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Tax Section

Report on Regulations under Section 871(m)

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I. INTRODUCTION

This report[1] analyzes final, temporary, and proposed regulations under section 871(m),[2] which were issued on September 18, 2015.[3] Since this is the NYSBA's fourth report on section 871(m), the goal here is to focus on issues that have not been considered in prior reports.[4]

Section 871(m) addresses concerns about the use of derivatives to avoid withholding tax on U.S. source dividends. Section 871(m)(1) treats "dividend equivalent payments" as U.S. source dividends for withholding tax purposes, so they are subject to withholding tax when paid to a non-U.S. recipient. Section 871(m) creates three categories of dividend equivalent payments: (a) substitute dividend payments made pursuant to securities lending or sale-repurchase agreements; (b) payments made pursuant to "specified notional principal contracts" ("specified NPCs") that are directly or indirectly contingent upon or determined by reference to the payment of a U.S. source dividend; and (c) any other payment determined by the Secretary to be substantially similar to a payment described in (a) or (b).

[1] The principal drafter of this Report was David Schizer. Significant contributions were made by Michael Farber, Lucy Farr, Stephen Land, Bill McRae, Erika Nijenhuis, and Michael Schler. Helpful comments were received from Micah Bloomfield, Dan Breen, Peter Connors, Simcha David, David Miller, and Jason Schwartz 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.

[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. §" 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] 80 Fed. Reg. 56,866 (Sept. 18, 2015).

[4] *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Section 871(m)*, 2011 TNT 47-16 (Mar. 8, 2011); N.Y. ST. BA. ASS'N, TAX SEC., *Report on Proposed and Temporary Regulations under Section 871(m)*, 2012 TNT 13-6 (Apr. 25, 2012); N.Y. ST. BA. ASS'N, TAX SEC., *Report on Proposed Regulations Under Section 871(m)* (May 20, 2014), http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1306.html.

Proposed regulations issued on January 23, 2012 used a seven-factor test to identify when a transaction was a specified NPC. Those regulations also created a new category called "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 the seven factors.

Proposed regulations issued on December 5, 2013 replaced the seven-factor test with a 70% delta test to determine whether a transaction is a specified NPC or a specified ELI. Very generally, once a transaction met the delta threshold, implied dividends would be subject to taxation and withholding.

In response to comments, these regulations were revised and finalized on September 18, 2015, and new temporary and proposed regulations were issued as well on complex contracts and various withholding requirements. The 2015 regulations raised the delta threshold to 80%, and made other important changes in response to comments from taxpayers.

After a summary of recommendations in Part II, Part III discusses a number of issues that arise in deciding whether a derivatives transaction is covered by section 871(m), including when the transaction should be tested and whether to use the test for simple or complex contracts. Assuming a transaction is covered, Part IV considers issues that arise in deciding the consequence of being classified as a section 871(m) transaction, including how much to withhold and who is responsible for this withholding.

II. SUMMARY OF RECOMMENDATIONS

1. In the final regulations, we recommend clarifying when delta should be tested. In general, it should be tested on the earlier of: (a) the trade date, or (b) the date on which all material economic terms have been determined (as long as this "pricing date" is within 14 days of the trade date). We also recommend giving guidance about how issuers can ensure that overallotment options have the same section 871(m) status as the original issuance.

2. In the temporary regulations, we recommend clarifying that the test for simple contracts should be used whenever transactions offer economic exposure to an ascertainable number of shares, including instruments that include an automatic adjustment for mergers and stock splits, instruments that are "net share settled," and put and call spreads.

3. In the temporary regulations, complex contracts have to be compared with a "closely comparable simple contract." More guidance should be offered about the criteria for determining that a simple contract is "closely comparable." The regulations should clarify that this is a hypothetical instrument, and that the material terms, including the treatment of dividends, should be consistent with the terms of the complex contract (aside from the terms that make the contract complex, as well as the terms that make the delta of the closely comparable benchmark 0.8).

4. In the final regulations, the Treasury and IRS should consider changing the safe harbor for indices with a relatively modest U.S. component. To prevent taxpayers from tailoring the index to make tax-advantaged investments in specific U.S. stocks, the index should have to be widely traded, and also should not have been formed for the purpose of avoiding U.S. withholding tax.

5. In the final regulations, loans and sale-repurchase transactions of convertible securities can qualify as section 871(m) transactions in some cases, as can swaps and other equity-linked instruments based on the value of convertibles. Guidance is needed about whether the "underlying" in these potential section 871(m) transactions is the convertible or the stock.

6. In the final regulations, the Treasury and IRS generally have struck a reasonable balance by ordinarily basing the dividend equivalent on the actual dividend, but allowing taxpayers to elect to use an estimate, as long as this choice is made in advance. It is important, moreover, for the Treasury and IRS to enforce the requirement that estimates have to be reasonable.

7. In the final regulations, section 871(m) withholding is not required when section 305(c) already imposes withholding. Similar relief should be offered when a section 871(m) transaction is subject to withholding for a reason other than section 305(c), such as when a periodic payment is treated as "FDAP" income.

8. In the final regulations, withholding generally is deferred until a payment is made. We assume the intention also is to delay the foreign holder's tax liability – not just the obligation to withhold – and ask the Treasury and IRS to clarify that this is the case.

9. In the final regulations, the obligation to withhold is paired with the obligation to decide whether withholding is necessary. The regulations generally seek to rely on a broker or dealer. When both parties are brokers or dealers, the regulations rely on the short party. But this does not make sense when the long party sells in the secondary market, since the short party may not even be aware of the sale. In this circumstance, it would make more sense for the long party's broker to withhold. The Treasury and IRS also should work with industry to ensure that sufficient information is shared among brokers to avoid duplicative withholding.

10. In the final regulations, guidance is also needed about who is responsible for determining whether equity linked notes are section 871(m) transactions and for withholding on these instruments. If the issuer is a broker or has an affiliate that is a broker, the issuer should be tasked with these responsibilities.

11. In the final regulations, further guidance is needed about what information the responsible party has to provide. The regulations require a range of information, including delta and the amount of the dividend equivalents. But if the transaction is not a section 871(m) transaction, the other parties arguably no longer need this information, and it is potentially costly to provide. The regulations should clarify what must be shared in this circumstance.

III. SCOPE OF THE REGIME: WHEN A DERIVATIVE IS A SECTION 871(m) TRANSACTION

This Part considers various issues that arise in determining whether a derivative transaction is reached by section 871(m), and thus is subject to withholding.

A. Timing of Testing Delta: "Inception and Issuance"

To determine whether a derivative transaction is similar enough to the underlying stock to be subject to withholding, the 2013 regulations used a test based on delta, which is the ratio of the change in the value of the derivative to the change in the value of the underlying. The 2013 regulations applied the delta test both when the relevant derivative was issued, and again each time it was acquired. In contrast, the 2015 regulations apply the delta test only when the instrument is issued, without retesting each time a new holder acquires it.[5]

1. Trade Date, Settlement Date, or Pricing Date?

Under the new final regulations, delta is supposed to be tested only at "inception" or "original issuance,"[6] but this language is imprecise. Does it mean the settlement date, the trade date, or something else? Because certainty is especially important for withholding, the precise timing should be clarified.

The trade date has two important advantages, which are not shared by the settlement date. First, the trade date ordinarily is the time when the parties commit to the transaction. In doing so, they presumably want to know whether withholding will be required under section 871(m). At the settlement date, by contrast, the parties usually have already committed to the transaction.

Second, the trade date typically is the day when all the material economic terms have been set. This is important because section 871(m) is supposed to turn on the economics of a transaction, and in particular, on how closely it tracks the underlying stock. Therefore, the purposes of the rule are well served by testing at the moment when price terms have been finalized. Relatedly, the test for complex contracts assesses how a potential section 871(m) transaction would be fully hedged,[7] so the date when this hedge is established is a logical time to test.

A caveat, though, is that the economic terms are sometimes set *before* the trade date. In these cases, the considerations discussed above counsel in favor of this pricing date, instead of the trade date. Using this earlier date still affords the parties certainty when they commit, and also permits an assessment of the transaction's economic terms at the point when they are set, as well as when complex contracts are hedged.

5 Treas. Reg. § 1.871-15(g)(2).

6 Treas. Reg. § 1.871-15(a)(6).

7 Treas. Reg. § 1.871-15T(h)(1).

For example, assume the price on a forward contract is based on the average of the underlying's price over a three-day period, which ends the day before the trade date. The counterparty is likely to put a portion of the hedge in place every day over the course of these three days; in fact, this averaging approach often is used for over-the-counter derivatives to ensure that the counterparty's hedge can be established in an orderly and effective manner. In this example, we believe the appropriate time to test delta is the last day of this three-day pricing period, since the economic terms are finalized then.[8]

Even so, there could be room for abuse if the terms are set too far in advance of the trade date. For example, the purposes of the regime would be undercut if a dealer could price an instrument a year before the trade date, and then allow clients to decide on the trade date whether or not to enter into the transaction (*i.e.*, once they know which way prices have gone). Given this risk, we would use the trade date if the pricing date is too far in advance of the trade date (*e.g.*, more than 14 days).[9]

What if the pricing date comes *after* the trade date? We generally would use the trade date in order to provide certainty to the parties about whether section 871(m) applies. A caveat, though, is that the parties should not be able to "hard wire" the transaction so delta increases after the trade date. This raises the question of what to do when a transaction's terms are scheduled to change.

2. Retesting When the Terms Have Been Significantly Modified

What if the terms have been set *initially*, but are scheduled to be modified? If the modification is significant enough, the transaction should then be tested again after the new terms have been finalized.

