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October 17, 2014

The Honorable John Koskinen  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: Comments on Proposed Regulations Issued Under Section 871(m)

Dear Commissioner Koskinen:

Enclosed please find comments on proposed regulations issued on December 5, 2013 under section 871(m) of the Internal Revenue Code of 1986, as amended (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with your or your staff if that would be helpful.

Sincerely,



Armando Gomez  
Chair, Section of Taxation

Enclosure

cc: Hon. Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury  
Hon. William J. Wilkins, Chief Counsel, Internal Revenue Service  
Robert Stack, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury  
Danielle Rolfes, International Tax Counsel, Department of the Treasury  
Steven Musher, Associate Chief Counsel, Internal Revenue Service

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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION  
COMMENTS ON PROPOSED REGULATIONS  
ISSUED UNDER SECTION 871(m)**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Matthew Stevens of the Committee on U.S. Activities of Foreigners and Tax Treaties and the Committee on Financial Transactions. Substantial contributions were made by Michael Bauer, Jonathan Lebow, Eileen Marshall, Erika Nijenhuis, Menna Eltaki, Special thanks are due to Matt Maggiacomo for cite checking the Comments. The Comments were reviewed by Steven Rosenthal on behalf of the Section’s Committee on Government Submissions, by Lucy Farr, the Section’s Council Director for the Committee on Financial Transactions, and by Peter Blessing, the Section’s Vice-Chair for Government Relations.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 17, 2014

## EXECUTIVE SUMMARY

On December 5, 2013, the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) published a Notice of Proposed Rulemaking in the Federal Register<sup>1</sup> containing revised proposed regulations (the “2013 Proposed Regulations”) that provide guidance under section 871(m) for payments made on or after January 1, 2016.<sup>2</sup> The 2013 Proposed Regulations represent a considerable expansion of the scope of withholding under section 871(m) from the prior proposed regulations published on January 23, 2012 (the “2012 Proposed Regulations”), which themselves substantially expanded the coverage of that section.<sup>3</sup> While we believe that it was not unreasonable for Treasury and the Service to broaden the scope of section 871(m) to include, in general, virtually all “delta one” derivative instruments, we also believe that such broadening imposes an increased responsibility on the part of Treasury to write rules guarding against potential over breadth. As the general scope of section 871(m) is expanded, Treasury should be increasingly careful that specific rules are narrowly tailored to achieve the legislative objectives while allowing financial markets to function efficiently.

There are several transactions that do not pose any potential for tax avoidance and should be excluded from section 871(m). Specifically, we recommend that the corporate acquisition exception of Proposed Regulation section 1.871-15(j)(2) should be expanded by lowering the ownership threshold and changing the notification requirement. Additionally, because the definition of equity linked instrument (“ELI”) has been greatly expanded and withholding tax has been extended to implicit dividend payments, certain equity based compensation could be subject to United States (“U.S.”) withholding tax, even if such compensation does not provide for the pass-through of dividends. Thus, we recommend that the final section 871(m) regulations should confirm that an amount described in section 862(a)(3) is not subject to withholding under section 871(m). In addition, we do not believe due bills (payments made by a seller of stock to the purchaser of the stock pursuant to an agreement to deliver a pending U.S. source dividend after the record date) should be treated as substantially similar payments. Instead, we believe that due bills can be addressed by the anti-abuse rule if they are utilized with a principal purpose of tax avoidance.

While we agree that instruments with sufficiently low deltas do not replicate the ownership of stock to a sufficient degree to fall within the scope of a “tax avoidance transaction,” we respectfully suggest that Treasury and the Service consider increasing the delta threshold of 0.70 when the 2013 Proposed Regulations are finalized. Additionally, the application of the delta-based exception to indices raises difficult issues. First, merely adding deltas of certain transactions to determine whether the delta test is satisfied gives anomalous

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<sup>1</sup> 78 Fed. Reg. 73,128 (Dec. 5, 2013).

<sup>2</sup> References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

<sup>3</sup> 77 Fed. Reg. 3202 (Jan. 23, 2012). The Section’s comments on the 2012 Proposed Regulations, dated May 15, 2012, are available at: <http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/051512Comments.authcheckdam.pdf>.

results in many common situations. We recommend that the final regulations should apply the combination rule by constructing a fraction, the numerator of which consists of the values of both options, and the denominator of which consists of the values of all the shares subject to both options. Second, the rule in the 2012 Proposed Regulations indicates that only transactions with positive deltas are to be included. We recommend that taxpayers be permitted to compute an aggregate delta with respect to their total exposure to each underlying security, and that if that delta, as thus computed, is less than the delta threshold, the position should not be treated as a specified notional principal contract (“NPC”) or specified ELI. Finally, we note that the delta rule prescribed in the 2013 Proposed Regulations does not work well in the case of many structured products, because the rule requires computing the underlying number of shares, which is not always possible. We recommend that in such a circumstance, the taxpayer should be able to bifurcate the ELI so as to isolate the gross long position.

With respect to the definition of qualified index in Proposed Regulation section 1.871-15(k)(2), we believe that, as long as the other requirements are met, the requirement that the index be modified or rebalanced only according to predefined objective rules at set dates for intervals is ambiguous, and may exclude indices that present little to no potential for abuse.

The 2013 Proposed Regulations substantially broaden the scope of section 871(m) by subjecting to withholding tax “implicit dividends.” The implicit dividend rule provides that even if the short party does not agree to pay any dividend related payments to the long party, the long party is presumed to receive the benefit of any dividend paid on the stock and such amount is deemed paid back to the short party. We agree that when there is a tax-motivated investment form coupled with a relative lack of economic substance, it is appropriate under the general anti-avoidance directive in section 871(m) to deem the taxpayer to have received the dividend income. We believe, however, that two types of common transactions do not satisfy either the “tax-motivated form” aspect or the “economic substance” aspect of this paradigm, and that taxpayers who enter into such transactions should not be deemed to receive dividend equivalent payments under section 871(m). Specifically, we recommend that for options with a delta less than 1.0, such options should not be treated as specified ELIs when there is no adjustment for actual dividends. The same can also be said of certain instruments such as structured notes that have a delta of 1.0, but where the delta is reasonably expected to fluctuate substantially over the life of the instrument. We believe that treating an investor in such a structured note as having received the expected dividend and then paid an equal amount to the issuer in exchange for some other unrelated benefit is inconsistent with the Congressional intention underlying section 871(m). With respect to an instrument with a delta of one that is expected to remain 1.0 over the term of the instrument, we believe the implicit dividend rule should apply only if the date on which the stock goes ex-dividend occurs within 60 days after the derivative is entered into by the long party.

Last, but certainly not least, we believe that the anti-abuse rule in the 2013 Proposed Regulations is too broad. In addition, we recommend that the rule specifically provide that a sale of stock on the last day before the ex-dividend date, followed by a purchase at the beginning of the ex-date, is not subject to the anti-abuse rule.

## DISCUSSION

### I. Section 871(m): The Statute

Under section 871(m), a “dividend equivalent” is treated as a dividend from sources within the United States, so that if paid to a foreign person, the dividend equivalent is subject to U.S. withholding tax at a statutory rate of 30% (subject to reduction under an applicable income tax treaty).<sup>4</sup> For purposes of section 871(m), the term dividend equivalent includes any substitute dividend made pursuant to a securities lending or a sale-repurchase (repo) transaction and any payment made pursuant to a “specified notional principal contract,” in each case that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. In addition, the term “dividend equivalent” also includes any other payment determined by the Secretary to be substantially similar to these types of payments.<sup>5</sup>

A “specified notional principal contract,” or specified NPC, is defined to include any NPC if: (i) in connection with entering into the NPC, any long party to the NPC transfers the underlying security to any short party to the NPC (referred to as “crossing in”), (ii) in connection with the termination of the NPC, any short party to the NPC transfers the underlying security to any long party to the NPC (referred to as “crossing out”), (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into the NPC, the underlying security is posted as collateral by any short party to the NPC with any long party to the NPC, or (v) the NPC is identified by the Treasury as a specified NPC.<sup>6</sup> In addition to these enumerated categories of specified NPCs, for payments made after March 18, 2012, section 871(m)(3)(B) provides that any NPC will be a specified NPC unless the Treasury determines that the NPC is of a type that does not have the potential for tax avoidance.

