



## **Introduction to Section 871(m) of the Internal Revenue Code (IRC)**

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# 1 Introduction to Section 871(m)

In the US, a dividend payment is regarded as a US-source taxable income and therefore subject to a 30% withholding tax when paid to non-US persons. Thus, the US has signed Double Taxation Treaties (DTTs) with different counterparty jurisdictions so that non-US persons domiciled in those jurisdictions could benefit from a reduced withholding tax rate<sup>1</sup>. For instance, when a non-US person holds shares of a US firm and receives a dividend paid by that firm, the dividend received is not gross (i.e. 100% of the dividend) because the bank must withhold 30% (or less in case there is an applicable DTT).

Nevertheless, this simplistic scenario does not consider investors' desire to maximize their portfolio's return. Thus, thanks to financial innovations combined with some tax expertise, some knowledgeable market participants were able to find a way to optimize their withholding tax rate. A financial strategy that besides being entirely legal allows investors to increase their return without taking any additional market risks consists of using a total return swap<sup>2</sup>. As an initial situation, there are (1) a non-US person, domiciled in a country without any DTT (i.e., subject to a withholding tax of 30%) who holds IBM shares, and (2) a broker domiciled in a jurisdiction with a DTT rate of 15%. Before IBM pays a dividend, the non-US person sells its IBM shares and enters into a total return swap agreement<sup>3</sup> (i.e., a "Notional Principal Contract" (NPC)). Specifically, the total return of an asset (for example, an IBM share) is exchanged for a fixed interest rate. The non-US person agrees to pay, for instance, a London Interbank Offered Rate (LIBOR) + 25 basis points to the broker and in exchange, it receives the return on IBM<sup>4</sup>. NPCs are generally not subject to a US withholding tax due to sourcing rules<sup>5</sup>. Therefore, when IBM pays the dividend, the broker receives 85% of the dividend due to a 15% withholding tax and as agreed, it must pay this amount as manufactured dividend to the non-US person. Thanks to this strategy, the non-US person increases his return by receiving more than 70% of the dividend<sup>6</sup>, namely, 85% of the dividend minus the regular payment made to the broker (in this example, it is LIBOR + 25 basis points).

Consequently, in 2010, the US decided to combat this avoidance of withholding tax on US-source dividends by enacting IRC Section 871(m) as part of the Hiring Incentives to Restore Employment Act (the "HIRE Act")<sup>7</sup>. So far, it is reasonable and understandable that the US intends to close this

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<sup>1</sup> However, it appears that the US has not discussed with other jurisdictions regarding dividend equivalents (DE) (see footnote 8) being treated as dividends under double tax treaties. Thus, there are currently different views. Switzerland, for example, seems to accept that a DE qualifies as a dividend. On the other hand, other countries such as the UK classify DE under "other income" (i.e. the US has no taxing rights where the beneficial owner is a UK resident) and does not give tax credit against their UK tax liability. Nevertheless, the UK will still allow UK banks to comply with 871(m).

<sup>2</sup> In this example, the investor now faces a counterparty risk.

<sup>3</sup> A total return swap allows a party to gain exposure and benefit from a reference asset (for example, an IBM share) without being its legal owner in exchange of a regular payment based on a set rate that could be fixed or variable.

<sup>4</sup> Due to the total swap return agreement, the broker now has an exposure to IBM, however, this exposure can be hedged by buying IBM shares for instance.

<sup>5</sup> The source of the payment is perceived as non-US because historically, under Treas. Regs. §1.863-7(b)(1), the source of an NPC payment was determined based on the residence of the "long party" (see 2.5 of this memorandum for explanation regarding "short" and "long"), the recipient of the payment (i.e. the taxpayer). Nowadays, 871(m) supersedes Treas. Regs. §1.863-7(b)(1) when it concerns a DE payment (see footnote 8), however, Treas. Regs. §1.863-7(b)(1) remains in force for NPCs that are out-of-scope for 871(m) (see 2.1 of this memorandum for additional information). 871(m) determines the source of the payment based on the underlying security the NPC (or any other derivative instruments) refers to.

<sup>6</sup> If the non-US person holds IBM shares and receives a dividend, it only receives 70% of it due to the 30% withholding tax.