To determine whether the modification is significant enough to warrant retesting, the regulations use the principles of section 1001.[10] If the new term has not been preset – so it is not

[8] For transactions priced over a period of days, an alternative approach would be to use the price on the first day of that period. The OID rules use this convention, defining the issue price as the price paid by the first group of buyers (even though later buyers may pay a different price, which could generate more or less original issue discount). *See* Treas. Reg. § 1.1273-2(a)(1) ("If a substantial amount of the debt instruments in an issue is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money."). While this approach has the advantages of simplicity and of uniformity, it is less accurate than an approach that tests delta once all material economic terms have been finalized.

[9] As an analogy, the rules for qualified reopenings provide a 7-day window for the issuer to announce a trade and then price it. *See* Treas. Reg. § 1.1275-2(k)(2)(iv).

[10] Treas. Reg. § 1.871-15(a)(6) ("An NPC or ELI is treated as issued at inception, original issuance, or at the time of an issuance as a result of a deemed exchange pursuant to section 1001.").

provided "by operation of the terms of the instrument"[11] – the question generally is how material the modification is. In this context, the focus presumably is on how much the change is likely to affect delta.

In contrast, if the modification is preset "by operation of the terms" of the instrument, there presumably is no need to retest, since the initial delta of the instrument should already reflect these terms. As a somewhat stylized example, assume a two-year call option is issued with a $106 exercise price when the stock is trading at $52 – so it is deep out of the money – but the option is scheduled to decline by $1 every week "by operation of the original terms." Since the exercise price will be only $2 at maturity, the option will then be effectively deep in the money. Therefore, the option should have a very high delta because of its low exercise price at maturity.[12]

3. Overallotment Options

Finally, the Treasury and IRS should clarify the treatment of overallotment options under the final regulations. When firms issue equity-linked notes, they often issue a first tranche, while authorizing the underwriter to sell additional notes to the public shortly thereafter as part of the underwriter's efforts to establish a liquid market for the notes.

A key question is whether the delta of the overallotment option must be retested, or whether these subsequently-issued notes can simply assume the section 871(m) status of the first tranche. We recommend the latter approach. Otherwise, the notes in the overallotment option might not be fungible with the notes in the initial tranche, since one – but not the other – could be subject to withholding.[13]

For example, assume Issuer issues 1 million Notes, and also authorizes Underwriter to sell an additional 100,000 Notes. To ensure that it has enough buyers, Underwriter accepts 1.1

[11] *See* Treas Reg. § 1.1001-3(c)(1)(ii) ("Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.").

[12] Presumably, the anti-abuse rule is another mechanism for concluding that section 871(m) applies, even if the taxpayer otherwise would argue that the delta at the outset is below 0.8 (*e.g.*, based on the $53 mean exercise price).

[13] For a discussion of the value of ensuring that notes are fungible, *see* Jeffrey D. Hochberg & Michael Orchowski, *What Looks the Same May Not Be the Same: The Tax Treatment of Securities Reopenings*, 67 TAX LAW. 143 (2013).

million orders for the Notes (even though there are only 1 million Notes, at least initially). If 100,000 buyers back out at the last minute, the Notes are still all sold. But if all 1.1 million buyers remain interested, Underwriter borrows 100,000 Notes from initial purchasers to do short sales. This means that 1.1 million Notes are (notionally) held by the public, even though only 1 million actually have been issued. If the price of the Notes declines, Underwriter is likely to "cover" these short sales – that is, to return Notes to the holders who lent them – by acquiring Notes in the (newly-created) secondary market. But if the Notes appreciate, the Underwriter will want to buy additional Notes from Issuer (at a preset price), using the overallotment option. But to do so – that is, to be able to use the overallotment option for its intended purpose – the Notes in the overallotment option must be fungible with the Notes in the first tranche (so the Notes that are returned to lenders are identical to those they lent).

However, if Notes in the overallotment option are section 871(m) transactions, but Notes in the initial tranche are not, or vice versa, the Notes will not be fungible. This means Underwriter cannot use them to "cover." If Underwriter knows there is a risk it cannot use the overallotment option to cover short sales, it will be wary of accepting excess orders. As a result, Underwriter will be less able to assure a liquid market for the Notes.

The qualified reopening rules generally deal with the same sort of problem, offering ways to treat subsequently issued securities as fungible with securities that were issued earlier.[14] In addition, debt securities generally are treated as part of the "same issue" as long as they are issued within thirteen days of the original issue.[15] The Treasury and IRS should clarify that these rules apply to section 871(m) transactions that are debt instruments. In addition, similar rules should apply to 871(m) transactions that are issued to the public but are not debt instruments, such as mandatorily exchangeable equity-linked securities, since fungibility is important even when original issue discount is not an issue.

B. Boundary Between Simple and Complex Contracts

In testing delta, the 2015 regulations use different tests for "simple" and "complex" contracts. Although these tests are supposed to come to the same answer, it still matters which test applies because the reporting obligations are considerably more onerous for complex contracts than for simple ones.

Conceptually, the difference between "simple" and "complex" presumably should turn on how easy or hard it is to compute a consistent and reliable delta for the instrument. As a proxy, the regulation asks whether payments are "calculated by reference to a single, fixed number of shares." This makes sense because delta usually is hard to compute if the number of referenced

[14] Treas. Reg. § 1.1275-2(k).

[15] Treas. Reg. § 1.1275-1(f)(1)(iii).

shares cannot be determined. In such a case, the methodology for simple contracts does not work, so the alternative methodology for testing complex contracts ("the complex test") is needed. In our view, it is reasonable for this consideration to define the boundary between the simple and complex tests. In other words, as long as the number of referenced shares is ascertainable, the simple test should apply. The definition of simple contracts[16] and the preamble each shows that this is, in fact, the drafters' intention.[17]

To delineate the boundary between simple and complex contracts, the regulations create what in effect is a safe harbor for simple contracts,[18] and then treat complex contracts as the residual category.[19] In our view, this overall structure is reasonable.[20]

The regulatory language appropriately classifies two types of transactions as "complex": first, transactions that offer exposure to the upside of one number of shares, but the downside of a different number of shares;[21] and second, "digital," "barrier" or "knock-out" options (such as "autocalls"), which cease offering any exposure (or offer very different exposure) if a particular condition is (or is not) satisfied.

Nevertheless, the definition of simple contracts should be somewhat broader. This definition arguably excludes a number of transactions that actually are simple, such as the examples below. In particular, they offer exposure either to all, or to a portion of, the economics of an ascertainable number of shares.

1. Adjustments for Mergers, Stock Splits, Cash Dividends, and Other Conventional Adjustments

For example, assume *X* is a publicly traded company whose stock price is $100 on January 1, 2016. On that day, a taxpayer acquires an American style call option to buy 100 shares of

[16] Treas. Reg. § 1.871-15(a)(14)(i) (to qualify as simple, a contract must reference a "single fixed number of shares" that "can be ascertained when the contract is issued").

[17] "In particular, a contract that provides for payments based on a number of shares of stock that varies at different points, or that provides for a payment that does not vary with the price of the shares (often called 'digital' options), have an indeterminate delta because the number of shares of the underlying security that determine the payout of the derivative cannot be known at the time the contract is entered into."

[18] Treas. Reg. § 1.871-15(a)(14)(i).

[19] Treas. Reg. § 1.871-15(a)(14)(ii).

[20] Another option is to offer taxpayers the choice about which to use, as long as the taxpayer has no reason to expect the tests to come out differently. Admittedly, though, a test offering discretion in this way is more likely to be gamed, especially since financial institutions are likely to have greater expertise about the delta of complex derivatives than the Service.

[21] Treas. Reg. § 1.871-15(a)(14)(ii)(B) (example of an ELI that offers upside of 200 shares and downside of 100 shares).

X for $130, which expires in two years (on January 1, 2018). Assume the call option provides that if X consolidates or merges with or into another corporation, this call option entitles the holder to 100 times the consideration received in the merger for each share of *X*. Assume also that no merger has been announced. Assume the option also provides that if the stock splits, the number of shares doubles, but no stock split has been announced.

Because this option conveys exposure to a fixed number (100) of shares of *X*, it makes sense to test it under the "simple" test. Yet because of the potential adjustments, the option may end up offering exposure to a different number of shares (and possibly a different stock). Arguably, then, this contract may not qualify as "simple," since "the number of shares" (*e.g.*, after a split or the merger, if one occurs) cannot "be ascertained when the contract is issued." We doubt this result is intended, and recognize that the language can be read to treat this call option as "simple." In general, we believe adjustments that would not give rise to a dividend under section 305(c) should not prevent a contract from being eligible for the simple test. Clarification would be helpful, for instance, with examples in the regulations.

The analysis is similar for adjustments for cash dividends. Like the adjustments discussed above, these adjustments also are supposed to keep the derivative's value from changing in unpredictable ways as a result of a somewhat arbitrary event (in this case, a change in dividend policy). Even though the underlying number of shares changes, this change should not keep us from calculating delta.

2. Net-Share Settled Options

Assume the option above can be settled either in cash, or it can be "net share settled." This means that if the stock price is $230 when the taxpayer exercises the option, she receives either $100 x 100 shares, or $10,000, or she receives $10,000 *worth* of stock – that is, $10,000 / 230 or 43.48 shares.[22] In other words, if the stock price is *Y*, and *Y* is greater than $130, upon exercise the holder receives the following number of shares: 100*(*Y* – $130)/*Y*.

Again, this option conveys exposure to a fixed number (100) of shares, so it should be eligible for the simple test. Yet the currency used to settle the option can be stock, as well as cash. As a result, even though the number of shares that are the *subject of the bet* does not vary, the number of shares *delivered* does vary with the stock price. Technically, this call option may not qualify as "simple," since "the number of shares" to be delivered cannot "be ascertained when the contract is issued" (even though the number of shares that are the subject of the economic bet can, indeed, be ascertained). Again, we doubt this result is intended, and recognize that the language can be read to treat this call option as "simple." The regulation requires a "single, fixed

[22] 43.48 shares is worth $10,000 when the share price is $230.

number of shares" to calculate "[a]ll amounts to be paid or received," not to calculate how many shares will be delivered. Even so, clarification with an example would be helpful.