Under prior Temporary Regulations, the application of the statutory categories of specified NPCs was extended through December 31, 2013,<sup>7</sup> and was further extended through December 31, 2015 by Final Regulations released on December 5, 2013.<sup>8</sup> Thus, for payments made before January 1, 2016, the only NPCs that will be specified NPCs are the four enumerated categories set forth in the statute (i.e., where there is crossing in or crossing out, the underlying security is not publicly traded or the underlying security is posted as collateral).

### II. Prior Proposed Regulations

Under the 2012 Proposed Regulations, which would have applied to payments made on or after January 1, 2014, an NPC would have been a specified NPC if it fell into one of seven categories, which came to be referred to as the “seven deadly sins.”<sup>9</sup> In addition, the 2012

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<sup>4</sup> I.R.C. § 871(m)(1).

<sup>5</sup> I.R.C. § 871(m)(2).

<sup>6</sup> I.R.C. § 871(m)(3)(A).

<sup>7</sup> T.D. 9572, 77 Fed. Reg. 3108 (Jan. 23, 2012), *amended by*, Announcement 2012-35, 2012-38 I.R.B. 356.

<sup>8</sup> T.D. 9648, 78 Fed. Reg. 73,709 (Dec. 5, 2013).

<sup>9</sup> Prop. Reg. § 1.871-16(c), 77 Fed. Reg. 3202 (2012). The seven categories are: (1) the long party to the NPC is

Proposed Regulations would have expanded the section 871(m) definition of “dividend equivalent” to include any payment, including the payment of the purchase price or an adjustment to the purchase price, if made pursuant to an ELI that is contingent upon or determined by reference to a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States.<sup>10</sup> The 2012 Proposed Regulations defined an ELI as a financial instrument or combination of financial instruments that referenced one or more underlying securities to determine its value, including a futures contract, forward contract, option, or other contractual arrangement.<sup>11</sup> An ELI that provided for a payment treated as a dividend equivalent would have been treated as an NPC, and therefore could have been a specified NPC, making dividend equivalent payments on the ELI subject to withholding as U.S. source income.<sup>12</sup> Additionally, under the 2012 Proposed Regulations, the term dividend equivalent would not have included any payment made pursuant to a specified NPC or any substantially similar payment if the payment was contingent upon or determined by reference to an estimate of expected (but not yet announced) dividends, and the estimate was not adjusted in any way for the amount of an actual dividend.<sup>13</sup>

Thus, under the 2012 Proposed Regulations, payments on NPCs and ELIs would not be sourced to the United States under section 871(m) unless one of the seven categories applied and the actual amount of dividends on the underlying securities was passed through to the long party. For example, “price only” swaps would not have been covered by section 871(m).

### **III. 2013 Proposed Regulations**

The 2013 Proposed Regulations are proposed to apply to dividend equivalent payments made on or after January 1, 2016. As noted above, Final Regulations released at the same time as the 2013 Proposed Regulations extended the application of the statutory categories of specified NPCs for payments made on or before December 31, 2015.<sup>14</sup> Thus, until January 1,

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“in the market” with respect to the underlying security on the same day or days that the parties price the NPC or on the same day or days that the NPC terminates, (2) the security underlying the NPC is not regularly traded on a national securities exchange or the national market system, (3) the short party to the NPC posts the underlying security with the long party as collateral and the underlying security posted as collateral represents more than 10% of the total fair market value of all the collateral posted by the short party on any date that the NPC is outstanding, (4) the NPC has a term of fewer than 90 days, including the termination date but excluding the date the NPC was entered into, (5) the long party controls contractually or by conduct the short party’s hedge of the short position; or the long party enters into an NPC using an underlying equity control program (as defined therein), (6) the notional principal amount of the underlying security in the NPC is greater than 5% of the total public float of that class of security, or 20% of the 30- day average daily trading volume determined as of the close of the business day immediately preceding the first day in the term of an NPC, and (7) the NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

<sup>10</sup> Prop. Reg. §1.871-15(d)(1)(ii), 77 Fed. Reg. 3205 (2012).

<sup>11</sup> Prop. Reg. §1.871-15(d)(2)(i), 77 Fed. Reg. 3205 (2012).

<sup>12</sup> Prop. Reg. §1.871-15(d)(2)(ii), 77 Fed. Reg. 3205 (2012).

<sup>13</sup> Prop. Reg. §1.871-15(b)(2), 77 Fed. Reg. 3205 (2012).

<sup>14</sup> T.D. 9648, *supra* note 8. The Preamble to the 2013 Proposed Regulations did not specifically explain why those Proposed Regulations were issued in proposed rather than final form, given that one set of proposed regulations had already been issued. It seems reasonable, however, to believe that this was done in conjunction with the withdrawal of the 2012 Proposed Regulations in order to provide the public with an opportunity to comment on the

2016, the only NPCs that will be specified NPCs are the four enumerated categories set forth in the statute (i.e., where there is crossing in or crossing out, the underlying security is not publicly traded or the underlying security is posted as collateral).

The 2013 Proposed Regulations defines a dividend equivalent as any payment pursuant to a securities lending or sale-repurchase transaction, a “specified NPC,” or a “specified ELI”, in each case that references the payment of a dividend from an underlying security, as well as any other substantially similar payment.<sup>15</sup> A payment pursuant to a securities lending or sale-repurchase transaction, a specified NPC, or specified ELI that references a distribution with respect to an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to section 871 or 881, or withholding under Chapter 3 or 4, if the long party owned the underlying security. For example, if a specified NPC references stock in a regulated investment company that pays a capital gains dividend described in section 852(b)(3)(C) that would not be subject to withholding tax if paid directly to the long party, then an NPC payment determined by reference to the capital gains dividend is not a dividend equivalent.<sup>16</sup> A payment pursuant to a securities lending or sale-repurchase transaction, a “specified NPC,” or a “specified ELI” is not a dividend equivalent to the extent that the payment is treated as a distribution taxable as a dividend pursuant to section 305.<sup>17</sup> A dividend equivalent is treated under section 871(m) as a dividend from sources within the United States.<sup>18</sup>

An ELI is defined as a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, which references the value of one or more underlying securities, including a futures contract, forward contract, option, debt instrument, or other contractual arrangement.<sup>19</sup> An underlying security is any interest in an entity taxable as a C corporation if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to Treasury Regulations section 1.861-3.<sup>20</sup> If a potential section 871(m) transaction references an interest in more than one C corporation (including a reference to an index that is not a qualified index, as defined below) or different interests in the same entity, each referenced interest is treated as a separate underlying security.

With respect to payments made on or after January 1, 2016, a “specified NPC” is any NPC that has a delta of 0.70 or greater with respect to an underlying security at the time the long party acquires the NPC.<sup>21</sup> For this purpose, delta is the ratio of the change in the fair market value of an NPC or ELI to the change in the fair market value of the property referenced by the

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approach taken, especially in view of the substantial expansion of the scope of section 871(m) that the 2013 Proposed Regulations would effect.

<sup>15</sup> Prop. Reg. §1.871-15(c)(1), 78 Fed. Reg. 73,137 (2013).

<sup>16</sup> Prop. Reg. §1.871-15(c)(2)(i), 78 Fed. Reg. 73,137 (2013).

<sup>17</sup> Prop. Reg. §1.871-15(c)(2)(ii), 78 Fed. Reg. 73,137 (2013).

