IRS issues final, temporary, and proposed regulations under Sections 871(m) and 1441 dealing with dividend equivalent payments

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In brief

The Internal Revenue Service (IRS) and the US Department of the Treasury (Treasury) on January 19, 2017 issued final, temporary, and proposed regulations (the 2017 Section 871(m) Regulations) under Section 871(m) of the Internal Revenue Code (Code). The 2017 Section 871(m) Regulations provide much anticipated guidance in response to comments provided with respect to the existing Section 871(m) regulations as well as additional guidance provided by the IRS in Notice 2016-76 and the new qualified intermediary agreement (2016 QI Agreement) provided in Revenue Procedure 2017-15. The 2017 Section 871(m) Regulations:

- consistently with Notice 2016-76, provide that Section 871(m) will apply to delta-one transactions only for 2017,
- consistently with the 2016 QI Agreement, provide for changes to the treatment of payments made to qualified derivatives dealers (QDDs) and calculation of their tax liability, and
- address a multitude of comments made with respect to the existing Section 871(m) regulations, including providing clarification with respect to the timing of the determination of delta, the ability for withholding agents to choose to withhold on the underlying dividend payment date, and the treatment of parties to Section 871(m) transactions.

Observation: *These 2017 Section 871(m) Regulations were issued immediately prior to the memorandum issued by the White House Chief of Staff freezing the publication of new regulations. However, the 2017 Section 871(m) Regulations were subsequently published in the Federal Register on January 24, 2017 and therefore appear to be currently effective. However, future action may change the current status.*

In detail

Final and temporary regulations under Section 871(m) released in September 2015 (the 2015 Section 871(m) Regulations) generally impose a withholding tax on 'dividend equivalent amounts' paid or deemed paid to non-US taxpayers on derivatives over US equities. The 2015 Section 871(m) Regulations were to be effective for all in-scope contracts issued on or after January 1, 2017.

Since the 2015 Section 871(m) Regulations were issued, multiple industry bodies, financial institutions, and governments have provided comments requesting changes or clarifications.

The IRS and Treasury on December 2, 2016 issued Notice 2016-76, which granted temporary transitional relief in certain circumstances and announced prospective changes to the 2015 Section 871(m) Regulations. In particular, the Notice provided that the regulations would be changed so that only delta-one transactions would be subject to reporting and withholding under Section 871(m) in 2017. The Notice also provided for a phased-in approach to Section 871(m) for 2017 and 2018, set forth a simplified approach to the combination rule for 2017, and outlined significant changes to the treatment of QDDs.

The IRS and Treasury on December 30, 2016 issued Rev. Proc. 2017-15 setting forth the 2016 QI Agreement including extensive changes to the treatment of QDDs. The 2016 QI Agreement's provisions with respect to QDDs expanded upon Notice 2016-76 by clarifying that QDDs would calculate their tax liability using a net delta approach. The trade-off for that concession is a requirement that QDDs be subject to withholding on actual and deemed dividends on US equities. These provisions were deferred to 2018 since they represent a major change to the treatment of QDDs.

The 2017 Section 871(m) regulations

Prior PwC Tax Insights have addressed changes in Notice 2016-76 (*IRS notice provides relief under Section 871(m) regulations and qualified derivatives dealer regime*), the 2016 QI Agreement (*IRS releases final qualified intermediary agreement*) and the new QDD provisions in the 2016 QI Agreement (*Final qualified intermediary agreement includes qualified derivatives dealer provisions*). As such, the commentary in this insight focuses primarily on the provisions of the 2017 Section 871(m) Regulations that address comments made with respect to the 2015 Section 871(m) Regulations.

Determination of delta

A number of industry comments focused on the date on which the delta of a transaction is calculated. Particularly with respect to listed options, market participants were concerned about the complexity of determining delta where multiple transactions take place on a single trading day. To address these comments, the 2017 Section 871(m) Regulations contain the following provisions:

- The delta of a non-listed simple contract will be determined on the earlier of the pricing date or the issue date, unless the issue date is more than 14 days after the pricing date (in which case the issue date must be used). The 2017 Section 871(m) Regulations refer to this standard as the 'calculation time' for the transaction.
- The delta of options listed on a 'regulated exchange' will be determined based on the delta of the option as of the close of business on the date prior to issuance. The calculation of delta for a customized option, even if listed, may not benefit from this rule. The 2017 Section 871(m) Regulations do not define 'customized option.'
- For transactions that reference ten or more underlying securities, the 2015 Section 871(m) Regulations allowed the short party to use an exchange-traded security with substantially all the same underlying securities to calculate delta based on that exchange-traded security if they actually hedged with that security. The 2017 Section 871(m) Regulations provide that the delta of the exchange-traded security can be used irrespective of whether the short party actually uses it as a hedge.
- Third-party data can be used to determine delta, but taxpayers and withholding agents remain responsible for the accuracy of the information.
- An issuer of structured notes that holds or purchases the notes in its capacity as a market maker may not rely on Code Section 108 principles to get comfortable that such notes are not treated as redeemed and reissued on a subsequent sale. This provision applies whether the notes are held directly or via an affiliate. Accordingly, it may not be clear whether such instruments must be retested for delta (or substantial equivalence) at such time.