3. Call Spreads

A call option offers opportunity for gain in the underlying stock, but with limited risk of loss. Assuming the call is not deep-in-the money, it is unlikely to qualify as a section 871(m) transaction, but it still has to be tested.

Likewise, a call spread offers opportunity for gain on the underlying, up to a cap. Admittedly, the cap could make delta somewhat harder to compute – so a call spread is not as obvious a candidate for the "simple" test as a call with an adjustment for mergers and stock splits – but we still recommend evaluating it with the "simple" test. The economics of a call spread on a fixed number of shares can be implemented in different ways. Some are clearly eligible for the "simple" test, but others may not be unless the language is clarified.

For example, assume *X* is a publicly traded company whose stock price is $100 on January 1, 2016. On that day, a taxpayer acquires an American style call option with a two year term to acquire 100 shares of *X* for $100 per share. At the same time (and "in connection with" this call), the taxpayer also sells a call on 100 shares with an exercise price of $130. This pair of options, known as a "call spread," offers a defined range of exposure – the upside between $100 and $130 – on a fixed number of shares (100). As a result, it should be tested under the "simple" test.

Alternatively, assume taxpayer buys 100 shares of convertible preferred stock in *X*, which has a liquidation preference of $100. If the stock price is below $100, taxpayer does not convert the preferred stock. If the stock price is above $100, but remains below $130, taxpayer can convert and receive 100 shares of common stock (*i.e.*, one share of common for each share of preferred). Like the call spread described above, the taxpayer does not benefit from appreciation above $130. Therefore, the taxpayer receives a maximum of $130 worth of common stock for each share of preferred stock. For example, if the common stock is at $260, the taxpayer receives only ½ a share of common stock (worth ½ of $260 or $130) for each share of preferred; the taxpayer thus receives 50 common shares in total. More generally, if the stock price, *Y*, is greater than $130 when the taxpayer converts, the taxpayer receives 130/*Y* shares for each share of preferred, or 100*(130/*Y*) for all 100 shares of preferred. As with the "net share settled" option, "the number of shares" to be delivered cannot "be ascertained when the contract is issued," even though the number of shares that are the subject of the economic bet – 100, in this case – certainly can be ascertained. As a result, it would be appropriate to test this transaction with the "simple" test. Although the language already can be read this way, a clarification would be helpful.

4. Put Spreads

The seller of a put option has risk of loss when the stock price declines in value.[23] Since the seller of a put option does not have opportunity for gain in the stock, this position is unlikely to qualify as a section 871(m) transaction (assuming the put option is not deep-in-the money), but it still has to be tested.

Likewise, the seller of a put spread bears risk of loss in the underlying stock down to a specified level, but not below that point. Again, this exposure can be conveyed in ways that clearly are eligible for the simple test, and also in ways that may not be eligible, even though they should be.

For example, assume *X* is a publicly traded company whose stock price is $100 on January 1, 2016. On that day, a taxpayer sells an American style put option with a two year term, which entitles her counterparty to sell her 100 shares of *X* for $100 per share. At the same time (and "in connection with" this put), the taxpayer also buys a put on 100 shares with an exercise price of $80. This pair of options, known as a "put spread," exposes the the taxpayer to a defined range of exposure – the risk of loss between $100 and $80 – on a fixed number of shares (100). As a result, it should be tested under the "simple" test.

The economic exposure is the same if the taxpayer offers her counterparty the option to sell her a varying number of shares for $10,000. The counterparty sells 100 shares as long as the price is between $100 and $80, but must deliver more shares – in effect, $8,000 worth of stock – if the price declines below $80 per share. For example, if the price is $40 per share, the counterparty has to deliver 200 shares. In general, if the share price, *Y*, is below $80, taxpayer receives 8000/*Y* shares. As with the call spread, "the number of shares" that will *change hands* cannot "be ascertained when the contract is issued," even though the number of shares that are the *subject of the economic bet* – 100 – is constant and ascertainable. As a result, it would be appropriate to test this transaction with the "simple" test, and the language should be clarified to ensure this result.

C. Methodology for Testing Complex Contracts

In addition to clarifying when the methodology for complex contracts must be used, the regulations should also further clarify how it should be done. We do not have the expertise to evaluate the efficacy of the test in the temporary regulations, so our comment here is brief. We encourage the Treasury and IRS to assess the malleability of the test and the latitude it offers experts to understate the similarity of a complex contract to the underlying. This risk is

[23] While the purchaser of a put option has "short" exposure (profiting when the price goes down), the seller of a put option has "long" exposure (losing money when the price goes down).

compounded by the need to make subjective judgments in computing delta, for instance, about future volatility, dividends, and interest rates.

Specifically, complex contracts must be compared with a "closely comparable simple contract."[24] More guidance should be offered about the criteria to use in determining that a simple contract is "closely comparable."

First, the regulations should clarify that this is a hypothetical instrument. In other words, taxpayers cannot choose something fairly different and defend it as "the most similar instrument currently trading in the markets." As when taxpayers determine the "comparable yield" under the contingent debt regulations, they should construct a hypothetical instrument that has essentially the same terms as the contingent debt regulations (except that it has a fixed interest rate, instead of contingent interest).

Second, and relatedly, the regulations should clarify that all material terms should be consistent (aside from the terms that make the contract complex, as well as the terms that make the delta of the closely comparable benchmark 0.8). Otherwise, there is a risk that the test will be too malleable. For example, the closely comparable contract should treat dividends in the same way as the actual contract. Thus, if a complex contract does not treat dividends as reinvested, the closely comparable contract should make the same assumption. Otherwise, the number of referenced shares in the closely comparable simple contract increases over time, so its return will not track the complex contract as closely, and the delta test could come out differently. For similar reasons, if the complex contract estimates the dividend as a fixed dollar amount, the closely comparable contract should do so as well, instead of estimating dividends as a percentage of the stock's value.

We do not have the expertise to identify all the ways in which the delta test might be gamed by using an imperfect benchmark. We encourage the Treasury and IRS to investigate this issue further, and to clarify that the closely comparable simple contract must have the same material terms as the actual contract (aside from the terms that render the actual contract complex). In addition, for the terms that render the contract complex, the simple contract should be adjusted, as much as possible, to mirror those terms.

D. Qualified Indices

Taxpayers usually do not have to use either the simple or the complex test if a derivative is based on a qualified index. In general, no withholding is required for these derivatives, regardless of what delta is.[25] There are two ways for an index to qualify for this safe harbor: the index

[24] Treas. Reg. § 1.871-15T(h)(2).

[25] Treas. Reg. § 1.871-15(*l*)(2) ("For purposes of this section, a qualified index is treated as a single security that is not an underlying security.").

can be "broad-based,"[26] or it can be a global index in which U.S. stocks represent less than 10% of the index.[27]

The "broad-based" exception has more requirements than the 10% safe harbor. For example, to qualify as "broad based," an index must include at least 25 securities, have a dividend yield below a threshold percentage, be referenced on exchange-traded futures or option contracts, and be "modified or rebalanced only according to publicly stated, predefined criteria."[28]

In contrast, the 10% safe harbor does not include these requirements. Instead, the only requirement is that the "the referenced component" of U.S. "underlying securities in the aggregate" – that is, U.S. dividend-paying stocks – must "comprise 10 percent or less of the weighting of the component securities in the index."[29]

1. 10% Safe Harbor

We agree that the 10% safe harbor for indices with a relatively modest U.S. component is appropriate, but a potential issue is that some taxpayers might seek to tailor an index, pairing U.S. dividend-paying stocks – representing just under 10% of the portfolio – with broad-based exposure that foreign investors otherwise want (*e.g.*, to foreign equities, commodities, or fixed-income investments).[30]

This transaction probably is foreclosed by the "purpose rule," which indicates that the purpose of the index rules is "is to provide a safe harbor for potential section 871(m) transactions that reference certain passive indices that are based on a diverse basket of publicly-traded securities and that are widely used by numerous market participants," and provides that "an index is not a qualified index if treating the index as a qualified index would be contrary to the purpose described in this paragraph."[31]

As an additional safeguard, the Treasury and IRS should consider adding a requirement that the index has to be widely traded and not formed for the purpose of avoiding U.S. withholding tax, since these requirements significantly reduce the likelihood that the index has been tailored as part of a strategy to make tax advantaged investments in specific U.S. stocks. With

[26] Treas. Reg. § 1.871-15(*l*)(3).

[27] Treas. Reg. § 1.871-15(*l*)(4).

[28] The government has clarified that these criteria can be "interpret[ed] by the index provider or a board or committee responsible for maintaining the index." Treas. Reg. § 1.871-15(*l*)(3)(v). Although this modification offers some flexibility, it unfortunately is not broad enough to include some widely-used indices that are modified at the discretion of the relevant decision makers.

[29] Treas. Reg. § 1.871-15(*l*)(4).

[30] Note that the regulations prevent a taxpayer from shorting elements of this index. Treas. Reg. § 1.871-15(*l*)(6).

[31] Treas. Reg. § 1.871-15(*l*)(1).

this additional safeguard, we believe a percentage of U.S. equities higher than 10% should be acceptable as well.

2. Short Positions Against the Index

Another aspect of the qualified index rule should be clarified as well. This safe harbor allows taxpayers to short a portion of the index that is "five percent or less of the value of the long positions in component securities in the qualified index."[32] Yet the timing of when this 5% test should be conducted is not always clear.

Specifically, the regulation provides that indices generally are supposed to be tested using their value and composition on January 1.[33] But what if a taxpayer enters into a potential section 871(m) transaction based on this index on another day, such as August 1, and shorts a portion of the index on the same day? Presumably, the value of the short position should be determined at the moment when the taxpayer enters into it (August 1). But in deciding whether the short position represents more than 5% of the index, should the taxpayer use the value of the index on January 1, or on the date of the short (August 1)? The latter has the advantage of being contemporaneous, and thus seems better calculated to assess the short position's significance, but this approach is somewhat in tension with the index rules' general reliance on January 1 values.

