developed to address post-issuance acquisitions that are structured to avoid the threshold. We would be happy work with Treasury and the IRS to consider whether and how the anti-abuse rule could effectively be used to address abuses relating to post-issuance acquisitions.

I. Compensation-Related Positions

The Proposed Regulations could be read to apply to equity compensation awards such as restricted stock units ("RSUs") or unvested restricted stock granted by a non-U.S. subsidiary to non-U.S. employees. Although it does not appear that the consequences of such treatment have been fully explored within the different branches of the IRS, our understanding is that this result was intended. Our 2012 Report recommended an exception for compensation-related options, given that these transactions are not entered into to evade U.S. withholding tax, and if services were rendered abroad, they are sourced to the location where they are performed. The same rationale applies to restricted stock units. Section 83(b) already provides a framework applicable to compensatory payments, and there is no need to apply section 871(m) to such arrangements. We do not believe that the Proposed Regulations should apply to compensation-related positions.

J. Cascading Withholding Tax

If a dividend equivalent flows through multiple chains of intermediaries, there is potential for withholding tax at each payor level. For example, if a non-U.S. dealer is the short party to a specified ELI, and it hedges its position with another long specified ELI, there is withholding tax potential on both the payment by the non-U.S. dealer to the holder of the first specified ELI and then again on the payment to the non-U.S. dealer on the second specified ELI. The potential for withholding can apply at each intermediate level.

Section 871(m)(6) of the Code grants the Secretary authority to reduce or eliminate withholding tax to avoid duplication of tax on dividend equivalents paid through chains of financial intermediaries and otherwise to address the roles of financial intermediaries in the payment of outbound dividends. As drafted, the section applies both to actual dividends and all dividend equivalent payments.

Pursuant to this authority, the Proposed Regulations provide a narrow exception for payment of dividend equivalents to "qualified dealers."[86] If a non-U.S. taxpayer meets the qualified dealer exception, payments of dividend equivalents are not subject to withholding.[87] The term "dealer" is defined by reference to section 475.[88]

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[86] A "qualified dealer" is any dealer in securities within the meaning of section 475 that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized.

[87] Prop. Reg. § 1.871-15(j)(1)(i).

[88] Prop. Reg. § 1.871-15(a)(2).

Our 2012 Report proposed that rules similar to those applicable to securities lending transactions be adopted. Under those rules, which are contained in Notice 2010-46,[89] a "qualified securities lender"[90] that actively withholds and reports on substitute dividends paid to foreign lenders of U.S. stocks and is subject to audit by the IRS can receive substitute dividend payments from other payors free of U.S. withholding tax. Under Notice 2010-46, a qualified securities lender is also entitled to reduce the amount of withholding on substitute dividend payments that the qualified securities lender is obligated to make by the amount of withholding tax collected by an earlier withholding agent within the same series of securities lending transactions, including for withholding tax on actual dividends.

Thus, we recommend extending the approach of Notice 2010-46 by combining the concepts of a "qualified dealer" and "qualified securities lender" and having the same regime for both securities lending payments and section 871(m) dividend equivalent payments. In the situation where the foreign person is subject to withholding tax, the final regulations should also permit a non-U.S. dealer to receive credit for withholding tax on actual dividends received on shares it holds to hedge a customer transaction.

If the above recommendation is not adopted, we believe that certain modifications should be made to the definition of a "qualified dealer." Specifically, we recommend that there be no limitation regarding the taxpayer's status as a dealer, or at least that entities used by dealers to sell ELIs to customers be treated as within the scope of the rule. Moreover, dealer status is determined on an entity basis, but the entity could be subject to regulatory supervision in the location of a branch and not in the jurisdiction in which it was created or organized. In determining whether a dealer is qualified, it should be sufficient if the dealer is subject to

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[89] 2010-24 I.R.B. 757.

[90] A "qualified securities lender" is a bank, custodian, broker-dealer or clearing organization that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized, and is regularly engaged in a trade or business that includes the borrowing of securities of domestic corporations (as defined in section 7701(a)(4)) from, and lending of securities of domestic corporations to, its unrelated customers.

regulatory supervision in the location of a branch, whether or not it is subject to regulatory supervision in the jurisdiction in which it was created or organized.

