SULLIVAN & CROMWELL LLP

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Withholding Tax on Dividend Equivalent Payments

IRS Issues Interim Guidance on Section 871(m) and the Qualified Derivatives Dealer Program

SUMMARY

On December 2, 2016, the IRS and Treasury Department issued interim guidance under Section 871(m) in Notice 2016-76 (the "*Notice*"). Significant changes made by the Notice include the following:

- The January 1, 2017 effective date for Section 871(m) withholding will apply only to "delta-one" contracts. Other contracts will only be subject to Section 871(m) if they are issued on or after January 1, 2018. This delayed effective date is intended to address industry concerns regarding the feasibility of fully implementing Section 871(m) by January 1, 2017.
- Although a "combination" rule will still apply for determining whether a contract has a "delta" of one, withholding agents will not need to combine transactions that are entered into in 2017 unless they are over-the-counter transactions that are priced, marketed or sold in connection with each other.
- Qualified derivatives dealers ("*QDDs*") will be required to determine their residual Section 871(m) tax liability for dealer transactions under a "net delta" methodology that evaluates a QDD's aggregate dealer position in a given U.S. stock. This change from prior guidance was apparently made in response to concerns that the previous methodology could have caused a fully hedged QDD to owe residual Section 871(m) tax in certain unintended circumstances. However, the use of a "net delta" approach means that a QDD may be subject to tax on dealer positions with a "delta" of less than 0.8.
- By contrast to the approach taken in prior guidance, actual dividends paid to a QDD will remain subject to U.S. withholding tax. In the absence of additional guidance, this rule may result in the imposition of more than one level of tax on the same dividend.
- "Qualified securities lenders" will be entitled to rely on Notice 2010-46 (including the "credit-forward" rules) until January 1, 2018.
- The effective date of the new Section 871(m) rules for certain exchange-traded notes will be postponed until January 1, 2020. The Notice identifies a list of 25 such structured notes, but indicates that the IRS and Treasury Department are willing to consider extending comparable relief to other exchange-traded notes if those products were outstanding before September 18, 2015.

In addition to the above, the Notice announces several interim rules that will apply to Section 871(m) during 2017 and—in some cases—during 2018. These rules provide, among other things, that the IRS will generally take "good faith" compliance efforts into account before taking enforcement action under Section 871(m), that parties collecting and paying tax under Section 871(m) will have additional time to make deposits, and that entities seeking QDD status will be able to certify to third-parties that they are QDDs while their applications are pending before the IRS (and, until March 31, 2017, prior to applying for QDD status).

The guidance announced in the Notice will be reflected in revised Section 871(m) regulations and a final "qualified intermediary" ("*QI*") agreement incorporating the QDD rules.

BACKGROUND

A. "DIVIDEND EQUIVALENT" WITHHOLDING

Section 871(m) treats "dividend equivalent" payments on certain financial contracts as U.S.-source dividends for withholding tax purposes. Accordingly, dividend equivalent payments (*i.e.*, certain amounts that—while not themselves U.S.-source dividends—are contingent upon, or determined by reference to, U.S.-source dividends) are generally subject to the 30% withholding tax imposed on U.S.-source "fixed or determinable, annual or periodical" income paid to a foreign beneficial owner, unless the tax is reduced by an applicable treaty.[1]

Initially, dividend equivalent withholding applied only to: (i) substitute payments made in respect of securities loans and "repo" transactions and (ii) dividend equivalent payments on swaps that provided for a "cross in" or "cross out" of the underlying security, that related to an illiquid security, or that were collateralized by the underlying security. This narrow definition is currently in effect. However, in September 2015, final, temporary and proposed regulations (the "*Section 871(m) Regulations*") were issued that significantly expanded the scope of Section 871(m).[2] These regulations are currently effective for transactions entered into on or after January 1, 2017, and provide that "simple" equity-linked contracts with a "delta" of 0.8 or greater, and "complex" equity-linked contracts that meet a "substantial equivalence test" can also give rise to dividend equivalent payments if they reference a security that pays (or would pay) dividends from sources within the United States. Under the Section 871(m) Regulations, such contracts will be deemed to include a dividend equivalent payment under Section 871(m) even if they do not provide for any payments that are determined by reference to

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1 *See generally* Section 871.