Similarly, what if the taxpayer enters into a long position on the index (*e.g.*, on August 1), and waits a period of time before shorting a portion of the index (*e.g.*, on October 1)? For most issues, the regime seeks to determine section 871(m) status on the issuance date – August 1 in this example – unless there has been a reissuance under section 1001. Shorting a portion of the index presumably does not constitute a reissuance in most cases. So does this mean a short after a sufficiently long delay does not have to be tested at all? If the test must still be conducted, what value should be used for the index and the short? In this example, should taxpayers use the value on August 1, October 1 or, for that matter, January 1? Guidance on these issues would be helpful.

[32] Treas. Reg. § 1.871-15(*l*)(6)(ii) ("Notwithstanding paragraphs (*l*)(3)(ii) and (*l*)(6)(i) of this section, an index may be a qualified index if the short position (whether part of the index or entered into separately by the taxpayer or related person within the meaning of section 267(b) or section 707(b)) reduces exposure to referenced component securities of a qualified index (excluding any short positions with respect to the entire qualified index) by five percent or less of the value of the long positions in component securities in the qualified index.").

[33] Treas. Reg. § 1.871-15(*l*)(2) ("The determination of whether an index referenced in a potential section 871(m) transaction is a qualified index is made at the time the transaction is issued based on whether the index is a qualified index on the first business day of the calendar year in which the transaction is issued.").

3. Testing the Index or its Components

Finally, what if a transaction is based on indices that are not "qualified" indices? In applying the delta test, must the taxpayer test each component of the index separately? Presumably, the rule will be easier to administer if the taxpayer can compare the delta of the transaction to the index as a whole.

E. Convertible Securities and Derivatives on Derivatives

1. Treatment of Convertibles Under Section 871(m)

A security that is convertible into U.S.-dividend-paying stock can qualify as a section 871(m) transaction, as long as it satisfies the delta test. This is unlikely for principal-protected instruments issued out of the money,[34] but it is plausible for instruments that are deep in the money or mandatorily exchangeable (so they do not protect the holder from risk of loss in the underlying stock).[35]

When a convertible security qualifies as a section 871(m) transaction on the stock (*e.g.*, because delta is above 0.8), the holder has to include dividend equivalents based on the dividend on the underlying stock. But there is a risk that the holder could be taxed not only under the section 871(m) regulations, but also under section 305(c), for instance, if conversation ratios are adjusted for dividends. To avoid double taxation, the regulations include a special rule, which provides that "[a] dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction."[36]

2. Derivatives on Convertibles

While the regulations offer guidance about whether a convertible security qualifies as a section 871(m) transaction – and what to do if it does – a further issue, which should be clarified, is what happens if a taxpayer *lends* a convertible security, enters into a sale-repurchase transaction of a convertible security, or enters into a swap or other equity-linked instrument based on the value of a convertible security. In these potential section 871(m) transactions, is the "underlying security" the convertible security, or the underlying stock?

[34] Preamble ("the fact that convertible debt ordinarily has been issued with a delta on the embedded option of less than 0.80 is expected to significantly reduce the effect of these regulations on the convertible debt market").

[35] As the preamble notes, "a convertible debt obligation is a specified ELI if the delta of the embedded option at the time the convertible debt is originally issued is 0.80 or higher."

[36] Treas. Reg. § 1.871-15(c)(2)(ii).

This question is relevant for two reasons. First, it affects whether section 871(m) applies to a transaction. For example, if a convertible bond ("*D1*") is issued with a delta of 0.85 with the underlying stock ("*S*"), what if a taxpayer enters into an equity swap ("*D2*") with a derivatives dealer that is based on the value of this newly-issued convertible? If the swap *D2* has a delta of 0.85 with the convertible *D1*, the swap presumably has a delta of 0.72 with the underlying stock *S.* In deciding whether *D2* is subject to section 871(m), should we use the delta of 0.85 with *D1* (in which case section 871(m) applies), or the delta of 0.72 with *S* (in which case section 871(m) does not apply)? In other words, is the relevant "underlying security" the convertible or the stock?

There is a second reason why the regime needs to be more precise about which of these is the underlying. When a transaction *does* constitute a section 871(m) transaction, we need to identify the "underlying" to determine the tax consequences. The reason is that dividends on the underlying generally give rise to dividend equivalents on the section 871(m) transaction. For instance, if a convertible (*"D1"*) generates section 305(c) dividends, a swap based on this convertible (*"D2")* is supposed to have dividend equivalents based on these section 305(c) dividends.[37] Likewise, if a convertible itself generates dividend equivalents under section 871(m), these dividend equivalents presumably are supposed to generate dividend equivalents on the swap as well.[38]

Given the importance of identifying the "underlying," the government should clarify what the "underlying" is when a taxpayer lends a convertible or enters into a derivative based on its value. Is the "underlying" the convertible or the underlying stock? The key language obviously is the regulatory definition of "underlying security":

> An underlying security is any interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to § 1.861-3, where applicable taking into account paragraph (m) of this section. Except as provided in paragraph (1) of this section, if a potential section 871(m) transaction references an interest in more than one entity described in the preceding sentence or different interests in the same entity, each referenced interest is a separate underlying security for purposes of applying the rules of this section.[39]

[37] The relevant regulatory test, which section 305(c) dividends satisfy, is that they "could give rise to a U.S. source dividend pursuant to § 1.861-3." Treas. Reg. § 1.871-15(a)(15).

[38] For this to be the case, the dividend equivalents on the convertible have to be viewed as "payment[s] with respect to" the convertible. Treas. Reg. § 1.871-15(a)(15) ("An underlying security is any interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to § 1.861-3. . . .").

[39] Treas. Reg. § 1.871-15(a)(15).

If a swap based on the value of a convertible is viewed as "referenc[ing]" only the convertible itself, and not the underlying stock, the convertible is the underlying. The same is true of a securities loan of a convertible security.

Yet an alternative interpretation of the definition of "underlying" could treat both the convertible and the underlying stock as the "underlying." Under this reading, a loan of a convertible, as well as a swap based on the convertible's value, would be deemed to "reference" both the convertible and the underlying stock. In other words, these transactions might be viewed as "referenc[ing] . . . different interests in the same entity." Under this reading, *both* the convertible and the underlying stock could be viewed as the underlying security because "each referenced interest is a separate underlying security." Guidance clarifying this language would be helpful, since there is a significant volume of loans of convertible securities, as well derivatives based on their value.

3. Derivatives on Other Derivatives

In principle, this issue is not limited to convertibles. Taxpayers also could enter into derivatives based on other derivatives as well, such as forward contracts based on the value of swaps or options.

For instance, assume a taxpayer enters into a swap (*D2*) based on the value of a forward contract (*D1*) to buy stock (*S*). In applying the delta test, should the taxpayer use the "stated" underlying (*D1*) or the "ultimate" underlying (*S*)? We are not aware of a significant volume of this type of "derivative on a derivative" transaction, but that obviously could change if these transactions are not covered by section 871(m), and thus become a means of avoiding the rule.

In this example, the underlying stock (*S*) arguably qualifies as an "interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to § 1.861-3."[40] But does the forward (*D1*) qualify as well? If the forward contract is issued by the issuer of the underlying stock, it seems straightforward for the language "interest in an entity" to apply. Alternatively, if the forward contract is issued by an unrelated third party, such as a derivatives dealer, it is plausible to draw the same conclusion, although the point should be clarified.[41]

4. What is the Policy Goal?

In resolving whether the underlying should be the "stated" or "ultimate" underlying security – that is, *D1* or *S* – the Treasury and IRS should be precise about their policy objective. Is the

[40] *Id.*

[41] *Cf.* Section 897(c) (using phrase "interest in" as part of definition of "United States real property interest" in FIRPTA).

goal to tax close substitutes only for *dividend-paying stock*? Or also substitutes for *any* instrument that yields *dividend equivalents*, as well as dividends?

To pursue the first goal, the underlying should be *S*, since the regime's goal is to reach close substitutes for stock. In contrast, to pursue the second goal, the underlying should be the derivative *D1*, instead of *S*, to reach close substitutes for instruments that yield dividend equivalents. To pursue this second goal, the rule would have to reach derivatives on high-delta convertibles, swaps, and forward contracts (all of which can yield dividend equivalents under section 871(m)).

For example, assume a taxpayer enters into an equity swap (*D2*) based on the value of a forward contract (*D1*), and the equity swap's delta with the forward is 0.85. Assume also that the forward contract has a delta of 0.9 with the underlying stock. This means the swap (*D2*) is likely to have a delta of only 0.76 with the underlying stock (*S*).

If the goal is to reach only derivatives that are close substitutes for *S*, *D2* fails this test (since its delta is only 0.76). However, if the goal is to reach derivatives that are close substitutes for *any* instruments that yield dividends *or dividend equivalents* – in this case, *D1* (which has a 0.85 delta with *S*, and thus is reached by section 871(m)) – the underlying for *D2* should be *D1*, instead of *S*.

This example highlights the choice the Treasury and IRS need to make in deciding what underlying to use for derivatives on derivatives. Is it appropriate not to tax *D2*, since its delta with the stock is below 0.8? Or should *D2* be taxed because it is a close substitute for *D1*, which is subject to section 871(m)? By not taxing *D2*, is the regime allowing avoidance? Or generating the right answer?

5. Challenge in Using *D1* as the Underlying: Reaching "Disguised" High Delta Transactions

In addition to deciding which of these policy goals to pursue – and, thus, how broad the regime should be – the Treasury and IRS also need to address predictable avoidance strategies. For instance, assume the Treasury and IRS decide to pursue the broader goal, reaching substitutes for instruments that generate dividend equivalents. As noted above, this entails using *D1* (instead of *S*) as the underlying in testing delta. Yet using *D1* arguably could cause the regime to miss transactions that clearly should be covered.