K. The "In Connection With" Rule

The Proposed Regulations treat multiple transactions as a single transaction for purposes of determining if the transactions are a section 871(m) transaction with respect to an underlying security when a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into "in connection with" each other.[91] These rules apply only to combine transactions in which the taxpayer (or a related person within the meaning of sections 267(b) or 707(b)) is the long party.[92] The Proposed Regulations do not combine transactions when a taxpayer is the long party with respect to an underlying security in one transaction and the short party with respect to the same underlying security in another transaction. Transactions that are combined for purposes of determining whether there is a section 871(m) transaction are treated as separate transactions for all other purposes of the Proposed Regulations, including for purposes of determining the amount of a dividend equivalent with respect to each transaction.[93]

The Proposed Regulations illustrate the application of this rule with a number of examples. In one example, a taxpayer buys a call option on day one and sells a put option two weeks later on the same underlying stock and the two transactions are entered into "in connection with" each other because the put option was sold to adjust the position on the underlying stock.[94] The example states that the call option is tested on day one to determine whether it is a section 871(m) transaction, and the combination of positions is tested as a single transaction on the day the put transaction is entered into, based on the deltas of the call option and put option at that time. In the example, the combined transaction is not a specified ELI

[91] Prop. Reg. § 1.871-15(l)(1).

[92] Prop. Reg. § 1.871-15(l)(1)(i).

[93] Prop. Reg. § 1.871-15(l)(5).

[94] Prop. Reg. § 1.871-15(l)(6), Ex. (3).

(because the delta test was not met at the time the put option was entered into), but the purchased call option remains a specified ELI (because of the delta threshold at the time that transaction was entered into).

Under the Proposed Regulations, a withholding agent, however, is not required to withhold on a dividend equivalent paid pursuant to a transaction that has been combined with one or more other transactions unless the withholding agent knows that the long party (or a related person) entered into the potential section 871(m) transactions in connection with each other.[95] However, we note that the reporting rule under which the short party must provide information to the long party requires the reporting party to exercise reasonable diligence.[96]

The Preamble requests further comments on the combination rule:

> The Treasury Department and the IRS request comments regarding whether (and, if applicable, how) the rules for combining separate transactions to determine whether the transactions are section 871(m) transactions should apply in other situations, such as when a taxpayer holds both long and short positions with respect to the same underlying security. Comments also are requested regarding whether (and, if applicable, how) the remaining transaction (or transactions) should be retested when a long party terminates one or more, but not all, of the transactions that make up a combined position.

On balance, we believe that the combination rule is a necessary rule. Moreover, we believe that it is appropriate to limit a withholding agent's liability unless it has actual knowledge. Examples should be set forth in the final regulations identifying common situations where knowledge will not exist. For instance, it is appropriate to include an example in which one desk executes a trade and another unit of the same taxpayer, without the knowledge of the activities of the first desk, enters into a trade that meets the threshold. We believe that the example should conclude that no knowledge exists in that circumstance.

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95 Prop. Reg. § 1.1441-1(b)(4)(xxiii).

96 Prop. Reg. § 1.871-15(o)(1) (the party required to make the determinations is required to exercise reasonable diligence to determine whether a transaction is a section 871(m) transaction, any dividend equivalents, and any other information necessary to apply the rules of this section).

This raises a fundamental issue regarding the Proposed Regulations. If taxpayers are permitted to net their long and short positions to bring themselves below the chosen delta threshold, and that netting is (like the Proposed Regulations' combination rule) tested on the day the newest position is entered into, then when a section 871(m) transaction's delta falls below the chosen threshold, taxpayers can at that time enter into relatively non-economic short positions and "cleanse" the taint of section 871(m). However, this risk exists in practical terms even absent a rule permitting netting of long and short positions: Taxpayers can simply dispose of their section 871(m) transactions at the point when delta falls below the chosen threshold, and reacquire them. The Proposed Regulations should make clear whether this is considered an abusive practice, assuming that there is a real (that is, not sham) disposition and reacquisition. Absent specific guidance there may be disagreement as to whether a disposition-and-reacquisition transaction is an avoidance of the rules, or a legitimate way of allowing a taxpayer to obtain the same tax treatment as another taxpayer that acquires the same position at that time. If the practice is considered abusive, then it seems clear to us that there must be some period of time a taxpayer could wait after disposing of a tainted position before acquiring the same or a very similar position and not have the series of transactions be considered abusive, and the Proposed Regulations also should provide guidance in this regard. In any event, one could imagine simply limiting the application of the "netting down" provision, where the original section 871(m) transaction's delta has fallen below the chosen threshold, to short positions that materially change the taxpayer's net position.

