

## Tax Alert

August 17, 2017

### Key Points

- The broader application of Section 871(m) has been delayed further until January 1, 2019, 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 transition period.
- The broader application of the combination rule adopted under the final regulations has also been delayed until January 1, 2019, 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. or non-U.S. broker/dealers acting in such capacity, they should generally not expect to act as the U.S. withholding agent under Section 871(m) with respect to short positions. However, updated withholding tax forms should be obtained from any non-U.S. broker/dealers to confirm such capacity (generally, IRS Form W-8IMY).



---

### U.S. Withholding on Synthetic Trades over U.S. Equities—Further Delay of Full Implementation Until 2019 (Notice 2017-42)

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) to the Internal Revenue Code, 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. Very 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 a 30 percent gross-based U.S. withholding tax.

Final U.S. Treasury regulations were adopted in 2015 and 2017 (the “Regulations”) that greatly expanded the scope of a Specified Notional Principal Contract that is 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, very generally, is satisfied where the swap or derivative substantially replicates the economic performance of the underlying security. For this purpose, “delta” is very 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 be 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)).

Since the Section 871(m) withholding regime under the new Regulations is very complex and requires U.S. withholding agents to develop new systems permitting to identify, report and withhold on such transactions, the Internal Revenue Service (IRS) had provided 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, 2018 (Notice 2016-76). Before January 1, 2018, a simplified standard also applies for the combination rule adopted under the Regulations, pursuant to which only long parties are required to combine transactions involving listed securities and over-the-counter transactions that are 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 has now announced that it is further extending such relief for Non-Delta 1 Transactions, as well as applying the simplified combination rule for transactions entered into before January 1, 2019 (Notice 2017-42). 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 2019 when Section 871(m) is expected also to apply to Non-Delta 1 Transactions. Additional guidance is likely forthcoming.

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 retested if they are significantly modified and treated as reissued under general U.S. federal income tax principles.

## Contact Information

If you have any questions regarding this alert, please contact:

**Patrick B. Fenn**

[pfenn@akingump.com](mailto:pfenn@akingump.com)

+1 212.872.1040

New York

**Stuart E. Leblang**

[sleblang@akingump.com](mailto:sleblang@akingump.com)

+1 212.872.1017

New York

**Olivier De Moor**

[odemoor@akingump.com](mailto:odemoor@akingump.com)

+1 212.872.1032

New York

**Kevin M. Rowe**

[krowe@akingump.com](mailto:krowe@akingump.com)

+1 212.872.8064

New York

**Howard Leventhal**

[hleventhal@akingump.com](mailto:hleventhal@akingump.com)

+1 212.872.1099

New York