For instance, assume a taxpayer would like to buy stock (*S*), but wishes to avoid withholding on dividends. What if the taxpayer enters into the "short" side of an equity swap (*D2*), and the stated underlying of the equity swap is a forward contract to sell S – that is, a short forward (*D1*). This "short of a short" is economically equivalent to a long position, so the taxpayer's "short" position on the swap has a delta of one with *S*.

If the regime treats the underlying as *S*, section 871(m) clearly applies to *D2*. Yet what if the regime treats *D1* (the short forward) as the underlying, instead of *S*? In that case, *D2*'s delta actually is negative one, so *D2* arguably avoids section 871(m). Obviously, this result is inconsistent with the regime's purpose. Therefore, we assume the anti-abuse rule covers this transaction. The Treasury and IRS may wish to clarify that this is the case.

Likewise, assume an investment bank entered into a long forward contract (*D1*) on stock *S* in 2015, which was before the effective date of the section 871(m) regulations. Assume that in 2018 (after the effective date) a taxpayer enters into the long side of a swap (*D2*) with the investment bank, which is based on the value – not of the stock itself – but of this grandfathered forward contract. In other words, the stated underlying is not *S*, but *D1*. Assume *D1* (the pre-effective date forward contract) has a delta of one with *S*, and *D2* (the swap) has a delta of one with *D1* (the forward). As a result, *D2* has a delta of one with *S*.

If the regime treats *S* as the underlying for *D2*, section 871(m) obviously applies to *D2*. But what if instead the regime treats *D1* (the forward) as the underlying for *D2*? Since *D1* predates the effective date and thus is grandfathered, *D1* presumably does not generate any dividend equivalents. Therefore, if *D1* is treated as the underlying (instead of *S*), the taxpayer might claim that he does not have to include dividend equivalents on *D2*. We believe the anti-abuse rule blocks this strategy. The Treasury and IRS may wish to confirm this, for instance, with an example in the regulations.[42]

6. Challenge in Using *S* as the Underlying: Electivity in Retesting Delta

If the regime uses *S* as the underlying, instead of *D1*, it has to address a different challenge: the ability of taxpayers to retest delta on an elective basis. For instance, assume an equity-linked security (*D1*) was deep in the money (with a delta above 0.8) when issued, but the price of the underlying stock (*S*) has declined significantly when a taxpayer buys *D1* two years later. Even so, *D1* is still subject to section 871(m). The regime tests securities only when they are issued, without retesting every time they are acquired. Even if *D1*'s delta has fallen to 0.6 at this point, the taxpayer cannot avoid section 871(m) if she buys *D1*.

But instead of buying *D1*, suppose the taxpayer enters into a swap (*D2*), which is based on the value of *D1*. Assume the swap (*D2*) has a delta of one with the equity linked note (*D1*), and thus a delta of 0.6 with *S*. Does section 871(m) apply to *D2*? The answer is "yes" if *D1* is the underlying (since *D2* has a delta of one with *D1*) and "no" if *S* is the underlying (since *D2* has a delta of 0.6 with *D1*).

[42] A related wrinkle that arises in using *D1* as the underlying, instead of *S*, is that – at least in principle – *D1* might be a hypothetical instrument that does not exist. For instance, the assumption here is that the investment bank actually did enter into a pre-grandfathered derivative, and is using it as the underlying. But in principle, the investment bank might use a hypothetical grandfathered derivative as the underlying.

Put another way, as long as the regime treats *S* as the underlying (instead of *D1*), a taxpayer can replicate the economics of *D1*, without being bound by its section 871(m) status. This can be accomplished by entering into a swap based on the equity-linked security, instead of buying the security itself. Yet this strategy does not work – so a taxpayer cannot "reset" delta this way – if the regime treats *D1* as the underlying (instead of *S*). In that case, *D2* has a delta of 1 with *D1*, and thus is subject to section 871(m) to the same extent as *D1*.

In the above example, "resetting" delta enables taxpayers to *avoid* section 871(m). On other facts, though, resetting delta has the opposite effect. For instance, assume an equity-linked note (*D1*) is out of the money when issued – with a delta below 0.8 – but the price of the underlying stock (*S*) has increased substantially when a taxpayer buys *D1* two years later. Even so, *D1* is not subject to section 871(m), since the regime tests securities only when they are issued, without retesting them when they are acquired. Even if *D1*'s delta has increased to 0.9 when taxpayer buys *D1*, the taxpayer is not subject to section 871(m) if she buys *D1*.

Yet as discussed above, the analysis changes if the taxpayer enters into a swap (*D2*) that is based on the value of *D1*, instead of buying *D1*. *D2* does not "inherit" *D1*'s delta from two years ago. Instead, *D2*'s delta is tested currently (*i.e.*, when the taxpayer enters into this swap). Again, as long as the regime treats *D2*'s underlying as *S* (instead of *D1*), section 871(m) would apply to *D2* – even though it does not apply to *D1*.

To sum up, when taxpayers enter into a derivative (*D2*) based on the value of another derivative (*D1*), the choice to use *S* as the underlying instead of *D1* allows taxpayers to retest delta. The result can be favorable to taxpayers (in allowing them to avoid section 871(m) when *D1*'s delta has declined) or unfavorable to taxpayers (in subjecting them to section 871(m) when *D1*'s delta has increased).

Yet although this effect is symmetrical in theory – in the sense that it seemingly can either help or hurt taxpayers – it is unlikely to be symmetrical in practice. The reason is that taxpayers have a *choice*: the equity linked note or a high delta derivative based on its value. If section 871(m) treats these alternatives differently – which can happen if *S* is the underlying, but not if *D1* is the underlying – taxpayers can choose the more favorable alternative.

7. Alternative Rules

The bottom line, then, is that for derivatives on convertibles (and other derivatives), guidance is needed about whether the underlying is the stock, on one hand, or the convertible (or other derivative), on the other. The Treasury and IRS could resolve this issue in three ways. Each has advantages and disadvantages.

The first alternative is to use the stated underlying – that is, the convertible in the case of a derivative on a convertible. This approach has two advantages. First, it conforms the treatment

of convertibles and derivatives on them. For instance, if a convertible generates section 305(c) dividends, a swap based on this convertible would generate taxable dividend equivalents, as long as the swap has a high enough delta with the convertible. Second, and relatedly, taxpayers cannot "refresh" delta on an elective basis. For instance, if an equity-linked note is subject to section 871(m), a high delta derivative on this equity-linked note is also subject to section 871(m), even if the equity-linked note no longer has a delta above 0.8 with the stock.

On the other side of the ledger, though, using the stated underlying has two disadvantages. First, taxpayers might try to use a "short on a short" or a derivative on a grandfathered derivative, as discussed above, unless the anti-abuse rule (or other guidance) blocks these avoidance strategies. Second, if the Treasury and IRS allow taxpayers to use the stated underlying as the underlying – but only if the underlying derivative is a real transaction, instead of a hypothetical one – a rule is needed to decide whether this underlying "exists." Must it be currently outstanding? Is a minimum volume required? Must it involve independent third parties?

A second alternative is to use the stock as the underlying, instead of the convertible (or other stated derivative). This rule has two advantages. First, if the policy goal is to require withholding only for close substitutes for the stock, but not for close substitutes for derivatives that have dividend equivalents, this approach is well tailored to that goal. Second, taxpayers cannot avoid this rule with a "short on a short" or a derivative on a grandfathered derivative.

However, using the stock as the underlying has two offsetting disadvantages, which are the mirror image of the advantages of using the stated underlying. First, the rule is less effective at conforming the treatment of convertibles (or other derivatives) with derivatives based on them. In our examples, *D1* and *D2* are more likely to be taxed differently. Second, and relatedly, taxpayers can "refresh" delta on an elective basis, as discussed above.

A third possibility is to use a combination of both rules. For instance, taxpayers could begin by using the stated underlying as the underlying. If the stated underlying has dividends or dividend equivalents that are subject to withholding – that is, cash dividends, section 305(c) dividends, or section 871(m) dividend equivalents – the taxpayer applies the delta test. Yet if (and only if) the stated underlying does not have dividends or dividend equivalents, taxpayers have to retest with another underlying, such as the underlying stock. This process continues until the taxpayer (a) either reaches an underlying that pays dividends or dividend equivalents, or (b) has no more potential underlyings to test.

This sequential approach has the advantage of (usually) reaching the "short on a short" and the derivative on a grandfathered derivative without relying on the anti-abuse rule. For instance, if a taxpayer enters into a delta one swap on a grandfathered forward contract, she would first check to see if the forward contract has dividends or dividend equivalents. Since it presumably does not, the taxpayer would then retest with the underlying stock. Similarly, with a "short

on a short," the short sale (the stated underlying) does not generate dividends or dividend equivalents, so the taxpayer would have to test against the underlying stock.

Likewise, if a taxpayer enters into a swap on a convertible, the convertible is treated as the underlying as long as it pays cash dividends[43] generates section 305(c) dividends, or yields dividend equivalents under section 871(m). If the swap has a high enough delta with these dividend-paying convertibles, section 871(m) would apply.

Yet this rule can also yield unexpected results. For example, suppose a high-delta equity-linked note was issued before the section 871(m) effective date, and this grandfathered equity-linked note has section 305(c) dividends. After the effective date, if a taxpayer enters into a delta one swap *(D2)* based on the value of this grandfathered note *(D1)*, the sequential rule would require the taxpayer first to test the *D2* swap against the grandfathered *D1* note. Since *D1* has Section 305(c) dividends and a delta of one with the *D2* swap, *D2* qualifies as a section 871(m) transaction. Yet because the D1 note is grandfathered, it does not yield any dividend equivalents under section 871(m). Therefore, the withholding on the *D2* swap presumably is based only on *D1's* section 305(c) dividends, and not on the dividends on the underlying stock (*"S")*. In contrast, if the *D2* swap had been based on *S*, instead of on *D1*, section 871(m) would also require withholding based on these dividends on *S*. In other words, if *D1* is used as the underlying – instead of *S* – there is less withholding under section 871(m). In theory, the remedy for this is to test *D2* against *S* as well – and not just against *D1* – but the sequential rule would not require this: the reason is that *D1* has section 305(c) dividends, and the sequential rule presumably would provide for retesting against *S only if D1* does not have *any* dividends.