<sup>18</sup> Prop. Reg. §1.871-15(b), 78 Fed. Reg. 73,132 (2013).

<sup>19</sup> Prop. Reg. §1.871-15(a)(4), 78 Fed. Reg. 73,137 (2013).

<sup>20</sup> Prop. Reg. §1.871-15(a)(11), 78 Fed. Reg. 73,137 (2013).

<sup>21</sup> Prop. Reg. §1.871-15(d)(2), 78 Fed. Reg. 73,133 (2013).

NPC or ELI.<sup>22</sup> With respect to payments made on or after January 1, 2016, a “specified ELI” is any ELI acquired by the long party on or after the date that is 90 days after the date on which the 2013 Proposed Regulations are finalized<sup>23</sup> that has a delta of 0.70 or greater with respect to an underlying security at the time the long party acquires the ELI.<sup>24</sup> The delta of an NPC or ELI must be determined in a commercially reasonable manner, and if a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of the 2013 Proposed Regulations.<sup>25</sup> If an NPC or ELI references more than one underlying security, the NPC or ELI is a specified NPC or specified ELI only with respect to underlying securities for which the NPC or ELI has a delta of 0.70 or greater at the time the long party acquires the NPC or ELI.<sup>26</sup> If, at the time an NPC or ELI is acquired by the long party, it has a delta that is not reasonably expected to vary during the term of the transaction with respect to that underlying security (a constant delta), the NPC or ELI is treated as having a delta of 1.00.<sup>27</sup> If a transaction would not have a delta of 1.00 with respect to an underlying security in the absence of the constant delta rule, the number of shares of the underlying security of an NPC or ELI is adjusted. The purpose of this rule is to cover a transaction that reduces delta but retains the economics of a fixed amount of shares. For example, a swap that requires the long party to pay the short party half of the depreciation in the value of two shares of Corporation X stock and an interest rate based return, and requires the short party to pay the long party half of the appreciation in the value of and half dividends on two shares of Corporation X stock, is an NPC with a delta of approximately 0.50, but has a delta of approximately 1.00 with respect to one share of Corporation X stock.

The 2013 Proposed Regulations substantially broaden the scope of section 871(m) by subjecting to withholding tax “implicit dividends.” Thus, the 2013 Proposed Regulations provide that:

[a] payment includes an actual or estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction, including interest rate, notional amount, purchase price, premium, upfront payment, strike price, or any other amount paid or received pursuant to the potential section 871(m) transaction.<sup>28</sup>

Moreover, the 2013 Proposed Regulations further provide that:

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<sup>22</sup> Prop. Reg. §1.871-15(g)(1), 78 Fed. Reg. 73,133 (2013).

<sup>23</sup> This date was initially set as March 5, 2014 (*i.e.*, 90 days after the date the 2013 Proposed Regulations were published in the Federal Register), but was extended to the date set forth in the text by Notice 2014-14, 2014-13 I.R.B. 881.

<sup>24</sup> Prop. Reg. §1.871-15(e), 78 Fed. Reg. 73,137 (2013).

<sup>25</sup> Prop. Reg. §1.871-15(g)(1), 78 Fed. Reg. 71,138 (2013).

<sup>26</sup> Prop. Reg. §§1.871-15(d)(2) (last sentence), -(d)(3) (last sentence), 78 Fed. Reg. 71,137 (2013).

<sup>27</sup> Prop. Reg. §1.871-15(g)(2), 78 Fed. Reg. 71,138 (2013).

<sup>28</sup> Prop. Reg. §1.871-15(h)(2)(ii), 78 Fed. Reg. 71,138 (2013).

a section 871(m) transaction is treated as paying a per share dividend amount equal to the actual dividend amount unless the short party to the section 871(m) transaction identifies a reasonable estimated dividend amount in writing at the inception of the transaction. For this purpose, a reasonable estimated dividend amount stated in an offering document or the documents governing the terms of the transaction will establish the estimated dividend amount in writing at the inception of the transaction. To qualify as an estimated dividend amount, the written estimated dividend amount must separately state the amount estimated for each anticipated dividend or state a formula that allows each dividend to be determined. If a stock is not expected to pay a dividend, a reasonable estimate of the dividend amount may be zero.<sup>29</sup>

While the rules are not entirely clear, it appears that the long party is irrebutably presumed to receive the benefit of any dividend paid on the stock, and any such amount is then deemed paid back to the short party (e.g., in the form of a lower financing charge on a swap).

#### **IV. Detailed Comments on the 2013 Proposed Regulations**

The 2012 Proposed Regulations would have significantly expanded the scope of withholding under section 871(m), and the 2013 Proposed Regulations would represent an even more considerable expansion. The statute itself focuses on securities loans, repos and U.S. equity swaps possessing narrowly-defined tax avoidance factors, although all equity swaps would be covered after March 18, 2012, unless Treasury excluded some of them. The 2012 Proposed Regulations broadened the scope of coverage to both NPCs and ELIs, and expanded the list of tax avoidance factors, but essentially retained the same approach. In large part because of the difficulties inherent in crafting regulations that would reach only (and all) abusive tax avoidance transactions, the 2012 Proposed Regulations were roundly criticized as unadministrable. The extension of withholding tax to all “delta one” equity derivatives over dividend-paying U.S. corporate equities (unless specific exceptions apply) raises a number of policy and technical issues. In particular, was it appropriate for Treasury and the Service to expand the universe of contracts covered by section 871(m) not only to all notional principal contracts, but also to all other “delta one” equity derivatives (again, unless a specific exception applies)?

##### **A. Scope of the Proposed Regulations**

In drafting regulations under any Code provision, the initial question generally must be whether a particular set of regulations will carry out the intention of Congress as manifested in the text of the statute. In days past, this process was frequently limited to expanding upon the meaning of specific statutory terms, and Treasury was not called upon to make (and the Treasury generally did not make) its own decisions on fundamental tax policy issues. As time went on, both tax legislation and taxpayer business and investment activity generally became more

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<sup>29</sup> Prop. Reg. §1.871-15(h)(2)(iii), 78 Fed. Reg. 71,138 (2013).

specialized, and Congress began to delegate broader and broader grants of authority to the Treasury to write regulations that carried out policies that were only vaguely identified in the governing statute.<sup>30</sup>

Even given this trend, however, the enactment of section 871(m) reflects an unusually broad grant of authority to Treasury to determine the appropriate tax policy underlying a particular Code section. As noted above, Congress determined that, for payments made after March 18, 2012 on any notional principal contract referencing U.S. equities, U.S. withholding tax would apply unless the Treasury determined that such transactions did not constitute tax avoidance transactions. Similarly, Treasury was given the power to extend U.S. source treatment, and therefore U.S. withholding tax, over “substantially similar payments.” Taking the first part of this two-part instruction first, it appears reasonable to believe that Congress may have believed that all notional principal contracts over U.S. corporate equity should produce U.S. source FDAP, unless Treasury could come up with a good policy justification for excluding such amounts. In one sense, any notional principal contract over a U.S. dividend paying equity could be viewed as facilitating tax avoidance, because, if such a contract were exempted from section 871(m), the taxpayer would pay less U.S. federal income tax than it would pay if it held the underlying stock. Under this reading of section 871(m)(3)(B), then, it appears reasonable to broaden the scope of specified NPCs to cover every NPC.

Conversely, one might also argue that Congress did not intend the term “tax avoidance” to be taken as meaning “any transaction that resulted in a taxpayer’s paying less U.S. federal income tax than it would have paid for an economically similar alternative transaction.” Instead, one might argue that if Congress had intended Treasury to cover all derivative transactions over U.S. equities, Congress would simply have said so, and that by using the phrase “tax avoidance,” Congress intended Treasury to write regulations that excluded transactions from specified NPC treatment based on specific indicia of tax avoidance, difficult though it might be for reasonable people to agree upon such indicia, given the variation in facts that inevitably arises in real world transactions. Phrased differently, under this view, an NPC would be viewed as a tax avoidance transaction if, and only if, it possessed significant indicia that the taxpayer would simply have held the physical stock absent the (hypothetical) withholding tax benefit that an exemption for derivatives would have conveyed. This appears to have been the philosophy that underlay the prior proposed regulations.