Observation: *Secondary purchasers of structured notes should consider whether a note should be properly re-tested at the time of such purchase and whether a note that was originally out of scope may become in scope based on its economics at such time.*

Amount and timing of taxpayer liability

Several clarifications were made to the 2015 Section 871(m) Regulations with respect to the computation of the taxpayer's liability driven in part by the fact that the amount of a dividend equivalent may be determined before the actual withholding occurs. These clarifications include the following:

- The 2017 Section 871(m) Regulations provide that the long party is liable for tax on a dividend equivalent in the same year in which the amount is subject to withholding. For payments of dividend equivalent amounts by a QDD, the liability always arises when the underlying dividend is subject to withholding (see *Withholding rules* below).
- The amount of a dividend equivalent is determined based on the facts as they exist on the date of its calculation; a subsequent change in facts will not change the amount of withholding required to be levied. ***Observation:*** *The regulations contain a helpful example where the long party is eligible for treaty relief when the dividend equivalent amount is calculated, but later loses that eligibility. In this example, the applicable withholding rate will be the treaty rate.*
- The long party on a Section 871(m) transaction will be liable for tax on dividend equivalents that arise during the period that the long party is a party to the transaction. ***Observation:*** *A number of asset managers had questioned how they should allocate Section 871(m) liability to partners who bought and sold during the year. These provisions clarify that the allocation should be done based on the partners' interests on the dividend equivalent calculation date and not the withholding date.*

Withholding rules

Under the 2015 Section 871(m) Regulations, a dividend equivalent amount is determined on the earlier of the record date for the dividend or the day before the ex-dividend date. Withholding on the dividend equivalent amount by non-QDDs is deferred until payment is made on the Section 871(m) transaction or the position is sold, exchanged, transferred, or otherwise disposed of. In addition, QDDs now must withhold on the underlying dividend payment date. The 2017 Section 871(m) Regulations provide several clarifications to these provisions:

- As requested by multiple commenters, the IRS agreed to allow a withholding agent (other than a QDD) to elect to withhold at the underlying dividend payment date so long as the election is applied to all Section 871(m) transactions of the same type (such as securities loans or notional principal contracts). The withholding agent is required to notify each payee (treating an intermediary or flow-through entity as a single payee) in writing that it has made this election prior to the determination of the first dividend equivalent payment. The withholding agent must notify the IRS with the filing of its income tax return identifying the types of transactions for which the election has been made and certifying that the appropriate notifications were performed.

  Observation: *As the long party generally is liable for tax in the year in which the dividend is subject to withholding, the election by the short party to accelerate (or defer) withholding under this provision could affect the long party's tax liability. This new provision may create significant uncertainty in the market since the default method is to withhold on the payment or transfer date in respect of a derivative, but withholding agents may have different approaches to withhold on the underlying dividend payment date. This means long parties may need to understand and track how a withholding agents will be withholding for each type of instrument to properly track future tax liability (especially if the long party utilizes multiple brokers). In addition, the example provided in the 2017 Section 871(m) Regulations with respect to transaction of the same type is extremely broad. This raises the question whether all equity linked instruments must be treated consistently.*
- Custodians requested a change to the rules so that a transfer of a Section 871(m) transaction from one custodian to another for which a dividend equivalent amount had previously accrued would trigger withholding on that amount. The IRS agreed with this position and provides administrative relief so that custodians do not have to track accrued dividend equivalent amounts on transferred positions.
- For Section 871(m) transactions that reference partnerships, the withholding is due on March 15 following the year in which the payment of the dividend equivalent occurs.

Observation: *This provision appears to override the other withholding provisions that generally allow for flexibility as to when withholding takes place and should allow holders of instrument linked to partnerships to align their tax liability with the obligation to withhold only in the following year when the partnership information is more likely to be available.*

Substantial equivalence test

While a number of suggestions were made with respect to the substantial equivalence test, the IRS did not make any significant changes to the test. The substantial equivalence test requires the establishment of a simple contract benchmark against which the transaction will be tested. The 2017 Section 871(m) Regulations allow the simple contract benchmark to be either an actual or a hypothetical transaction. The benchmark also must consistently apply reasonable inputs, including a reasonable time period.

