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Section 871(m): Final and temporary regulations released

Background. In January 2012, temporary and proposed regulations were published addressing the treatment of dividend equivalents from sources within the United States paid to nonresident alien individuals and foreign corporations. On December 5, 2013, final and re-proposed regulations were published describing a new delta-approach for determining whether a payment is a dividend equivalent.

In response to numerous written comments on the 2013 proposed regulations, the Treasury Department ("Treasury") and the IRS today released final regulations that generally adopt the 2013 proposed regulations, with numerous modifications. Temporary regulations were also released, which provide, among other things, rules for determining whether certain complex derivatives (a new term defined in the final regulations) are subject to section 871(m) and for payments to certain dealers.

Some of the more notable changes from the proposed regulations are discussed below.

Final Regulations

Definition of a Dividend Equivalent. The 2013 proposed regulations define a dividend equivalent as payments on certain equity-linked instruments ("ELIs") and specified notional principal contracts ("specified NPCs") that reference a U.S.-sourced dividend. The final regulations retain this definition but also provide certain exceptions. For example, the final regulations clarify that a dividend equivalent is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend. The final regulations also exclude payments for due bills, for employee compensation, and in certain corporation acquisitions. The final regulations extend the temporary definition of specified NPC to payments made before January 1, 2017.

Delta Threshold. Under the 2013 proposed regulations, any specified NPC or ELI with a delta of 0.70 or greater when the long party *acquired* the contract would be a section 871(m) transaction.

The final regulations adopt a threshold of 0.80. Further, the delta is now determined *only* when the instrument is issued; it is not re-tested when the instrument is purchased in the secondary market.

The above delta test would be difficult to apply to certain exotic equity derivatives, such as structured notes. To address these contracts, the final regulations distinguish between “simple contracts” and “complex contracts.” Generally, a simple contract is a contract that references a single, fixed number of shares of one or more issuers to determine the payout. The number of shares must be known when the contract is issued. Thus, for example, an American-style option is a simple contract. Simple contracts are subject to the general delta test. A complex contract is any contract that is not a simple contract, such as a contract with indeterminate deltas. Complex contracts are not subject to the delta test but are subject to the substantial equivalence test in the temporary regulations (below).

Payment of a Dividend Equivalent. The 2013 proposed regulations provide that a dividend equivalent includes any amount that references an actual or estimated payment of a U.S. source dividend, whether the reference is explicit or implicit. The final regulations retain this rule.

Amount of a Dividend Equivalent. The final regulations simplify the rules for determining the amount of a dividend equivalent. For a simple contract, the amount of the dividend equivalent for each underlying security equals the amount of the per-share dividend, multiplied by the number of shares referenced in the contract, multiplied by the applicable delta. Importantly, this formula references the delta of the transaction at the time the simple contract is issued, rather than when the dividend is paid. 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.

Also, if a section 871(m) transaction references a basket of more than 25 underlying securities, the short party is allowed to treat all of the dividends on the basket as paid on the last day of the calendar quarter. The final regulations also eliminate the rule for contracts with terms of one year or less.

Qualified Indices. The final regulations made several changes to the qualified index provisions, such as

- Providing that the time for determining whether an index as a qualified index is made on the first business day of each calendar year;

- Permitting an index to qualify with fewer than 25 component underlying securities provided that the index contains a total of at least 25 component securities (in other words, a component security may include a security that does not give rise to U.S. source dividends) so long as it does not reference five or fewer component underlying securities that together represent more than 40 percent of the weighting of the component securities in the index;

- Increasing the 10 percent limit for the maximum weighting of a single underlying security to 15 percent; and
- Not requiring that an index be modified or rebalanced at set dates or intervals.

The final regulations also permit a qualified index to reference one or more short positions that represent 5 percent or less, in the aggregate, of the value of the long positions in underlying securities in the qualified index.

Combined Transactions. The 2013 proposed regulations treated multiple transactions as a single transaction when a long party enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other.

The final regulations retain this general rule but add a requirement that the potential section 871(m) transactions, when combined, replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction. Thus, the purchase of two out-of-the-money call options would typically not be combined because each call option provides the taxpayer with exposure to appreciation, but not depreciation, on the referenced stock.

The final regulations also provide brokers acting as short parties with two presumptions. First, a broker may presume that transactions are not entered into in connection with each other if the long party holds the transactions in separate accounts. Second, a broker may presume that transactions entered into two or more business days apart are not entered into in connection with each other. These presumptions do not apply if the broker has actual knowledge that transactions were entered into in connection with each other. These presumptions are not available to the long party; a long party must treat two or more transactions as combined transactions if the transactions satisfy the requirements to be a combined transaction. The IRS will also follow these presumptions, although the IRS may rebut them. Further, the IRS will presume that transactions that are entered into fewer than two business days apart *and* reflected on the same trading book are entered into in connection with each other.