2 For additional background on the Section 871(m) Regulations, please see the Sullivan & Cromwell LLP publications entitled "Withholding Tax on 'Dividend Equivalent Payments': IRS and Treasury Issue Temporary and Proposed Regulations on 'Dividend Equivalents' on 'Specified Notional Principal Contracts'" (January 24, 2012), "Withholding Tax on Dividend Equivalent Payments: IRS and Treasury Issue Final and Proposed Regulations on Withholding Tax on 'Dividend Equivalent Payments'" (December 5, 2013) and "Withholding Tax on 'Dividend Equivalent' Payments: IRS and Treasury Issue New Final and Proposed Regulations on Withholding Tax on 'Dividend Equivalent Payments'" (September 21, 2015).

dividends on U.S. equities, and even if no payment is made by the short party to the long party under the contract.

B. QUALIFIED DERIVATIVES DEALERS

A requirement that "dividend equivalent" or similar payments be subject to U.S. withholding tax can—in the absence of a relief mechanism—create "cascading withholding tax" scenarios in which a single dividend payment becomes subject to more than one level of U.S. withholding tax. For example, if a foreign dealer loaned U.S. equities that it borrowed from a foreign person, U.S. withholding tax could (unless an exception is available) apply to the substitute dividends that are paid and received by the dealer.

Shortly after Section 871(m) was enacted, the IRS and Treasury Department issued Notice 2010-46,[3] which provided relief from "cascading withholding tax" in the case of substitute dividend payments on securities loans that are subject to Section 871(m).[4] As a backup to this system, Notice 2010-46 included a "credit-forward" regime that permitted a withholding agent to reduce or eliminate the withholding tax if it had reliable documentary evidence that a withholding tax had previously been paid in the chain of payments.

The broadened definition of dividend equivalent payments in the Section 871(m) Regulations significantly expanded the possibility of "cascading" withholding tax with respect to the same item of income. This could be illustrated by an example in which: (i) a foreign dealer issues a note linked to a U.S. stock that is subject to Section 871(m) to a foreign customer; (ii) 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; and (iii) the second foreign dealer hedges its position by acquiring the stock referenced by the swap. In such a case, unless an exception applies, U.S. withholding tax would be due under Section 871(m) on the embedded dividend equivalent payments on both the note and the swap, and a third level of U.S. withholding tax would be imposed on the dividend payments received by the second dealer. The Section 871(m) Regulations address this issue by providing for a special QDD regime under which a QDD will generally not be subject to U.S. withholding on dividend equivalents that it receives in a dealer capacity.[5] On July 1, 2016, the IRS released a draft QI agreement (the

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3 2010-24 I.R.B. 757.

4 For additional background on Notice 2010-46, please see the Sullivan & Cromwell LLP publication entitled "Withholding Tax on Substitute Dividends: IRS and Treasury Outline New Rules for Withholding on Substitute Dividends" (May 24, 2010). Even prior to Section 871(m), substitute dividend payments in respect of U.S. equities were treated as U.S.-source income under Treasury Regulations. A prior notice (Notice 97-66, 1997-2 C.B. 328) addressed "cascading withholding tax" under this regime.

5 *See* Treas. Reg. § 1.871-15T(q). Under the current Section 871(m) Regulations, both dividends and dividend equivalents received by a QDD are exempt from U.S. withholding tax. However, as discussed further below, the Notice changes this result and provides that actual dividends received by a QDD will be subject to withholding.

"*Proposed QI Agreement*") in Notice 2016-42,[6] which, among other changes, updated the IRS's standard QI agreement to implement the QDD regime.