<sup>7</sup> For instance, FATCA was also enacted at the same time as part of the HIRE Act.

loophole. However, this seems simple only from a theoretical perspective in which a payment derived from and triggered by an actual dividend payment of a US firm must be treated as a US-source dividend payment. In reality, things have been and are still very difficult to implement. Indeed, after years of uncertainties, delays, amendments of the regulations and despite the numerous requests to the IRS by various financial associations to postpone 871(m), the IRS provided the industry with some hope on 2 December 2016 by officially announcing a phase-in schedule for 2017 (partial deferral) by way of Notice 2016-76. However, on 30 December 2016, the last hope of seeing 871(m) postponed has evaporated as the IRS has finally issued the new Qualified Intermediary (QI) Agreement, including provisions for QDDs under 871(m) with an effective date 1 January 2017.

To summarize, 871(m)'s objective is to ensure that non-US persons cannot hold derivative instruments that substantially replicate the economic benefits of holding US securities while enjoying an effectively lower withholding tax rate (i.e. avoiding the higher withholding tax rate that would normally apply). Conceptually, the idea behind 871(m) is (1) to consider payments triggered by an actual dividend payment and generated by derivative instruments referencing at least one US security (for instance, the IBM manufactured dividend in the previous example) as "dividend equivalent"<sup>8</sup> (DE) and (2) to change the source of the DE from non-US to US-source even when it is a transaction between two non-US parties.

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<sup>8</sup> See Treas. Regs. §1.871-15(c) for a detailed definition of DE.

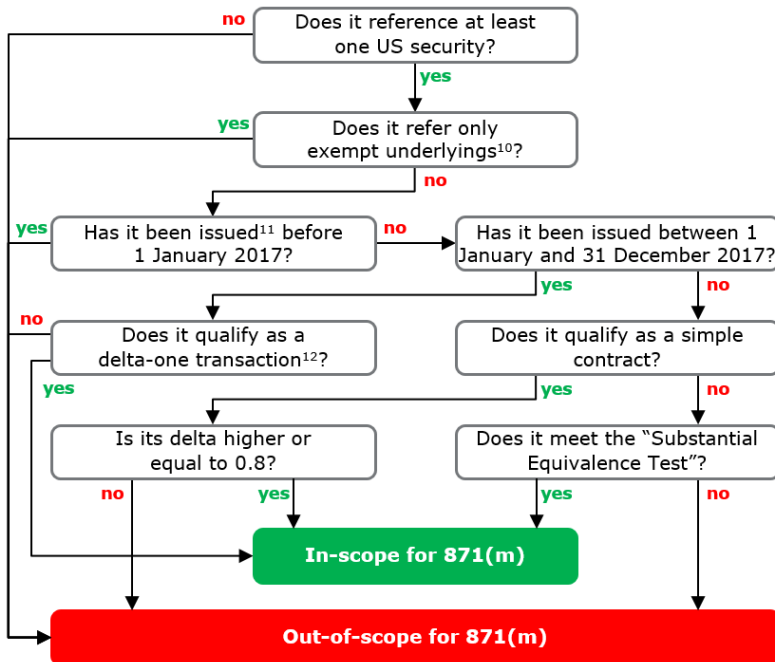
## 2 Overview of Section 871(m)

This second part provides an overview of derivative instruments to be considered for 871(m) (referred to as in-scope instruments) and the importance of the QDD status for issuers of potentially in-scope instruments<sup>9</sup>. After introducing the in-scope test and some of its key elements, namely, the delta threshold, the requirements for qualifying as a simple contract, and the “combined transactions” rules, this part ends with the relevance of the QDD status for hedging purposes and the “QDD tax liability”.

### 2.1 In-scope test

As already mentioned, 871(m) aims to curb tax avoidance from non-US persons by introducing a withholding tax on DE payments from instruments that qualify as in-scope for 871(m). The in-scope determination of an instrument is done within a few steps as illustrated by the below flowchart.

#### The different steps of the 871(m) in-scope test



<sup>9</sup> It should be noted that there are still many aspects of 871(m) that are not discussed in this paper on purpose. Some examples include the party of a transaction responsible to execute the in-scope test (see Treas. Regs. §1.871-15(p)(1)), the party responsible to withhold upon a DE payment (see Notice 2016-42, Sec 3.03(B) of the 2017 QI Agreement), the Substantial Equivalence Test (SET) and its issues linked to the determination of standard deviation (which data points to use) or complex contracts with a standard deviation higher than their knock-out level (see Treas. Regs. §1.871-15(h)), how to determine the DE amounts (see Treas. Regs. §1.871-15(j)) and the requirements to obtain the QDD status and the responsibilities attached to it (see Treas. Regs. §1.1441-1(e)(6), and Notice 2016-42, SECTION 2, Sec 2.01 and Sec 2.02).

