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In This Alert:

Transitional Relief for Equity-Linked Products but Challenges Remain

Taxpayers and withholding agents face challenges in complying with the withholding rules for dividend equivalent payments under section 871(m) of the Internal Revenue Code (the "Code")[1]. These challenges affect dealers, banks, parties with indirect exposure to U.S. equities, withholding agents, and intermediaries. While Congress enacted section 871(m) in 2010, and it became effective for certain types of contracts that year, the full scope of section 871(m) has been the subject of ongoing discussions between the US Treasury Department, the Internal Revenue Service, and industry participants. In late 2015, the US Treasury Department and the IRS released final, temporary, and proposed regulations outlining the scope of 871(m) that were largely responsive to industry input. Nonetheless, significant questions remained under section 871(m) following the release of these regulations. The IRS addressed some open issues in guidance released on 2 December 2016. That guidance, issued in Notice 2016-76, addresses the challenges market participants face by providing transitional relief and answering several (but not all) open questions.

Significant developments made in Notice 2016-76 include the following:

1. To obtain qualified derivatives dealer ("QDD") status as of 1 January 2017, prospective QDDs have until 31 March 2017 to submit their updated qualified intermediary ("QI") agreement with QDD provisions.

2. QDDs will determine the residual US tax owed under section 871(m) (the "section 871(m) amount") using a "net delta" approach.

3. QDDs will remain subject to US withholding tax on actual and deemed dividends with respect to physical stock positions.

4. For 2017, the IRS will take the good-faith efforts of QDDs into account when enforcing compliance with the QDD provisions in their QI agreement.

5. Grandfathering rules are extended to apply to "delta one" transactions issued before 2017 and non-"delta one" transactions issued before 2018.

6. The IRS will take the good-faith efforts of taxpayers and withholding agents into account when enforcing section 871(m) for delta one transactions in 2017 and non-delta one transactions in 2018.

7. Withholding agents can use a simplified rule for the requirement to combine transactions for section 871(m) purposes for 2017 transactions.

8. Dividend equivalent withholding will not apply to certain existing exchange traded notes until 1 January 2020.

[1] All references to "Code" herein refer to the US Internal Revenue Code of 1986, as amended.

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The following discussion provides a more comprehensive background of the dividend equivalent withholding regime and Notice 2016-76, as well as a discussion of treaty issues and the creditability of taxes imposed on dividend equivalents in non-US jurisdictions. The discussion concludes with proposed next steps for persons impacted by section 871(m).

What is Dividend Equivalent Withholding?

Congress enacted section 871(m) in 2010 in response to concerns that non-US persons could avoid US withholding tax on US source dividends by using equity derivatives or other means of achieving synthetic exposure to US equities. The United States imposes a 30% withholding tax on US source dividends and other fixed or determinable annual or periodical ("FDAP") income. An applicable tax treaty can reduce or eliminate the 30% withholding on US source FDAP.

Under the applicable US tax rules, dividends paid by US issuers are generally treated as US source dividends subject to FDAP withholding. By contrast, the residence of the recipient generally determines the source of income on notional principal contract. The term "notional principal contract" is a US tax term, which generally includes swaps.

Prior to section 871(m), these different rules created tax planning opportunities. For example, a non-US investor holding the shares of a US corporation would be subject to 30% withholding tax on dividends paid by the US corporation, absent treaty relief. Instead of investing directly in the shares, the non-US investor could enter into an equity swap with a financial institution. The financial institution would pay the investor an amount equal to the dividend paid on the underlying US shares; however, this amount would not, itself, trigger FDAP withholding because the payment would be sourced based on the residence of the non-US investor. Section 871(m) closes this loophole by treating payments (and deemed payments) calculated by reference to US dividends as US source dividends, subject to FDAP withholding.

What is a "Dividend Equivalent"?

Payments currently treated as dividend equivalent payments subject to section 871(m) include:

1. Substitute dividends paid on a securities lending or sale-repurchase (i.e., a repo) transaction;

2. Payments on notional principal contracts that are contingent upon or determined by reference to the payment of a dividend from US sources where:

    a. in connection with entering into such contract, the long party to the contract transfers the underlying security to the short party ("crossing in" or "legging in") or the short party transfers the underlying security to the long party ("crossing out" or "legging out");

b. the underlying security is illiquid; or

c. the short party posts the underlying security as collateral to the long party.

The 2015 regulations expanded the universe of payments and transactions that may be treated as giving rise to dividend equivalent payments, which now includes a wider group of notional principal contracts and "equity-linked instruments". An "equity-linked instrument" is a financial transaction (other than a notional principal contract, a repo, or a securities loan) that references the value of one or more underlying securities, and could include forwards, options, and even certain debt instruments. As a result of this expansion, many derivatives and other transactions linked to US equities could trigger dividend equivalent withholding obligations.