DISCUSSION

The Notice makes the following changes to the Section 871(m) and QDD rules:

A. EFFECTIVE DATES

1. Deferred Application of Section 871(m) to Instruments that Are Not "Delta-One" Instruments

The Notice announces that the Section 871(m) Regulations will be amended to exclude contracts (other than contracts that are subject to Section 871(m) under current law) that are both: (i) entered into before January 1, 2018 and (ii) not "delta-one" contracts. Although the Notice does not specifically define "delta-one" transactions, a footnote in the Notice indicates that the "delta" of an instrument is to be determined under the current Section 871(m) Regulations. Under these rules, the delta of an instrument is generally the ratio of the change in the fair market value of the contract to the change in the fair market value of the property referenced by the contract,[7] as determined at the time when the instrument is issued.[8]

Although not explicitly stated in the Notice, "complex" instruments subject to the "substantial equivalence" test of the Section 871(m) Regulations[9] are not "delta-one" contracts, and therefore will not be subject to Section 871(m) if issued before January 1, 2018. However, the Notice does not defer the effective date for "delta-one" structured notes, notwithstanding industry concerns regarding the additional complexity in applying Section 871(m) to structured notes that are held through intermediaries. Additionally, under an anti-abuse rule in the Section 871(m) Regulations, a transaction that is entered into with a principal purpose of avoiding the application of Section 871(m) can be treated as subject to Section 871(m).[10] According to the Notice, this anti-abuse rule will be in effect during 2017. It is therefore possible that the anti-abuse rule could apply to an equity derivative that is entered into in 2017 with a delta that is less than 1.0, if the derivative was deliberately structured so that it would not be subject to the January 1, 2017 effective date.

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6 2016-29 I.R.B. 67. For additional background on Notice 2016-42, please see the Sullivan & Cromwell LLP publication entitled "Qualified Intermediaries and 'Dividend Equivalent' Withholding: IRS Publishes New Proposed QI Agreement, Providing New Details on the 'Qualified Derivatives Dealer' Program" (July 19, 2016).

7 *See* Treas. Reg. § 1.871-15(g)(1). The delta of a transaction must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is treated as the delta for purposes of the Section 871(m) Regulations. *See id.*

8 *See* Treas. Reg. § 1.871-15(g)(2).

9 In general, "simple" contracts (which are subject to the "delta" test) are instruments that both: (i) have an amount due that is calculated by reference to a fixed number of shares and (ii) have a single maturity date, while instruments that do not meet the definition of a "simple" contract are considered "complex" contracts. *See* Treas. Reg. § 1.871-15(a)(14).

10 *See* Treas. Reg. § 1.871-15(o).

In determining whether a series of transactions amounts to a "delta-one" contract that is subject to Section 871(m), the "combination rule" of the Section 871(m) Regulations will apply.[11] However, withholding agents (but not long parties) will be entitled to apply a simplified "combination rule" to transactions entered into during 2017, under which different transactions (including transactions that are entered into within two business days of each other) are only aggregated if they are both: (i) entered into over-the-counter and (ii) priced, marketed or sold in connection with each other. Once aggregated under this rule, a series of transactions will generally continue to be treated as a combined transaction during future years, and conversely, a set of transactions entered into in 2017 and not integrated under this simplified standard will not become a combined transaction in the future unless a reissuance or other event requires a re-testing under the combination rule.

2. "Qualified Securities Lender" Rules Will Remain Available During 2017

The Notice states that taxpayers will be entitled to rely on Notice 2010-46 until January 1, 2018. Accordingly, dealers that are subject to Section 871(m) solely because they act as securities lenders will not need to qualify for QDD status until 2018 and may continue to rely in 2017 on the "credit forward" regime of Notice 2010-46.

