The Section 871(m) Qualified Index Rules

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Abstract

This Article examines the portion of the section 871(m) Regulations that addresses when a financial contract that references an index should be treated for section 871(m) purposes as referencing the components of the index and when it should be treated as referencing a notional index that is independent of the index components. Aside from their importance in implementing section 871(m), these Regulations are of particular significance because they represent the first time that the Service has issued rules that address the tax treatment of modern financial indices. The tax treatment of financial indices has become increasingly important in recent years in light of the very significant increase in the number and scope of financial indices and the amount of financial instruments that are linked to such indices. This Article examines the policy, interpretive, and practical issues that arise under the Regulations and considers the application of the Regulations to many common financial transactions.

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I. Introduction

In 2015, I co-authored an article entitled *The Tax Treatment of Indices in the Modern Financial Marketplace*.[1] The article addressed the tax treatment of indices in many different contexts, with a particular emphasis on whether a financial instrument that references an index should be treated for tax purposes as referencing (1) the components of the index or (2) a notional index that is independent of the components of the index. As discussed in that article, this question has consequences in many different areas of the tax law, including the section 1260 constructive ownership rules, FIRPTA, section 871(m), the section 1091 wash sale rules, the section 1001 disposition rules, the section 1256 mark-to-market rules, the section 246 dividends received deduction rules, as well as other areas of tax law.[2]

The Service has since issued final Regulations under section 871(m) that address, among other topics, when an index should be treated as a "qualified index" for section 871(m) purposes. More specifically, as discussed in more detail below, these Regulations address when a financial contract that references an index should be treated for section 871(m) purposes as referencing the components of the index and when it should be treated as referencing a notional index that is independent of the index components. Aside from their importance in implementing section 871(m), these Regulations are of particular significance because they represent the first time that the Service

[1] Jeffrey D. Hochberg & Alexander P. Apostolopoulos, *The Tax Treatment of Indices in the Modern Financial Marketplace*, 68 Tax Law. 487 (2015).

[2] Unless otherwise noted, all references in this Article to a "section" are references to a section of the Internal Revenue Code of 1986, as amended, and all references to "Reg." are references to sections of the Treasury regulations promulgated thereunder (with temporary regulations indicated by "Temp." and proposed regulations indicated by "Prop.").

has issued rules that address the tax treatment of modern financial indices.[3] The tax treatment of financial indices has become increasingly important in recent years in light of the very significant increase in the number and scope of financial indices and the number of financial instruments that are linked to such indices. In addition, the Service has informally indicated that it is considering the tax treatment of contracts that reference baskets or indices, and it is possible that the Service may apply the section 871(m) qualified index rules in some of the other contexts that are discussed in the 2015 article I co-authored.[4]

This Article discusses the qualified index rules and the issues that arise under these rules and briefly considers whether the qualified index rules should apply outside of section 871(m). This Article is divided into five parts. In addition to this introduction, the second Part provides an overview of the qualified index rules, the third Part discusses the policy considerations behind the qualified index exception, the fourth Part addresses a variety of issues and problems under the qualified index rules, and the final Part offers some concluding thoughts regarding the scope of the qualified index rules.

II. The Qualified Index Rules

Section 871(m) and the final Regulations promulgated thereunder (the Section 871(m) Regulations) provide that "dividend equivalents" that are paid (or deemed paid) to a foreign investor on a contract that references the performance of U.S. equities may be subject to a 30% withholding tax, subject to reduction under an applicable treaty.[5] As a general matter, the Section 871(m) Regulations provide that a contract that references U.S. equities will

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[3]While Treasury and the Service previously issued Regulations under section 246 that addressed when an index should be treated as opaque for purposes of the dividends received deduction, those Regulations simply set forth certain numerical tests with respect to the index and do not take into account some of the features that are more relevant to modern day indices, such as rebalancings, index committee discretion, customized indices, and whether other investments reference the index.

[4]*See* Hochberg, *supra* note 1. According to one report, a Service official noted that future guidance could potentially apply the Section 871(m) qualified index rules in order to determine whether a change to the components of an index triggers a deemed disposition of a derivative that references the index for section 1001 purposes. *See* Lee A. Sheppard, *ABA Section of Taxation Meeting: News Analysis: Recognition Rules for Index Derivatives Coming*, 155 Tax Notes (TA) 1062, 1063 (May 22, 2017).

[5]I.R.C. § 871(m)(1), (2); Reg. § 1.871-15(b), -15(c), -15(d)(2), -15(e). The Treasury Department issued Proposed Regulations under section 871(m) in 2013 (Notice of Proposed Rulemaking, 78 Fed. Reg. 73,128 (Dec. 5, 2013) [hereinafter the Proposed Section 871(m) Regulations]) and final Regulations in 2015 (T.D. 9734, 80 Fed. Reg. 56,866 (Sept. 18, 2015)).

be subject to section 871(m) if the contract has a delta of 0.8 or above.[6] The Service has announced, however, that the section 871(m) tax will not apply to contracts that are entered into before January 1, 2021, unless the contract is a "delta-one" contract.[7] The withholding tax generally applies even if the contract does not provide for any dividend equivalent payments.[8] Accordingly, price return swaps, options, and structured notes could be subject to the section 871(m) withholding tax even if they do not provide for a pass-through of dividends on the underlying stock.

Under a special combination rule, transactions entered into "in connection with" one another must be combined in order to determine whether they satisfy the delta threshold and are thus subject to section 871(m) withholding.[9] For example, a foreign investor could be subject to section 871(m) if it purchases a call option with respect to a stock and sells a related put option on the same stock with the same strike price. Withholding agents may rely on a rebuttable presumption that two transactions are not entered in connection with one another and thus need not be combined if either (1) the long party holds the transactions in separate accounts or (2) the transactions were entered into more than two business days apart.[10] Note that withholding agents are not required to apply the combination rule prior to 2021 unless the contracts are over-the-counter contracts that are priced, marketed, or sold together.[11]

Under a broad anti-abuse rule, a transaction that is otherwise not subject to section 871(m) will be subject to section 871(m) if it is entered into with a principal purpose of avoiding the application of section 871(m).[12]

The Section 871(m) Regulations provide that a contract that references a "qualified index" will be treated as referencing the notional index and will

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[6] Reg. § 1.871-15(c). The delta of a contract with respect to an equity expresses the degree to which changes in the value of the equity are reflected as changes in the value of the contract. Reg. § 1.871-15(g)(1). Thus, the value of a contract with respect to an equity with a delta of one would increase or decrease by 100% of any corresponding increase or decrease in the value of the underlying equity. The delta standard, however, only applies in the case of "simple" contracts. *See* Reg. § 1.871-15(d)(2)(i), -15(e)(1). Contracts that are treated as "complex" under the Section 871(m) Regulations are subject to section 871(m) if the contract satisfies the "substantial equivalence test" set forth in the Section 871(m) Regulations. *See* Reg. § 1.871-15(d)(2)(ii), -15(e)(2), -15(h).

[7] Notice 2018-72, 2018-40 I.R.B. 522.

[8] Reg. § 1.871-15(i)(2)(ii). In such a case, the Section 871(m) Regulations deem the investor to have received a payment equal to the dividends on the shares that are referenced by the contract.

[9] Reg. § 1.871-15(n).

[10] Reg. § 1.871-15(n)(3). These presumptions, however, are not available if the withholding agent has actual knowledge that the transactions were entered into in connection with one another.

[11] Notice 2018-72, 2018-40 I.R.B. 522.

[12] Reg. § 1.871-15(o). For a more comprehensive discussion of the Section 871(m) Regulations, see David S. Miller & Jason Schwartz, *New 871(m) Regulations Finalize Dividend-Equivalent Payment Withholding Rules for Equity Derivatives*, 42 Int'l Tax J. 17 (Jan.–Feb. 2016).

not be treated as referencing any U.S. equities in the index, if the index constitutes a "qualified index" as defined in the Regulations.[13] Accordingly, a contract that references a qualified index will not be subject to the section 871(m) withholding tax. A contract that references the performance of a security (such as stock in an exchange traded fund) that tracks the performance of a qualified index will be treated as referencing the qualified index and thus will likewise be exempt from the section 871(m) withholding tax.[14]

If a derivative references an index that is not a qualified index, then the contract will be treated for section 871(m) purposes as multiple contracts with each contract referencing a single component of the index.[15]

The determination as to whether an index is a qualified index is made on the first business day of the applicable calendar year.[16] If an index is a qualified index as of such day, then all contracts that are issued within that year with respect to the performance of the index will be treated as referencing a qualified index during the term of the contract (assuming there is no deemed reissuance of the contract for tax purposes as a result of an adjustment to the index components), notwithstanding that the index may not be a qualified index in future years.[17]

An index will constitute a qualified index if it satisfies one of two tests that are set forth in the Section 871(m) Regulations. The first type of qualified index is an index that at the time a contract that references the index is entered into or acquired by the investor:

- references at least 25 component securities (whether or not the securities are U.S. stock);
- references only long positions, other than short positions with respect to the entire index and short positions that represent no more than five percent of the aggregate value of the index's long positions;
- does not contain any single U.S. stock that represents more than 15% of its weighting or any collection of five or fewer U.S. stocks that together represent more than 40% of its weighting;
- 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);

[13] Reg. § 1.871-15(l). As a technical matter, the Section 871(m) Regulations state that a qualified index is treated as a single security that is not an "underlying security," and the Regulations elsewhere state that section 871(m) withholding only applies to a contract that references an "underlying security." Reg. § 1.871-15(l)(2)(i), -15(c)(1).

[14] Reg. § 1.871-15(l)(7).

[15] Reg. § 1.871-15(a)(15).

[16] Reg. § 1.871-15(l)(2). In the case of a newly created index, the determination is made on the first business day on which the index is created. The dividend yield test would then be applied based on the hypothetical yield that the index would have had if it had existed in the prior year.

[17] *Id.*

- did not provide a dividend yield in the immediately preceding calendar year from the U.S. stocks in the index that exceeded 150% of the annual dividend yield reported on the S&P 500 index for that year; and
- is referenced by futures or option contracts that trade on either (1) a national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade that is designated as a contract market by the Commodity Futures Trading Commission ("CFTC") or (2) a foreign exchange or board of trade that the Treasury Secretary has determined is a qualified board of trade for section 1256 purposes[18] or that has an effective "no action" letter from the CFTC permitting direct access from the United States, if U.S. stocks comprise less than 50% of the weighting of the component securities in the index.[19]

For purposes of simplicity, this test is hereinafter referred to as the "Primary QI Test" as this is the only test that will be relevant to most U.S. equity indices.

Under a second test (the "10% QI Test"), an index will constitute a qualified index if (1) the "underlying securities" in the index represent ten percent or less of the value of all of the "component securities" in the index (the "QI Ratio"), (2) the index is widely traded, and (3) the index was not formed or availed of with a principal purpose of avoiding U.S. withholding tax.[20] An "underlying security" is an interest in an entity if a payment with respect to that interest would be treated as a U.S. source dividend (*i.e.*, an equity interest in a U.S. corporation).[21]

An index that otherwise constitutes a qualified index under either of the two tests set forth above will, nevertheless, not be treated as a qualified index unless the index is a "passive" index that is based on a "diverse basket of publicly-traded securities" and that is "widely used by numerous market participants."[22] Thus, these requirements apply in addition to the more specific requirements set forth above.

