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Dividend Equivalents From Sources Within the United States; Final Rule

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9734]

RIN 1545–BJ56

Dividend Equivalents From Sources Within the United States

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and temporary regulations.

SUMMARY: This document provides guidance to nonresident alien individuals and foreign corporations that hold certain financial products providing for payments that are contingent upon or determined by reference to U.S. source dividend payments. This document also provides guidance to withholding agents that are responsible for withholding U.S. tax with respect to a dividend equivalent.

DATES: *Effective Date:* These regulations are effective on September 18, 2015.

Applicability Dates: For dates of applicability, see §§ 1.871–14(j)(3), 1.871–15(r), 1.871–15T(r)(4), 1.1441–1(f)(4), 1.1441–1T(f)(3), 1.1441–2(f), 1.1441–3(h)(3), 1.1441–7(a)(4), and 1.1473–1(f).

FOR FURTHER INFORMATION CONTACT: D. Peter Merkel or Karen Walny at (202) 317–6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control numbers 1545–0096 and 1545–1597. The collections of information in this final regulation are in § 1.871–15(p), and are an increase in the total annual burden in the current regulations under §§ 1.1441–1 through 1.1441–9, 1.1461–1, and 1.1474–1. This information is required to establish whether a payment is treated as a U.S. source dividend for purposes of section 871(m). This information will be used for audit and examination purposes. The IRS intends that these information collection requirements will be satisfied by persons complying with revised chapter 3 reporting requirements and the requirements of the applicable QI revenue procedure to be revised by the IRS, or alternative certification and documentation requirements set out in these regulations. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Background

On January 23, 2012, the **Federal Register** published temporary regulations (TD 9572) at 77 FR 3108 (2012 temporary regulations), and a notice of proposed rulemaking by cross-reference to the temporary regulations and notice of public hearing at 77 FR 3202 (2012 proposed regulations, and together with the 2012 temporary regulations, 2012 section 871(m) regulations) under section 871(m) of the Internal Revenue Code (Code). The 2012 section 871(m) regulations relate to dividend equivalents from sources within the United States paid to nonresident alien individuals and foreign corporations. Corrections to the 2012 temporary regulations were published on February 6, 2012, and March 8, 2012, in the **Federal Register** at 77 FR 5700 and 77 FR 13969, respectively. A correcting amendment to the 2012 temporary regulations was also published on August 31, 2012, in the **Federal Register** at 77 FR 53141. The Treasury Department and the IRS received written comments on the 2012 proposed regulations, and a public hearing was held on April 27, 2012.

On December 5, 2013, the **Federal Register** published final regulations and removal of temporary regulations (TD 9648) at 78 FR 73079 (2013 final regulations), which finalized a portion of the 2012 section 871(m) regulations. Also on December 5, 2013, the **Federal Register** published a withdrawal of notice of proposed rulemaking, a notice of proposed rulemaking, and a notice of public hearing at 78 FR 73128 (2013 proposed regulations). In light of comments on the 2012 proposed regulations, the 2013 proposed regulations described a new approach for determining whether a payment made pursuant to a notional principal contract (NPC) or an equity-linked instrument (ELI) is a dividend equivalent based on the delta of the contract. In response to written comments on the 2013 proposed regulations, the Treasury Department and the IRS released Notice 2014–14, 2014–13 IRB 881, on March 24, 2014 (see § 601.601(d)(2)(ii)(*b*)), stating that the Treasury Department and the IRS anticipated limiting the application of the rules with respect to specified ELIs described in the 2013 proposed regulations to ELIs issued on or after 90 days after the date of publication of final regulations.

The Treasury Department and the IRS received written comments on the 2013 proposed regulations, which are available at *www.regulations.gov*. The public hearing scheduled for April 11, 2013, was cancelled because no request to speak was received. This Treasury decision generally adopts the 2013 proposed regulations with the changes discussed in this preamble. This Treasury decision also includes temporary regulations, which provide new rules for determining whether certain complex derivatives are subject to section 871(m) and for payments to certain dealers in response to comments on the 2013 proposed regulations.

Summary of Comments and Explanation of Provisions

I. In General

The Treasury Department and the IRS received numerous comments regarding the 2013 proposed regulations. Most comments agreed that the approach taken in the 2013 proposed regulations, in particular the use of a test based on delta, was a fair and practical way to apply section 871(m) to financial instruments linked to one or more U.S. equity securities. Commenters, however, identified a number of issues with the 2013 proposed regulations. Many of the comments suggested modifications and clarifications to the 2013 proposed regulations before they are issued as final regulations. Those comments are summarized in Part II of this preamble. Part II also explains the changes made to the final regulations in response to those comments.