<sup>10</sup> See Treas. Regs. §1.871-15(c)(1) and Treas. Regs. §1.871-15(l)(3) for exceptions.

<sup>11</sup> See Treas. Regs. §1.871-15(a)(6) for the definition of issuance in a Section 871(m) context.

<sup>12</sup> See Notice 2016-76(III)(A)(1).

## 2.2 Simple and complex contracts

Under 871(m), a simple contract must meet all the following requirements:

- All amounts to be paid or received on maturity, exercise, or any other payment determination date are calculated by reference to a single, fixed number of shares of the underlying security<sup>13</sup>; and
- The contract has a single maturity or exercise date with respect to which all amounts (other than any upfront payment or any periodic payments) are required to be calculated with respect to the underlying security.

Besides, if an instrument is not a simple contract, then it is by default a complex contract for 871(m) purposes.

## 2.3 Delta threshold

A delta shows by how much a derivative instrument mimics its underlying security's value. Thus, a delta indicates the rate of change of the derivative instrument value with respect to changes in the value of the underlying security. For instance, a derivative instrument with a delta of 0.8 means that for every \$1.00 the underlying security varies, the derivative instrument varies by \$0.80. Since the delta can change over the lifetime of the instrument, and in order to avoid any unnecessary administrative burden (for example, re-calculating the delta of a potentially in-scope structured product each time it is sold on the secondary market), the IRS has decided that absent of substantial modification, both simple and complex contracts must be tested only at issuance.

The IRS considers that simple contracts with a delta of at least 0.80<sup>14</sup> and complex contracts meeting the SET<sup>15</sup> are substantially replicating the economic benefits of holding US securities and as a result, must be subject to 871(m).

## 2.4 Combined transactions rules<sup>16</sup>

The goal of this rule is to prevent market participants to split an in-scope instrument into smaller out-of-scope instruments to avoid 871(m). Thus, when entered in connection with each other<sup>17</sup>, two or more transactions referencing the same underlying security must be treated as a single transaction for purposes of applying the relevant in-scope test. Consequently, it is not possible to avoid 871(m) by being, for example,

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<sup>13</sup> The finalized Treas. Regs. §1.871-15(a)(14)(i) released in TD 9815 on 24 January 2017 provides further guidance:

- A contract that provides an adjustment to the number of shares of the underlying security for a merger, stock split, cash dividend, or similar corporate action that affects all holders of the underlying securities proportionately will not cease to be treated as referencing a single, fixed number of shares solely as a result of that provision;
- A contract has a single exercise date even though it may be exercised by the holder at any time on or before the stated expiration of the contract; and
- An NPC or ELI that includes a term that discontinuously increases or decreases the amount paid or received (such as a digital option), or that accelerates or extends the maturity is not a simple contract.

<sup>14</sup> See Treas. Regs. §1.871-15(d)(2) and Treas. Regs. §1.871-15(e)(1).

<sup>15</sup> See Treas. Regs. §1.871-15(h). The SET evaluates whether a complex contract substantially reproduces the economic performance of the underlying security. It analyses (1) the economic relationship between the complex contract and its initial hedge and compares it to (2) the economic relationship between a theoretical in-scope simple contract benchmark with a delta of 0.8 and its respective initial hedge.

<sup>16</sup> See Treas. Regs. §1.871-15(n).

<sup>17</sup> The IRS presumes that transactions are entered in connection with each other if (1) they are entered into less than two business days apart and (2) they are reflected in the same trading book. However, as a part of the partial deferral for 2017, Notice 2016-76, provided a simplified standard for short parties or other withholding agents (see Treas. Regs. §1.1441-1(b)(4)(xxiii)) to determine whether transactions are combined transactions.

short put and long call instead of holding a future position, because when combined together they have the same payoff as a future position, which is in-scope for 871(m).

## 2.5 QDD status

After discussing instruments relevant for 871(m), the next topic is as important because it concerns the issuer of those instruments (structured products). When an issuer issues a structured product, this creates a risk position for the issuer. For instance, an issuer issues a structured product on IBM, whereby investors are so-called "long"<sup>18</sup> and the issuer is now so-called "short" on IBM. As a result, the issuer hedges its position (i.e. getting a "long" position on IBM to close the short one) by buying the same underlying securities or by entering into a derivative contract with another counterparty (hedge party) when it issues the structured product. Thus, the issuer neutralizes its exposure to the underlying security of the issued structured product and makes a profit by taking a margin from structuring the product.