In addition, an index that otherwise constitutes a qualified index under the rules set forth above will, nevertheless, not be treated as a qualified index with respect to a contract that is held by a particular investor if the investor holds related short positions in respect of more than five percent of the value of the long equity positions in the index (unless the short position relates to the entire index).[23]

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[18] *See* I.R.C. § 1256(g)(7)(c).
[19] Reg. § 1.871-15(l)(3).
[20] Reg. § 1.871-15(l)(4).
[21] Reg. § 1.871-15(a)(15).
[22] Reg. § 1.871-15(l)(1).
[23] Reg. § 1.871-15(l)(6).

III. Policy Considerations

The following section discusses the policy considerations applicable to the qualified index exception to section 871(m). As discussed later in this Article, an understanding of the policy behind the exception can assist in considering certain interpretive questions regarding the scope of the exception and its application to particular indices.

A. *Primary QI Test – Policy Considerations*

As an initial matter, one could question whether there should be any exception under the Primary QI Test, particularly once the Section 871(m) Regulations apply to all delta-one contracts (and beginning on January 1, 2021, contracts with a delta of 0.8 or above) that reference U.S. equities, even if the investor does not receive the dividends on the equity that is referenced by the contract.[24] If that is the case, does it make sense that a foreign investor in a swap over a qualified index of U.S. equities will not be subject to section 871(m) even if the swap provides that the investor will receive all of the dividends that are paid on the equities in the index, while an investor in a contract that references a single U.S. equity will be subject to section 871(m) even if the contract does not provide for any dividend equivalent payments to the investor? This could be viewed as a gap in the Section 871(m) Regulations that allows foreign investors to receive in effect dividends on U.S. equities without tax. Moreover, the language of section 871(m) and its legislative history do not mandate such an exception,[25] and the preambles to the final and Proposed Section 871(m) Regulations do not address the policy considerations that underlie the Primary QI Test. As discussed below, however, there may be policy considerations that support the Primary QI Test, depending upon the general policy considerations for the expansive approach of the Section 871(m) Regulations.

More specifically, section 871(m) initially only imposed section 871(m) withholding on (1) substitute payments made in respect of securities loans and "repo" transactions and (2) dividend equivalent payments on swaps that provided for a "cross in" or "cross out" of the underlying security, that related

[24] Reg. § 1.871-15(i)(2)(ii).

[25] Section 871(m)(4)(C) provides that an index is treated as a single security for section 871(m) purposes. The section 871(m) legislative history states that in applying this rule it is intended that an index will be deemed to be regularly traded on an established securities market for section 871(m) purposes if every component of the index is readily tradable on an established securities market. Staff of Joint Comm. on Tax'n, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, The "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate 79 (2010). There is no indication that the statutory treatment of an index as a single security was intended to provide that section 871(m) should not apply to certain indices. Rather, based on the legislative history cited above, it may have been intended to address the narrow question as to when an index will be deemed to be regularly traded on an established securities market for section 871(m) purposes.

to an illiquid security, or that were collateralized by the underlying security.[26] The Section 871(m) Regulations expanded the application of section 871(m) so that contracts that have a delta beyond a specified threshold will be subject to section 871(m) even if they do not contain any of the aforementioned factors. There are at least two policy considerations that may have warranted this expansion of the scope of section 871(m).[27]

Under one approach, the Section 871(m) Regulations may have expanded the scope of section 871(m) in order to ensure that dividends that are paid by U.S. corporations do not escape U.S. taxation. The U.S. tax system generally applies an income tax on dividends that are received by U.S. taxable investors (subject to reduction for corporate recipients) and a withholding tax on dividends that are paid to foreign investors. If foreign investors are not subject to tax on derivatives in respect of U.S. equities, then such dividends could escape U.S. tax altogether. This could be illustrated by an example in which a foreign investor enters into a total return swap with a U.S. financial institution with respect to the performance of shares of a U.S. corporation. Assume that the U.S. financial institution acquires the shares that are referenced by the swap in order to hedge its short position under the swap.[28] The financial institution in such a case would not be subject to tax in respect of the dividends that it receives on the shares because its inclusion of the dividends would be offset by the deduction that it realizes when it makes a dividend equivalent payment under the swap. If the foreign investor is not subject to withholding tax in respect of the dividend equivalent it receives on the swap, then the dividend payment will never be subject to U.S. tax. The drafters of the Section 871(m) Regulations may have, therefore, decided to impose

[26] I.R.C. § 871(m)(3). The statute does provide, however, that all notional principal contracts would be subject to section 871(m) beginning two years after the statute was enacted, "unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance." I.R.C. § 871(m)(3)(B).

[27] The discussion herein does not consider the merits of the policy arguments in favor of the approach of the Section 871(m) Regulations (other than in respect of the qualified index rules) nor does it address the many practical and administrative issues that arise under the Section 871(m) Regulations. For a discussion of these issues, see Securities Industry and Financial Markets Association, Comments to the Treasury and IRS on Section 871(m) Regulations (March 31, 2016), https://www.regulations.gov/document?D=IRS-2015-0050-0022 [hereinafter SIFMA March 31 Comments]; Tax Section, New York State Bar Association, Report 1340, Report on Regulations under Section 871(m) (March 28, 2016), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2016/Tax_Section_Report_1340.html; Securities Industry and Financial Markets Association, Comments on the Regulatory Project to Reduce Burdens Under Section 871(m) (December 8, 2017), https://www.sifma.org/wp-content/uploads/2017/12/Regulatory-Rroject-to-Reduce-Burdens-Under-Section-871m.pdf.

[28] Many financial institutions, however, would not hedge by acquiring the reference shares but would instead hedge by offsetting their short position under the swap against a long position that they hold under a different client swap that references the same shares (*i.e.*, a swap in which the client holds the short position and the financial institution holds the long position in respect of the reference shares). In such a case, the concern that a dividend on physical shares would escape U.S. taxation would not be present.

section 871(m) tax in such a case in order to ensure that the dividend does not entirely escape U.S. taxation. If that is the policy rationale behind the general approach of the Section 871(m) Regulations, then it is questionable whether there should be an exception under the Primary QI Test because dividends on an index that is the subject of a swap could likewise escape U.S. taxation. That could be illustrated by the example above if one assumes that the swap in the example relates to an equity index rather than a single stock. In such a case, the financial institution may hedge its position under the swap by acquiring physical shares of all of the index components or by acquiring shares of an exchange traded fund that holds the shares of the index components. If section 871(m) does not apply to the swap, the dividends on the index components that are referenced by the swap would not be subject to U.S. tax.

Alternatively, it is possible that the policy rationale for the expanded scope of the Section 871(m) Regulations is not related to the possibility that dividends on U.S. equities may escape U.S. taxation but is rather related to the general policy consideration that equivalent economic positions should be taxed in the same manner and that tax considerations should not dictate the form of an investment. Under this approach, it would be inappropriate as a tax policy matter to exempt a foreign investor from withholding tax when it receives dividend equivalent payments under an equity swap if it would have been subject to withholding tax if it had instead elected to hold the physical shares that are referenced by the swap. That is because the investor's economic position in respect of the shares is arguably substantially the same irrespective of whether it holds a physical or synthetic position in respect of the shares.[29] If section 871(m) did not apply to such swaps, foreign investors would choose to enter into swaps over U.S. equities rather than acquiring U.S. equities, even though they may view both transactions as substantially economically equivalent. To the extent that one believes that the tax law should attempt to eliminate tax considerations from playing a role in selecting between two equivalent investments, then section 871(m) should arguably apply to all equity swaps that reference U.S. corporations so that tax considerations do not play a role in a foreign investor's decision to invest in a physical or synthetic position in respect of U.S. equities.

If that is the policy rationale for the Section 871(m) Regulations, then there is likewise a policy rationale to support the exception from section 871(m) under the Primary QI Test. That is because a typical investor would presumably not view an investment in a swap that references a widely available index as an economic equivalent to an investment that it might make

[29] A swap is different than physical ownership in that a swap provides leverage and creates credit exposure to the counterparty under the swap. A delta-one swap and physical ownership, however, provide the same level of participation in the performance of the underlying equity. A swap is, therefore, often viewed as economically equivalent to a direct leveraged position in the underlying equity.

in a particular stock or group of stocks. The index would almost certainly include many stocks that differ from the stocks that the investor would seek to invest in, and the various requirements of the Primary QI Test (including the diversification, trading, and widely used requirements) would prevent an investor from constructing or identifying an index that matches the specific stocks that it might seek to acquire.[30] Under this approach, the Primary QI Test would rightfully apply in cases in which a typical investor would view a derivative in respect of an index as economically distinct from a physical investment in shares that it might seek to acquire because the policy basis for the expansive approach of the Section 871(m) Regulations would not apply in such a case. Moreover, under this approach, while one could debate some of the specific requirements under the Primary QI Test, the distinction under the Primary QI Test between diverse and widely available indices and more customized indices would be the correct methodology to distinguish between indices that should be viewed as opaque and those that should be treated as an aggregate of the index components for section 871(m) purposes.

Finally, it is possible that the policy for the qualified index exception has nothing to do with the general policy approach of the Section 871(m) Regulations. Rather, it is possible that the qualified index exception was included because of the difficult administrative and practical issues that would arise if section 871(m) were to apply on a look-through basis to the components of large and widely available indices. For example, as discussed below in respect of nonqualified indices, withholding agents and foreign investors would then be required to compute delta and the dividend equivalents in respect of each index component separately.[31] In addition, many index linked derivatives (*e.g.*, structured notes) are sold to retail investors who may be ill equipped to comply with section 871(m) and who presumably are not investing in the derivative as part of a tax avoidance strategy. The Service may, therefore, have decided to exempt indices as long as they are not customized in a manner that could be used to convert an investor's physical position into an index derivative that is not subject to section 871(m).

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[30] This approach is somewhat weakened once the qualified index exception is extended to contracts that reference the performance of an entity (such as an ETF) that tracks the performance of a qualified index. A foreign investor that seeks to invest in an ETF that tracks the performance of a qualified index might then instead invest in a derivative with respect to the ETF that is not subject to section 871(m) under the qualified index exception.

[31] *See infra* text accompanying notes 98-101. The delta computation, however, would not be difficult to compute if section 871(m) only applies to delta-one positions (as is the case with respect to contracts that are issued before January 1, 2021) or if, as is suggested below, the delta in respect of a contract that references a nonqualified index is determined solely at inception based on the entire index. The dividend equivalent information may not be difficult to compute in the case of widely available indices, particularly if investors and withholding agents demand that the index provider make that information available.

B. *10% QI Test – Policy Considerations*

There are two possible policy rationales for the 10% QI Test. As discussed later in this Article, the policy rationale that one adopts could affect whether an index of partnerships should be a qualified index under the 10% QI Test.