B. NEW GUIDANCE FOR QDDS

1. "Net Delta" Approach to Computing a QDD's Tax Liability Under Section 871(m)

The Notice makes two noteworthy changes to the manner in which a QDD will be required to compute its residual Section 871(m) tax liability. First, a QDD's "section 871(m) amount" (*i.e.*, the residual U.S. tax owed by a QDD under Section 871(m) in respect of dealer transactions) will be computed using a "net delta" methodology. Accordingly, a QDD's "section 871(m) amount" in respect of a stock will generally be determined by calculating its net delta exposure to the stock (measured in number of shares, and determined by aggregating all of its physical and derivative positions with respect to the stock) on the day prior to the ex-dividend date of any dividend paid, and multiplying the "net delta" by the relevant dividend amount per share.

The "net delta" approach was apparently based on a very similar proposal that was made by the Securities Industry and Financial Markets Association in order to address concerns that the methodology in Notice 2016-42 for computing a QDD's tax liability could have caused a fully hedged QDD to owe residual Section 871(m) tax in unintended circumstances.[12] For example, the approach of Notice 2016-42—which determined this liability by reference to the difference between: (i) the

[11] *See* Treas. Reg. § 1.871-15(n). In general, the "combination rule" aggregates transactions entered into by the same "long party" (or a related person) if those transactions reference the same underlying security, replicate the economics of a transaction that would be subject to Section 871(m) withholding and are entered into in connection with each other.

[12] *See* Securities Industry & Financial Markets Association, Comments on Notice 2016-42, Proposed Qualified Intermediary Agreement, and Section 871(m) Implementation Delay (August 31, 2016 (the "*SIFMA Letter*")). By contrast to the approach taken by the Notice, the SIFMA Letter recommended that the "net delta" approach should be optional and not mandatory for all QDDs.

actual dividends and dividend equivalents received by a QDD in a dealer capacity and (ii) the "dividend equivalent payments" made by a QDD in its dealer capacity—could have subjected a QDD to residual Section 871(m) tax if it entered into a short dealer derivative position that is not subject to Section 871(m) (*e.g.*, because the position does not have the requisite delta, relates to a qualified index, or is grandfathered) and it hedged the position with an offsetting long dealer derivative position that is subject to Section 871(m).[13] By contrast, a QDD would not have any residual Section 871(m) liability in respect of offsetting dealer positions under the "net delta" approach set forth in the Notice.

Under the "net delta" approach, however, a QDD's residual Section 871(m) tax liability with respect to its dealer positions will be based on all of its physical and synthetic positions with respect to a particular equity, irrespective of whether any of the synthetic positions has a delta that is at least equal to 0.8 or satisfies the substantial equivalence test. A QDD could therefore have a residual tax liability under the Notice even if all of its long dealer derivative positions have a delta that is below 0.8.

The second change made by the Notice is that, unlike the approach in prior guidance, QDDs will remain subject to U.S. withholding tax on actual (and deemed) dividends with respect to physical stock positions. Such withholding tax will be creditable against a QDD's residual Section 871(m) tax liability in respect of the same dividend payment. However, in the absence of additional guidance, the effect of this rule is that there will be two levels of withholding tax on a single dividend if a QDD holds the short position under an equity swap that is subject to Section 871(m) and hedges its position by acquiring the stock that is the subject of the swap.

2. Transitional Certification Procedures

Under Notice 2016-42, an entity that is seeking QI status (which is a prerequisite to QDD status) for an entire year is not required to apply for QI status until March 31 of that year, notwithstanding that the QDD rules will take effect on January 1, 2017. In view of this, the Notice states that during 2017, an entity that has applied for QDD status (and, until March 31, 2017, an entity that intends to apply for QDD status) may generally represent to counterparties (including, for example, on an IRS Form W-8) that it is a QDD, notwithstanding that such a prospective QDD has not yet been approved by the IRS as a QDD.

