



EBF TAX CONFERENCE 2017

Achieving Tax Certainty in a World of Uncertainty



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Section 871(m) IRC

Recap of primary requirements

- Sec. 871(m) of the Internal Revenue Code (IRC) imposes withholding on dividend equivalent payments
- Subject to certain exceptions, a dividend equivalent includes any payment that references the payment of a dividend from an underlying U.S. equity pursuant to
 - a securities lending or sale-repurchase transaction, or
 - a specified notional principal contract (NPC, e.g. equity swaps), or
 - a specified equity-linked instrument (ELI, e.g. listed and OTC options, futures, forwards, structured notes, and convertible debt)
- Sec. 871(m) IRC was enacted in 2010 as part of the HIRE Act in response to concerns that non-U.S. persons were able to avoid U.S. withholding tax on dividends through the use of equity swaps or other derivatives that reference stock of a U.S. issuer

Section 871(m) IRC

Recap of primary requirements

- Final regulations under Sec. 871(m) IRC were issued in September 2015 and then reissued in modified form on 24 January 2017
- The 2015 final regulations introduced a new regime for qualified derivatives dealers (QDDs) which is intended to prevent cascading withholding that would otherwise occur when making substitute dividend payments
- To provide a safe harbor for transactions that reference widely-used passive indices that are based on a diverse basket of publicly-traded securities, a “qualified index” is not treated as an underlying security subject to Sec. 871(m) IRC even if the index consists of U.S. equities
- Two or more transactions that reference the same underlying security are treated as a single transaction (“combined transaction”) if they
 - are entered into in connection with each other by the same long party and
 - when combined, replicate the economics of a transaction that would be subject to Sec. 871(m) IRC if they had been entered into as a single transaction

Section 871(m) IRC Extraterritoriality

- From the U.S. Treasury's perspective, Sec. 871(m) IRC and the regulations thereunder apply to a dividend equivalent payment without regard to the residence of the person paying the dividend equivalent
- To achieve this, dividend equivalent payments are treated as U.S. source dividends subject to withholding under Chapter 3 (NRA withholding) and Chapter 4 (FATCA) according to the regulations under Sec. 871(m) IRC
- By entering into a QI agreement with the U.S tax administration, a foreign custodial institution becomes a withholding agent under Chapters 3 and 4 for amounts that it pays to its account holders
- This puts foreign custodial institutions in a position of having to choose between their obligations under the QI agreement and the view of their local tax administration

Section 871(m) IRC Tax treaty issues

- Generally, 30% U.S. withholding tax applies to dividends paid by a U.S. corporation to a non-U.S. person, subject to rate reduction by treaty
- France, Germany, Italy, Spain and the UK (the G5 countries) stated their position that dividend equivalent payments under Sec. 871(m) IRC do not qualify as dividends under the applicable U.S. Double Taxation Treaty when paid by non-U.S. entities
- Instead, these payments would fall under the “Other income” Article of the applicable U.S. Double Taxation Treaty
- The United States has not yet resolved this point with the G5 countries
- In addition, some tax administrations already stated that they would not grant a credit against their local tax liability if their taxpayers were subject to withholding tax on dividend equivalent payments in circumstances overriding the applicable U.S. Double Taxation Treaty

Section 871(m) IRC Implementation delay

- The 2015 Sec. 871(m) IRC regulations were to be effective for all in-scope contracts issued on or after 1 January 2017
- Notice 2016-76, released on 2 December 2016, provided transition rules for complying with the withholding requirements of Sec. 871(m) IRC
- Notice 2017-42, issued on 4 August 2017, extended the transition period
- The guidance set forth in these two Notices includes:
 - limiting the additional transactions in scope for calendar years 2017 and 2018 to delta-one transactions
 - limiting the application of the combination rules for calendar years 2017 and 2018
 - providing that the IRS will consider “good faith efforts” in its enforcement for calendar years 2017, 2018 and 2019

Section 871(m) IRC

Recent developments

- Notice 2017-42 also stated that the Treasury Department and the IRS will continue to evaluate the administrative burdens imposed by the regulations and consider whether other changes might reduce unnecessary burdens
- Dana Trier (U.S. Treasury Deputy Assistant Secretary for tax policy) stated recently that rules related to non-delta-one transactions in the dividend equivalent regulations may never take effect
- In his view, the Sec. 871(m) IRC regulations are primarily anti-abuse rules, and therefore targeting delta-one transactions is the bigger priority
- He expects a formal announcement in the next couple of months and added that practitioners may want to hold off on updating their systems