8. Conforming the Treatment of Convertibles With the Treatment of Derivatives Based on Them

Assuming the goal is to conform the tax treatment of convertibles, on one hand, with the treatment of derivatives based on their value, on the other, the regulations should be clarified to ensure they accomplish this parity. For instance, if a convertible generates dividends under section 305(c), a delta one swap based on this convertible is supposed to generate dividend equivalents based on these section 305(c) dividends. In other words, section 305(c) dividends on the convertible should give rise to dividend equivalents on the swap. Yet the rule coordinating section 305(c) and section 871(m) arguably does not provide this result: Rather, it *reduces* the dividend equivalent on a section 871(m) transaction (the swap) by the amount of a section 305(c)

[43] For instance, convertible preferred stock often pays cash dividends.

dividend on the underlying security (the convertible).[44] If the withholding on the swap is supposed to track withholding on the convertible bond, clarification would be helpful.[45]

Similarly, if a convertible itself (*D1*) is a section 871(m) transaction that gives rise to dividend equivalents, a high-delta swap on this convertible (*D2*) should do so as well. In other words, dividend equivalents on the convertible should generate dividend equivalents on the swap. Yet the relevant regulatory language is not perfectly clear, as noted above. It defines a dividend equivalent as "[a]ny payment that references the payment of a dividend from an underlying security …"[46] The first use of the term "payment" refers to a "payment" on the section 871(m) transaction (*e.g.*, the swap), and is defined very broadly. Yet the second use of the term "payment" refers to payments on the convertible. If the term "payment" includes dividend equivalents, then dividend equivalents on the convertible (*D1*) would give rise to dividend equivalents on the swap (*D2*). But some might argue that this second use of the term "payment" refers to actual (*e.g.*, cash) payments, and thus might take the position that dividend equivalents (on the convertible) do not give rise to dividend equivalents (on the swap). The Treasury and IRS may wish to clarify that the term "payment" is supposed to be read more broadly.

IV. CONSEQUENCES: THE TAX TREATMENT OF SECTION 871(m) TRANSACTIONS

The focus of the last Part was on whether a transaction qualifies as a section 871(m) transaction. Assuming it does qualify, a number of issues arise about how it is taxed. This Part identifies a range of issues which would benefit from further clarification.

A. Amount Withheld

In an effort to conform the taxation of derivatives to the treatment of the underlying stock, the regulations seek to collect withholding tax on "dividend equivalents." In general, this withholding is supposed to track the withholding tax that would apply to dividends themselves.

In some cases, dividend equivalents are easy to determine. For example, if a swap entitles the long party to receive a payment equal to dividends on the underlying stock, this amount is treated as a dividend equivalent, which (generally) is subject to withholding.

[44] Treas. Reg. § 1.871-15(c)(2) ("A dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction.").

[45] Notably, the timing of the withholding on a convertible may diverge from the timing of withholding on derivatives based on a convertible. For instance, section 305(c) treats dividend as occurring when adjustment takes effect (for the convertible itself). In contrast, section 871(m) generally delays withholding until a cash payment is made (*e.g.*, for a swap on the convertible). Since we do not consider this delay inappropriate, we do not believe the timing needs to be conformed.

[46] Treas. Reg. § 1.871-15(c)(1).

1. Net Payments

The dividend equivalent is harder to determine, though, if there is an offsetting payment (*e.g.*, based on interest rates), so the net payment to the long party is smaller than the dividend. The regulations are clear that the dividend equivalent in these cases is computed on a gross basis, rather than a net basis.[47]

For example, assume XYZ stock is trading at $100 on April 1, 2016, and *A* enters into the long side of a "delta 1" three-year equity swap, which is based on the value of 100 shares of XYZ stock. The swap provides for an annual payment on April 1 of 2017, 2018, and 2019. The payment is based on formula: if the formula yields a positive number, *A* receives this amount, and if the formula yields a negative number, *A* pays this amount. The formula is: (a) any increase in the value of 100 shares of XYZ between April 1 and March 31, plus (b) any dividends paid on 100 shares of XYZ stock between April 1 and March 31, minus (c) any decline in the value of 100 shares of XYZ stock between April 1 and March 31, minus (d) the product of $10,000 and Libor plus 100 basis points.

Assume XYZ pays dividends of $1.25 per share, Libor is 1%, and the stock price increases by $10 per share. *A* would receive a $925 payment, which is based on the $1,000 increase in the shares' value, the $125 dividend, and the $200 payment based on Libor. The regulations require the withholding to be based on the $125 dividend, even though this $125 is netted against other payments, so no separate $125 payment is made.

2. Implicit Dividends

Similarly, determining the dividend equivalent also is more challenging if the dividend is not explicitly referenced; instead, the parties might account for it implicitly in setting the instrument's terms. Even in this circumstance, though, the regulations require the dividend equivalent to be based on the gross amount of the dividend in these cases, "whether the reference is explicit or implicit."[48]

In the above example, assume the parties implicitly have estimated that dividends would be 1.25%. Instead of explicitly including dividends in the formula, they could simply reduce the Libor-based payment by the 1.25% expected dividend, so the formula is as follows: (a) any increase in the value of 1,000 shares of XYZ between April 1 and March 31, minus (b) any decline in the value of 1,000 shares of XYZ stock between April 1 and March 31, minus (c) the product of $10,000 and Libor minus 25 basis points. Assuming the 1.25% estimate of dividends proved

[47] Treas. Reg. § 1.871-15(i)(1) ("a payment includes any gross amount that references the payment of a dividend and that is used in computing any net amount transferred to or from the long party even if the long party makes a net payment or no amount is paid because the net amount is zero.").

[48] Treas. Reg. § 1.871-15(i)(2)(i).

to be correct, the payment is the same $925, and the withholding also should be based on $125 of (implicit) dividends.

3. Estimated Dividends

In setting the terms, therefore, the parties might choose to rely either on the actual dividend or on an estimate. But what happens if the estimate turns out to be incorrect? Do the parties use the estimate, or the actual payment? In general, the regulations respect the parties' choice, basing withholding on what the parties provided. The default is to use the actual payment, but parties can affirmatively opt to use the estimate instead, if they comply with the relevant requirements.

For example, assume the instrument's terms are based on an estimate, and the terms do not adjust if the estimate proves incorrect. Assume also that the estimate is not explicitly mentioned in the offering documents. In this case, the regulations provide that the actual dividend is used to determine the dividend equivalent payment.[49]

Returning to the example above, assume again that the formula accounts for the dividend implicitly, instead of explicitly, by reducing the Libor-based payment by the 1.25% expected dividend. In other words, the formula once again is: (a) any increase in the value of 100 shares of XYZ between April 1 and March 31, minus (b) any decline in the value of 100 shares of XYZ stock between April 1 and March 31, minus (c) the product of $10,000 and Libor minus 25 basis points (that is, the right interest rate, reduced by a 1.25% estimate for the dividend).

Assume also that the offering documents never mention this estimate or provide for an adjustment if it proves inaccurate. If the dividend ends up being either lower or higher than the estimate (*e.g.*, $1.00 per share or $1.75 per share, instead of the estimated $1.25), the dividend equivalent amount is based on the actual amount, not on the estimate.

However, if the parties want withholding to be based on the estimate, instead of the actual dividend, they have to satisfy two requirements. First, the estimate has to be reasonable. The regulations indicate, for instance, that the estimate can be zero if a stock "is not expected to pay a dividend." On the other hand, if a stock consistently has paid a $1.25 per share dividend, and there is no reason to expect this dividend to be cut, then zero presumably is not a reasonable estimate.

Second, the use of the estimate, and the amount, has to be indicated explicitly and in advance, when the parties enter into the transaction. The regulations require it to be "in an offering

[49] Treas. Reg. § 1.871-15(i)(2)(ii) ("A short party to 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 time the transaction is issued.").

document or the other documents governing the terms at the time the transaction is issued."[50] If both of these conditions are satisfied, the dividend equivalent amount is based on the estimate, rather than the actual amount.

Returning to the recurring example, assume again that the formula accounts for the dividend implicitly, instead of explicitly, by reducing the Libor-based payment by the 1.25% expected dividend. In other words, the formula once again is: (a) any increase in the value of 100 shares of XYZ between April 1 and March 31, minus (b) any decline in the value of 100 shares of XYZ stock between April 1 and March 31, minus (c) the product of $10,000 and Libor minus 25 basis points (that is, the right interest rate, reduced by a 1.25% estimate for the dividend). But assume that the offering document indicates that the dividend is estimated to be $1.25 per share, and that this estimate will be used for withholding. Since the two relevant conditions are satisfied, this $1.25 can be used, even if the dividend turns out to be either $1.00 or $1.75 per share.

Notably, if the deal documents provide for a "true up," so an adjustment will made if the dividend changes (even if the terms do not otherwise reference the dividend), the inclusion of this "true up" means that withholding is based on the actual amount, not the (initial) estimate. "If a potential section 871(m) transaction provides for a payment based on an estimated dividend that adjusts to account for the amount of an actual dividend paid, the payment is treated as referencing the actual dividend amount and not an estimated dividend amount."[51]

As a policy matter, the question of whether the regime should use the actual dividend or an estimate to determine the dividend equivalent is not straightforward. An argument can be made for either approach.