C. GENERAL COMPLIANCE PROVISIONS

1. "Good-Faith" Compliance Efforts to Be Taken Into Account

The Notice states that in administering and enforcing the Section 871(m) Regulations for 2017 (in the case of "delta-one" contracts) and 2018 (in the case of other contracts), the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the Section 871(m) Regulations, including by: (i) building and updating withholding and documentation

[13] Alternatively, a QDD could have residual Section 871(m) liability under the Notice 2016-42 approach if it periodically adjusted its long hedges of its Section 871(m) short positions, because in such a case the long hedges could have a delta that exceeds the delta of the short positions even if they are completely offsetting positions (because the delta of each position would be determined when acquired).

systems to comply with the Section 871(m) Regulations; (ii) determining whether transactions are combined transactions; (iii) reporting information to counterparties as required under the Section 871(m) Regulations; and (iv) implementing the substantial equivalence test provided for "complex" products during 2018. A similar "good faith" provision also applies to QDDs.

Both of these provisions indicate that taxpayers that have not endeavored to comply with their Section 871(m) obligations in "good faith" will not be eligible for penalty waivers or other relief from IRS enforcement under Section 871(m), but neither aspect of the Notice provides guidance on the nature of the dispensation that will be available to taxpayers that have made the required "good faith" efforts (*i.e.*, whether the available relief will be limited to waivers of penalties, or whether the IRS may—in appropriate circumstances—be willing to refrain from enforcing substantive tax liabilities). A similar concession for taxpayers that have made "good faith" attempts at compliance was included in the IRS's transitional guidance on FATCA, and it may be possible to draw parallels between the two provisions.[14]

2. Postponed Deposit Deadlines

According to the Notice, a withholding agent will be considered to have timely made a deposit of any tax due under Section 871(m) during 2017 if it makes deposits of amounts withheld for dividend equivalents during any calendar quarter on or before the last day of that calendar quarter. This represents a significant relaxation of the general deadline for making deposits of U.S. non-resident withholding tax, which can ordinarily be required as frequently as four times per month.[15]

3. Adjustments to Section 871(m) Withholding

The Notice confirms that the IRS views Section 871(m) withholding as within the scope of existing Treasury Regulations[16] that allow a "withholding agent" to adjust underwithholding so long as the correct amount of tax is withheld by March 15 of the year following the year in which the underwithholding occurred. This provision may be particularly useful in the case of MLP-linked derivatives that are subject to Section 871(m) because the information necessary to determine the proper withholding for such derivatives will generally not be available (if it is available at all) in the year in which the dividend equivalent is paid.

D. JANUARY 1, 2020 EFFECTIVE DATE FOR CERTAIN EXCHANGE-TRADED NOTES

As noted above, "delta-one" structured notes, including many exchange-traded notes, are subject to the January 1, 2017 effective date of the Notice. To maintain market liquidity and limit differences between the market value and the "indicative value" (*i.e.*, the amount that would be due upon a maturity or redemption) of an exchange-traded note, an issuer will often "create" and sell new exchange-traded notes with the same legal terms and same CUSIP number as notes that are

[14] *See* Notice 2014-33, 2014-21 I.R.B. 1033.

[15] *See* Treas. Reg. § 1.6302-2(a)(1)(ii).

[16] *See* Treas. Reg. § 1.1461-2(b).

currently outstanding in the market. Absent a relief provision, such "new" notes would—if they were issued on or after January 1, 2017 and subject to Section 871(m)—not be fungible with currently outstanding exchange-traded notes for tax purposes because dividend equivalents arising from the "new" notes would be subject to withholding under Section 871(m), while the currently outstanding notes would be "grandfathered".

In response to these concerns, the Notice includes a list of 25 exchange-traded notes that will not be subject to the Section 871(m) Regulations until January 1, 2020. These notes were all outstanding before September 18, 2015 (the date upon which the Section 871(m) regulations were issued). In addition, the Notice requests comments regarding other exchange-traded notes that were outstanding before September 18, 2015 that will become subject to Section 871(m) withholding on January 1, 2017, and states that the IRS will consider similarly postponing the effective date of Section 871(m) for such products until January 1, 2020, either through published guidance or a private letter ruling.

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