Several of the issues identified by commenters required more significant changes or additions to the 2013 proposed regulations. To allow taxpayers adequate opportunity to consider and comment on these changes, the Treasury Department and the IRS are issuing portions of the regulations as temporary and proposed regulations. Those provisions, and the relevant comments, are summarized in Part III of this preamble.

II. Final Regulations

A. Source of a Dividend Equivalent

The 2013 proposed regulations provide that a dividend equivalent is treated as a dividend from sources within the United States for purposes of sections 871(a), 881, 892, 894, and

4948(a), and chapters 3 and 4 of subtitle A of the Code. This rule follows section 871(m)(1) but adds the reference to section 894 to clarify (as provided in § 1.894–1(c)(2)) that a dividend equivalent is treated as a dividend for purposes of any provision regarding dividends in an income tax treaty. The final regulations retain the general sourcing provision. *See* § 1.871–15(b).

B. Definition of a Dividend Equivalent

The 2013 proposed regulations define a dividend equivalent as (1) any substitute dividend that references a U.S. source dividend made pursuant to a securities lending or sale-repurchase transaction, (2) any payment that references a U.S. source dividend made pursuant to a specified NPC, (3) any payment that references a U.S. source dividend made pursuant to a specified ELI, or (4) any other substantially similar payment. A payment references a U.S. source dividend if the payment is directly or indirectly contingent upon a U.S. source dividend or determined by reference to such a dividend. While the transactions described in (1) and (2) are transactions described in sections 871(m)(2)(A) and (B), respectively, the 2013 proposed regulations extend section 871(m) to the transactions described in (3) and (4) under the regulatory authority granted in section 871(m)(2)(C), which includes as a dividend equivalent ''any other payment determined by the Secretary to be substantially similar to a payment described in subparagraph (A) or (B)'' of section 871(m)(2). The final regulations retain this four-part definition of a dividend equivalent. *See* § 1.871–15(c)(1). The final regulations also provide certain exceptions to the term ''dividend equivalent,'' which are described in section II.D of this preamble.

Section 871(m)(3)(A) provides a temporary definition of the term ''specified notional principal contract.'' This definition is effective for payments made on or after September 14, 2010, and on or before March 18, 2012. Section 871(m)(3)(B) provides that, for payments made after March 18, 2012, a specified NPC includes ''any notional principal contract unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance.'' The 2013 final regulations extend the applicability of the temporary statutory definition in section 871(m)(3)(A) (the four-part definition provided in paragraphs (3)(A)(i) through (iv)) to payments made before January 1, 2016. These final regulations amend the 2013 final regulations to extend the application of the temporary statutory definition adopted in the 2013 final regulations to payments made before January 1, 2017.

Pursuant to the grant of authority in section 871(m)(2)(C), the 2013 proposed regulations provide that certain payments made pursuant to a specified ELI are substantially similar to a dividend equivalent payment. Section 1.871–15(c)(1)(iii) of the 2013 proposed regulations defines a dividend equivalent to include any payment that references the payment of a dividend from an underlying security on a specified ELI. Section 1.871–15(a)(3) of the 2013 proposed regulations defines an ELI (whether or not specified) as any financial transaction (other than a securities lending or sale-repurchase transaction or an NPC) that references the value of one or more underlying securities. Forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments that have payments linked to underlying securities are common examples of an ELI.

C. The Delta Test

The 2012 proposed regulations used a multi-factor test to determine whether an NPC or ELI is a specified contract subject to withholding under section 871(m). The 2013 proposed regulations replace the multi-factor test with a single-factor test that employs a ''delta'' threshold to determine whether a transaction is a section 871(m) transaction. Delta refers to the ratio of a change in the fair market value of a contract to a small change in the fair market value of the property referenced by the contract. Delta is widely used by participants in the derivatives markets to measure and manage risk. Under the test in the 2013 proposed regulations, any NPC or ELI that had a delta of 0.70 or greater when the long party acquired the transaction would be a section 871(m) transaction subject to withholding.

The Treasury Department and the IRS proposed a delta-based standard after concluding that it would provide a comparatively simple, administrable, and objective framework that would also minimize potential avoidance of U.S. withholding tax. A financial instrument that provides an economic return that is substantially similar to the return on the underlying stock should be taxed in the same manner as the underlying stock for the purpose of section 871(m). The Treasury Department and the IRS concluded that the delta test was the best way to identify these instruments.

