Client Alert

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Final and Temporary Dividend Equivalent Regulations Issued – Some Good, Some Bad, and Some Ugly

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On September 17, 2015, the Internal Revenue Service ("IRS") released final and temporary regulations under Section 871(m),[1] the Internal Revenue Code provision that treats "dividend equivalents" paid under certain contracts as dividends from sources within the United States and therefore subject to U.S. withholding tax if paid to a non-U.S. person. The regulations finalize regulations proposed in 2013 (the "2013 Proposed Regulations"), with significant changes.

The new regulations generally adopt the "delta" approach introduced in the 2013 Proposed Regulations, which treat payments on notional principal contracts ("NPCs") and equity-linked instruments ("ELIs") as dividend equivalents if they have a delta above a threshold.[2] However, the delta approach is limited to "simple" NPCs and ELIs and a new framework has been designed for "complex" NPCs and ELIs. We discuss this and other significant changes to the 2013 Proposed Regulations below.

The new regulations generally apply to NPCs and ELIs issued on or after January 1, 2017. NPCs and ELIs issued on or after January 1, 2016, and before January 1, 2017, are also subject to the new regulations, with a delayed effective date of January 1, 2018.

Important highlights of the regulations include:

- ***Delta Threshold of 0.80***. The delta threshold has been increased to 0.80 from 0.70. Generally, if an NPC or ELI has a delta of 0.80 or greater, the NPC or ELI is a Section 871 transaction and payments on the instrument that reference dividends paid on a U.S. corporation's stock are "dividend equivalents" treated as U.S.-source dividends subject to withholding. However, "complex" NPCs and ELIs are subject to different rules, as further described below.

- ***Delta Determined Once***. The delta of an instrument is determined when the instrument is issued.[3] Delta is not re-tested when the instrument is acquired in the secondary market. This is a change from the 2013 Proposed Regulations, which required determining delta in the hands of each taxpayer on the relevant acquisition date.

[1] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

[2] For a summary of the 2013 Proposed Regulations, please see our client alert available at http://media.mofo.com/files/Uploads/Images/131212-IRS-Regulations.pdf

[3] The regulations clarify that, in the case of a contingent debt instrument or convertible debt instrument, the delta of the embedded derivative or of the convertible feature is determined separately from the delta of the overall debt instrument.

- ***Delta Determined Using Hedge***. A taxpayer that issues an instrument that references a basket of 10 or more underlying securities and uses an exchange-traded security (e.g., an exchange-traded fund) that references substantially the same underlying securities to hedge the instrument at the time it is issued, may calculate the delta of the instrument by determining the ratio of the change in fair market value of the instrument to the change in the fair market value of the hedge (rather than of each underlying security in the basket). A similar approach (i.e., substituting the hedge for the basket securities) applies in the case of a complex NPC or ELI.

- ***Estimated and Implicit Dividends Count***. The new regulations retain the provisions of the 2013 Proposed Regulations that include estimated and implicit dividends as dividend equivalents. For example, a "price return" only instrument can give rise to dividend equivalent payments if the expected dividends on the underlying security are taken into account in pricing the instrument or setting its terms.

- ***Qualified Index Exception***. Similar to the 2013 Proposed Regulations, instruments linked to "qualified indices" are carved out from the dividend equivalent rules. However, the definition of a qualified index has been modified.[4] Whether an index is a qualified index is determined on the first business day of each calendar year, and such determination applies for all relevant instruments issued during that year. In addition, an underlying security that tracks a qualified index (e.g., an exchange-traded fund) will be treated as a qualified index.

- ***Limited Partnership Look-Through***. For purposes of applying the Section 871(m) rules, an instrument that references a partnership interest is not treated as a potential Section 871(m) transaction, unless the partnership is a dealer or trader in securities for tax purposes, holds significant investments in securities,[5] or directly or indirectly holds an interest in a lower-tier partnership that engages in those activities.

