Tax Alert

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Full Implementation of Section 871(m) Further Delayed Until 2025: Impacting US Withholding on Swaps over US Stocks and Narrow-Based Indices

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Key Points

- The broader application of Section 871(m) has again been delayed, this time until January 1, 2025, and, as a result, investment funds with non-U.S. feeders or investors up the chain should generally expect to incur U.S. withholding only if they act as the "long" party on certain synthetic U.S. equity trades with a delta of 1.0 during the extended transition period.
- The broader application of the combination rule adopted under the final regulations has also been delayed further until January 1, 2025, making the rule easier to administer for withholding agents during the transition period.
- Since investment funds typically enter into synthetic U.S. equity trades with U.S. broker/dealers, or non-U.S. broker/dealers acting as qualified derivatives dealers (QDD), the funds should generally not expect to act as the U.S. withholding agent under Section 871(m) with respect to short positions.

Consistent with prior guidance, the Internal Revenue Service (IRS) has further extended until 2025 certain transitional relief from full implementation of the U.S. withholding regime under Section 871(m) to the Internal Revenue Code (Section 871(m)) with respect to "dividend equivalent" amounts (Notice 2022-37).

In response to perceived abuses in taxpayers' use of swaps and other derivative transactions (e.g., options, futures or forwards) to avoid withholding tax on U.S. source dividends, Congress added Section 871(m), which provides that any "dividend equivalent" amount payable on a "specified notional principal contract" (a Specified Notional Principal Contract) over U.S. equity is treated as U.S. source dividend income. Generally, a dividend equivalent payment is a payment under a derivative that is directly or indirectly contingent on the payment of a dividend by a U.S. corporation. Therefore, income received or paid by non-U.S. investment funds, or flow-through funds with non-U.S. feeders or investors up the chain, pursuant to certain U.S. equity derivative transactions could potentially be subject to 30 percent gross-based U.S. withholding tax.

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Final U.S. Treasury regulations that were adopted in 2015 and 2017 (the Regulations) greatly expanded the scope of a Specified Notional Principal Contract covered by Section 871(m). The Regulations are very complex, but in essence treat swaps and other derivative contracts as Specified Notional Principal Contracts if they qualify as (i) “simple” equity swaps or derivatives that have a “delta” of at least 0.8 or (ii) “complex” equity swaps or derivatives that meet a “substantial equivalence” test which is generally satisfied where the swap or derivative substantially replicates the economic performance of the underlying security. For this purpose, “delta” is generally the ratio of a change in the fair market value of the derivative relative to a change in the fair market value of the underlying equity security. The Regulations also adopted a combination rule that requires that multiple transactions are treated as a Specified Notional Principal Contract if they are entered into in connection with each other and replicate the economics of a single swap or derivative that would have been treated as such. Special look-through rules were also adopted for swaps and other derivatives over equity indices and exchange-traded funds that include or reference one or more U.S. equities, or over flow-through entities (including, without limitation, master limited partnerships (MLPs)).

The IRS has provided and several times extended certain transitional relief for the implementation of Section 871(m) withholding for transactions that do not achieve a delta of 1.0 (Non-Delta 1 Transactions) entered into before January 1, 2025. Before January 1, 2025, a simplified standard also applies for the combination rule adopted under the Regulations, pursuant to which only long parties are required to combine trades involving either (i) listed securities or (ii) over-the-counter (OTC) transactions that are not priced, marketed or sold in connection with each other (i.e., investment funds should not be withheld upon but may have substantive U.S. tax liability under Section 871(m) when the combination rule applies and a delta of 1.0 is achieved during the transition period). The IRS will also take into account any good faith efforts of investment funds to comply with the Regulations during the transition period, and in 2025 when Section 871(m) is expected also to apply to Non-Delta 1 Transactions.

Investment funds should note that the transitional relief described above does not prevent the IRS from applying an anti-abuse rule pursuant to which a payment may be treated as subject to Section 871(m) if the relevant transaction was entered into with a principal purpose of avoiding the Regulations. Further, investment funds should note that certain swaps and other derivative transactions entered into before January 1, 2017, will continue to be treated as Specified Notional Principal Contracts subject to Section 871(m) if they meet at least one of four factors enumerated in the Section 871(m) statute (i.e., the transitional relief does not apply irrespective of the delta achieved by such transactions):

(i) in connection with entering into such transaction, any long party transfers the underlying security to any short party (so-called “crossing in”), (ii) in connection with the termination of such transaction, any short party transfers the underlying security to any long party (so-called “crossing out”), (iii) the underlying security is not readily tradable on an established securities market, or (iv) in connection with entering into such transaction, the underlying security is posted as collateral by any short party with any long party. Investment funds should also note that swaps and other derivatives that were previously not treated as Specified Notional Principal Contracts may need to be re-tested if they are significantly modified and treated as reissued under general U.S. federal income tax principles.

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Since this is the fifth time the IRS has delayed the broader application of Section 871(m) to Non-Delta 1 Transactions and combination trades, it raises the question whether the Regulations will ever fully go into effect. The U.S. Treasury Department had previously targeted the Section 871(m) regime for reform in an effort to mitigate burdens imposed on taxpayers, so it remains to be seen whether the current relief will be extended permanently over time.

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