US IRS issues Section 871(m) regulations addressing dividend equivalent payments

Executive summary

In T.D. 9734 and REG-127895-14, the US Internal Revenue Service (IRS) has issued the long-awaited final regulations under Section 871(m), which govern withholding on certain notional principal contracts, derivatives and other “equity-linked instruments” with payments that reference (or are deemed to reference) dividends on US equity securities. These regulations, which generally apply to transactions issued on or after 1 January 2017, impose US withholding tax on certain amounts arising in derivative transactions over US equities when those amounts are paid to a non-US person. The final regulations generally adopt the proposed regulations issued in 2013, with some (generally pro-taxpayer) changes. This Treasury decision also includes temporary (and proposed) regulations that provide new rules for determining whether certain complex derivatives are subject to Section 871(m) and for payments by certain dealers.

Highlights of the new guidance include:

• The final regulations retain the concept of “delta” (discussed below) to determine whether a derivative is in scope, with three important changes from the proposed regulations: (1) the minimum delta to be within scope increased from 0.7 to 0.8; (2) delta is tested only at original issuance or at a material modification of the instrument; this one-time value for delta is also used for determining the amount of a dividend equivalent payment; and (3) special rules have been added for instruments with an indeterminate delta.

• Special presumptions are provided for brokers who may be required to determine when two or more transactions must be treated as a single transaction.
Coordination rules have been provided to prevent double withholding on constructive dividend payments under Section 305(c).

Due bills and certain compensation-related payments are out of scope.

The requirements for an equity index, to be “qualified,” such that transactions and derivatives with respect to it are out of scope, are loosened.

A dividend equivalent payment is not deemed to be made for withholding tax purposes any earlier than when a payment actually is made.

The existing (old) rules on withholding on swaps that reference US equity securities will continue to apply to payments, including future payments, on contracts entered into before 2017. However, if such a swap entered into during 2016 would be within the scope of withholding under the new rules but not the old rules, withholding will apply to payments made after 2017.

To mitigate the risk of cascading withholding on chains of payments of dividend equivalents (and dividends), the “qualified intermediary” regime for non-US locations of banks and brokers will be extended to cover Section 871(m).

Payments made by US insurance companies and certain foreign insurance companies will be out of scope for Section 871(m).

Detailed discussion

Background

Payments on notional principal contracts (NPCs) are generally sourced by reference to the residence of the recipient, thus generally exempting from US withholding tax a payment made to a non-US person under an NPC. Payments under many other derivatives are deemed to be gains from the sale of property, also outside the scope of withholding. In 2010, however, Congress enacted Section 871(m), which treats dividend equivalent payments made on a narrow class of NPCs as US-source income and, therefore, subject to withholding when paid to a non-US person. Pursuant to statutory authority, on 4 December 2013, the IRS released proposed regulations that would have broadened the scope of instruments on which withholding was required to include virtually every derivative instrument that related to US dividend-paying stocks and that had a “delta” of 0.7 or greater at the time it was acquired by the long party to the derivative.

2015 Regulations

The 2015 final regulations generally adopt the approach of the 2013 proposed regulations with some significant changes in response to comments received on those regulations.

Significant changes in final regulations

The delta test

The 2013 proposed regulations used a single-factor test based on “delta” to determine whether an instrument with payments referencing (or deemed to reference) US stocks was in scope. The “delta” of an instrument is a measure of the relationship between changes in value of the instrument and changes in value of the underlying stock. If an instrument has a delta of one, changes in the value of the instrument should mirror changes in the value of the stock exactly. Under the 2013 proposed regulations, any NPC or equity-linked instrument that had a delta of 0.7 or greater when the long party acquired the transaction would be a Section 871(m) transaction subject to withholding, regardless of the delta when the transaction was originally entered into. The final regulations raise the delta threshold from 0.7 to 0.8 and provide that delta is tested only upon initial issuance of a transaction (or upon a material modification), not upon a later acquisition. Thus, if a contract had a delta of less than 0.8 when issued, it can never fail the delta test absent a modification that would cause a deemed taxable exchange under Section 1001, even if its delta later increases (unless the contract becomes part of a combined trade).

The delta of certain types of “exotic” derivatives, such as “binary” and “digital” options, is indeterminate. The final regulations deal with such products (complex products) with a new “substantial equivalence test,” which, very
generally, measures how much the short party would need to vary the number of shares of stock in its hedge as the price of the underlying security changes.

As with the proposed regulations, the final regulations have a rule that can require two or more transactions that, by themselves, would have a delta below the threshold to be combined into one transaction with a higher delta if the two were entered into “in connection with” each other. This could happen, for example, if one were to buy a call and sell a put with the same price over the same stock. However, the final regulations provide two presumptions that the “short” party, i.e., the party that would be viewed as making a dividend equivalent payment (the withholding agent), may use. Short parties are allowed to presume that two or more transactions are not entered into in connection with each other if either (i) they are entered into two or more business days apart or (ii) they are entered into in separate trading accounts. This presumption can be overcome by the IRS. No such favorable presumptions are provided for a long party.

**Amount of a dividend equivalent**
The final regulations provide that the dividend equivalent amount of a payment for a simple contract will equal the amount of the per-share dividend, multiplied by the number of shares referenced in the contract, multiplied by the applicable delta. The final regulations, consistent with the rule for determining when a contract is within scope, require that delta be determined only once, when the contract is issued. The proposed regulations would have required delta to be redetermined every time a payment was made. The rule in the final regulations will apply to all products regardless of their term; the exception in the proposed regulations for certain short-term obligations has been eliminated. Under the final regulations, for a complex contract, the amount of the dividend equivalent equals the amount of the per-share dividend multiplied by the number of shares that constitute the initial hedge of the complex contract.