First, it is possible that the policy of the 10% QI Test is that the government did not want to subject taxpayers to the burden of applying section 871(m) based on a deconstruction of an index to its component parts when only a small percentage of the contract would then be subject to section 871(m). In such a case, the section 871(m) tax that would be collected under a look-through to the components of the index would be small relative to the notional value of the index, and the government may have, therefore, been willing to forego the section 871(m) tax if the QI Ratio is ten percent or less.

Alternatively, it is possible that the policy of the 10% QI Test is that as a general matter section 871(m) looks through an index to its components because otherwise investors could intentionally avoid section 871(m) by investing in a derivative with respect to a stock index rather than a derivative with respect to the components of the index. This concern generally would not exist, however, if U.S. stocks represent ten percent or less of the components of the index. An investor that seeks to obtain exposure to specific U.S. stocks would presumably not acquire a derivative with respect to an index that includes such stocks if the index is almost entirely comprised of other non-U.S. stocks. In such a case, there is arguably no concern that the taxpayer is using the index derivative to avoid section 871(m), and there is, therefore, no need to impose the section 871(m) withholding tax in such a case.

IV. Detailed Discussion of Qualified Index Rules

A. *Index Modification and Rebalancing*

One factor that is ordinarily taken into account when considering whether an index should be treated as opaque for tax purposes is whether the index is primarily determined based upon objective formulaic criteria or subjective human discretion. If an index is primarily formulaic, a contract that references the index is more likely to be treated as referencing the notional formula rather than the components of the index. By contrast, a contract that references an index that is primarily based on subjective discretion is more likely to be treated as referencing the index components because the notional index in such a case arguably does not have any independent economic significance apart from its components.

The Proposed Section 871(m) Regulations issued in 2013 provided that an index will only be treated as a qualified index under the Primary QI Test if, among other requirements, the index can only be adjusted based on objective rules.[32] Under this approach, most equity indices, including the S&P 500

[32] Prop. Reg. § 1.871-15(k)(2)(iv), 78 Fed. Reg. 73,128 (Dec. 5, 2013).

Index, would technically not constitute a qualified index because the index committee typically exercises some discretion regarding the components of the index. In response to a significant amount of comments regarding this issue,[33] the Section 871(m) Regulations relaxed this requirement and instead provide that an index will only constitute a qualified index under the Primary QI Test if it "[i]s 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."[34]

While the revised approach in the Section 871(m) Regulations allows for more flexibility with respect to index governance, some of the vague and ambiguous terminology employed in formulating this requirement has created uncertainty as to whether some equity indices can satisfy this requirement. For example, consider the Dow Jones Industrial Average Index (the "Dow Jones Index"). The published guidelines for the Dow Jones Index provide that stock selection is not governed by quantitative rules but a "stock typically is added [to the index] only if the company has an excellent reputation, demonstrates sustained growth and is of interest to a large number of investors."[35] The guidelines further provide that "[m]aintaining adequate sector representation within the ind[ices] is also a consideration in the selection process."[36] The index committee that governs the Dow Jones Index otherwise has complete discretion regarding the components of the Dow Jones Index. Are these guidelines considered to be "predefined criteria" for purposes of the Section 871(m) Regulations even though they do not provide for any objective criteria? If so, what about an index that is created by a bank that provides that the index will consist of large capitalization stocks that are selected by a committee of its employees that will select stocks that it believes has the greatest price appreciation potential? If the Dow Jones Index guidelines are "predefined," why would these guidelines not be "predefined"? If both guidelines are "predefined," then what index guidelines would not be "predefined"?

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[33] *See, e.g.*, Tax Section, New York State Bar Association, Report 1306, Report on Proposed Regulations under Section 871(m) (May 20, 2014), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1306.html; Securities Industry and Financial Markets Association, Comments on Proposed Section 871(m) Regulations under Section 871(m) (May 7, 2014), https://www.regulations.gov/document?D=IRS-2012-0002-0046; American Bar Association Section of Taxation, Comments on Proposed Regulations Issued under Section 871(m) (Oct. 17, 2014), https://www.regulations.gov/document?D=IRS-2012-0002-0058; U.S. Chamber of Commerce, Proposed Rule Dividend Equivalents from Sources within the United States IRS Reg. 120282-10 (Feb. 27, 2014), https://www.regulations.gov/document?D=IRS-2012-0002-0032; Managed Funds Association, MFA Comments IRS REG-120282-10, Dividend Equivalents from Sources within the United States (Mar. 5, 2014), https://www.regulations.gov/document?D=IRS-2012-0002-0039.

[34] Reg. § 1.871-15(l)(3)(v).

[35] *See* S&P Dow Jones Indices, *Dow Jones Averages Methodology*, S&P Dow Jones Indices 5 (April 2018), https://us.spindices.com/documents/methodologies/methodology-dj-averages.pdf.

[36] *Id.*

Moreover, are the index committees for both indices "interpreting" the rules of the applicable index or does their stock selection role represent more than interpretation of the guidelines? Notwithstanding the difficulty in applying the "predefined" and "interpretation" standards, there is an instinctive difference between an index, such as the Dow Jones Index, that is designed to reflect the performance of a particular market and the bank index described above that is designed to outperform the market, and it is likely that the drafters of the Regulations intended that the former should be a qualified index and the latter should not be a qualified index.

It should be noted, however, that the term "interpretation" was in all likelihood intended to allow an index committee to play some stock selection role. This could be illustrated by considering the S&P 500 Index which was presumably intended to constitute a qualified index.[37] The published index guidelines for the S&P 500 Index provide for specific objective listing, market capitalization, and trading requirements that must be satisfied in order to be included in the S&P 500 Index.[38] The index committee for the S&P 500 Index, however, has discretion to select stocks subjectively for inclusion in the index as long as they satisfy these criteria. While these guidelines, unlike the Dow Jones Index, provide for objective criteria, they, nevertheless, grant wide latitude to the index committee to select the index components that seemingly go beyond an interpretive function. The reference to "interpretation by the sponsor" is, therefore, presumably not intended to preclude the sponsor from engaging in some degree of stock selection beyond the objective criteria in the index guidelines. In the absence of any specific guidance regarding the meaning of the term "predefined" and "interpretation," however, there will continue to be significant uncertainty as to whether certain widely available indices, such as the Dow Jones Index, have too much discretion to satisfy the Primary QI Test.

Finally, it should be noted that the "publicly stated, predefined criteria" rule only applies to a rebalancing of an index but does not apply to the original constitution of an index. Accordingly, an index that is initially selected by an individual stock picker without any criteria or guidelines should satisfy this requirement as long as there is no impermissible rebalancing of the index.

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[37] The preamble to the Section 871(m) Regulations, when discussing the changes it made to the rebalancing rules, specifically noted that that the government received comments that the S&P 500 index would not be a qualified index under the rebalancing rule in the Proposed Regulations. T.D. 9734, 80 Fed. Reg. at 56,871. This strongly implies that the drafters of the Regulations intended that the S&P 500 index would satisfy the revised rebalancing test in the final Regulations.

[38] *See* S&P Dow Jones Indices, *S&P U.S. Indices Methodology*, S&P Dow Jones Indices 5–8 (April 2018), https://us.spindices.com/documents/methodologies/methodology-sp-us-indices.pdf.

B. *Traded Options and Futures Contracts*

As noted above, an index will only constitute a qualified index under the Primary QI Test if options or futures contracts on the index are "traded" on certain specified markets.[39] The Section 871(m) Regulations, however, do not define the minimum level of trading that is necessary to satisfy the "traded" requirement. The preamble to the Regulations, in discussing this requirement, states that futures or options contracts must be listed for trading, thereby implying that the "traded" requirement only requires that futures or options contracts be available for trading without requiring a minimum level of trading activity.[40] In addition, there are regulations that in other contexts specifically require "regular trading" that satisfies a particular level of trading activity.[41] The fact that the Section 871(m) Regulations merely refer to "traded" arguably implies that all that is required is that the index be eligible for trading or that there be at least one trade in order to satisfy this requirement.[42]

Aside from the uncertain technical meaning of the "traded" requirement, the purpose and policy of the requirement is likewise unclear. It is possible that this requirement is intended to substantiate that an index is not customized and is widely available. Under this approach, the term "traded" should be understood to require active trading because the mere listing of an option or futures contract with respect to an index would not substantiate that the index is widely available for investment and is not customized.

Alternatively, it is possible that the "traded" requirement was not intended to substantiate that an index is widely available because the Section 871(m) Regulations separately require that a qualified index be "widely used by numerous market participants."[43] This should be sufficient to ensure that a qualified index is widely used in investment transactions, and the "traded" requirement would thus arguably be duplicative if it required a minimum level of trading activity with respect to futures and options contracts on the index. Under this approach, the "traded" requirement is presumably designed to ensure that options or futures contracts are available to be traded in respect

[39] Reg. § 1.871-15(l)(3)(vii).

[40] T.D. 9734, 80 Fed. Reg. at 56,871.

[41] *See, e.g.*, Reg. §§ 1.883-2(d), 1.1273-2(f), and 1.1472-1(c)(1)(i)(A); Temp. Reg. § 1.897-9T(d).

[42] Whether listing or minimal trading satisfies the "traded" requirement could affect whether some widely used indices can constitute a qualified index. For example, the MSCI World Index is a widely used index for which there is a significant amount of futures that trade on foreign exchanges. The trading on foreign exchanges, however, will not satisfy the "traded" requirement because U.S. stocks comprise most of the index. Futures contracts on the index are also listed on ICE (which is a U.S. exchange), but there is very little trading of the contracts. Similarly, the MSCI USA index is a widely used index for which futures contracts are listed on ICE, but there is a minimum amount of trading of the contracts. Accordingly, both of these indices may not constitute a qualified index if the "traded" requirement can only be satisfied if there is regular or substantial trading of the futures contracts.

[43] Reg. § 1.871-15(l)(1).

of an index, which can be accomplished via a listing of a contract even if there is no, or a minimal amount of, actual trading of the contract.

The issue as to whether listing is sufficient to satisfy the "traded" requirement may be of particular importance to a newly created index because a newly created index will only satisfy the Primary QI Test in its initial year if it satisfies the test on the day that it is created.[44] If listing of an option or futures contract is not sufficient to satisfy the "traded" requirement, an index sponsor will have no way of knowing in advance whether there will be sufficient trading of such contracts on the first day that the index is created to enable the index to constitute a qualified index for its first year. In addition, it may not be realistic to expect that there will be trading of futures and options contracts on the first day that an index is created. Accordingly, if the "traded" requirement requires active trading of an option or futures contract, it is likely that many new indices will not constitute a qualified index in their initial year of creation.[45]

C. *Requirement that Index be Passive, Diverse, and Widely Used*

As noted above, an index will not constitute a qualified index, even if it otherwise satisfies the specific requirements of the Primary QI Test or the 10% QI Test, unless it is (1) "passive", (2) "based on a diverse basket of publicly-traded securities," and (3) "widely used by numerous market participants."[46] The preamble to the Section 871(m) Regulations states that these general rules are designed to ensure that an index will not constitute a qualified index if the index is "customized or reflects a trading strategy, is unavailable to other investors, or targets special dividends."[47] The Section 871(m) Regulations and the preamble do not otherwise address or provide any examples regarding the meaning of the terms "passive," "diverse," and "widely used by numerous market participants." As discussed below, this has created uncertainty

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[44] Reg. § 1.871-15(l)(2)(ii).