We also believe, however, that it is appropriate to allow taxpayers to demonstrate to the IRS that their net position is, in fact, below the delta threshold by identifying short positions in determining application of the delta rule. While the use of short positions has the potential to modify the tax characteristics of a given transaction, such a rule is necessary to prevent an overbroad application of section 871(m). Timely documentation of the transaction and confirmation that the taxpayer holds no other positions in the same stock and that related parties have not entered into any transactions in connection with the taxpayer's positions should serve as an appropriate mechanism to allow policing of transactions. We also recommend that taxpayers be permitted to seek a refund if they can adequately demonstrate that their "net" position is below the applicable delta threshold.

We also note that if taxpayers are allowed to net positions, they will likely seek to net newly-acquired positions in determining their net position. If the effect of the newly-entered into position is cause a transaction to no longer meet the delta threshold, much like the example referred to above involving the acquisition of a put option, the question arises whether the original transaction should continue to be subject to section 871(m). To the extent that there is uncertainty, taxpayers are likely to terminate positions (presumably prior to the payment of a dividend) and enter into new positions that are below the threshold level.

L. Partnerships and Trusts

The Proposed Regulations require that pass-through entities be tested for application of the rules. If a transaction references an interest in an entity that is not a U.S. domestic corporation, then for purposes of the Proposed Regulations, the transaction instead references the allocable portion of any underlying security or potential section 871(m) transaction held, directly or indirectly (including through one or more other entities that are not U.S. domestic corporations), by the referenced entity.[97] An exception applies for pass-through entities in which 10% or less of the value of the partnership or trust is comprised of interests in U.S. domestic corporations.[98]

As noted in our 2012 Report, we do not believe that the testing should be applied at the partnership (entity) level.[99] Rather, testing based on the underlying assets should be the exclusive way of testing pass-through entities.

Taxpayers will have difficulty obtaining the information needed to apply the 10% test. We believe that taxpayers should be able to rely on publicly available audited financial

97 Prop. Reg. § 1.871-15(m)(1).

98 Prop. Reg. § 1.871-15(m)(2).

99 2012 Report, Part V.D.5, page 42

statements that are no more than 90 days old (unless they have actual knowledge that a subsequent transaction has caused the entity to cross the 10% threshold). In the event that such statement fails the 10% test, the long investor will be required to test each underlying security.

The Proposed Regulations also provide that the 10% safe harbor does not apply where there is a plan or intention to acquire or dispose of the securities. In such case, we believe that the long party should have reason to know of the plan or intention that would cause underlying securities to represent more than 10% of the value of the referenced interests. If such a standard were adopted, it would be appropriate to require the party to demonstrate that it had some due diligence procedures to prevent taxpayers from blindly claiming that they had no reason to know of the plan or intention.

M. The Scope of the Anti-Abuse Rule

The Proposed Regulations contain a broad anti-abuse rule. If a taxpayer (directly or through the use of a related person) acquires a transaction or transactions with a principal purpose of avoiding the application of the Proposed Regulations, the Commissioner may treat any payment made with respect to any transaction as a dividend equivalent to the extent necessary to prevent the avoidance of the Proposed Regulations.[100] The Proposed Regulations go on to state that, therefore, notwithstanding any other provision of the Proposed Regulations, the Commissioner may adjust the delta of a transaction; change the number of shares; adjust an estimated dividend amount; adjust the timing of payments; combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions; or otherwise depart from the rules of the regulations under section 871(m) as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent. The Preamble does not address the anti-abuse rule.

We support the inclusion of an anti-abuse rule. We recommend that the anti-abuse rule should be revised to apply to transactions that are the substantial economic equivalent of an

[100] Prop. Reg. § 1.871-15(n).

investment in the stock of a U.S. corporation and that have been structured with a principal purpose of avoiding the application of section 871(m). If this recommendation is not adopted, then we urge that the regulations clearly state an alternative standard, so that taxpayers know what the intended target of the regulations is and therefore whether a transaction structured so that it is not on its face subject to section 871(m) should be considered abusive or permissible.