On one hand, an advantage of using the actual dividend is that the withholding tax on the section 871(m) transaction generally is conformed to the withholding tax on the underlying stock. Relatedly, this approach avoids the situation in which the amount of withholding on the section 871(m) transaction is *greater* than on the underlying dividend, which, in a sense, increases the tax rate on foreign investors above the level authorized by Congress (and our treaty obligations).

A further advantage of using the actual dividend, instead of an estimate, is that taxpayers are not able to minimize withholding tax with low-ball estimates. In the above example, for instance, if the section 871(m) transaction is priced with the implicit assumption that dividends will be $1.25, but the parties claim their estimate is actually only $1.10, they can reduce the withholding tax, unless the IRS challenges the estimate.

[50] *Id.*

[51] Treas. Reg. § 1.871-15(i)(2)(i).

On the other hand, using an estimate (without a "true up") has the offsetting advantage of allowing withholding agents to know how much to withhold, without having to monitor and account for changes in the dividend on the underlying stock. This administrative advantage is significant, since withholding rules in particular should be as clear, simple, and predictable as possible.

In addition, if the economic terms are based on estimates – and these do not adjust to reflect what actually is paid – the estimate is, in a sense, a better reflection of what the taxpayer actually is earning. For instance, if a section 871(m) transaction is priced on the assumption that the underlying pays $1.25, so the periodic payments on a swap "lock in" this level, this is the amount the long party will receive based on dividends, even if the actual dividends diverge from this level. If the actual dividend is increased to $2.00, but the taxpayer does not benefit from this increase, the rationale for taxing her on dividend increases she did not enjoy – or, for that matter, of reducing the withholding tax even though she has not experienced any reduction in her pretax return – is debatable.

Admittedly, this approach can lead to the awkward situation in which the withholding on the section 871(m) transaction exceeds the withholding on the underlying stock, but this risk arises only for taxpayers who elect this treatment. The fact that taxpayers choose this treatment presumably ensures that the rule does not violate treaty obligations. Taxpayers who want to avoid the possibility of a dividend equivalent that exceeds the actual underlying dividend can do so by not explicitly using an estimate.[52]

In general, we believe the Treasury and IRS have struck a reasonable balance by ordinarily using the actual return, but allowing taxpayers to elect to use an estimate, as long as this choice is made in advance. It is important, moreover, for the Treasury and IRS to enforce the requirement that estimates have to be reasonable.

In administering the regime, moreover, we assume that an estimate is binding not only if the dividend declines, but also if it is discontinued. In other words, we see no rationale for distin-

[52] The risk also could be avoided by using a "lesser of" rule, so the estimate is used when it is *lower* than the actual dividend, but not when it is *higher*. Yet if the rationale for using an estimate is to spare withholding agents from having to monitor actual dividends, a "lesser of" rule does not relieve them of this burden. In addition, a "lesser of" rule treats over- and under- estimates asymmetrically. With this rule, a taxpayer is better off using an estimate than the actual dividend: the estimate can reduce a taxpayer's withholding tax (if the dividend is higher than expected) without a imposing a corresponding risk of *increasing* it (if the dividend is lower than expected). To an extent, the policy merits of this asymmetry depend on one's view of withholding on implicit dividends. On one hand, for those who are skeptical of this withholding – on the theory that implicit dividends are not a close substitute for dividends – a "lesser of" rule affords relief from an overly broad rule. On the other hand, for those who consider this withholding necessary to block straightforward avoidance strategies, this asymmetry seems unduly generous to taxpayers. In any event, if the government is concerned about this asymmetry, one possible response is to seek to withhold the excess of the estimate over the actual dividend as FDAP.

guishing between a one penny dividend and no dividend at all. If the estimate is going to be binding, it should be binding in either circumstance.

4. Double Withholding

In some circumstances, a section 871(m) transaction will *already* be subject to withholding, and it is important to coordinate these rules to avoid *double* withholding. For instance, a convertible security can be subject to withholding under section 305(c) when the conversion ratio is adjusted in response to increases in dividends on the underlying stock. As noted above, the regulations include a rule clarifying that section 871(m) does not impose duplicative withholding in this circumstance.[53]

Yet this rule does not apply if the section 871(m) transaction is already subject to withholding for a reason *other than* section 305(c). For instance, assume a mandatorily exchangeable security qualifies as a section 871(m) transaction. Its periodic payments may already be subject to withholding as fixed, determinable, annual, periodical ("FDAP") income. Likewise, for equity-linked debt instruments, some types of contingent interest are subject to withholding (since they do not qualify as exempt contingent interest).[54] In either case, a portion of these payments might be a substitute for dividends on the underlying stock. (In some cases, these periodic payments could be economically equivalent to option premium, which compensates holders for giving up some appreciation in the underlying stock.) To the extent that a periodic payment is a substitute for the underlying dividend – so a portion of it is a dividend equivalent – there could be double withholding if section 871(m) withholding also is required.[55]

To avoid this result, it would be helpful for the Treasury and IRS to generalize the relief provided for section 305. The Treasury and IRS should clarify that section 871(m) generally is not supposed to trigger additional withholding for amounts already subject to withholding. A caveat, though, is that if treaties have reduced (but not eliminated) withholding, section 871(m) might justify imposing additional withholding (*e.g.*, if treaty relief applies to FDAP income, but not dividends). In other words, the amount withheld on dividend equivalent payments (or the portion of overall withholding allocable to a dividend equivalent payment) should not be less than the amount that would have been withheld in respect of an actual dividend paid.

[53] Treas. Reg. § 1.871-15(c)(2)(ii) ("A dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction.").

[54] Section 871(h)(4).

[55] In some circumstances, taxpayers may be able to use self-help to avoid this result by identifying this portion of the periodic payment as an estimate of the dividend equivalent.

5. Is the Underlying Tax Liability Also Deferred Until a Payment is Made?

The regulations generally delay withholding until a payment is made.[56] This delay is needed for administrability reasons. Without cash, there is nothing for a withholding agent to withhold.

A question, though, is whether the foreign holder's tax liability is also deferred until a payment is made. For instance, assume the section 871(m) transaction has a ten year term, and the underlying stock pays dividends every year, but cash payments on the section 871(m) transaction – and thus withholding – do not occur until the tenth year.

In principle, the delay might apply only to the withholding agent's obligation to withhold, but not the foreign investors' obligation to file returns and pay tax.[57] In the above example, do holders have to file returns every year in order to pay tax under section 871(m), since withholding is delayed? If they wait for the withholding, do they lose the opportunity to claim deductions, or to seek refunds? Would the statute of limitations have run by then?

If the Treasury and IRS still expect foreign investors to file, the administrability advantages of delaying withholding are significantly eroded. Indeed, many foreign investors would rather have accelerated withholding than an obligation to file U.S. tax returns. We assume the intention here is not only to defer withholding, but also to defer the tax liability. It would be helpful for this point to be clarified.

B. Reporting and Withholding for Secondary Market Transactions

1. Who Should Determine Whether Section 871(m) applies?

In general, the regulations pair the obligation to withhold with the obligation to decide whether withholding is necessary.[58] In other words, before anyone withholds, someone has to

[56] Treas. Reg. § 1.1441-2(e)(8).

[57] Withholding eliminates the need for a beneficial owner to report the income. *See* section 1462 ("Income on which any tax is required to be withheld at the source under this chapter shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return."); Treas. Reg. § 1.1463-1 ("If the tax required to be withheld under chapter 3 of the Internal Revenue Code is paid by the beneficial owner of the income or by the withholding agent, it shall not be recollected from the other, regardless of the original liability therefor.").

[58] The party with this "reporting" obligation is secondarily liable for withholding. Withholding agents generally can rely on these determinations. If the party with the reporting responsibility is wrong, this party becomes responsible for the withholding tax. Treas. Reg. § 1.1441-3 ("When a withholding agent fails to withhold the required amount because the party described in § 1.871-15(p) fails to reasonably determine or timely provide information regarding whether a transaction is a section 871(m) transaction, the timing and amount of any dividend equivalent, or any other information required to be provided pursuing to § 1.871-15(p), and the withholding agent relied, absent actual knowledge to the contrary, on that party's determination … , then the failure

decide that withholding is needed by determining whether the transaction qualifies as a section 871(m) transaction.

Acknowledging that this determination requires expertise, the regulations generally seek to rely on a broker or dealer. If one of the parties is a broker or dealer, and the other is not, the broker or dealer is obligated to make this determination, and thus ultimately is responsible for the withholding.[59]

We understand why the Treasury and IRS want the delta test to be applied by experts, and why these experts need to be motivated to take this responsibility seriously. But making them liable for all the relevant taxes is an unusually strict sanction. The Treasury and IRS should consider whether a less severe penalty could also accomplish this important goal.

In any event, since the regulations define "parties to a transaction" very broadly – to include not just the party itself, but also its "agent" or "intermediary"[60] – there almost always is a "party to a transaction" who is a broker or dealer under this expansive definition. When both parties are brokers or dealers, the regulations offer a "tiebreaker": the short party is tasked with determining whether the transaction is a section 871(m) transaction,[61] and thus implicitly has ultimate responsibility to withhold.

2. Withholding on Secondary Market Transactions

Even so, relying on the short counterparty does not always make sense. For example, assume the long party in a section 871(m) transaction transfers its position to someone else. Although the obligation to withhold generally is delayed until a "payment" is made, a secondary market sale qualifies as a "payment," and thus can trigger withholding for prior dividend equivalents (assuming there have not already been any cash payments).[62] In this circumstance, though, the short party is not as well positioned as the long party – or, really, as the long party's broker – to withhold. The short party will not receive any of the cash that is changing hands and, in some cases, the short party will not *even know* that the long party has sold.

to withhold is imputed to the party required to make the determinations described in § 1.871-15(p). In that case, the IRS may collect any underwithheld amount from the party to the transaction that was required to make the determinations described in § 1.871-15(p).").

[59] Treas. Reg. § 1.871-15(p)(1).

[60] Treas. Reg. § 1.871-15(a)(9)(ii).