However, those hedging transactions create a risk of cascading withholding on chain of payments of DE (and dividends). For example, the issuer hedges itself with a derivative contract with the hedge party. When the underlying security pays a dividend, the hedge party withholds on the DE payment that it is obliged to make to the issuer due to the derivative contract between them. Then, the issuer receives the DE and withholds on it before passing it to the final investor, the owner of the structured product. In the end, the final investor receives a DE amount that has been withheld twice, once by the hedge party and once by the issuer. In reality, there could be many more parties involved (for example, the hedge party must also protect itself with another party or hold the IBM shares) which increases the risk of cascading withholding on the chain of payments.

In order to mitigate that risk, the IRS introduced the QDD status. Having the QDD status allows a party to receive DE payments (but not dividends starting in 2018) gross from the upstream party (for example, the hedge party). In exchange, the QDD is responsible for the withholding and the deposit with the IRS when it makes the DE payments to the downstream party (for example, the final investor). In short, the QDD informs everybody in the chain of payments to not withhold because it will do it.

## 2.6 QDD tax liability<sup>19</sup>

In addition to the withholding and deposit requirements mentioned above, a QDD must satisfy its QDD tax liability which is a tax due to the IRS. While being an essential part of 871(m), the QDD tax liability is also one of the most complex and technical aspects of 871(m). From a mathematical perspective, the QDD tax liability is the sum of the three following components:

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<sup>18</sup> They have a positive view on IBM and expect that the price will raise.

<sup>19</sup> See Sec 3.09 of the 2017 QI Agreement and Notice 2016-76(III)(C)(1).



**First component<sup>20</sup>:**

It is equal to *"Section 871(m) Amount" – "any amount of tax paid by the QDD under section 881(a)(1) on dividends received with respect to that underlying security on that same dividend"*.

The "Section 871(m) Amount" is equal to *"net delta exposure<sup>21</sup>" x "the dividend amount per share" x "the QDD's DTT rate"*.

However, the result of the first component cannot be below zero.

**Second component:**

It is equal to *"DE payments received gross as a QDD in a non-dealer capacity" x "the QDD's DTT rate"*.

**Third component:**

It is equal to *"any payments, such as dividends or interest, received as a QDD with respect to potential section 871(m) transactions or underlying securities that are not dividend equivalent payments, to the extent the full liability was not satisfied by withholding" x "the QDD's DTT rate"*.

As a result, a QDD must assess its own tax liability (for example, a tax liability could be the result of an over-hedge position). Based on the above calculation method, it appears that the most efficient hedging method is to use a synthetic hedge (i.e. derivative instruments that pay DE) instead of a physical one (i.e. shares that pay actual dividends). This is because (1) a QDD cannot receive actual dividend gross (except in 2017) and (2) the first component must always be equal to or greater than zero (i.e. any negative number becomes zero). Consequently, in the absence of a tax credit which allows a QDD to credit the entire tax amount withheld on actual dividend payments by upstream parties (i.e. allowing the first component to have a negative value), the QDD faces the risk of having the overall tax being overpaid.

Therefore, the physical hedge position of the QDD is a key element in determining whether there is an over-withholding in the entire payment chain. In conclusion, there are three different scenarios depending on the relative size of the physical position used for hedging compared to the net delta (i.e. the over-hedge position):

1. Physical hedge position is larger than the net delta, then "Section 871(m) Amount" is reduced to zero but overall tax is overpaid;
2. Physical hedge position is equal to the net delta, then "Section 871(m) Amount" is reduced to zero; and
3. Physical hedge position is smaller than the net delta, then "Section 871(m) Amount" is partially reduced but remains positive.

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<sup>20</sup> The first component is composed of transactions entered into by the QDD in its dealer capacity.

<sup>21</sup> It is what the QDD receives subtracted by what it is obliged to pay, so a positive net delta means that you are over-hedged and receives more than what you have to pay.

### 3 Conclusion

While keeping things as simple as possible and avoiding the numerous technicalities throughout this paper, 871(m) remains complex and challenging not only for the industry to implement but also for the IRS to fully grasp the interactions and effects that the different rules of 871(m) have on each other. Considering the several years spent to create 871(m) (for example and as a comparison, FATCA, which was enacted at the same time in 2010, entered into force in 2014) and the numerous amendments made to it, including the ones made on 30 December 2016 (via the 2017 QI Agreement) and the final and temporary Section 871(m) regulations released in TD 9815 on 24 January 2017, the authors believe that the IRS will still make changes during the phase-in year 2017. Therefore, the final regulation for 2018 might come with its surprises.

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