[45] It should be noted that the "traded" requirement only takes into account trading of futures and options contracts and does not take into account trading of other traded instruments, such as shares in an ETF or exchange traded notes. It is not clear as to why the Section 871(m) Regulations distinguish between different types of traded instruments in this regard.

[46] Reg. § 1.871-15(l)(1).

[47] T.D. 9734, 80 Fed. Reg. at 56,872. The preamble does not identify which of these four categories correspond to the three categories (*i.e.*, passive, diverse, and widely used) that are set forth in the text of the Section 871(m) Regulations. Although it is not entirely clear, it is likely that (1) the reference to "trading strategy" refers to the "passive" requirement, (2) the references to "customized" refers to the "diverse" and "widely used" requirements, and (3) the reference to "unavailable to other investors" refers to the "widely used" requirement. It is not clear how the reference to an index that "targets special dividends" relates to any of the three requirements, and in any case such an index would almost certainly fail the yield test under the Primary QI Test. As noted below in the discussion of the "passive" requirement, an understanding of how the preamble language relates to the regulatory language can assist in understanding the intent of the Regulations.

regarding the application of these requirements to some indices. The discussion below separately addresses each of these three requirements.

1. *Passive Index*

As noted above, an index will only constitute a qualified index if the index is "passive." The preamble to the Section 871(m) Regulations provides that a qualified index may not incorporate a "trading strategy,"[48] and although not entirely clear, it appears that the preamble uses that term in reference to the "passive" requirement. In any case, the "passive" requirement is clearly not intended to preclude any index adjustments because, as discussed above, the Primary QI Test otherwise allows for index adjustments, including adjustments that are not purely objective in nature.

It is possible, however, that an index will not be "passive" for this purpose if it provides for frequent adjustments that are intended to reflect a trading strategy that is designed to outperform a particular segment of the market. While it is difficult to delineate clearly when an index would be in that category, perhaps the commonly known "Dogs of the Dow" index would be an example of an index that may not be classified as "passive" for this purpose.[49] More specifically, the Dogs of the Dow index consists of the ten stocks in the Dow Jones Index that have the highest dividend yield, and the index is adjusted annually to reflect the highest-yielding stocks in the Dow Jones Index during the immediately preceding year. Such an index has a high degree of turnover that is intended to reflect a trading strategy that is designed to outperform the general market for large capitalization stocks. In the absence of further guidance, it is possible that such an index, as well as other indices with similar features, would not be treated as "passive" for purposes of the Section 871(m) Regulations and thus would not constitute a qualified index even if the index otherwise satisfies the requirements of the Primary QI Test or 10% QI Test.[50]

2. *Diverse Index*

As noted above, an index will only constitute a qualified index if the index is "diverse." The Primary QI Test already includes securities concentration

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[48] T.D. 9734, 80 Fed. Reg. at 56,871.

[49] The actual name of the index is the "Dow Jones High Yield Select 10 Index." The index is commonly known as the "Dogs of the Dow" index because it implements an investment strategy that is commonly referred to as the "Dogs of the Dow" investment strategy. *See* S&P Dow Jones Indices, *Dow Jones High Yield Select 10 Index*, S&P Dow Jones Indices (December 29, 2017), https://us.spindices.com/indices/strategy/dow-jones-high-yield-select-10-index-usd.

[50] The Dogs of the Dow index is in any case unlikely to constitute a qualified index because it is unlikely to satisfy the dividend yield test described above. It is, nonetheless, instructive in considering the meaning of the term "passive" for purposes of the qualified index rules.

limits[51] so presumably an index could fail the diverse requirement even if it satisfies the concentration limits. For example, an index could consist of more than 25 different securities of a single issuer (or a few issuers) that would satisfy the concentration limits, but such an index would in all likelihood not be "diverse" for this purpose. Although not entirely clear, an index that consists solely of companies in a single sector (*e.g.*, a utilities or transportation index) should be treated as "diverse" for this purpose notwithstanding the similarities in the business activities of the index components. If the drafters of the Section 871(m) Regulations intended to exclude such indices they surely could have said so. Moreover, the "diverse" requirement is presumably designed as a policy matter to exclude indices that are "customized" or that would not have broad market interest, or both, which should not be the case in respect of sector indices.

3. *Widely Used by Numerous Market Participants*

As noted above, an index will only constitute a qualified index if the index is "widely used by numerous market participants" (the "widely used requirement"). In most cases, it will be self-evident whether an index satisfies the widely used requirement. Furthermore, if the "traded" requirement of the Primary QI Test requires regular trading of options and futures contracts on the index, then every index that satisfies the "traded" requirement will by definition satisfy the widely used requirement. If, however, the "traded" requirement does not require active trading of options or futures contracts on an index, then there may be cases in which it is uncertain whether an index satisfies the widely used requirement. This could particularly be the case if the index is exclusively used in over-the-counter derivatives transactions. In such a case, there may be no public information regarding the extent to which such derivatives are used in such transactions.[52]

In addition, it is uncertain how the widely used requirement should apply in the case of an index that is not referenced by actively traded financial instruments but that is referenced by a few exchange traded funds that have many thousands of investors. Whether the widely used requirement is satisfied in that case would depend upon whether one views all of the investors in the funds as "market participants" that are "using" the index or whether one views the funds themselves as the "market participants" that are "using" the index. Under the former approach, the index would satisfy the widely used requirement as there are thousands of investors in the funds. Under the latter approach, the index may not satisfy the widely used requirement as there are only a few funds that invest in the index. As a policy matter, it seems

[51] Specifically, as noted above, an index will only satisfy the Primary QI Test if the index (1) references at least 25 component securities and (2) does not contain any single U.S. stock that represents more than 15% of its weighting or any collection of five or fewer U.S. stocks that together represent more than 40% of its weighting.

[52] It is possible, however, that such information could be obtained from the index sponsor.

that such an index should be treated as widely used because the widely used requirement is presumably intended to exclude customized indices that an investor could employ in order to convert a direct physical position subject to withholding tax into a synthetic position not subject to withholding tax. If there are funds with thousands of investors that invest in an index, then the index is clearly a public index that was not designed or customized for a small group of investors in a manner that could be used to inappropriately avoid the section 871(m) withholding tax. In the absence of further guidance on this issue, however, there may be uncertainty as to whether an index of this type satisfies the widely used requirement.

D. *Related Short Positions*

The Section 871(m) Regulations provide for an anti-abuse rule under which a contract with respect to an index will not be treated as relating to a qualified index if the investor holds a short position with respect to more than five percent of the value of the long positions in the index, and it holds the short position "in connection with" its position under the contract (the "short position rule").[53] For the reasons described below, this rule has created significant uncertainty for investors and withholding agents.

As an initial matter, there is no guidance in the Section 871(m) Regulations or elsewhere as to when two positions are held "in connection with" each other for this purpose. In addition, the short position rule does not include the "two day" and "same account" presumptions that, as described above, withholding agents may apply for purposes of determining whether two positions are related to each other for purposes of the combination rule. Furthermore, unlike the combination rule, there is no rule that would limit a withholding agent's obligation to apply the short position rule prior to January 1, 2021, to cases in which the contract and short position are priced, marketed, or sold in connection with each other.

In addition, it is unclear whether the short position rule only applies if the investor entered into the short position and index contract in connection with each other (*i.e.*, pursuant to a common plan) or whether the rule can apply as long as the short position is economically related to the contract. For example, assume that a foreign investor that holds significant long equity positions, including a swap over a qualified index, enters into a short position months later with respect to some stocks that are included in the index in order to reduce its global long equity position. It is arguable that the short position could be treated as entered into "in connection with" the long position under the swap, even though the investor did not contemplate the short position when it entered into the long position, because the investor may

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[53] Reg. § 1.871-15(l)(6). It is unclear whether the five percent test described above is applied once based on the value of the index components when the investor enters into the short position or whether a contract that initially satisfies the five percent test could lose such status due to changes in the value of the index components.

have not entered into the short position (or may have entered into a short position with a smaller notional amount) if it had not entered into the long position under the swap.[54] Alternatively, it is possible that the investor should not be treated as having entered into the short position in connection with the index contract because it did not enter into the two contracts pursuant to a common plan.

The issues described above have created significant operational and administrative problems for foreign investors, such as hedge funds that engage in active trading, due to the difficulty in identifying short positions that should be taken into account under the short position rule, particularly when there is no guidance regarding the appropriate legal standard. Moreover, the lack of any standards or presumptions will likely result in taxpayers taking different positions with respect to the same facts, which undermines tax compliance efforts and the Service's ability to apply the short position rule.

In addition, withholding agents have struggled with the level of diligence in which they should engage in order to determine whether an investor holds a short position that is subject to the short position rule. The Section 871(m) Regulations generally require that withholding agents apply "reasonable diligence" in order to determine whether a transaction is subject to section 871(m),[55] and that is arguably the standard of diligence that withholding agents should apply in order to determine whether a contract is subject to the short position rule. The Section 871(m) Regulations, however, do not provide any guidance regarding the level of diligence that is "reasonable" in order for a withholding agent to determine (1) whether an investor in an index derivative holds a short position with respect to the components of an index and (2) if the investor does hold any such short position, whether it was entered into "in connection with" the investor's position under the derivative. In addition, in some cases the withholding agent with respect to an index derivative will be an intermediary that has no relationship with the investor,

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[54] This position is arguably supported by the different manner in which related transactions are defined for purposes of the combination rule and the short position rule. More specifically, Regulation § 1.871-15(n)(1) states that two positions may only be combined if they "are entered into in connection with each other . . . ." This suggests that each position must be entered into as part of a plan that involves the other transaction. By contrast, the short position rule states that the rule can apply if the short position is entered into "in connection with a potential section 871(m) transaction that references a qualified index." Reg. § 1.871-15(l)(6)(i). This formulation arguably implies that the short position has to be connected to the long position, but the long position does not have to be conversely connected to the short position, in order for the short position rule to apply. Under this interpretation, the short position rule could apply even if the taxpayer did not contemplate the short position when it acquired a long derivative position with respect to a qualified index as long as the short position is, when entered into, connected to the long position.

[55] Reg. § 1.871-15(p)(1).

and it will, therefore, have no ability to conduct any diligence as to whether the investor holds any short positions with respect to the index.[56]

A withholding agent may seek to obtain an investor certification to the effect that the investor does not hold any short position "in connection with" its long position under an index derivative. Although foreign investors routinely make certification regarding factual matters, investors may object to such a representation because it is a legal representation and because of the general uncertainty regarding the application of the "in connection with" standard.

