Index derivatives can be subject to US withholding tax in 2017

"Delta-one" derivatives entered into on or after January 1, 2017 that reference stock of a US issuer (including certain indices and custom baskets) may be subject to a 30% withholding tax in the US on dividend equivalents.[1] Nonetheless, derivatives that reference certain passive, widely-used indices that are based on a diverse basket of publicly-traded securities may be exempt from the dividend equivalent withholding tax under 871(m) (a "Qualified Index").[2]

The Qualified Index safe harbor does **not** apply when a taxpayer enters into one or more transactions that reduce exposure to any referenced component security (or securities) of a Qualified Index by more than five percent of the notional long exposure in the index *in connection with* a transaction referencing the Qualified Index.[3] When a transaction references an index that fails to meet the Qualified Index safe harbor, the section 871(m) transaction is treated as referencing all of the individual components of the index (i.e., a look-through approach) resulting in potentially multiple dividend equivalent payments to the long party. A taxpayer that trades long and short indices with overlapping constituents may be trading in section 871(m) transactions despite each index meeting the definition of a Qualified Index when viewed in isolation (e.g., long SPX futures contract versus short NDX futures contract).

The rules for taxpayers and brokers differ under the Final Regulations. While a broker has joint and several liability for any US withholding tax, the long party is also liable for the substantive tax, as is the case with other FDAP income. Accordingly, beginning in 2017, a non-US fund may have a substantive tax liability and reporting obligation regardless of what their broker or custodian may or may not report to them.

Traders of index derivatives should design controls and develop a ruleset to identify and connect trades where applicable. The ruleset could include an entity-level approach or a more narrow approach which may include a combination of factors, such as: trading strategy, governance structure, order-type, trade date, and notional amount. This process involves significant coordination among the front-office analysts and traders, mid-office operations, and back-office finance personnel. Documentation of the controls and ruleset are important to support an ASC 740 or 450 analysis related to the fund's accounting records, as well as provide support for a potential future IRS audit.

Given the attention on the Final Regulations and the complexity of the rules, taxpayers should consult their tax advisors to determine potential payment and reporting obligations resulting from derivative transactions entered into in 2017.

Contacts:

Eric Fox
Principal
Deloitte Tax LLP
+1 203 905 2618

Matt Kaufman
Senior Manager
Deloitte Tax LLP
+1 202 220 2711

---

[1] Final regulations under section 871(m) of the Internal Revenue Code of 1986, as amended (the "IRC") were originally issued in September, 2015 (TD 9734, Sept. 17, 2015) and amended in January, 2017 (TD 9815, Jan. 19, 2017) (the "Final Regulations").
[2] See Treas. Reg. 1.871-15(l) to determine when an index meets the definition of a Qualified Index.
[3] Treas. Reg. 1.871-15(l)(6).