The 2015 regulations divide transactions (other than securities lending or repo transactions) into (i) simple contracts, and (ii) complex contracts. Generally, a "simple contract" is a contract that upon issuance references a single fixed number of shares of an underlying security and has a single maturity or exercise date. A "complex contract" is any contract that is not a simple contract.

A simple contract is not subject to section 871(m) dividend equivalent withholding unless its delta is 0.8 or greater when compared to the underlying security. "Delta" is a measure of the relationship between changes in the value of the contract and changes in the value of the underlying security. Imposing withholding on high-delta contract reflects the policy behind section 871(m) because the economics of holding a high-delta contract more closely reflect the economics of holding the security underlying the contract. A delta of one indicates perfect correlation between changes in the value of the contract and changes in the value of the underlying security.

- For example, assume a notional principal contract between a non-US investor and a US bank require the investor to pay the bank an amount equal to all of the decrease in the value of 100 shares of ABC Co stock and an interest-rate based return. In return, the bank must pay the investor an amount equal all appreciation of 100 shares of ABC Co stock and any dividends paid on ABC Co stock. The value of the contract will change by $1.00 for each $0.01 change in the price of a share of ABC Co stock. This contract has a delta of 1.0 ($1.00 / $0.01 * 100).

A complex contract is subject to dividend equivalent withholding if it meets a substantial equivalence test. The substantial equivalence test is outlined in temporary regulations as a multi-step analysis intended to determine whether the contract replicates the economic performance of an underlying US security.

The 2015 regulations contemplate the possibility of parties using multiple transactions in order to replicate the economic return of a section 871(m) transaction without being subject to the 871(m) rules. Therefore, the regulations require parties to determine whether contracts need to be combined for section 871(m) purposes. Combined transactions are linked transactions that are treated

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as a single transaction for the purposes of testing whether the transaction is subject to section 871(m). The short party and withholding agent for possible combined transactions may rely on certain presumption rules when determining whether the transactions are subject to withholding (there is no analogous relief for the long party). The 2016-76 Notice allows withholding agents to rely on a simplified standard for determining whether transactions are combined transactions for 2017.

Qualified Derivatives Dealers

Withholding on dividend equivalent payments comes with a risk of cascading withholding. Cascading withholding, in the section 871(m) context, occurs when withholding is required more than once with respect to a single dividend payment.

- For example, assume a non-US bank and a non-US client enter into an equity swap over stock of a US issuer. The non-US bank may decide to hedge by holding the physical security. If the bank receives a US source dividend on the hedge, the bank would be subject to withholding on the actual dividend payment it receives from the issuer. The bank must then withhold if it makes a dividend equivalent payment subject to 871(m) withholding to its client, resulting in two instances of withholding from the same original dividend payment. Had the client received the US dividend directly, there would have been only one instance of withholding.

The QDD rules are intended to provide relief from cascading withholding for entities that qualify as QDDs. Treasury and the IRS amended the existing QI agreement to add QDD provisions. Treasury and the IRS published a proposed modified QI agreement with QDD provisions on 1 July, 2016. The proposed QI agreement outlines eligibility for QDD status, as well as the tax, withholding, and compliance obligations of a QDD. Treasury and the IRS intend to publish a final QI agreement before the end of 2016.

A QDD must be one of the following:

i. a securities dealer that subject to regulatory supervision by a governmental authority in the jurisdiction in which it is organized or operates,

ii. a bank subject to regularly supervision as a bank by a governmental authority in the jurisdiction in which it is organized or operates that issues potential section 871(m) transactions to customers and receives dividends or dividend equivalent payments pursuant to section 871(m) transactions entered into to hedge the customer transactions,

iii. an entity wholly owned by a bank described in (ii), or

iv. a non-US branch of a US financial institution.

Further, in order to be treated as a QDD, it must enter into and comply with a QI agreement.

Significant obligations attach to QDD status. When a QI acts as a QDD, it must assume primary chapter 3 and 4 withholding responsibility and primary Form 1099 reporting and backup withholding responsibility for all payments with respect to potential section 871(m) transactions for which it acts as a principal. The QDD rules reduce the risk of cascading withholding by limits the circumstances when a QDD is subject to tax on dividends and dividend equivalents it receives in its dealer capacity. However, Notice 2016-76 provides that a QDD is subject to withholding on actual dividends received on physical securities it holds as a hedge. Further, Notice 2016-76 does not address the possibility of cascading withholding in transactions involving non-QDDs.

What does Notice 2016-76 mean for Market Participants?

Notice 2016-76 outlines and updates the phased implementation of dividend equivalent withholding. Treasury and the IRS expect to change the section 871(m) regulations in combination with Notice 2016-76. The key developments in Notice 2016-76 are the following:

QDD Provisions

Notice 2016-76 introduced several important developments for QDDs. We summarize these developments as follows.