Finally, it is surprising that the short position rule does not include any presumptions or a priced, marketed, or sold standard in light of the limited abuse that it is apparently intended to address. More specifically, while the preambles to the Section 871(m) Regulations and the Proposed Section 871(m) Regulations do not discuss its underlying policy, the short position rule is presumably intended to address a case in which a foreign investor seeks to enter into a derivative with respect to a basket of stocks that does not constitute a qualified index and instead enters into (1) a derivative with respect to a qualified index that includes those stocks and (2) a short position with respect to the remainder of the stocks in the index. The investor in such a case would be inappropriately employing the qualified index rule in order to avoid the section 871(m) withholding tax with respect to a derivative transaction that effectively does not reference a qualified index. While this fact pattern is possible, in many cases a taxpayer would not benefit from entering into such a transaction because the hedging costs and administrative inconvenience of the short hedging transaction would outweigh the withholding tax savings of the transaction. Moreover, this is a transaction in which the taxpayer's purpose for entering into the derivative and short position, as opposed to entering into a single derivative with respect to the net long position, is to avoid the section 871(m) withholding tax that would apply to a single derivative with respect to the net long position. In contrast, the "in connection with" standard in the short position rule arguably includes transactions that are economically related to each other that do not have this abusive purpose.[57] The short position rule is thus over inclusive and will unnecessarily include many transactions that are well beyond the transactions that should be of concern to the government. Finally, it is surprising that the short position rule applies a stricter standard than the combination rule when the potential for abuse in respect of combined transactions is significantly greater than any potential for abuse of the qualified index rule via the use of related short positions.

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[56] For example, this could be the case if an investor holds a structured note, as structured notes are typically held through financial intermediaries.

[57] For example, there would be no abusive purpose if an investor acquires a short position to hedge a pre-existing long qualified index position; yet such a transaction could implicate the short position rule.

E. *Change in Qualified Index Status*

As noted above, the determination as to whether an index is a qualified index is made on the first day of each calendar year (subject to a special rule for new indices).[58] If a contract references a qualified index when issued, the contract will continue to be treated as referencing a qualified index in subsequent years even if the index is not a qualified index in the subsequent year.[59] Nevertheless, foreign investors in a derivative that references a qualified index must ensure that there are no amendments of the derivative or changes to the derivative pursuant to its terms that could cause a deemed disposition of the derivative for tax purposes.[60] If there is such a deemed disposition, the derivative would no longer be exempt from section 871(m) withholding under the qualified index exception if the index is no longer a qualified index in the year of the deemed disposition.

In addition, the potential future loss of qualified index status could raise fungiblity issues in the case of exchange traded notes ("ETNs") that reference the performance of a qualified index. Such ETNs generally provide for a delta-one position in respect of the reference index and would, therefore, be subject to section 871(m) withholding in the absence of the qualified index exception. The issuers of such ETNs typically issue additional ETNs on an ongoing basis in order to satisfy investor demand,[61] and the ability to issue additional ETNs in this manner is often necessary in order to ensure that the ETNs properly reflect the value of the reference index.[62] If the reference index is no longer a qualified index when the issuer issues additional ETNs, they would not be fungible with the originally issued ETNs because the original ETNs would not be subject to section 871(m) while the new ETNs would be subject to section 871(m).[63]

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[58] Reg. § 1.871-15(l)(2).

[59] *Id.*

[60] For a discussion of when an amendment to a derivative could cause a deemed disposition of the derivative for tax purposes, see James M. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 Tax Notes (TA) 737 (Apr. 29, 2002). For a discussion of when a change to a derivative pursuant to its terms could cause a deemed disposition of the derivative for tax purposes, see Michael Shulman & Nathan Tasso, *Changes to Derivatives 'Pursuant to Their Terms,'* 155 Tax Notes 653 (TA) (May 1, 2017).

[61] This is sometimes done through a new issuance of notes and is sometimes done through a sale of notes that were held as inventory on the books of the issuer. In either case, the additional notes would be treated as newly issued for tax purposes.

[62] That is because the price for an ETN could be artificially inflated beyond its intrinsic value if there is too much market demand for the ETN. ETN issuers rely on the ability to issue additional ETNs in order to maintain a balance between sellers and buyers of ETNs so that the value of an ETN is approximately equal to the "indicative value" of the ETN.

[63] The Section 871(m) Regulations acknowledge the importance of maintaining the fungibility of newly issued ETNs with ETNs that were issued before the issuance of the Section 871(m) Regulations, and they accordingly provide a special rule that exempts a specified list of ETNs from section 871(m) prior to January 1, 2020. *See* Reg. § 1.871-15(r)(3); Notice 2016-76, 2016-2 C.B. 834.

This issue could also arise if an issuer of ETNs that acts as a market maker acquires the ETNs in a dealer capacity and then sells them into the market. In such a case, it is likely that the acquisition and sale of the ETNs would be treated as a deemed reissuance of the ETNs for tax purposes.[64] Accordingly, the deemed newly issued ETNs would not be fungible with the remainder of the outstanding ETNs for tax purposes if the ETNs reference an index that was a qualified index when the ETNs were issued and is not a qualified index at the time of the deemed reissuance.[65]

F. *Qualified Index Variations*

There are some indices that are mostly identical to a particular qualified index but that have a feature that causes the index to slightly differ from the qualified index. For example, the S&P 500 price return index is a qualified index. The S&P 500 total return index is identical to the S&P 500 price return index except that the index incorporates dividends that are paid on the components of the index. The S&P 500 total return index does not independently constitute a qualified index because there are no listed options or futures with respect to the index and thus the index does not satisfy the "traded" requirement described above. Although not entirely clear, the Section 871(m) Regulations seem to provide that a total return index that does not independently satisfy the "traded" requirement will nonetheless be treated as satisfying such requirement if the price return version of the index satisfies the "traded" requirement. The same rule applies if the total return version of the index satisfies the trading requirement and the price return version of the index does not satisfy the trading requirement.[66] That makes sense as a policy matter because such an index is not customized and does not incorporate a

[64] That is because the rule in Regulation § 1.108-2(e)(2) that sometimes prevents a deemed reissuance in the case of an issuer that acquires its own debt in a dealer capacity does not apply to instruments that are not classified as debt instruments for tax purposes.

[65] The issues discussed in this section could also apply in the case of a structured note that is not an ETN. The discussion above, however, addresses ETNs because (1) other structured notes rarely rely on the qualified index exception (either because they do not reference a qualified index or because they are issued with a delta that is below the applicable section 871(m) threshold) and (2) reopenings of such notes are much less common, and less necessary to prevent market discontinuities, than in the case of ETNs (although there could be deemed reissuances as a result of issuer dealer activity even in the absence of a reopening).

[66] Reg. § 1.871-15(l)(3)(vii). While this seems to be the intent of the Section 871(m) Regulations, it is not entirely clear that the regulatory language accomplishes this objective. That is because the Regulations do not refer to the price return or total return versions of an applicable index. Rather, the Regulations state that the "traded" requirement will be satisfied "regardless of whether the contracts provide price only or total return exposure to the index." Reg. § 1.871-15(l)(3)(vii). In other words, under a literal reading of the Regulations, they are arguably referring to a case in which the options or futures contract references an index that independently satisfies the "traded" requirement, but the contract itself provides for an adjustment to the index return to account for a price return or total return in respect of the index components.

trading strategy but rather represents a slightly modified version of an index that constitutes a qualified index.

The same rule does not, however, apply with respect to other variations of an index. For example, a "capped" version of a qualified index will often not constitute a qualified index. More specifically, in some foreign jurisdictions, certain categories of investors are prohibited for nontax legal reasons from entering into a derivative with respect to an index if a single component of the index could potentially exceed a specified percentage of the index. Many such investors instead invest in a "capped" version of an index that replicates the index in which the investor seeks to invest, except that the percentage of the index that is invested in any single stock is capped by the applicable legal limit. This could be illustrated by an example in which a foreign investor seeks to acquire a total return swap with respect to the S&P 500 index, but it is subject to a cap requirement that precludes it from investing in an index if any component of the index exceeds more than one percent of the weighting of the index. The investor might then enter into a derivative on the capped version of the S&P 500 index that would be exactly the same as the S&P 500 index except that the index would be adjusted if any component of the index exceeds one percent of the weighting of the index. In such a case, the portion of the index that is attributable to the index component that exceeds the one percent threshold would be proportionally reallocated to the remainder of the components of the S&P 500 index (assuming the reallocation does not cause any other component of the index to exceed the one percent limitation). Accordingly, the capped index, while very similar to the index that it is designed to replicate, could slightly differ from the underlying index due to the cap limitation. Capped indices of this type are widely used in some jurisdictions, and they often reference an index that constitutes a qualified index under the Section 871(m) Regulations. The capped indices, however, typically do not independently constitute a qualified index because options and futures on capped indices are generally not listed for trading on qualified exchanges and thus do not satisfy the "traded" requirement described above.[67]

There is no apparent policy reason why a total return or price return version of a qualified index should constitute a qualified index while a capped version of a qualified index should not similarly constitute a qualified index. If anything, there is more of a reason to treat a capped version of an index as a qualified index because, unlike a total return or price return version of an index which an investor elects, an investor in a capped index has no legal choice other than to invest in the capped version of the index. In the absence of any guidance to the contrary, however, many capped indices (and other similar indices) will not constitute a qualified index, notwithstanding that the equities in the index are substantially identical to those in the corresponding qualified index.

[67] For a further discussion of the application of Section 871(m) to capped indices, see SIFMA March 31 Comments, *supra* note 27.

In some cases a contract that references a nonqualified index that is a variation of a qualified index may nonetheless be exempt from section 871(m) tax under the qualified index exception if the nonqualified index references the qualified index and no other U.S. equity positions. For example, there are many indices that provide for a foreign currency adjusted version of the S&P 500 index.[68] These indices track the U.S. dollar ("USD") value of the S&P 500 index and then convert such value into a particular foreign currency value of the index. This enables foreign investors to invest effectively in the S&P 500 index without incurring exposure to the performance of the USD. These indices will generally not independently constitute a qualified index because there are typically no listed options or futures contracts with respect to such indices, in which case the index will not satisfy the "traded" requirement described above. As discussed above, however, a contract that references a nonqualified index will be treated as referencing the index components for section 871(m) purposes. The question in this case is whether the index components are the components of the S&P 500 index or the S&P 500 index itself. Under the former approach, a contract that references a currency adjusted version of the S&P 500 index would not be exempt from section 871(m) under the qualified index exception (assuming the index does not independently constitute a qualified index), whereas under the latter approach the contract would be treated as referencing the S&P 500 index and thus would be exempt from section 871(m) under the qualified index exception. Although not entirely clear, the latter approach is more consistent with the text and intent of the Section 871(m) Regulations, particularly if the index in form references the underlying index rather than the components of the index. Moreover, the latter is the better approach as a policy matter as there is no policy reason why a contract that references an index that is comprised of the S&P 500 index and a foreign currency derivative should be treated any differently for section 871(m) purposes than a contract that only references the S&P 500 index.

G. *Exchange Traded Funds*

As noted above, a contract that references a security, such as shares of an exchange traded fund ("ETF"), that tracks the performance of a qualified index will be treated as referencing a qualified index and thus will likewise generally be exempt from the section 871(m) withholding tax.[69] The drafters of the Section 871(m) Regulations presumably thought that it would be inappropriate to treat a contract with respect to an entity that tracks a qualified index differently for section 871(m) purposes than a contract that directly

[68] *See, e.g.*, S&P Dow Jones Indices, *S&P 500 CAD Daily Hedged Index*, S&P Dow Jones Indices, https://us.spindices.com/indices/equity/sp-500-cad-daily-hedged-index (last visited Sept. 22, 2018); S&P Dow Jones Indices, *S&P 500 Daily EUR Hedged*, S&P Dow Jones Indices, https://us.spindices.com/indices/equity/sp-500-eur-daily-hdg-net-tr (last visited Sept. 22, 2018).