The Treasury Department and the IRS received many comments regarding the delta test. Commenters generally agreed that the delta test was both a fair and comprehensive way to implement section 871(m), but provided comments on several aspects of the test. The major concerns noted in the comments relate to: (1) The use of 0.70 as the delta threshold; (2) the time for testing delta; (3) the ability of parties to the transaction to obtain and track the necessary delta information; and (4) the difficulty of determining an initial delta with respect to certain complex equity derivatives (in contrast with simple contracts, as defined in Part II.C.4 of this preamble).

1. Delta Threshold

Comments on the 2013 proposed regulations recommended raising the delta threshold, with suggestions ranging from a delta of 0.80 to 0.95. The majority of comments preferred a delta threshold of 0.90 or greater. Comments maintained that a higher delta would more accurately capture transactions that are economically equivalent to stock ownership and likely to be used for tax-avoidance. One comment noted that a 0.80 delta standard, although not prescribed in regulatory guidance, is used by some practitioners as a yardstick to judge economic equivalence in other tax contexts.

The Treasury Department and the IRS agree that the 0.70 delta in the 2013 proposed regulations could apply to contracts with economic characteristics that do not sufficiently resemble the underlying security to be within the scope of section 871(m). On the other hand, a delta threshold that is 0.90 (or higher) would exclude many instruments that are surrogates for the underlying security, such as deep-in-the-money options. The final regulations adopt a delta threshold of 0.80, which strikes a balance between the potential over-inclusiveness of the 0.70 delta threshold and the likelihood that a 0.90 (or higher) threshold would exclude transactions with economic returns that closely resemble an underlying security.

Several comments noted that a delta ratio is intended to measure the sensitivity of the value of a contract to comparatively small changes in the market value of the referenced property and suggested that the regulations incorporate this qualification in the definition of delta. The final regulations accept this suggestion and clarify the definition of delta by specifying that delta is calculated with respect to a small change in the fair market value of the property referenced by the contract.

Typically, a small change is a change of less than 1 percent.

2. Time for Testing Delta

Many comments stated that the requirement to test delta each time a contract is acquired would be extremely difficult to administer, especially for ELIs that trade frequently. Multiple testing events create the possibility that identical instruments acquired at different times would have different tax characteristics, which withholding systems are generally not designed to handle. To ease compliance, comments suggested that delta be tested only when a contract is issued. For derivatives that are listed and cleared through central clearinghouses, another comment suggested that the delta test would be more administrable if taxpayers were permitted to simplify their calculations. For example, delta could be calculated using the fair market value of an ELI determined as of the market close on the trading day prior to the date the ELI is acquired, even though this approach would result in a less accurate calculation. Other comments suggested that, in determining the delta of an option, only the stock price at the time the option is entered into should be considered.

The Treasury Department and the IRS are persuaded that the difficulties of testing delta each time an NPC or ELI is acquired outweigh the benefit of the increased accuracy of that approach. Accordingly, the final regulations provide that the delta of an ELI or NPC is determined only when the instrument is issued; it is not re-tested when the instrument is purchased or otherwise acquired in the secondary market. Consequently, only an NPC or ELI that has a delta of 0.80 or greater at the time it is issued is a specified NPC or specified ELI.

For purposes of § 1.871–15, an instrument is treated as ''issued'' when it is entered into, purchased, or otherwise acquired at its inception or original issuance, which includes an issuance that results from a deemed exchange pursuant to section 1001. The requirement to test delta only at the time an instrument is issued also extends to the rules for determining the amount of each dividend equivalent (as discussed in section E.1 of this preamble).

3. Access to Delta Information

Comments noted practical issues with obtaining delta information, particularly for exchange-traded positions where the dealer is not involved in determining pricing and the short party may not have the expertise to calculate delta. Comments suggested adopting an alternative test for identifying high-delta options based on their relative intrinsic value (amount by which the option is in-the-money) and relative extrinsic value (time value). This test would require the simpler calculation of determining the applicable strike price as a percentage of the current fair market value of the ELI and deeming ELIs at a certain percentage as passing or failing the delta threshold. Alternatively, comments suggested permitting the long party to rely on commonly available online tools to calculate delta for exchange-traded ELIs, provided that the taxpayer uses inputs that are within the range of commercially acceptable variation, uses a consistent methodology, and records its calculations contemporaneously. Comments also recommended relying on an anti-abuse rule for particularly complex derivatives for which delta information would be unavailable to any party other than the issuer, speculating that the increased cost and risk of complex transactions generally would outweigh any tax savings.