(a) Effective Dates of QI Agreement and QDD Status

Under the terms of the updated QI agreement, there is a three-month window in which to apply for a QI agreement effective for the entire calendar year. Therefore, if a prospective QDD applies for QI status on or before 31 March 2017, and the IRS accepts that status, then the QDD status will be effective as of 1 January 2017. Later QI applications can still be effective as of 1 January, but only for QDDs that did not receive any reportable payments prior to the QI application being submitted. Prospective QDDs waiting on approval of their application have a grace period during which they can represent that they are QDDs.

(b) Calculation of "Section 871(m) Amount" and "Net Delta" for QDDs

Notice 2016-76 introduced an important change to how a QDD calculates its residual tax liability under section 871(m). Contrary to past guidance, the Notice provides that a QDD will be liable for tax and subject to withholding on actual dividends it receives on physical positions. Instead of an exemption from these taxes, to determine its total 871(m) tax liability, the QDD will calculate its "section 871(m) amount" based on its "net delta" exposure to a given underlying security multiplied by the relevant dividend amount per share. The net delta exposure requires aggregating the delta of all physical positions and potential section 871(m) transactions with respect to an underlying security entered into by a QDD in its equity derivatives dealer capacity. The QDD may offset any taxes it has already paid against associated section 871(m) tax liabilities.

(c) 2017 is a QDD Phase-in Year

2017 will be a phase-in year for QDD compliance. Because 2017 is a phase-in year, the IRS will take into account whether a QDD made a good-faith effort to comply with the relevant provisions of the QI agreement for 2017 when enforcing and administering the QDD rules for 2017.

"Good-faith" Compliance, Grandfathering for Delta One Transactions in 2017, Other Transactions in 2018

Section 871(m) dividend equivalent withholding will generally apply to relevant payments made on or after 1 January 2017 for delta one section 871(m) transactions issued on or after that date. However, 2017 is a phase-in year for delta one transactions, during which the IRS will take into account whether a withholding agent made a good-faith effort to comply with the section 871(m) regulations when enforcing section 871(m) for delta one transactions.

Further, Treasury and the IRS intend to revise the section 871(m) regulations to reflect a deferred implementation date for non-delta one transactions. No withholding is required on non-delta one transactions issued prior to 2018, which will be a phase-in year for such transactions. As a phase-in year, the IRS will take into account whether a withholding agent made a good-faith effort to comply with the section 871(m) regulations non-delta one transactions.

To benefit from the phase-in year relief, withholding agents and taxpayers must demonstrate good-faith efforts to comply with section 871(m) obligations. The IRS will take into account efforts such as (i) building or updating documentation and withholding systems to comply with section 871(m), (ii) determining whether transactions are combined (under the simplified standard discussed below), (iii) reporting required information to transaction parties, and (iv) implementing the substantial equivalence test for complex contracts.

Simplified Combination Rule for 2017

Under the simplified combination rule of Notice 2016-76, in 2017, a withholding agent will only be required to combine transactions when the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Transactions that are entered into in 2017 that are not combined under this simplified standard will not become combined transactions as a result of applying the broader combined transaction rule in later years, unless as a result of a reissuance or other event that causes retesting.

ETNs with Delayed Withholding Effective Date

Section 871(m) will not apply to certain exchange-traded notes specifically identified in Notice 2016-76 until 1 January 2020.

Treaty and Crediting Remains Uncertain

Non-US taxpayers are sensitive to the non-US tax treatment of US withholding on dividend equivalents. The United States takes the view that dividend equivalents are subject to the "Dividend" article of an applicable tax treaty.

However, non-US governments have argued that dividend equivalents fall under the "Other Income" article of the treaty. If a dividend equivalent is treated as being governed by the "Other Income" article of the treaty, this treatment would restrict the power of the United States to tax the dividend equivalent absent a treaty override. Moreover, the non-US tax characterization of the dividend equivalent will generally affect the taxpayer's ability to credit the US dividend equivalent withholding tax in the relevant non-US taxing jurisdiction. Without such a credit, the non-US taxpayer may be subject to double taxation with respect to dividend equivalents.

Next Steps

Withholding and reporting systems will need to account for the implementation of section 871(m) and the developments of Notice 2016-76. While the Notice provides valuable phase-in relief for good-faith efforts to comply with the new withholding obligations under the section 817(m) regulations, that relief is available only where the taxpayer is building and updating the relevant systems to comply with section 871(m).

Taxpayers and intermediaries need to review transactions, contracts, and products to identify any contracts that may have section 871(m) withholding obligations. These contracts should be analyzed to determine when such withholding may arise, and required documentation for section 871(m) compliance, and to ensure the contract properly allocates section 871(m) tax risk.

Taxpayers who may be subject to section 871(m) withholding should asses the home country treatment of dividend equivalents along with related treaty relief and credit eligibility.

Prospective QDDs must take action to determine eligibility for QDD status and enter or renew the QI agreement by 31 March 2017, to ensure that they are treated as a QDD effective as of 1 January 2017. Withholding agents should develop operational processes for accepting QDD documentation from account holders while QDDs should provide documentation of QDD status to counterparties.

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