While this argument seems to comport reasonably well with the legislative history, and certainly with the Senate Permanent Subcommittee on Investigation’s Report in 2008 (which focused heavily on various indicia of perceived tax abuse), as noted above, there was much criticism of the specific indicia that Treasury and the Service believed signified tax avoidance. Despite Treasury’s best efforts, which we understand included formal and informal discussions with many interested members of the public, Treasury and the Service appear to have concluded that it was impracticable (if not impossible) to draft a set of objective rules that were both

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<sup>30</sup> See, e.g., I.R.C. § 1275(d) (granting Treasury authority to “prescribe regulations providing that where, by reason of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the tax treatment under this subpart (or section 163(e)) does not carry out the purposes of this subpart (or section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or section 163(e))”).

sensitive to, and specific for, tax avoidance under the narrow definition.<sup>31</sup> The number of possible different fact patterns is simply too great.

On balance, then, taking into account the apparent presumption of Congress that all NPCs were to be subject to U.S. withholding tax on payments made after March 18, 2012, and also taking into account the considerable burden that a more targeted set of rules would have placed on the Service, taxpayers, and practitioners, we think it was reasonable for Treasury to adopt a policy that all NPCs were to be specified after the effective date of the 2013 Proposed Regulations.

The decision to include within the scope of section 871(m) all equity derivatives generally, not just notional principal contracts, requires additional analysis. The statutory language dealing with NPCs is very different than the statutory language Treasury relied upon to support the extension of withholding tax to specified ELIs. In the case of an NPC, as mentioned above, if Treasury had done nothing, all dividend equivalent payments on an NPC would be subject to U.S. withholding tax after March 18, 2012. By contrast, covering the dividend related payments on ELIs required affirmative action on the part of Treasury, because it had to use its legislative regulation authority to define such amounts as “substantially similar” to the payments on the NPCs. As a technical matter, therefore, the argument that Congress intended dividend related payments made on ELIs to be subject to U.S. withholding tax is weaker than the argument that Congress intended such payments made under NPCs to be so treated. In our view, however, once Treasury had decided to cover all NPCs, it becomes difficult to justify from a policy perspective why payments made under ELIs should, as a general matter, be excluded. That is, there would not appear to be any policy rationale for distinguishing between a one year total return swap, on the one hand, and a one year fixed price forward contract, on the other.

Moreover, the definition of a “dividend equivalent” payment included any payment “determined by the Secretary to be substantially similar to a payment” made pursuant to a sale-repurchase or a securities lending transaction or a specified notional principal contract. Thus, we conclude that Treasury’s decision to extend withholding tax from NPCs to futures, forward contracts, and other non-NPC contracts that nevertheless provide 100% of the gains and 100% of the losses with respect to a fixed number of shares was, on balance, within the realm of permissible choices available to Treasury, and that it was not unreasonable to do so.

Having concluded that it was not unreasonable for Treasury and the Service to broaden the scope of section 871(m) to include, in general, virtually all “delta one” derivative instruments, we believe that such broadening also imposes an increased responsibility on the part of Treasury to write rules guarding against potential over breadth. That is, as the scope of section 871(m) is expanded further and further from the core Congressional concerns, Treasury should be increasingly careful that the more specific rules (e.g., the ones dealing with combinations of transactions and implicit dividends) are narrowly tailored (even at the cost of some increased complexity) to prevent overreaching. Otherwise, the rules will run a high risk of

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<sup>31</sup> Here, we are appropriating two medical terms relating to accuracy of medical tests. In that field, a test is said to be “sensitive” to a medical condition to the extent it avoids false negatives. A test is said to be “specific” to the condition to the extent it avoids false positives. The relevant “condition” is tax avoidance, as such term is used in section 871(m)(3)(B).

imposing withholding taxes on transactions that present very little potential for abuse, and about which Congress evinced little if any concern. We will provide specific examples of this principle where it applies.

## **B. Exceptions for Certain Categories of “Delta One” Instruments**

Notwithstanding our general conclusion that it was not inappropriate for Treasury and the Service to broaden the scope of section 871(m) to cover virtually all “delta one” derivative instruments, there are, of course, transactions that replicate the leveraged ownership of a fixed number of shares that nevertheless do not pose any potential for tax avoidance and that should be excluded from section 871(m).

### **1. Long Party Takes Physical Delivery of All of the Stock of a U.S. Target Corporation<sup>32</sup>**

While we appreciate that the Treasury and the Service incorporated our concern (as reflected in our comments on the 2012 Proposed Regulations) into the 2013 Proposed Regulations in the form of the exception contained in Proposed Regulation section 1.871-15(j)(2), we have some remaining concerns regarding the narrowness of the scope of that exception. It provides that a potential section 871(m) transaction is not a section 871(m) transaction with respect to an underlying security if the transaction obligates the long party to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the long party) are obligated to acquire underlying securities representing more than 50 percent of the value of the entity issuing the underlying securities. To qualify for the exception provided in this paragraph, the long party must furnish a written certification, provided under penalties of perjury, to the short party that it satisfies the requirements set forth above.

We believe the provision should be expanded in two respects. First, the 50% threshold is too high, and should be lowered to apply to any person who is contractually obligated to acquire, and who actually does acquire, a 10% interest in the entity issuing the underlying securities.<sup>33</sup> This 10% threshold is high enough to eliminate the vast majority of those who are attempting to obtain exposure to a mere portfolio stake in the issuer, and therefore will only include those who intend to purchase the stock of the target and, in all likelihood, hold it for a substantial period of time (e.g. one year). They are therefore likely to receive, and (as applicable) pay withholding tax on, dividends paid on the underlying stock. Second, the notification requirement, as currently drafted, requires the long party to certify to the short party that it satisfies the

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<sup>32</sup> Such a transaction was discussed in our comments on the 2012 Proposed Regulations, *supra* note 3.

<sup>33</sup> Some may contend that, even if the contract provides for physical settlement, the parties could simply agree to cash settle the contract, and such cash settlement would effectively replicate the economics of a physical settlement. This may be true in the case of a physical position that is relatively small, and therefore highly liquid, because the short party can simply sell the stock on the market for a price that is reasonably close to the price that the long party would have paid under the contract. In the case of a position that reflects 10% or more of the equity of the issuer, however, a short party who must sell the stock on the market is likely to take a substantial loss, for which the long party is then liable. Thus, the long party has an economic incentive not to breach its obligation to accept physical delivery of the shares, and could not depend upon the short party to waive its right under the contract to receive the full purchase price.

requirements of the exception. While it may be appropriate for the regulations to require the short party to withhold unless such certification is provided, we see no reason why the long party's substantive entitlement to this exemption should be conditioned on the provision of this certification. That is, if the long party meets the substantive requirements set forth in the previous paragraph, but does not certify to the short party that it has met such requirements, then the short party should withhold tax on the buyer and the buyer should be entitled to a refund of such tax upon the filing of a refund claim with the Service.<sup>34</sup>

## 2. Equity-Based Compensation

In our comments on the 2012 Proposed Regulations, we pointed out that the definition of "equity linked instrument" was broad enough potentially to cover various types of equity-based executive compensation, such as phantom stock plans. The 2012 Proposed Regulations defined an equity-linked instrument "as a financial instrument or combination of financial instruments that references one or more underlying securities to determine its value, including a futures contract, forward contract, option, or other contractual arrangement."<sup>35</sup> That is, if a foreign national were employed by the foreign subsidiary of a U.S. multinational corporation, and were granted the right to participate in the U.S. parent's phantom stock plan, and such plan were viewed as an "equity linked instrument" and possessed one of the seven factors, the foreign national could be subject to U.S. tax on his receipt of the phantom dividend paid to him under the plan relating to a dividend paid on the parent's stock. Such a result would appear to be inconsistent with section 862(a)(3), which treats compensation for the performance of services outside the United States as foreign source income.