[69] Reg. § 1.871-15(l)(7).

references the qualified index if the two positions are substantially equivalent as an economic matter. The Section 871(m) Regulations do not provide any guidance as to when a security "tracks" the performance of a qualified index, which has created significant uncertainty regarding the scope of this rule.

1. *Minor Tracking Differences*

Most ETFs that are created to invest in a qualified index do not exactly track the performance of the reference index.[70] In particular, the value of most index ETFs will not exactly track the value of the reference index because an ETF will generally hold a small portion of its assets in cash investments in order to fund expenses or for other cash management purposes. Accordingly, the daily appreciation or depreciation in the value of the ETF shares will generally not correspond on a one to one basis to any appreciation or depreciation in the value of the qualified index. Should the ETF be treated as "tracking" the performance of the qualified index, notwithstanding the small tracking differential?[71]

Presumably the requirement that the ETF "track" the performance of a qualified index does not require an exact correspondence between the ratio of any increase or decrease in the value of the ETF and the corresponding increase or decrease in the value of the qualified index. If that were the case, practically no ETF would satisfy this test because index ETFs generally have some cash investments that would preclude such a direct relationship.[72] If the "tracking" requirement does not require such a direct relationship, however, how much of a disparity could there be between the performance of the ETF and the index? What if the ETF invests 20% of its assets in cash? Would the answer be different if the ETF invests some portion of its assets in noncash positions other than the qualified index?

While there are no clear answers to these questions, the most sensible way to interpret the Section 871(m) Regulations would be to treat an ETF as satisfying the tracking test if its only nonindex investments are nominal cash investments that are held for cash management reasons or to fund expenses. The market would presumably view such an ETF as effectively tracking the performance of the index and as substantially equivalent to a direct investment in the index, notwithstanding the slight discrepancies between the

[70] As noted above, this rule applies to any interest in an entity that tracks a qualified index, and not just an ETF (although the rule specifically references ETFs as an example of an entity that tracks the performance of an index). For purposes of simplicity, however, the discussion in this section refers to an ETF when describing this rule because that is the most common type of traded entity that tracks the performance of an index.

[71] This differs from the leveraged ETF example below because in that case the value of the ETF shares will increase or decrease based on a fixed ratio that is solely based on the performance of the underlying index.

[72] In addition, there could be slight discrepancies between the performance of an ETF and a corresponding index due to the fact some indices are computed based on a hypothetical reinvestment of a dividend on the applicable ex-dividend date while an ETF will typically reinvest the dividend on the date that it receives the dividend (which is later than the ex-dividend date).

performance of the ETF shares and the reference index. In such a case, the cash investments are not made as part of an investment strategy or to reduce the ETF's exposure to the index and thus should not undermine the intended relationship between the ETF and the index. Moreover, treating such an ETF as satisfying the tracking requirement would be consistent with the policy objective of treating two substantially equivalent economic positions in the same manner for section 871(m) purposes.

By contrast, an index ETF that invests in noncash positions other than the index components or that invests in cash positions in order to reduce its exposure to the reference index should not be viewed as tracking the performance of an index for this purpose, notwithstanding the fact that the value of the ETF may be primarily related to the performance of the index and thus in some sense "tracks" the performance of the index.[73] That is because the ETF in that case will generally not be viewed by investors as substantially equivalent to an investment in the qualified index and the ETF's investment objectives are designed to create a disparity between the performance of the ETF and the qualified index. In such a case, the policy objective of creating symmetry between the tax treatment of two substantially equivalent investments would not apply; rather, this policy objective would support creating symmetry between the tax treatment of a direct foreign investor in the ETF (who would be subject to withholding tax, subject to reduction under a treaty, with respect to any dividends that are distributed by the ETF) and a holder of a delta-one contract with respect to the performance of the ETF.[74]

In some cases, an index ETF may not acquire every single component of the reference index. This could occur if the ETF is unable to acquire certain shares due to regulatory constraints or if it would incur unusual costs to acquire the shares (*e.g.*, increased brokerage fees, particularly in the case of shares with limited liquidity). The ETF may then acquire other shares that it expects will perform similarly, or it may not acquire any equivalent shares if the particular component represents a very small percentage of the index. In this case, any change in the value of the shares of the ETF will not exactly match the corresponding change in the value of the reference index. This raises difficult questions as to how much of a tracking differential of this type should be permitted without causing contracts in respect of the ETF to be ineligible for the qualified index exception. In considering this question for a specific case, taxpayers and advisors should consider (1) the expected and historic price differential between the ETF shares and the reference index and

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[73] For example, many ETFs reference an adjusted version of a qualified index that incorporates other positions (such as a currency adjusted version of an index) or that provides for an alternative weighting of the components of the index.

[74] It should be noted that a contract that references an ETF that provides a nonequity adjustment to a qualified index (such as a currency adjusted version of an index) will not be exempt from section 871(m) notwithstanding the fact that, as discussed above, a contract that directly references such an adjusted index might itself be exempt from section 871(m) under the qualified index exception.

(2) whether the ETF is marketed and perceived by investors as tracking the performance of the reference index.[75]

2. *Leveraged and Short Indices*

In some cases, an ETF will be designed to take a position that is leveraged or inverse to the performance of the qualified index. For example, in the case of a 2x leveraged ETF that invests in a qualified index, the value of the ETF shares will increase or decrease on an approximate two to one basis based on any appreciation or depreciation in the value of the index. Should the shares of the ETF be treated as "tracking" the performance of the index for section 871(m) purposes despite the fact that the percentage changes in the value of the index and ETF will differ from each other?

In addition, consider an ETF that holds a short position in respect of a qualified index so that the value of the shares of the ETF increase or decrease inversely on an approximate one to one basis based on any appreciation or depreciation in the value of the index. Should the shares of the ETF be treated as "tracking" the performance of the index for section 871(m) purposes despite the fact that the performance of the shares will be inverse to the performance of the index?

First, as a technical matter, while not entirely clear, the two ETFs described above do apparently "track" the performance of the index because any increase or decrease in the value of the ETF shares will be determined based on a percentage of the performance of the index, albeit on a leveraged or inverse basis. There is nothing in the language of the "tracking" rule that requires that the ETF and the index must track each other on a one to one basis, although that is presumably the primary case that the drafters had in mind.

Moreover, these two indices should as a policy matter be exempt from section 871(m) withholding pursuant to the qualified index exception. That is because, as described above, the policy basis for the ETF "tracking" rule is that a contract that directly references the performance of an index should not be treated differently for section 871(m) purposes than a contract that references the performance of an ETF that tracks the performance of the same index. The two positions are substantially equivalent as an economic matter and should accordingly be treated in the same manner for section 871(m) purposes. In the case of the leveraged index position described above, a holder of a direct leveraged index position in respect of a qualified index would not be subject to section 871(m) as the qualified index rule only requires that a contract reference the performance of a qualified index and does not require any level of participation in the performance of the index. Accordingly, a contract

[75] In addition, in some cases the aggregate value of the shares of an ETF may (at least temporarily) differ from the value of its assets due to market factors, such as excess or insufficient demand for the ETF shares. Any temporary tracking differential of this type should presumably not cause the ETF shares to fail the tracking test, but any material tracking differential that persists over time could call into question whether the tracking test is satisfied.

that references the performance of an ETF that holds a long leveraged position with respect to the performance of the index should as a policy matter be likewise exempt from the section 871(m) withholding tax. In the case of the short index position described above, a holder of a direct short position in respect of an index (irrespective of whether the index is a qualified index) would not be subject to section 871(m) because the position would not have a delta in excess of the 0.8 threshold (in fact, it would have a negative delta). Accordingly, a contract that references the performance of an ETF that holds a short position in respect of the performance of a qualified index should as a policy matter be likewise exempt from the section 871(m) withholding tax.[76]

H. *QDD Net Delta and Qualified Indices*

While a qualified index should generally be treated as opaque for section 871(m) purposes, there may be limited cases in which section 871(m) should be more properly applied on a look-through basis to the components of a qualified index. This could be illustrated by the following discussion regarding the application of section 871(m) to dealer positions that are held by a "qualified derivatives dealer."

The Section 871(m) Regulations provide special rules that apply in the case of a foreign dealer that qualifies as a "qualified derivatives dealer" (a "QDD").[77] While a QDD is generally exempt for the section 871(m) withholding tax in respect of its dealer positions, a QDD will, beginning on January 1, 2021, be required to self-assess a section 871(m) tax if it has a positive "net delta" with respect to U.S. shares, after taking account all of its dealer positions with respect to the shares.[78] For example, a QDD that enters into the short position under a swap with a client that references shares of a U.S. issuer and then hedges that position by acquiring a long position under a swap with respect to such shares will not be subject to the section 871(m) tax with respect to the long position because it would have a net delta of zero in respect of the shares (assuming the QDD does not hold any other dealer position with respect to the shares).

It is not clear, however, how "net delta" should be computed when a QDD holds a long position in respect of the components of a qualified index as a

[76] One difficulty with this policy argument is that under this approach a derivative with respect to the performance of an ETF that holds a short index position should be exempt from the section 871(m) withholding tax even if the index is not a qualified index, but there is nothing in the Section 871(m) Regulations that provides for such a result.

[77] Reg. § 1.871-15(q). In the absence of a special rule for QDDs, there could be cascading withholding tax in respect of the same dividend. This could be illustrated by an example in which (1) a foreign dealer issues an equity-linked note that is subject to section 871(m) to a foreign customer and (2) the foreign dealer hedges its position by entering into a total return swap over the payments due on the note with a second foreign dealer. In such a case, unless an exception applies, section 871(m) withholding tax would be due on the dividend equivalent payments on both the note and the swap, and the second dealer may be subject to a third level of section 871(m) tax on its hedge of the swap.

[78] Reg. § 1.871-15(q)(3); Notice 2018-72, 2018-40 I.R.B. 522.

hedge of a short position in respect of a qualified index. This could be illustrated by an example in which a QDD enters into the short position under a swap with a client that references a qualified index and then hedges that position by acquiring (or increasing) a long position under a swap that references the components of the index.[79] As a technical matter, the QDD would seemingly have a positive "net delta" in respect of the components of the index, notwithstanding that the QDD has, as an economic matter, offset its long position via its short position in respect of the qualified index. That is because the Section 871(m) Regulations would treat the short position as relating to a notional index and not as relating to the components of the index.[80] Accordingly, when the QDD computes its net delta in respect of the shares that are the subject of the long position, it would apparently not be permitted to take into account its indirect short position with respect to those shares under its swap with the client. This clearly is not the right result, and one would hope that the Service will issue guidance that confirms that there should be a look-through to the components of a qualified index in this case.