**Section 305(c) and other exceptions**
In certain cases a modification of the terms of an instrument relating to a US corporation can create a deemed taxable dividend under Section 305(c) that itself could be subject to withholding under pre-Section 871(m) law. The final regulations clarify the overlap between Section 305(c) and Section 871(m) by providing that Section 871(m) applies to a payment or transaction implicating Section 305(c) only to the extent (if any) that the dividend equivalent amount for purposes of Section 871(m) exceeds the amount of the constructive dividend under Section 305(c). Other exceptions are provided for certain amounts that are compensation (e.g., under certain restricted stock plans), for distributions that are not dividends for tax purposes (e.g., return of capital distributions), and for some “due bills” used with certain extraordinary dividends when an exchange sets an ex-dividend date after the record date (usually, the ex-dividend date is before the record date), resulting in some sellers receiving a dividend that they must pay over to the buyer.

**Certain insurance contracts**
Section 871(m) will not apply to payments made pursuant to the terms of an annuity, endowment or life insurance contract issued by a domestic insurance company (including non-US branches). A similar blanket exception applies for certain contracts issued by certain foreign insurance companies, subject to terms and conditions.

**Qualified indices**
A derivative with respect to a “qualified index” will be out of scope for Section 871(m). The final regulations modify the definition of a “qualified index” from the proposed regulations as follows: (i) the maximum permissible weighting for any one underlying security is increased from 10% to 15%, (ii) more flexibility is provided on when and how an index may be modified or rebalanced, and (iii) short positions are permitted, provided that they represent 5% or less, in the aggregate, of the value of the positions in US securities. The final regulations also provide that if an index is qualified as of the first business day of a calendar year, it is deemed to be qualified for the remainder of the calendar year.

**Time for withholding**
The final regulations provide that a withholding agent is not obligated to withhold on a dividend equivalent until the later of (i) when a payment is made with respect to
a Section 871(m) transaction or (ii) when the amount of a dividend equivalent is determined. A payment with respect to a Section 871(m) transaction will generally occur when the long party receives or makes a payment, when there is a final settlement of the Section 871(m) transaction, or when the long party sells or otherwise disposes of the Section 871(m) transaction.

Effective dates
The final regulations will be effective for transactions entered into on or after 1 January 2017. If a transaction is entered into during 2016 that would be within scope of Section 871(m) under the final regulations but not the prior effective guidance (i.e., the contracts are not “specified NPCs”), payments on the contract made after 2017 will be subject to withholding. Otherwise, pre-2017 contracts are grandfathered under the new rules.

New temporary and proposed regulations

Withholding requirements of qualified derivatives dealers (QDDs)
The statute envisages that there will be rules to prevent cascading withholding at an all-in rate in excess of 30% on a chain of dividend equivalent (and dividend) payments. The temporary and proposed regulations would accomplish this by creating a regime of QDDs, who could receive payments in their capacity as dealers without withholding under Section 871(m). The QDD regime would be an expansion of the existing qualified intermediary (QI) regime for banks and brokers outside the United States that receive dividends as intermediaries for the account of customers. The existing qualified securities lender (QSL) regime for intermediaries that receive payments under securities lending and sale-repurchase transactions will also be folded into the new regime. QDD status will be effective no sooner than 1 January 2017. All existing QI agreements will expire on 31 December 2016; the IRS expects to publish a new QI agreement that will incorporate the QDD regime (and the QSL regime).

Implications

By raising the delta threshold from 0.7 to 0.8 and providing that testing is only required at initial issuance, the changes made by the final regulations greatly reduce the likelihood that US withholding tax will be imposed on options and convertible bonds. Moreover, while long parties cannot rely on the presumptions governing the “in connection with” test, the existence of those presumptions will as a practical matter reduce the likelihood that dealers will withhold on derivative contracts. Given the scope of transactions covered and the details on exempted transactions, these rules will require that affected parties implement systems by the general 2017 effective date, in addition to monitoring certain 2016 contracts to be prepared for their 2018 withholding effective date.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, International Tax Services – Capital Markets**

- Alan Munro, *Washington, DC*  +1 202 327 7773  alan.munro@ey.com
- Matthew Stevens, *Washington, DC*  +1 202 327 6846  matthew.stevens@ey.com
- Matthew Blum, *Boston*  +1 617 585 0340  matt.blum@ey.com
- Colleen Zeller, *New York*  +1 212 773 6463  colleen.zeller@ey.com
- Petya Kirilova, *Washington, DC*  +1 202 327 6075  petya.kirilova@ey.com

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International Tax Services

- Global ITS, *Alex Postma, Tokyo*
- ITS Director, Americas, *Jeffrey Michalak, Detroit*
- Director of NTD Washington ITS, *Jose Murillo, Washington*

**Member Firm Contacts, Ernst & Young LLP (US)**

- Northeast
  - *Johnny Lindroos, McLean, VA*
- Financial Services
  - *Phil Green, New York*
- Central
  - *Mark Mukhtar, Detroit*
- Southeast
  - *Scott Shell, Charlotte, NC*
- Southwest
  - *Amy Ritchie, Austin*
- West
  - *Beth Carr, San Jose, CA*
  - *Canada - Ernst & Young LLP (Canada)*
    - *Albert Anelli, Montreal*
  - *Israel - Kost Forer Gabbay & Kasierer (Israel)*
    - *Sharon Shulman, Tel Aviv*
  - *Mexico - Mancera, S.C. (Mexico)*
    - *Koen Van ‘t Hek, Mexico City*
  - *Central America - Ernst & Young, S.A.*
    - *Rafael Sayagues, San José*
  - *South America - Ernst & Young Serviços Tributários S.S.*
    - *Gil F. Mendes, São Paulo*
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