The 2013 Proposed Regulations not only did not cure this potential concern, they appear to have increased the number of circumstances in which this concern arises, by greatly expanding the definition of an "equity linked instrument," and by extending withholding tax to implicit dividend payments, as discussed further below. Thus, an executive compensation plan need not possess any of the seven factors in order to be subject to withholding tax under the 2013 Proposed Regulations; it simply needs to be a "financial transaction" that refers to the stock of a U.S. issuer. Additionally, the executive compensation plan need not entitle the employee to dividend pass-through payments; the withholding tax generally applies if the underlying stock pays a dividend. In addition to a phantom stock plan, stock appreciation rights, nonqualified stock options, and restricted stock could produce payments subject to U.S. withholding tax, even if such plans did not provide for the pass-through of dividends to their participants. Because this

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<sup>34</sup> This comment also applies to the similar certification requirement for qualified dealers. Under the "qualified dealer" exception, a potential section 871(m) transaction is not a section 871(m) transaction if the transaction is entered into by a "qualified dealer" in its capacity as a dealer in securities and the dealer is the long party with respect to the underlying security. For this purpose, a qualified dealer is any dealer that: (A) is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized; and (B) furnishes a written certification to the short party confirming that the dealer is a qualified dealer acting in its capacity as a dealer in securities and that the dealer will withhold and deposit any tax imposed by section 871(m) with respect to any section 871(m) transactions that the dealer enters into as a short party in its capacity as a dealer in securities. Here again, it is only the withholding tax, not the substantive tax liability, that should depend upon the provision of a certification that the dealer will satisfy the withholding requirements.

<sup>35</sup> Prop. Reg. § 1.871-15(a)(4), 77 Fed. Reg. 3205 (2012).

result was not contemplated by Congress in enacting section 871(m), and because it contradicts the policies underlying section 862(a)(3), the final section 871(m) regulations should confirm that an amount described in section 862(a)(3) is not subject to withholding under section 871(m) since it does not arise from a financial transaction.

### 3. Due Bills

Proposed Regulation section 1.871-15(f) provides that a gross-up amount paid by a short party in satisfaction of the long party's tax liability with respect to a dividend equivalent is a dividend equivalent received by the long party. Treasury and the Service requested comments regarding whether other payments should be treated as substantially similar payments, such as a payment made by a seller of stock to the purchaser of the stock pursuant to an agreement to deliver a pending U.S. source dividend after the record date (e.g., a due bill). Although the payment under a due bill would appear to fall within the scope of a dividend equivalent, it is unclear to us whether the frequency of due bills with respect to publicly traded equities may mean that treating them as dividend equivalents would impede the orderly functioning of the capital markets. If that is found to be the case, due bills could be addressed by the anti-abuse rule if they are utilized with a principal purpose of tax avoidance.

#### **C. Exceptions for Non-“Delta One” Instruments**

The major exception to the application of U.S. withholding tax rules to all equity derivatives over U.S. stocks is the exception for NPCs and ELIs with deltas that are less than 0.70. We agree with the view of Treasury and the Service that instruments with sufficiently low deltas do not replicate the ownership of stock to a sufficient degree to fall within the scope of a “tax avoidance transaction” even under the broad definition of such term that appears to have been adopted by Treasury. We also agree that instruments with deltas that are sufficiently close to one generally do replicate such ownership (at least where the derivative explicitly passes through dividend payments to the long party). While as tax lawyers we lack the theoretical understanding and the practical knowledge to evaluate definitively whether, and under what circumstances, a delta threshold of 0.70 is appropriate, it does appear to us that a delta of 0.70 will frequently not appear to replicate direct ownership of the underlying shares, at least as that concept is generally understood.<sup>36</sup> Thus, while we do not comment specifically on what the delta threshold should be, a threshold of 0.70 strikes us as rather low, and we respectfully suggest that Treasury and the Service may wish to raise that threshold when the 2013 Proposed Regulations are finalized. For the remainder of this Report, we refer to whatever threshold is ultimately selected as the “Delta Threshold.” Moreover, we do have some comments on the application of the delta-based exception to indices, the Combination Rule (as hereinafter defined), and to certain structured products.

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<sup>36</sup> Thus, for example, we do not believe that most investors would view a 30 day call option that was 5% in the money (e.g., a strike price of \$100 at a time when the stock was worth \$105) as being the substantial equivalent of a direct investment in the underlying stock. Yet according to one online Black-Scholes calculator, if the stock underlying such an option has a volatility of 15%, the option will have a delta of approximately 0.89, and would clearly be subject to withholding tax under the 2013 Proposed Regulations. See Montgomery Invest. Tech., Inc., *Black-Scholes*, <http://www.fintools.com/resources/online-calculators/options-calcs/options-calculator> (last visited August 29, 2014).

## 1. Application of the Delta Test to Indices

We note first that, for broad-based indices that are not qualified indices (e.g., because no futures based on such indices are traded), the delta test raises difficult issues. Under the 2013 Proposed Regulations, if an ELI references more than one underlying security, the ELI is a specified ELI only with respect to underlying securities for which the ELI has a delta that exceeds the Delta Threshold at the time that the long party acquires the ELI. Suppose that a taxpayer purchased a call option on a non-qualifying stock index with 100 separate underlying stocks. Thus, the option is written on the index itself, and not on each of the individual underlying securities. In order to apply the rule set forth in the 2013 Proposed Regulations, it appears that one would need to compute the delta of the option with respect to each of the individual underlying stocks, and then add those deltas together to see if such aggregate delta exceeded the Delta Threshold. Each individual delta would be computed as the fraction where the numerator is the change in the value of the index, and the denominator is a small change in the value of each underlying stock. This process will not necessarily produce sensible answers, because the aggregation process will involve the adding together of many deltas without regard to the relative size of each of the positions in a stock index with 100 underlying stocks. More fundamentally, where the option is based on the relationship between a fixed value (e.g., the strike price) and the value of the index taken as a whole, it is not clear to us that it is economically meaningful to refer to the ELI's having a delta with respect to each individual security. If the payout of the ELI is based on the relationship of an index to a strike price, it seems more reasonable to us to compute the delta with respect to the ELI, taken as a whole (i.e., by determining the percentage increase in the value of the ELI given a small percentage increase in the value of the index).

## 2. Combination Rule

The 2013 Proposed Regulations contain a rule requiring the combination of certain transactions in determining whether the delta test is satisfied (the "Combination Rule"). Thus, the rule provides that, for purposes of determining whether a potential section 871(m) transaction is a section 871(m) transaction, two or more potential section 871(m) transactions are treated as a single transaction with respect to an underlying security when: (i) a person (or a related person within the meaning of section 267(b) or 707(b)) is the long party with respect to the underlying security for each potential section 871(m) transaction; (ii) the potential section 871(m) transactions reference the same underlying security; and (iii) the potential section 871(m) transactions are entered into in connection with each other (regardless of whether the transactions are entered into simultaneously or with the same counterparty). The combined transactions are tested each time the long party (or a related person) acquires a potential section 871(m) transaction that meets these requirements. The deltas used to determine whether the combined transactions are section 871(m) transactions pursuant to the Combination Rule are the deltas of each of the combined transactions at that time. Once it is determined that a potential section 871(m) transaction is a section 871(m) transaction, either by itself or as a result of a combination, it does not cease to be a section 871(m) transaction as a result of applying the Combination Rule. That is, the Combination Rule can only subject transactions to withholding tax; it cannot be used by a taxpayer to exclude a transaction from tax. Potential section 871(m) transactions that are combined for purposes of determining whether there is a section 871(m) transaction with respect to an underlying security are treated as separate transactions for all other

purposes of section 871(m), including separately determining the amount of a dividend equivalent with respect to each transaction.