[61] Treas. Reg. § 1.871-15(p)(1).

[62] A payment is made when "[m]oney or other property is paid to or by the long party," Treas. Reg. § 1.1441-2(e)(8)(ii)(A), and also when "[t]he long party sells, exchanges, transfers, or otherwise disposes of the section 871(m) transaction." Treas. Reg. § 1.1441-2(e)(8)(ii)(C).

In contrast, the long party who is selling obviously knows about the sale, as does its broker. As a result, it would make sense for the long party's broker to withhold, paying the tax from proceeds received in the sale. We recommend clarifying this in the regulations.

In principle, the broker representing the purchaser – that is, the "new" long party – also could withhold, since (unlike the short party) it also knows that this transfer is taking place and is directly involved in it. In principle, this broker could hold back some of the purchase price to pay withholding tax. But the broker of the "new" long party lacks important information possessed by the broker of the long party who is selling: how long the "selling" long party has held the position, and thus how much must be withheld. As a result, the broker for the buyer arguably is not the right party to withhold.

Other practical issues also can arise. For instance, assume an equity linked note is cleared through a clearing system that is a qualified intermediary ("QI"). What if a non-US investor holds this note through a foreign broker that is a member of the clearing system, but is not itself a QI? Even though all the parties in the payment chain are withholding agents, our sense is that the QI ordinarily would be the one to withhold. But in this circumstance, the foreign non-QI broker may be the only one who knows relevant information about the non-US investor, such as the investor's holding period, as well as whether this investor is engaging in any other transactions that could impact the treatment. In principle, then, the non-QI broker should be the one to withhold, but it may not have the necessary infrastructure to do so.

3. Accounting for Prior Withholding

In addition to tasking the right party to withhold, the regulations also need to ensure that all parties are sharing information about withholding tax that already has been collected. For example, if one non-U.S. holder of a long position sells to another non-U.S. holder, and the seller's broker withholds, the broker of the short party needs to know that this withholding tax has already been collected. Otherwise, if a payment is made later, the short party's broker may withhold a second time for the same dividend equivalents. But if the relevant tax has already been withheld (*i.e.*, when the long party sold its position), the short party should not withhold a *second time* on the same dividend equivalents. But to avoid this duplicative withholding, the parties need to inform each other of any withholding that has already occurred. We encourage the Treasury and IRS to work with industry to ensure that the necessary communication takes place among the parties' brokers.

This sort of problem can arise not only with secondary market sales, but also with secondary market purchases. For instance, assume a potential section 871(m) transaction has a ten-year term, and the long party during the first four years was a U.S. person (who obviously is not subject to section 871(m)). Assume also that no payments were made during the first four years. If a non-U.S. person purchases this long position after four years, and a payment is made shortly

thereafter, the short party presumably should withhold only for dividend equivalents during the non-U.S. holder's holding period – that is, only for dividend equivalents after the fourth year.[63] To compute the withholding correctly, then, the short party has to know that the long party during the first four years was a U.S. person, and that the long party thereafter has been a non-U.S. person. Again, the parties need to share information to ensure that the right amount of withholding tax is collected, and the Treasury and IRS should work with industry to facilitate this information sharing.

Admittedly, there is a downside to this effort to police duplicative withholding: otherwise identical instruments might no longer be fungible. For instance, assume no payments have been made in the first four years, and a foreigner (*F2*) buys the instrument in the fifth year. If *F2* buys from a U.S. holder, no withholding is needed for dividend equivalents that accrued before the fifth year. In principle, the same should be true if *F2* buys from another foreigner (*F1*), since there should have been withholding when the *F1* sold the instrument. But if this withholding was never collected, and the system is designed to collect the first four years from *F2*, then *F2* is no longer indifferent about buying from *F1*, instead of from a U.S. holder.

In this circumstance, then, there is a tradeoff between ensuring that withholding is conducted at least once and only once, on one hand, and preserving the fungibility of otherwise identical instruments. Obviously, the importance of fungibility varies with the context. It is less important if the section 871(m) transaction is an over-the-counter derivative, but more important if the section 871(m) transaction is a publicly traded security.

C. Reporting and Withholding for Equity-Linked Notes

Expertise is required to compute delta and, more generally, to determine whether a potential section 871(m) transaction actually is a section 871(m) transaction. The regulations generally seek to impose this responsibility on brokers or dealers, who have the requisite expertise. But as noted above, the regulations are drafted broadly, and thus potentially could impose this responsibility on a number of different parties.

Even the "tie-breaking" principle – imposing this responsibility on "the short party" – is not always entirely clear. As noted above, the phrase "party to a transaction" is defined to in-

[63] Since non-U.S. investors who purchase derivatives from other non-U.S. investors are not taxed on dividend equivalents that accrued during their predecessors' holding period, the result presumably should be the same when non-U.S. investors buy from *U.S.* investors. Even if no payments were made during the U.S. investor's holding period, sale proceeds when the U.S. investor transfers the derivative qualify as a "payment." *See* Treas. Reg. § 1.1441-2(e)(8)(ii)(C) (treating sale proceeds as a payment). This treatment essentially tracks the rule for the underlying stock: Foreigners are taxed only on dividends paid during their holding period (although, admittedly, these dividends are taxable even if the relevant earnings and profits accrued during the predecessor's holding period).

clude the party itself, as well as its agents and intermediaries. Therefore, the phrase "short party" can be read to refer not only to the short party itself, but also to the short party's broker. In some circumstances, each of them would have the requisite expertise.

For instance, assume an investment bank issues an equity linked note which is a potential section 871(m) transaction. While the investment bank (or its affiliate) is a broker or dealer, it may also have retained one or more underwriters to help distribute its securities. Which of these experts is responsible for determining whether the equity-linked note is a section 871(m) transaction, and for providing the necessary information to holders?

It would be helpful for the Treasury and IRS to clarify this issue. If the issuer is a broker or has an affiliate that is a broker, the issuer should be tasked with these responsibilities. The Treasury and IRS also should designate who should supply this information if the issuer is not a broker and does not have a broker-dealer affiliate. Otherwise, if each holder's broker has to make an independent judgment, there is a chance that holders will be treated differently (*e.g.*, if some brokers determine that the note is a section 871(m) transaction, while others do not).

D. How Much Information Must Be Reported?

In addition to clarifying who is responsible for determining whether the transaction is a section 871(m) transaction (the "responsible party"), the regulations should further clarify what information has to be provided. The regulations require the responsible party to determine whether a transaction actually is a section 871(m) transaction, and to report its determination to the other parties. These other parties are bound by the responsible party's determination, unless they have reason to know the information is incorrect.[64] If the responsible party is mistaken, it is responsible for the withholding, as indicated above.

If the transaction is deemed to be a section 871(m) transaction, so withholding tax is due, the other parties – and, especially, the withholding agent – need a range of information, including delta and the amount of the dividend equivalents. The regulations explicitly require responsible party to share this information upon request with "any party to the transaction."[65]

But what if the transaction is *not* a section 871(m) transaction? In this case, the other parties arguably no longer need information about delta and dividend equivalents. After all, the regulations say they can rely on the responsible party's determination "unless the person knows or has reason to know the information is incorrect."[66]

[64] Treas. Reg. § 1.871-15(p)(1).

[65] Treas. Reg. § 1.871-15(p)(3)(ii).

[66] Treas. Reg. § 1.871-15(p)(1).

Even so, the regulations arguably still require the responsible party to share this information on request. The broad mandate to share "any other information required to apply the rules of this section"[67] is not limited, at least explicitly, to circumstances in which the transaction is deemed a section 871(m) transaction. Yet there are costs associated with disseminating this information, and some of it might be proprietary (or might help others to "reverse engineer" proprietary information). As a result, the Treasury and IRS should consider clarifying that the obligation to disseminate information to other parties is more limited when the responsible party determines that the relevant transaction is not a section 871(m) transaction.

To be clear, the Treasury and IRS would (and should) still have access to this information. The Treasury and IRS need the ability to review the responsible party's judgment that section 871(m) does not apply. After all, determining delta involves discretionary judgments (*e.g.*, about volatility, dividends, and interest rates), which can yield a range of plausible values. As a result, if the finding is that delta is 0.799999, the Treasury and IRS will want the ability to make an independent assessment of which side of the line the transaction is on. Access to the responsible party's records facilitates such a review. But the regulations already require the responsible party to maintain adequate records, including "documentation and work papers," and this requirement presumably would (and should) be maintained,[68] even if the obligation to share information with other parties is relaxed.

If the Treasury and IRS believe some information should still be shared with other parties, even if the transaction is deemed not to be a section 871(m) transaction – for instance, to help other parties make independent judgments about whether the delta test has been conducted appropriately – the Treasury and IRS should still consider relaxing this information sharing requirement, at least to an extent, when delta is sufficiently low. For instance, the obligation to share information might apply only when delta is above 0.6, so other parties can ask for information when the potential section 871(m) transaction is a "near miss," but not when the transaction is "not even close."

In some circumstances, the other parties will want information because of steps they personally choose to take. For instance, assume a short party (or the short party's broker) concludes that an index qualifies as a qualified index. Since the transaction is no longer a section 871(m) transaction,[69] is there any reason for the short party to be required to compute and report delta? One possibility is that the long party might consider shorting a component of the index and, in so doing, would lose the protection of the safe harbor.[70] In this circumstance, the long party has a

[67] Treas. Reg. § 1.871-15(p)(3)(i).

[68] Treas. Reg. § 1.871-15(p)(4).

[69] Treas. Reg. § 1.871-15(*l*).

[70] Treas. Reg. § 1.871-15(*l*)(6).

reason to want to know delta. Yet in this scenario, we recommend requiring the long party to compute delta itself, instead of having the right to seek this information from the short party. The reason is that the long party, by shorting a portion of the index, is choosing to make this computation necessary. In addition, a party making this choice is likely to be sophisticated enough to generate this information itself.