There is a strong basis, however, for the position that one should look-through a qualified index for this purpose even under the literal language of the Section 871(m) Regulations. That is because the Regulations provide that a QDD's net delta in respect of "underlying securities" should generally be computed in the same manner that it computes net delta for nontax purposes.[81] In this case, the QDD would generally treat itself for nontax purposes as having a net delta of zero in respect of the index components because it would treat its long and short swap positions as offsetting each other. This would be the case even though the long swap references the index components and the short swap references the qualified index.

The difficulty with the position in the prior paragraph is that the Section 871(m) Regulations only state that one should compute net delta in the same manner that it computes net delta for nontax purposes, but the Regulations do not state that one can determine the "underlying security" that is subject to the net delta computation in the same manner that one determines the reference asset for nontax purposes. In this case, the QDD arguably has a positive net delta in respect of the index components because (1) the Regulations require that the net delta be computed separately in respect of each "underlying security" and (2) the components of a qualified index are not treated as "underlying securities" for purposes of the Section 871(m) Regulations. It is,

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[79] This will often happen because a QDD will sometimes prefer to hedge an index swap by adjusting is pre-existing derivative positions with respect to the index components rather than entering into a new derivative position with respect to the qualified index.

[80] The Section 871(m) Regulations provide that the "net delta" of a QDD must be determined separately with respect to each "underlying security." Reg. § 1.871-15(q)(3). The Section 871(m) Regulations further state that a qualified index is treated as a single security that is not an "underlying security" (*i.e.*, there is no look-through to the "underlying securities" in a qualified index). Reg. § 1.871-15(l)(2).

[81] Reg. § 1.871-15(q)(4).

therefore, possible that, in the absence of future guidance to the contrary, the Service will assert that a QDD's net delta in respect of an underlying security cannot be computed by looking through the components of a qualified index, notwithstanding that the QDD does so when computing its net delta for nontax purposes.[82]

I. *Partnership Indices*

The following subsection addresses whether an index that is comprised of partnerships can constitute a qualified index under the 10% QI Test.[83] The first part of the discussion addresses how section 871(m) could apply to an index of partnerships even though section 871(m) generally only applies to contracts that reference corporate stock. The second part addresses whether a partnership index can technically satisfy the requirements of the 10% QI Test. The third part discusses whether, as a policy matter, an index of partnerships should be permitted to constitute a qualified index for section 871(m) purposes.

1. *Application of Section 871(m) to Partnerships*

Although section 871(m) generally only applies to contracts that reference stock of a U.S. corporation, the Section 871(m) Regulations provide that a contract that references a partnership interest will be treated for section 871(m) purposes as referencing any "C" corporation stock and U.S. equity derivatives[84] that are held by the partnership if the partnership is a "covered partnership."[85] This rule is presumably intended to address the concern that, in the absence of a section 871(m) look-through to the assets of a partnership, an investor could inappropriately avoid the application of section 871(m) by entering into a derivative with respect to a partnership that holds U.S. equities rather than entering into a derivative on the underlying U.S. equities themselves.

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[82] While treating a qualified index as transparent for net delta purposes seems to be the better approach from a policy perspective, the Service could, nevertheless, take the position that, because it provided a taxpayer favorable exception for qualified indices that treats such indices as opaque for section 871(m) purposes, a taxpayer should then be bound by this approach for all purposes (including for net delta purposes) even if in a particular case there may be a policy justification for applying a look-through to the components of a qualified index.

[83] There are many indices of publicly traded partnerships that are available for investment. *See, e.g.*, *Index Methodology Guide*, Alerian (September 29, 2017), https://www.alerian.com/wp-content/uploads/AMZmethod-v12.0.1.pdf; S&P Dow Jones Indices, *S&P MLP Indices Methodology*, S&P Dow Jones Indices (October 2017), http://www.chinese.spindices.com/documents/methodology/methodology-sp-mlp-index.pdf.

[84] More technically, the derivative will be treated as referencing the "potential section 871(m) transactions" that are held by the partnership. "Potential section 871(m) transactions" include notional principal contracts, equity linked instruments, "repos," and securities loans that reference U.S. equities. Reg. § 1.871-15(a)(12).

[85] Reg. § 1.871-15(m)(1).

The term "covered partnership" includes a partnership (1) that is a dealer or trader in securities or (2) in which at least 25% or $25 million of the value of its assets consists of "underlying securities."[86] For purposes of this rule, the term "securities" has the meaning set forth in section 475(c).[87] While not explicitly stated, this provision will generally only apply to a derivative with respect to a publicly traded partnership ("PTP") because it is very rare for a derivative to be issued with respect to a partnership that is not publicly traded.[88]

The overwhelming majority of PTPs are in the natural resource business, and they generally do not make significant investments in third party corporate stock. Many PTPs, however, own wholly-owned blocker corporations which hold assets that produce nonqualifying income under section 7704.[89] In many cases, such blocker corporations have a value in excess of $25 million, although they generally represent significantly less than 25% of the value of the assets of the applicable PTP. Accordingly, many PTPs will be a "covered partnership," in which case swaps with respect to the PTP will be subject to section 871(m), notwithstanding that "C" corporation stock may represent a small percentage of the PTP's assets.

If section 871(m) applies to a derivative with respect to a partnership, the dividend equivalent amount that is subject to withholding tax would be determined based on the dividends that are paid in respect of the corporate stock (and dividend equivalents in respect of any positions that the partnership holds that are subject to section 871(m)) that are held by the partnership.[90]

2. *Application of the 10% QI Test to a Partnership Index*

This subsection addresses whether an index that primarily or wholly consists of entities that are classified as partnerships for tax purposes can technically satisfy the requirements of the 10% QI Test. As an initial matter, it should be noted that the preamble to the Section 871(m) Regulations refers to the 10% QI Test as a "safe harbor for global indices with ten percent or less U.S. stocks,"[91] thereby implying that the drafters of the Section 871(m) Regulations did not consider partnership indices when they provided for the 10% QI Test. That being said, that reference should not preclude a partnership index from constituting a qualified index under the 10% QI Test as

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[86] Reg. § 1.871-15(m).

[87] Reg. § 1.871-15(m)(1).

[88] Moreover, a delta-one derivative in respect of a partnership that is not publicly traded will often be treated as an ownership interest in the underlying partnership for tax purposes.

[89] The "blocker corporation" would effectively "block" the nonqualifying income by effectively converting such income into qualifying income from the corporation.

[90] As has been discussed elsewhere, investors and withholding agents may be unable to (1) obtain the information necessary to determine whether a partnership is a "covered partnership" or (2) compute the dividend equivalent amount with respect to a derivative that references a "covered partnership." For a discussion regarding these issues, see SIFMA March 31 Comments, *supra* note 27.

[91] T.D. 9734, 80 Fed. Reg. at 56,871.

long as (1) the index satisfies the technical requirements of the 10% QI Test, (2) the treatment of the index as a qualified index does not clearly violate the policy behind the 10% QI Test, and (3) there is no indication that the drafters affirmatively believed that the 10% QI Test should not apply to a partnership index.

As discussed above, an index will constitute a qualified index under the 10% QI Test if (1) the index is a passive index that is based on a diverse basket of publicly traded securities and that is widely used by numerous market participants, (2) the index is widely traded, (3) the index was not formed or availed of with a principal purpose of avoiding U.S. withholding tax, and (4) the QI Ratio does not exceed ten percent. As noted above, the QI Ratio consists of a fraction the numerator of which is the "underlying securities" in the index and the denominator of which consists of all of the "component securities" in the index. This subsection discusses whether an index that is entirely comprised of entities that are classified as partnerships for tax purposes (some of whom are "covered partnerships") could satisfy the QI Ratio and thus constitute a qualified index under the 10% QI Test as long as the index otherwise satisfies the first three tests set forth above. The discussion below first considers the "underlying securities" that should be included in the numerator of the QI Ratio for a partnership index and then considers the "component securities" that should be included in the denominator of the QI Ratio for a partnership index.

a. *Numerator of the QI Ratio.* The 10% QI Test does not specifically address how the QI Ratio should be determined in respect of an index of partnerships. As a technical matter, the QI Ratio for a partnership index should arguably equal zero, in which case the index would satisfy the QI Ratio. That is because the numerator of the QI Ratio consists solely of "underlying securities" in the applicable index. The term "underlying securities" generally only includes corporate stock if the dividends on the stock would be U.S. source income (*i.e.*, generally, stock that is issued by a U.S. corporation).[92] Accordingly, if a partnership index does not include any U.S. corporate stock, the numerator of the QI Ratio should arguably equal zero.

For the reasons described below, however, it is probable that the QI Ratio should be determined based on the partnership look-through rule described above, notwithstanding that the 10% QI Test does not cross-reference or otherwise incorporate the partnership look-through rule. More specifically, as discussed above, the Section 871(m) Regulations provide that a derivative with respect to a covered partnership is treated for section 871(m) purposes as referencing U.S. corporate stock (as well as any equity derivatives with respect to such stock) that is held by the covered partnership. In other words, when considering the application of section 871(m) to a partnership, the Section 871(m) Regulations treat a covered partnership as a transparent entity to the extent of any "underlying securities" that are held by the partnership. If

[92] Reg. § 1.871-15(a)(15).

the numerator of the QI Ratio incorporates the partnership look-through rule, the "underlying securities" in the numerator of the QI Ratio would include any "underlying securities" that are held by any covered partnerships in the index.

First, while the term "underlying securities" is defined as equity securities the payments on which would generate U.S. source income, the definition further states that this determination should be determined "where applicable taking into account paragraph (m) of this section" (which is the paragraph that provides for the partnership look-through rule described above).[93] While the meaning of this proviso is not entirely clear, it likely means that the phrase "underlying securities," whenever used in the Section 871(m) Regulations, includes any "underlying securities" that are held by a covered partnership even if that particular provision does not specifically incorporate the partnership look-through rule.

Second, if the partnership look-through rule does not apply for purposes of the numerator of the QI Ratio, an index of covered partnerships whose assets consist solely of corporate stock could be a qualified index (because the numerator of the QI Ratio would be zero). That would clearly be contrary to the apparent policy of the 10% QI Test which is to preclude the application of section 871(m) to an index derivative only if U.S. source dividends represent a small percentage of the income from the index components.

Accordingly, based on the discussion above, it is likely that the numerator of the QI Ratio in the case of a partnership index should include any "underlying securities" that are held by the "covered partnerships" in the index.

b. *Denominator of the QI Ratio.* As noted above, the denominator of the QI Ratio consists of all of the "component securities" in the index. In the case of an index of partnerships, the critical question is whether all of the partnership interests in the index should be treated as "component securities" for this purpose even though, as discussed below, partnership interests are sometimes not classified as securities for tax purposes. If partnership interests are treated as component securities for this purpose and are thus included in the denominator of the QI Ratio, many (and perhaps most) partnership indices will satisfy the QI Ratio. That is because the numerator of the QI Ratio for most partnership indices (*i.e.*, the value of the blocker corporation stock that is held by the partnerships in the index) will generally be a relatively small number in comparison to the market value of all of the partnerships in the index. If, however, partnership interests are not treated as component securities for this purpose and are thus not included in the denominator of the QI Ratio, then a partnership index will not satisfy the QI Ratio because the denominator of the QI Ratio would then be zero.