Observation: *It appears that the IRS takes the view that industry will become accustomed to the substantial equivalence test calculations and absorb them into standard operating procedures. The test is based on a particular hedging model and may create issues for market participants who use other models for hedging. Comments suggested that an alternative test that produced the same result should be permitted but the IRS did not agree with that suggestion. The IRS is treating 2018 as phase-in year for non-delta one transactions to provide responsible parties with sufficient time to work through the implementation of the substantial equivalence test.*

Qualified index rule

While the qualified index rule remains largely as it was, the IRS did clarify a couple of points. First, the safe harbor for an index where US equities comprise 10% or less of the weighting of all component securities applies only if the index is 'widely traded' and not formed or availed of for tax avoidance purposes. Second, new indices will be tested on the first business day they are listed using the dividend yield that the index would have had if it had been in existence the prior year.

Observation: *The requirement that an index eligible for the 10% safe harbor be 'widely traded' does not appear to add an additional significant hurdle since the original safe harbor was already subject to the 'widely held' and other requirements included in the 'purpose test' under Treas. Reg. Sec. 1.871-15(l)(1).*

Combination rule

The 2015 Section 871(m) Regulations received extensive industry comments and suggestions with respect to the application of the combination rule. The IRS confirmed that transactions will be combined only into simple transactions, which had been a matter of concern with commentators. With respect to the multiple suggestions for clarification, the preamble notes that the combination rule provides a general framework and that industry should refine the application of the rule as they develop their internal systems. In the interim, the preamble to the 2017 Section 871(m) Regulations suggests taxpayers may combine positions in a 'reasonable manner.'

Observation: *The comments in the preamble are quite significant in that they interpret the 2015 Section 871(m) Regulations as requiring only combinations that result in simple contracts and explicitly allowing that more than one combination methodology in the industry may be allowed. The IRS essentially is telling industry to come up with processes and systems to apply the combination rule at which point the agency may consider additional advice. For parties to option transactions, the ability to show good faith in the application of the combination rule to their positions is advisable. Both long and short parties should consider the adoption of policies and procedures to show their awareness of the implications of the combination rule. The IRS may publish further guidance as this market understanding of the rule evolves.*

Party responsible for determining Section 871(m) transaction information

The 2015 Section 871(m) Regulations provide a set of rules for establishing which party to a Section 871(m) transaction is responsible for making the relevant determinations about the transaction, including whether it is in scope and dividend equivalent amounts. It was unclear, however, which party should be the 'responsible party' in situations where there are multiple brokers involved in a transaction. The 2017 Section 871(m) Regulations provide the following ordering rules for establishing the responsible party for Section 871(m) determinations:

- The short party is always the responsible party when the short party is a broker or dealer.
- If the short party is not a broker or dealer, but more than one agent or intermediary of the short party is a broker or dealer, the agent or intermediary closest to the short party in the payment chain is the responsible party.
- Where more than one agent or intermediary of the long party is a broker or dealer, and neither the short party nor its agents or intermediaries are brokers or

dealers, the agent or intermediary closest to the long party in the payment chain is the responsible party.

- Where the potential Section 871(m) transaction is traded on exchange and cleared by a clearing organization, and there is more than one broker or dealer involved, the broker or dealer that has an ongoing relationship with the foreign investor is the responsible party. This party generally will be the clearing firm (e.g., DTCC).

In addition to the ordering rules, the 2017 Section 871(m) Regulations require issuers of structured notes, warrants, convertible stock, and convertible debt instruments to be the responsible party.

In all cases, the responsible party may contract with third parties to make these determinations although they remain responsible for their accuracy.

Observation: *These rules will be extremely helpful in establishing market practices for the agents and intermediaries involved in Section 871(m) transactions. The IRS has attempted to align the responsibility for the distribution of the information to the party closest to the generation of the relevant information.*

Technical corrections to definitions

Finally, in response to industry comments, the IRS made the following changes to definitions in the 2015 Section 871(m) Regulations:

- The definition of 'broker' was changed so that regulated investment companies that met the definition solely because they regularly redeem their own shares now will be excluded.
- A Section 305(c) deemed dividend generally may reduce the amount treated as a dividend equivalent amount under Section 871(m). The interaction with Section 305(c) dividends was clarified so that only the person receiving the actual Section 305(c) dividend may credit that dividend against a corresponding Section 871(m) dividend equivalent amount. That is, investors that merely receive a Section 871(m) dividend equivalent are not entitled to an offset for a Section 305(c) deemed dividend if it was not treated as actually receiving such deemed dividend.
- The definition of a 'simple contract' was clarified so that adjustments to the number of underlying shares as a result of a merger, stock split, cash dividend, or similar corporate action will not prevent the transaction from being a simple contract.

The takeaway

The 2017 Section 871(m) Regulations addressed many of the most pressing comments that had been made with respect to the 2015 Section 871(m) Regulations, but some thorny issues remain to be interpreted and implemented by parties to Section 871(m) transactions. These include standards for determining when transactions are entered into 'in connection with' each other, application of the 5% qualified index short rule, and implementation of the substantial equivalence test. The phase-in periods and good faith standard are helpful in this respect, but industry participants, both long and short, should be mindful of the breadth of the anti-abuse rule as they craft policies and procedures to demonstrate their compliance with the rules.

Let's talk

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