Derivatives Referenced to Partnership Interests. The final regulations provide that section 871(m) applies to derivatives that reference a partnership interest only when the partnership is either a dealer or trader in securities, has significant investments in securities, or holds an interest in a lower-tier partnership that engages in those activities.

Anti-abuse rule. The 2013 proposed regulations provide that the IRS may treat any payment made with respect to a transaction as a dividend equivalent if the taxpayer acquires the transaction with a principal purpose of avoiding the application of section 871(m). The final regulations retain this rule.

Reporting Obligations. The 2013 proposed regulations provide that when a broker or dealer is a party to a potential section 871(m) transaction, the broker or dealer is required to determine whether the transaction is a section 871(m) transaction, and if so, the amounts of the dividend equivalents. If no broker or dealer is a party to a transaction or both parties are brokers or dealers, the short party is required to determine whether the transaction is a section 871(m) transaction and the amounts of the dividend equivalents.

The final regulations revise the period for providing requested information from 14 calendar days to 10 business days from the date of the request, and they permit "any party to the transaction" to request information. Like the 2013 proposed regulations, the final regulations permit parties to a transaction to obtain information on potential section 871(m) transactions in a variety of ways, including through electronic publication.

Contingent and Convertible Debt Instruments. The 2013 proposed regulations provide that contingent interest will not qualify for the portfolio interest exemption to the extent that the contingent interest payment is a dividend equivalent. The final regulations retain this rule.

The final regulations also do not provide an exception from section 871(m) for convertible debt. The delta of the convertible feature is tested separately from the delta of the debt instrument.

Amounts Subject to Withholding. The final regulations provide that a withholding agent is not obligated to withhold on a dividend equivalent until the later of when a payment is made with respect to a section 871(m) transaction or when the amount of a dividend equivalent is determined.

For options and other contracts that typically require an upfront payment, the final regulations do not treat the premium or other upfront payment as a payment for withholding purposes. Thus, withholding on these section 871(m) transactions is not required until there is a final settlement (including, in the case of an option, a lapse) or the long party sells or otherwise disposes of the transaction.

Temporary and Proposed Regulations

Test for Contracts with an Indeterminate Delta. As noted above, a contract with an indeterminate delta is not a simple contract and therefore is a complex contract. To test whether a complex contract is a section 871(m) transaction, the temporary regulations adopt a "substantial equivalence" test.

Generally, the substantial equivalence test measures the change in value of a complex contract when the price of the underlying security referenced by that contract is hypothetically increased by one standard deviation or decreased by one standard deviation (each, a "testing price") and compares that change to the change in value of the shares of the underlying security that would be held to hedge the complex contract at the time the contract is issued (the "initial hedge") at each testing price. When this difference is equal to or less than the difference for a simple contract benchmark with a delta of 0.80 and its initial hedge, the complex contract is treated as substantially equivalent to the underlying security.

Withholding Requirements and Qualified Derivatives Dealers. The Treasury and the IRS intend to amend the qualified intermediary ("QI") agreement to include new provisions that will permit an eligible QI to act as a qualified derivatives dealer ("QDD"). A QI that acts as a QDD will not be subject to withholding on dividends or payments that may be dividend equivalents made with respect to potential section 871(m) transactions that the QDD receives while acting in its capacity as a dealer.

Certain Insurance Contracts. The temporary regulations provide that there is no dividend equivalent associated with a payment that a foreign person receives pursuant to the terms of an annuity, endowment, or life insurance contract issued by a domestic insurance company (including the foreign or U.S. possession branch of the domestic insurance company).

Further, until further guidance is issued, the temporary regulations provide that annuity, endowment, and life insurance contracts that reference U.S. equities and that are issued by foreign life insurance companies do not include a dividend equivalent when issued by a foreign corporation that is predominately engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

Effective Date. The final and temporary regulations are generally effective on the date they are published in the *Federal Register* (September 18, 2015). To ensure that brokers have adequate time to develop the systems needed to implement the regulations, however, the final and temporary regulations generally apply to transactions issued on or after January 1, 2017.

In addition, with respect to transactions issued on or after January 1, 2016, and before January 1, 2017, that are section 871(m) transactions, the regulations also apply to any payment of a dividend equivalent made on or after January 1, 2018.

The chapter 4 regulations provide a coordinating effective date for the treatment of dividend equivalents as withholdable payments for purposes of chapter 4 withholding.

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