The term "component securities" is not defined in the Regulations. As an initial matter, the term "component securities" should not be interpreted as having the same meaning as "underlying securities" because "underlying

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[93] *Id.*

securities" is used to determine the numerator of the QI Ratio.[94] Accordingly, the Section 871(m) Regulations' use of a different term to determine the denominator of the QI Ratio indicates that "component securities" is intended have a different meaning than "underlying securities."[95]

The term "securities" in the Code sometimes incorporates PTP interests and sometimes does not include such interests. More specifically, section 475(c) provides that the term "securities" includes a "publicly traded" or "widely held" interest in a partnership, while the term "securities" in section 165(g)(2) and section 1236(c) does not include an interest in a publicly traded partnership.

Although the specific term "component securities" is not defined in the Section 871(m) Regulations, the term "securities" is defined in the partnership pass-through rule discussed above by reference to the section 475(c) definition of securities.[96] While the 10% QI Test does not specifically incorporate this definition, the section 475(c) definition of "securities" presumably should apply for purposes of the QI Ratio because that is the only definition of the term "securities" in the Section 871(m) Regulations. If the drafters of the Section 871(m) Regulations intended that the term "component securities" should have a different meaning for purposes of the QI Ratio, they would presumably have included the alternative definition. Moreover, as discussed above, it is likely that the term "underlying securities" in the numerator of the QI Ratio incorporates the partnership look-through rule and its definitions. If that position is correct, it would arguably be inconsistent for the Section 871(m) Regulations to incorporate the partnership look-through rule for purposes of computing the numerator of the QI Ratio and then to use a different definition of the term "securities" for purposes of the denominator of the QI Ratio. In addition, if the policy of the 10% QI Test is that section 871(m) should not apply to a contract that references "underlying securities" if such securities represent less than ten percent of the value of the index, then it would make sense to interpret the term "securities" in a broad manner that includes all of the components of the index that could arguably be classified as securities.

Accordingly, based on the discussion above, it is likely that the value of publicly traded partnership interests in an index should be treated as "component securities" that would be included in the denominator of the QI Ratio.

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[94] In addition, the language of the Primary QI Test clearly distinguishes between the terms "underlying securities" and "component securities" because it requires that the index reference "25 or more component securities (whether or not the security is an underlying security)." Reg. § 1.871-15(l)(3)(i).

[95] If the term "component securities" has the same meaning as "underlying securities" for this purpose, then the denominator of the QI Ratio would equal the numerator of the QI Ratio. The QI Ratio would then equal 100%, in which case the index would not constitute a qualified index under the 10% QI Test.

[96] Reg. § 1.871-15(m)(1).

In such a case, it is likely that many partnership indices will have a QI Ratio that does not exceed the ten percent threshold.

3. *Policy Considerations*

This subsection addresses whether the position that a partnership index can constitute a qualified index is consistent with the policy of the 10% QI Test. As discussed below, an argument could be made in either direction depending on the policy for the rule.

As discussed above, it is possible that the policy of the 10% QI Test is that the government did not want to subject taxpayers to the burden of applying section 871(m) based on a deconstruction of an index to its component parts when only a small percentage of the contract would be subject to section 871(m). In such a case, the section 871(m) tax that would be collected under a look-through to the components of the index would be small relative to the notional value of the index, and the government may have, therefore, been willing to forego the section 871(m) tax if the QI Ratio is ten percent or less. That argument would equally apply in the case of a partnership index that satisfies the 10% QI Test because in that case the application of section 871(m) on a look-through basis to the index components would likewise yield very little section 871(m) tax relative to the notional amount of the index. If anything, this policy argument is even stronger in the case of a partnership index because the administrative burden of looking through to the components of a partnership index and thereafter looking through to the assets of the covered partnerships in the index would generally be greater than looking through to the components of an index of foreign and U.S. corporations.

Alternatively, as discussed above, it is possible that the policy of the 10% QI Test is that as a general matter section 871(m) looks through an index to its components because otherwise investors could avoid section 871(m) by investing in a derivative with respect to a stock index rather than a derivative with respect to the components of the index. This would generally not be a concern, however, if U.S. stocks represent ten percent or less of the components of the index. That is because an investor that seeks to obtain exposure to specific U.S. stocks would presumably not acquire a derivative with respect to an index that includes such stocks if the index is almost entirely comprised of other non-U.S. stocks. In such a case, there is little concern that the taxpayer is using the index to avoid section 871(m). This argument does not likewise apply in the case of a partnership index because an index could be entirely comprised of covered partnerships and still satisfy the 10% QI Test.[97] For example, consider a case in which an investor seeks to enter into ten separate swaps with respect to ten covered partnerships. If the investor enters into ten

[97] That is because a partnership could be a covered partnership if it holds at least $25 million of "underlying securities" even though such securities may represent a small percentage of the partnership's total assets. An index of covered partnerships could accordingly satisfy the 10% QI Test.

separate swaps, then each swap would be subject to section 871(m). If there is an index of such partnerships, the index could be a qualified index under the 10% QI Test even though a swap with respect to each index component would be subject to section 871(m). Thus, under this approach, policy considerations would not support treating an index that is mostly comprised of covered partnerships as a qualified index under the 10% QI Test.

J. *Nonqualified Indices*

While this Article is primarily concerned with indices that are a qualified index for section 871(m) purposes, the following subsection addresses the application of section 871(m) to an index that is not a qualified index. As noted above, a contract that references a nonqualified index will be treated for section 871(m) purposes as multiple contracts with each contract referencing each individual U.S. stock that is included in the index. If section 871(m) only applies to delta-one contracts (as is the case with respect to contracts that are entered into before January 1, 2021), then the application of section 871(m) in such a case is relatively straightforward. Section 871(m) would then apply to each U.S. stock that is included in the index, and, if there is an adjustment to the index, section 871(m) would no longer apply to a stock that is removed from the index. There would likewise be a new contract that is subject to section 871(m) each time a new U.S. stock is added to the index.[98] The dividend equivalent amount for the index would be equal to all of the dividends that are paid on the U.S. stocks in the index (based on the notional amount of the index that is referenced by the contract).

The application of section 871(m), however, to a contract that references a nonqualified index and that has a delta between 0.8 and 1 (on or after January 1, 2021) will create operational complexity upon issuance and uncertainty when the index is adjusted and will often result in a delta computation that is inconsistent with the economics of the derivative.

These issues can be illustrated by an example in which an investor purchases a call option with respect to a nonqualified index that consists of 100 equally weighted U.S. equities. Assume that each stock has a current value of ten dollars so that the index has a value of $1,000 and that the strike price of the call option is $800.[99] Under the look-through approach of the Section 871(m) Regulations, the parties to the option would be required to compute 100 separate delta amounts for 100 hypothetical call options with respect to each component of the index. Although not entirely clear, the delta for each of the 100 call options would apparently be based on a strike price of eight dollars per option. Aside from the computational complexity of this approach, the

[98] The new contract would exist solely for section 871(m) purposes. I do not mean to suggest, however, that there would necessarily be a new contract for holding period or section 1001 purposes.

[99] While an at-the-money call option will generally not be subject to section 871(m) because the delta of the option will be below the requisite delta threshold, the option in the example could have a delta above 0.8 because it is "in the money" by $200.

single option in the example could be subject to up to 100 different withholding rates based on 100 different deltas for each hypothetical call option. This could happen if the 100 notional call options that are created under the Section 871(m) Regulations all have differing deltas above 0.8, in which case each of the hypothetical options would be subject to a different withholding rate with respect to the dividend equivalent attributable to the option.

In addition, it is unclear whether the Section 871(m) Regulations would require the computation of a new delta upon a subsequent rebalancing of the index with respect to any new or increased component of the index, even if the rebalancing does not trigger a deemed disposition of the derivative under section 1001. More specifically, the Section 871(m) Regulations provide that the delta of a contract is equal to the delta upon issuance.[100] The Section 871(m) Regulations, however, also state that the delta of a derivative with respect to a nonqualified index must be computed separately for each component of the index. Accordingly, it appears that a new delta should be computed when new components are added to a nonqualified index because there is no delta that was previously computed with respect to such components. If this is correct, the new delta computation for the new components of the index would only further complicate the application of section 871(m) to the call option in the example above because a new delta would likely increase the number of different section 871(m) consequences applicable to the hypothetical call options with respect to the components of the index.

Aside from the difficulties illustrated above, the computation of delta for nonqualified indices under the Section 871(m) Regulations will generally be inconsistent with the economics of the transaction because a single non-delta-one derivative with respect to an index is economically different than the aggregate of the same derivative with respect to each component of the index. That is because the single index derivative takes into account the aggregate changes in the value of the index components, whereas a separate derivative with respect to each index component only takes into account the performance of that component. Thus, the actual delta that is taken into account in the pricing of a non-delta-one derivative with respect to a nonqualifying index will almost certainly differ from the average of the delta amounts for the derivative that must be computed under the Section 871(m) Regulations.

These issues could be addressed if the Section 871(m) Regulations were to provide instead that a nonqualified index will be treated as a single underlying security for purposes of computing the delta of a contract that references the index. Under this approach, the delta for a derivative with respect to a nonqualified index would be based on the index as a whole rather than on each component of the index. In addition, the delta for the derivative would not be recomputed each time there is a change to the index because the underlying security that is represented by the index would remain the same, unless a change to the index triggers a deemed reissuance of the derivative

[100] Reg. § 1.871-15(g)(2).

under section 1001. If the dividend equivalent amount is based on estimated dividends, the delta would be determined upon the issuance of the derivative based on the projected dividends for the index (taking into account any projected changes to the index) and would not be readjusted upon a change to the components of the index. If the dividend equivalent amount is based on actual dividends, rather than estimated dividends, the actual dividends would be computed based on the actual components of the index, including any components that are included after an adjustment to the index.[101]

V. Conclusion

As discussed in this Article, the section 871(m) qualified index rules raise a number of legal and practical issues and concerns and demonstrate the difficulty in providing specific and objective rules that could be universally applied to all financial indices. The drafters of the Section 871(m) Regulations should, however, be commended for providing comprehensive, and generally objective, rules that take into account not only the number and weighting of the index components but also the features of modern-day indices, such as rebalancings, index committee discretion, customized indices, and whether other investments reference the index.

As noted above, the Service has informally indicated that it is considering the tax treatment of contracts that reference baskets or indices and may apply the concepts underlying the section 871(m) qualified index rules in other areas. That approach would have the benefit of providing defined rules and would provide some consistency regarding the tax treatment of indices for different tax purposes. It would be inadvisable, however, to apply the qualified index rules uniformly to all areas of the tax law because, as discussed in my 2015 article, different tax provisions often have unique and specific policy and practical considerations that necessitate a tailored approach to the tax treatment of indices under such provisions. Accordingly, while any new rules regarding the tax treatment of indices in other contexts should consider, and in some cases incorporate, all or a portion of the section 871(m) qualified index rules, such rules should be carefully constructed to address the particular index tax classification issues that arise in each case.

[101] For a more detailed discussion of the issues addressed in this section, see SIFMA March 31 Comments, *supra* note 27.