Adding the deltas of the two potential ELIs gives sensible results where the two ELIs are a put and a call option. However, the 2013 Proposed Regulations do not indicate how the combination rule is to be applied where both of the ELIs are call options. Simply adding the deltas could produce anomalous results in many common situations. For example, suppose a taxpayer purchases a call option on 100 shares of stock with a delta of 0.6, and, in connection with such purchase, purchases a second call option with a delta of 0.6 on 100 shares of the same stock. Because the 2013 Proposed Regulations would not impose withholding tax on the options had the taxpayer simply entered into a single option over 200 shares with a delta of 0.6, the drafters presumably did not intend for the Combination Rule to impose tax on the two options have this result (assuming the Delta Threshold is 0.70). This result could be avoided by eliminating the sentence in the 2013 Proposed Regulations that “[t]he deltas used to determine whether the combined transactions are section 871(m) transactions pursuant to the Combination Rule are the deltas of each of the combined transactions at that time.” Instead, the regulations should apply on a combined basis the general rule for computing delta. That general rule provides that “[d]elta is the ratio of the change in the fair market value of an NPC or ELI to the change in the fair market value of the property referenced by the NPC or ELI.” In the case of a combination transaction, one would apply the combination rule by constructing a fraction, the numerator of which consists of the values of both options, and the denominator of which consists of the values of all of the shares subject to both options. For example, if a taxpayer owned an option over 100 shares of stock with a delta of 0.6, and then purchased another option over 100 additional shares of stock also with a delta of 0.6, the denominator of the fraction used for determining delta would hypothetically be assumed to increase by an amount equal to \$.01 multiplied by the total number of shares subject to both options (200) for a total of \$2.00. The numerator would then increase by the sum of (A) the delta of the first option (0.6) applied to a \$.01 increase for 100 shares, for an increase of \$.60 and (B) the delta of the second option (0.6) applied to a \$.01 increase for 100 shares, for an increase of \$.60. The numerator of the fraction, then, is the sum of these two increases, which is \$1.20. Dividing \$1.20 by the denominator of the fraction, \$2.00, yields a delta of 0.6, which is appropriate.

The rule in the 2013 Proposed Regulations indicates that only transactions with positive delta are to be included, not transactions involving negative deltas, such as short call options and long puts. We believe that, for both technical and policy reasons, this rule should be changed. From a policy perspective, the Congressional charge to the Treasury and the Service was to identify transactions that did not have the potential for tax avoidance. As noted above, we agree with the view of Treasury and the Service that transactions with a delta of less than the Delta Threshold likely do not facilitate tax avoidance, because such transactions are quite dissimilar to the total return swap transactions that prompted the enactment of section 871(m). We believe, however, that it is inappropriate, in determining whether a transaction has a sufficiently high delta to approximate share ownership, to take into account only transactions that increase the delta of a taxpayer’s aggregate position, but not those transactions that decrease it. Accordingly, we recommend that taxpayers be permitted to compute an aggregate delta with respect to their total exposure to each underlying security, and that if that delta, as thus computed, is less than the Delta Threshold, that position should not be treated as a specified NPC or a specified ELI.

To see this point, consider an investor that is engaged in convertible bond arbitrage transactions. Such an investor frequently buys convertible bonds, not because it wishes to profit if the price of the underlying stock rises, but because it wishes to profit from substantial downside moves in the price of the stock. In order to accomplish this, the convertible investor generally delta hedges the convertible bond position. Thus, if the convertible bond has a delta of 0.9, the investor will sell short .9 shares of stock for every share of stock into which the bond is convertible. Such an investor then hopes to profit from a large downward move in the price of the underlying.<sup>37</sup> Critically, the purchase of the convertible bond is not in any sense a substitute for simply purchasing shares of the underlying stock; such shares could not be put to the company in the same way that a convertible bond is. As noted above, though, the extension of the definition of ELIs to non-“delta one” instruments is justifiable as a tax policy matter only if the instrument is effectively a proxy for direct investment in the underlying stock. It is, therefore, inappropriate to subject to dividend withholding tax on the convertible bond in this case.

Allowing taxpayers as well as the Service to use the Combination Rule is necessary to treat similarly situated parties alike. Consider, for, example, a taxpayer who buys a call with a delta of 0.8, and sells a separate call with a delta of -0.2. Under the 2013 Proposed Regulations, such a taxpayer would have entered into a specified ELI (i.e., the long call option), and would be subject to tax on any dividend payments that were made or deemed made on the underlying security. However, it is also reasonably clear (although an example would be useful) that if the taxpayer instead had bought a capped call option that had identical economics but constituted a single instrument, such an instrument would have a delta of 0.6, and would not be a specified ELI.<sup>38</sup> There is no policy rationale for treating similarly situated taxpayers so dissimilarly.

We understand that there is a need for withholding agents to know whether a transaction is “withholdable” (i.e., has a delta that exceeds the Delta Threshold). We think this problem could be solved by adopting a certification approach. Under this approach, the “separate transaction” method currently embodied in the 2013 Proposed Regulations would apply, and withholding generally would therefore be required on any specified ELI or NPC with a delta that exceeds the Delta Threshold. However, a long party would be permitted to certify to a short party (presumably as a part of the Form W-8BEN otherwise provided to the short party), that the long party had entered into a delta reducing transaction separate from the transaction with respect to which the certification was given, and that such delta reducing transaction reduced the delta of the taxpayer’s aggregate exposure to that particular underlying stock below the Delta Threshold. If this statement were given, the short party would be able to rely upon it and not treat any dividend related payments (whether actual or implicit) as dividend equivalent payments within the meaning of section 871(m).

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<sup>37</sup> Such a strategy is different than merely shorting the stock. While shorting the stock would enable the investor to profit if the share price declined, it would also leave him exposed to substantial loss if the share price rose. By contrast, the investor in the convertible arbitrage strategy described in the text will incur relatively minimal costs if the share price increases or remains high, and the bond is ultimately converted into stock.

<sup>38</sup> Prop. Reg. § 1.871-15(g)(1), 78 Fed. Reg. 73,133 (2013) (second sentence) (“[i]f an NPC or ELI contains more than one reference to a single underlying security, all references to that underlying security are taken into account in determining the delta with respect to that underlying security”).

Of course, the argument can be made that the distinction between the one- and two-transaction scenarios set forth above is merely an extension of the rough justice approach inherent in the gross basis taxation scheme of section 871 itself. That is, a taxpayer who held a long physical position in 100 shares of company X, and then shorted 100 shares of stock in company X, would still suffer U.S. withholding tax on those dividends, notwithstanding that it was economically neutral regarding the stock. While this is indisputably true, the section 871(m) regulations depart substantially from the general section 871 paradigm in other ways, for example, by imputing a dividend payment to a long party who does not actually receive a dividend and who has no economic exposure to whether a dividend is paid. And other aspects of the 2013 Proposed Regulations are appropriately tailored to ensure that a taxpayer is not subject to tax on a larger amount of dividend equivalent than the taxpayer would have suffered had it actually owned the shares underlying the specified ELI or specified NPC. We think the Combination Rule should be so tailored, as well.

Adopting a rule that allows taxpayers to integrate all transactions with the same underlying security will also avoid technical issues that arise where more than two option positions are entered into. (For purposes of the following analysis, we assume that all of the following option positions relate to the same underlying security, and are entered into “in connection with” each other, so that the pre-conditions for the application of the Combination Rule are satisfied.) Consider a taxpayer who purchases an out of the money call option on 100 shares of stock at a time when the delta of the option was 0.35, and later purchases a call option on 100 shares of the same stock that has a delta of 0.70 at a time when the delta of the first option remains 0.35 (again assuming the selected Delta Threshold is 0.70). Under the rule set forth in the 2013 Proposed Regulations, the first option would not be subject to withholding, because its delta was less than 0.70 when entered into and because the combined delta of the two options together is less than 0.70. However, the second option by itself would be subject to withholding, because its delta is 0.70.