There are a number of transaction types that could be identified as examples under the anti-abuse rule. For example, the Preamble asks for comments regarding the constant delta rule. Structuring transactions with *de minimis* price movements to attempt to avoid the constant delta rule could be addressed under the anti-abuse rule. Additionally, because the delta rule operates as the exclusive vehicle for determining specified NPC and specified ELI treatment, transactions that involve crossing in and out are now no longer within the scope of the rule. These transactions could fall within the scope of the anti-abuse rule. In addition, if a contract were modified prior to the dividend payment date and then modified again after the dividend payment date in a manner intended to avoid application of section 871(m), that could be abusive, and it might be appropriate to illustrate this situation in an example. In addition, as discussed above, if complex instruments are carved out of the delta test, as suggested in Part IV.B.3, they should nonetheless be subject to the anti-abuse rule. Finally, as suggested in Part IV.D.1, certain transactions involving the qualified index safe harbor might be subject to the anti-abuse rule.[101]

N. Other Issues

1. Substantially Similar Payments

Treasury and the IRS requested comments regarding other substantially similar payments that should be subjected to the rule. In particular, they ask about due bills, and reserve treatment on this issue in the regulations. Normally, the ex-dividend date precedes the record date for a dividend. That is not always the case; sometimes the ex-dividend date is after record date. In

[101] In order to facilitate future guidance, Treasury and the IRS may wish to consider providing a mechanism for identifying additional transactions to which the anti-abuse rule will apply. See Treas. Reg. § 1.704-2(f)(5) (providing that the Commissioner may provide exceptions to the minimum gain chargeback requirement by revenue ruling).

such case, a due bill is issued. The stock trades with a "due bill" for the dividend that is paid to the holder on the ex-date. The tax law treats the dividend as paid to the record date holder—the due bill is simply a receivable for cash (with full tax basis).[102] The question raised is whether a non-U.S. person receiving a dividend equivalent amount under due bill procedures should be treated as receiving a section 871(m) a dividend equivalent. It would appear as a pure policy matter that this would be an appropriate application of section 871(m). However, we understand that due bills are a fairly common occurrence with respect to exchange-traded stock, and we are not familiar with the mechanics of these procedures, so we are concerned that requiring withholding in these circumstances could have an adverse impact on the orderly functioning of the exchanges. This might be an appropriate situation to consider for development under the anti-abuse rule.

2. The Obligation to Provide Information Regarding the Delta

As noted above, brokers and dealers that are parties to potential section 871(m) transactions must provide information to the counterparty (on request). If there is no broker or dealer, the short party must provide this information. The party to the transaction that is required to determine whether a transaction is a section 871(m) transaction must also determine and report to the counterparty or customer (on request) the timing and amount of any dividend equivalent.[103]

Treasury and the IRS have solicited comments with respect to reporting rules, including comments regarding the parties that should be required to report and the extent of information that is appropriate.

We are concerned that the information needed to make the determination as to whether a transaction is subject to section 871(m) may not be available on a timely basis to prospective

[102] Rev. Rul. 82-11, 1982-1 C.B. 51. For a discussion of dividend payment date issues, see Robert Willens, "When the Ex-Dividend Date Falls After the Record Date," 2006 TNT 238-38 (Dec. 12, 2006).

[103] Prop. Reg. § 1.871-15(o)(1).

investors. As noted earlier, this information only has to be provided within 14 days of a request. In many cases, this will be too late to make an informed investment decision or for a withholding agent to determine the amount required to be withheld on a transaction that is a section 871(m) transaction. To remedy this, we suggest that information be required to be provided on the issuer's website at or prior to the time of issuance, and to be updated on a regular (say, weekly) basis. In that case, an investor should be able to rely on the information so posted with respect to any purchase during the interim between updates.

O. Effective Date

Notice 2014-14[104] modified the effective date of the Proposed Regulations with respect to specified ELIs, so that it now applies to specified ELIs issued on or after 90 days after the publication of final regulations. No change in the effective date has been made with respect to specified NPCs. There is no grandfathering based on the issue date of an NPC; rather, all specified NPCs will be subject to withholding beginning on January 1, 2016.

Many taxpayers hedge their specified ELI positions with NPCs. In some cases, the dealer exception will not apply, at least as the rule is presently drafted. For this reason, we recommend that the delayed effective date rule also apply to specified NPCs that hedge grandfathered specified ELIs and that have been appropriately identified or otherwise treated as hedges.

[104] 2014-13 I.R.B. 881.