- ***Combined Transactions***. The regulations mostly retain the rules included in the 2013 Proposed Regulations that two or more transactions may be treated as a single transaction in determining whether Section 871(m) should apply. However, to address challenges that brokers acting as short parties may have in determining whether multiple transactions should be combined, the regulations provide that brokers may generally rely on two presumptions. They may presume that transactions are not entered into in connection with each other if the long party holds the transactions in separate accounts and they may presume that transactions entered into two or more business days apart are not entered into in connection with each other (unless the brokers have knowledge to the contrary).

[4] Under the new regulations, a qualified index means an index that (i) references 25 or more component securities; (ii) references only long positions in component securities; (iii) references no component underlying security that represents more than 15% of the weighting of the component securities in the index; (iv) references no five or fewer component underlying securities that together represent more than 40% of the weighting of the component securities in the index; (v) is modified or rebalanced only according to publicly stated, predefined criteria, which may require interpretation by the index provider or a board or committee responsible for maintaining the index; (vi) did not provide an annual dividend yield in the immediately preceding calendar year from component underlying securities that is greater than 1.5 times the annual dividend yield of the S&P 500 Index as reported for the immediately preceding calendar year; and (vii) is traded through futures contracts or option contracts on a national securities exchange or certain foreign exchanges.

[5] A partnership holds significant investment in securities if either (i) 25% or more of the value of the partnership's assets consist of securities that could give rise to U.S.-source dividends or that are potential Section 871(m) transactions, or (ii) the value of such securities or transactions equals or exceeds $25 million.

- ***Complex vs. Simple***. Complex NPCs and ELIs[6] are not subject to the "delta" test; instead, a complex NPC or ELI gives rise to dividend equivalents if it passes a "substantial equivalence" test. Generally, the substantial equivalence test calculates the difference between the change in value of the complex contract (determined at various "testing prices" of the underlying) and the change in value of a number of shares that fully hedges the complex contract, as determined on the issue date. The differences are then given a probability-weighted average over the various testing prices of the underlying (the "Complex Contract Calculation"). A similar process is repeated with a "simple contract benchmark"[7] in place of the complex contract (the "Benchmark Calculation"). If the Complex Contract Calculation is less than or equal to the Benchmark Calculation, the complex contract is a Section 871 transaction. The IRS has requested comments regarding the administrability of the substantial equivalence test.

Select observations:

- The regulations make a few notable improvements to the 2013 Proposed Regulations, in particular increasing the delta threshold to 0.80 and allowing for the delta of a particular instrument to be determined once.
- Consistent with the 2013 Proposed Regulations, estimated and implicit dividends are not carved out and, since most price return only instruments take into account expected dividends on the underlyings, the regulations apply to price return only instruments.
- Since the determination of whether an index is "qualified" is made on the first business day of a calendar year and applies for the entire year, a published list (updated annually) of all qualified indices for purposes of Section 871(m) would be helpful. Who will take that publication on?
- The delta test or the substantial equivalence test, as applicable, needs to be conducted when the relevant instrument is issued. An instrument is issued at "inception" or upon "original issuance." Disclosure documents for instruments addressing the tax treatment are typically prepared on or immediately after the pricing date. Can the determination be made on the pricing date and included in the disclosure documents? The preamble to the regulations indicates that "an instrument is treated as "issued" when it is entered into, purchased, or otherwise acquired at its inception or original issuance."
- Many structured products will be considered "complex." The rules for determining whether a complex NPC or ELI gives rise to a Section 871(m) transaction seem rather *complex*, and time will tell whether the framework is workable in practice. Those rules are part of the temporary regulations and the IRS has requested comments regarding the administrability before it will finalize them.

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[6] A complex NPC or ELI is any NPC or ELI that is not a simple contract; a simple contract is an NPC or ELI that has a fixed term and references a fixed number of underlying shares.

[7] A simple contract benchmark is a "comparable simple contract" that has a delta of 0.8, references the same underlying security as the complex contract, and has the same maturity as the complex contract. Examples of simple contract benchmarks are put options, call options, or collars on a fixed number of shares.

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