Now suppose the taxpayer sells a put option on 100 shares, which has a stand-alone delta of 0.30. The put option would not be subject to withholding tax on a stand-alone basis, because its delta is below 0.70. Under the Combination Rule, however, one tests each potential section 871(m) transaction, based on its delta as of the time entered into. It is not clear, however, how the put in this example is supposed to be matched up. If matched against the first call, the aggregate delta is only 0.65, and so the first call would not a section 871(m) transaction. If matched against the second call, the combination would be a specified ELI. Is the taxpayer required to treat the combination of the short put and the second call as a specified ELI? The 2013 Proposed Regulations appear to suggest (perhaps because of the anti-avoidance character of the regulations) that the most taxpayer-unfavorable stacking rule be adopted.<sup>39</sup> We believe, however, that in determining whether a taxpayer is intending to use combinations of options to approach the economic equivalent of direct ownership of the underlying, the taxpayer is entitled to have its transactions evaluated as a unified whole.

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<sup>39</sup> Cf. I.R.C. § 1092 (requiring the deferral of losses sustained on the disposition of a position if there is any unrecognized gain in an offsetting position, even if gains are simultaneously triggered on other offsetting position, and even if there are unrecognized losses in still other offsetting provisions).

### 3. Structured Products

The delta rule prescribed in the 2013 Proposed Regulations does not work well in the case of many structured products, because that rule requires computing the underlying number of shares, which is not always possible. There are two reasons why the number of shares must be able to be determined. First, under the 2013 Proposed Regulations, the computation of delta requires knowing how much the shares underlying a non-qualified ELI will move in comparison to the change in value of the ELI itself. Second, the computation of the amount of withholding tax to be paid involves multiplying the number of underlying shares by the delta of the ELI by the per share dividend. Thus, the concept of an underlying number of shares is crucial to the application of the 2013 Proposed Regulations.

In the case of some structured products, however, is difficult to determine that a particular number of underlying shares exists. Consider, for example, a structured note that provides for twice the upside on 100 shares of a particular stock for the first 12% of appreciation, but no additional payment for any appreciation beyond that, and also provides for all of the depreciation on 100 shares of the same stock. Economically, this would be equivalent to owning 100 shares of stock outright, buying an at-the-money call option on another 100 shares, and selling an out-of-the-money call option at 112% of the current fair market value of the stock on 200 shares of such stock. How would one compute the number of underlying shares for this ELI?

In this circumstance, one should bifurcate the ELI so as to isolate the gross long position. Applying this theory to the fact pattern set forth above, the denominator of the fraction would be the change in the value of 200 shares for a very small increase in the stock price (i.e., the sum of the 100 share direct ownership position and the 100 share long call option position), while the numerator would of course be the change in value of the derivative instrument given such increase in the stock price. While this rule would result in tending to exclude some ELIs from withholding tax, we believe this result is appropriate, given that these instruments are not remotely similar to a direct investment in the underlying stock.

#### **D. Qualified Indices**

A qualified index generally means an index that: (i) references 25 or more component underlying securities; (ii) references only long positions in component underlying securities; (iii) contains no component underlying security that represents more than 10 percent of the weighting of the underlying securities in the index; (iv) is modified or rebalanced only according to predefined objective rules at set dates or intervals; (v) does not provide a dividend yield from component underlying securities that is greater than 1.5 times the current dividend yield of the S&P 500 Index as reported for the month immediately preceding the date the long party acquires the potential section 871(m) transaction; and (vi) futures contracts or option contracts on the index (whether the contracts provide price only or total return exposure to the index) trade on a national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading

Commission.<sup>40</sup>

We believe that, as long as the other requirements are met, the requirement that the index be modified or rebalanced only according to predefined objective rules at set dates or intervals is ambiguous, and may exclude indices that present little to no potential for abuse. Thus, for example, even the most widely known indices, such as the S&P 500, which would generally satisfy all of the other tests, may not qualify as being rebalanced according to predefined objective rules at set dates or intervals.<sup>41</sup> Regardless of how the rebalancing occurs, however, it is difficult to envision any index that satisfies the remaining factors could reasonably be considered to have the potential for tax avoidance.

Because investors in a regulated investment company (“RIC”) hold shares of stock rather than a financial derivative, it is not clear that the exclusion for qualified indices applies to ELIs or NPCs that are intended to track, and that actually do track, a RIC that tracks a qualified index. That is, the terms of the ELI typically would not refer to the index, but would refer only to the RIC that tracks such an index. Because there is obviously no tax avoidance potential for a taxpayer to invest in a derivative over such a RIC, any more than if it invested in an equity linked instrument that directly tracked a qualified index, the exemption for qualified indexes should extend to ELIs or NPCs based on such RICs.

#### **E. Rule for Implicit Payments**

As noted above, it appears that, even if the short party does not agree to pay any dividend related payments to the long party, the long party is irrebutably presumed to receive the benefit of any dividend paid on the stock, and then any such amount is then deemed paid back to the short party (e.g., in the form of a lower financing charge on a swap). We understand that Treasury believes dividends generally are predictable in both timing and amount, with the consequence that a non-U.S. investor could generally give up his right to receive any dividend related payments in return for receiving a lower financing cost or a greater exposure to gain or a smaller exposure to loss on the underlying equity, and that such an investor would not be taking any economic risk by giving up his right to dividend related payments. Suppose, for example, that a dividend of \$1 has been declared on a particular stock, which is trading for \$100 on the

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<sup>40</sup> Prop. Reg. §1.871-15(k)(2), 78 Fed. Reg. 73,140 (2013). Notwithstanding this general rule, an index is a qualified index if the index is comprised solely of long positions in assets and the referenced component underlying securities in the aggregate comprise 10% or less of the index’s weighting. For purposes of applying this rule, the weighting of a component underlying security of an index is the percentage of the index’s value represented, or accounted for, by the component underlying security. Any component of an index that is not an underlying security is not taken into account for purposes of determining whether an index is a qualified index, except for purposes of applying this exception.

<sup>41</sup> For example, according to McGraw Hill Financial, which publishes the Dow Jones Industrial Index, “[w]hile stock selection is not governed by quantitative rules, 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. Maintaining adequate sector representation within the indices is also a consideration in the selection process.” Dow Jones Industrial Average, *Fact Sheet*, [http://www.djindexes.com/mdsidx/downloads/fact\\_info/Dow\\_Jones\\_Industrial\\_Average\\_Fact\\_Sheet.pdf](http://www.djindexes.com/mdsidx/downloads/fact_info/Dow_Jones_Industrial_Average_Fact_Sheet.pdf) (last visited August 29, 2014). Obviously, these general considerations are scarcely “predefined objective rules,” and the rebalancing of the index does not appear to be limited to “set dates or intervals.”

close of business on the day before the ex-dividend date. A taxpayer sells the stock at market-on-close pricing for \$100, and then immediately enters into a contract to buy the stock back at a fixed price effective one week hence for \$99 (i.e., the \$100 current value, less the anticipated \$1 dividend). The taxpayer will in effect receive the economic benefit of the \$1 dividend by virtue of selling the stock for \$100 and repurchasing it for \$99, thus leaving him with \$1 of cash. Phrased differently, the taxpayer will be in exactly the same position as if it had simply held the stock over the ex-dividend date, collected the \$1 dividend, and then held a stock with a value of \$99, except that in this latter case, the taxpayer would have been subject to a 30% withholding tax, subject to reduction under a treaty.

It is understandable why Treasury would view this result as undesirable, and why it therefore adopted a rule that would treat the taxpayer as having received the \$1 as a dividend. Such an investor arguably would be changing the form of his investment (i.e., from physical to derivative) for a tax-motivated reason (avoidance of dividend withholding tax) without changing the substance thereof. In general, we agree with Treasury that when this paradigm is satisfied (i.e., a tax-motivated investment form, coupled with a relative lack of economic risk), it is appropriate under the general anti-avoidance directive in section 871(m) to deem the taxpayer to have received the dividend income, which essentially is what the 2013 Proposed Regulations do. We believe, however, that as discussed in the following paragraphs, two types of common transactions do not satisfy either the “tax-motivated form” aspect or the “no economic substance” aspect of this paradigm, and that taxpayers who enter into such transactions therefore should not be deemed to receive dividend equivalent payments under section 871(m).

As noted above, and as the 2013 Proposed Regulations appear to accept, transactions where the delta is substantially less than 1.0 generally are not entered into for tax avoidance purposes. For example, as discussed above, taxpayers generally do not enter into options, even options with a delta of 0.08 or 0.90, primarily for tax avoidance purposes because the value of such options does not track the value of a physical investment in the underlying stock precisely enough. Even if the Treasury should decide to treat such options as specified ELIs when they adjust for actual dividends, such options should not be treated as specified ELIs when there is no such adjustment.<sup>42</sup>

The same can also be said of certain instruments, such as some structured notes, that have a delta of 1.0, where such delta is reasonably expected to fluctuate substantially over the life of the instrument. Consider, for example, a structured note that provides its holder with no dividend pass-through payments and twice the upside of the stock up to a cap of 10%, with none of the downside risk. Such an instrument may arguably have a delta of 1.0 at the time a particular taxpayer acquires it, but such a note is clearly not a proxy for direct investment in the underlying, given its very different payout pattern compared to the underlying equity. Such

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<sup>42</sup> This is essentially the policy adopted in section 305. Thus, prior to the effective date of the 2013 Proposed Regulations, a non-U.S. investor in a warrant issued by a corporation would not be deemed under section 305 to have received a dividend merely because a dividend was paid on the shares into which the warrant was exercisable. Only if the number of shares underlying the warrant, the strike price, or some other factor were adjusted to compensate the warrant holder for the diminution of corporate assets would the warrant holder be deemed to have received a dividend. We do not believe that Congress intended, by enacting section 871(m), to change this result or to permit Treasury to change it.

transactions are not motivated by tax avoidance strategies, and, moreover, constitutes an entirely different transaction than an investment in the underlying stock. These investors (who include RICs, insurance companies and other non-foreign investors) typically want leveraged upside, buffered downside, or some combination of the two, and are willing to accept no dividends and a cap on their upside in return. We believe that treating an investor in such a structured note as having given up the expected dividends to the issuer in exchange for some other unrelated benefit is inconsistent with the Congressional intent underlying section 871(m).

An instrument in which the delta is 1.0, and is expected to remain 1.0 over its term, presents a more difficult case, because such an instrument frequently can serve as a proxy for direct investment in the stock, which does implicate the anti-avoidance directive of section 871(m). The question then becomes whether there is economic substance to the lack of dividend related payments, such that the parties' decision not to pass through such payments to the long party should be respected by the tax law. Consider, for example, a price only swap, covering a relatively short period of time, in which the long party is not entitled to receive dividend related payments (by contrast to a total return swap) and, in return, receives a lower financing charge. As noted above, the view of the 2013 Proposed Regulations appears to be that the exclusion of dividend related payments lacks substance, because the amount of dividends are easily knowable to both parties. Thus, neither of the parties' economic position changes by reason of the use of a price only swap rather than physical ownership, in the government's view, except that the long party avoids the tax imposed by section 871.

We believe that this is a reasonable position for the 2013 Proposed Regulations to take, but only if the date on which the stock goes ex-dividend occurs within a reasonably short period of time after the derivative is acquired by the long party.<sup>43</sup> For dividends that are not announced until well after the derivative has been entered into, it cannot reasonably be presumed that the amount of the dividend must have been well known to both parties. Instead, in cases such as these, it appears that the short party, whose economic return relates to the likely dividend payment (i.e., through its hedge), is taking real economic risk that the dividend will not be paid, or will not be paid in full, and stands to benefit from the payment of a larger-than-expected dividend will be paid, resulting in a windfall.

We believe that 60 days between the date a derivative is entered into and the date a dividend is paid is a reasonable period of time in order for the long party with no explicit right to payment of a dividend to be viewed as not having constructively received that dividend. A 60 day period is consistent with the treatment of dividends for a domestic investor, for whom dividends received on stock held for more than sixty days are generally taxed at the same rate as net capital gain.<sup>44</sup> This arguably represents a judgment by Congress that a holding period of 60

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<sup>43</sup> It is of course possible to argue that the risk of nonpayment of a dividend that has been declared is still a real risk. For example, in 2010, British Petroleum had already declared a quarterly dividend prior to the Gulf Oil spill, when it cancelled that dividend because of the magnitude of the spill. Tom Bergin, *BP cuts dividend and capex to pay for oil spill*, THOMSON REUTERS (Jun. 16, 2010, 4:59PM), <http://www.reuters.com/article/2010/06/16/us-bp-dividend-idUSTRE65F5JL20100616>. We understand, however, that Treasury may tend to view examples of this type as so infrequent as not to constitute justification for not deeming already-declared dividends to have been paid to the long party.

<sup>44</sup> I.R.C. § 1(h)(11)(B)(iii).

days imposes sufficient benefits and burdens of ownership on the holder of stock that such holder should be viewed as taking on the risks of an equity holder. Phrased differently, Congress appeared to believe that a holding period of this length would not permit taxpayers to use dividend capture strategies because the risk of a real economic loss was too great. Similarly, in circumstances where there is no explicit payment or adjustment to a “delta one” derivative for a dividend paid on the underlying stock, the short party, who will typically be looking to the dividends paid on the stock for a portion of his return, will be at risk that those dividends will not be paid, while the long party will be at risk that the dividend will exceed the forecast amount.

The same quantum of risk that effectively prevents taxpayers from entering into dividend capture strategies should also prevent taxpayers from entering into transactions to capture the economics of dividends without the withholding tax cost. Thus, we think it is reasonable to treat the long party as implicitly receiving a dividend payment only for a relatively short period of time (e.g., 60 days) after the derivative is entered into.

#### **F. Anti-Abuse Rule**

The anti-abuse rule provides that if a taxpayer (directly or through the use of a related person) acquires a transaction or transactions with a principal purpose of avoiding the application of Proposed Regulation section 1.871-15, the Commissioner may treat any payment made with respect to any transaction as a dividend equivalent to the extent necessary to prevent the avoidance of section 871(m). Therefore, notwithstanding any other provision of that section, the Commissioner may adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, adjust the timing of payments, combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions, or otherwise depart from the rules of this section as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent.

Given the breadth of the general rule described in the first sentence of the anti-abuse rule, it is not at all clear which transactions this rule is targeting. However, as drafted, it could apply to such transactions as selling a stock on the day before an ex-dividend date, and then repurchasing it at a later time so as to avoid the dividend. This transaction is clearly far beyond what Congress could conceivably have intended when it enacted section 871(m), and any attempt to reach such transactions by regulation should fail as unreasonable and inconsistent with the statute. To address this concern, the rule should specifically provide that a sale of stock on the last day before the ex-dividend date, followed by a purchase at the beginning of the ex-date, is not subject to the anti-abuse rule.

More generally, the anti-abuse rule really appears to be aimed at the manipulation of some of the technical rules dealing with deltas, customized indices, and so forth. If this is the case, then it would be better to adopt more narrowly targeted rules for each specific provision (i.e., the qualified index rules or the combination rule) than to have one overly broad rule that creates needless uncertainty for taxpayers and the Service.