The Treasury Department and the IRS are concerned that these alternative tests or shorthand methods for determining delta may result in uncertainty for withholding agents and the IRS that could make it difficult to determine the status of potential section 871(m) transactions. Moreover, the changes to the final regulations to require that delta be tested only when a contract is first issued, accompanied by enhanced reporting rules (described in more detail later in this preamble), make these alternative tests unnecessary. Accordingly, the final regulations do not adopt these recommendations.

However, in order to simplify the delta calculation for contracts that reference multiple underlying securities, the final regulations provide that a short party may calculate delta using a single exchange-traded security in certain circumstances. More specifically, if a short party issues a contract that references a basket of 10 or more underlying securities and uses an exchange-traded security, such as an exchange-traded fund, that references substantially the same underlying securities to hedge the contract at the time it is issued, the short party may use the hedge security to determine the delta of the security it is issuing rather than determining the delta of each security referenced in the basket.

4. Contracts With Indeterminate Deltas

Although commenters generally agreed that the delta test was fair and practical for the majority of equity-linked derivatives, numerous comments explained that the delta test would be difficult or impossible to apply to certain more exotic equity derivatives. For example, contracts that have asymmetrical or binary payouts may reference a different number of shares of an underlying security at different payout points. Similarly, contracts that have path-dependent payouts may reference multiple underlying securities, with payouts that are interdependent on the performance of each underlying security. In each of these cases, comments noted that the delta is indeterminate because the number of shares of the underlying security that determine the payout of the derivative cannot be known at the time the contract is entered into.

The Treasury Department and the IRS agree that an alternative to the delta test is needed for contracts with indeterminate deltas. To address these contracts, the final regulations distinguish between simple contracts and complex contracts.

Generally, a simple contract is a contract that references a single, fixed number of shares of one or more issuers to determine the payout. The number of shares must be known when the contract is issued. In addition, the contract must have a single maturity or exercise date on which all amounts (other than any upfront payment or any periodic payments) are required to be calculated with respect to the underlying security. The fact that a contract has more than one expiry, or a continuous expiry, does not preclude the contract from being a simple contract. Thus, an American-style option is a simple contract even though the option may be exercised by the holder at any time on or before the expiration of the option if amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date. Most NPCs and ELIs are expected to be simple contracts and remain subject to the delta test described above.

A complex contract is any contract that is not a simple contract. Contracts with indeterminate deltas are classified as complex contracts, which are subject to a new substantial equivalence test. That test is included in the temporary regulations, described in more detail in Part III of this preamble. The delta test in the final regulations therefore applies only to simple contracts.

D. Exceptions for Certain Payments and Transactions

Several comments requested that the final regulations exclude certain payments from the definition of

''dividend equivalent'' or exclude certain transactions from the definition of ''section 871(m) transaction.'' These comments generally noted that the payment or transaction at issue either is already taxed under another provision of the Code or does not provide the long party with an opportunity to avoid gross basis taxation on U.S. source dividends.

1. Payment Referencing Distributions That Are Not Dividends

The 2013 proposed regulations provide that a payment referencing a distribution on an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to section 871 or section 881 if the long party owned the underlying security directly. The final regulations retain this provision. *See* § 1.871–15(c)(2)(i).

2. Section 305 Coordination

Under sections 305(b) and (c) and regulations authorized by section 305(c), a change to the conversion ratio or conversion price of a convertible debt instrument that is a convertible security for purposes of section 305 (a convertible security) may be treated as a distribution of property to which section 301 applies made to the holder of the convertible security. *See* § 1.305–7. To the extent such a distribution is treated under section 301(c)(1) as a dividend as defined in section 316 (a section 305 dividend), § 1.1441–2(d)(1) would require withholding on the section 305 dividend without regard to the fact that there is no payment at that time. Absent special rules, a section 305 dividend resulting from a change in conversion ratio or price of a convertible security that is a section 871(m) transaction could also be subject to withholding as a dividend equivalent.

The 2013 proposed regulations provide that a payment pursuant to a section 871(m) transaction is not a dividend equivalent to the extent that it is treated as a distribution taxable as a dividend pursuant to section 305. Comments noted that section 305 dividends and dividend equivalents under section 871(m) arise in different contexts and are determined differently. Moreover, section 305 dividends will reduce earnings and profits pursuant to section 312. Comments suggested that the regulations provide more detail to coordinate these two provisions, including guidance on how to reconcile withholding on the delta-based dividend equivalent in these regulations with withholding otherwise required on section 305 dividends.

After consideration of the comments, these final regulations clarify that a dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction. For example, if a change in the conversion ratio of a convertible security that is a section 871(m) transaction is treated as a section 305 dividend made to the holder of the convertible security, a dividend equivalent is reduced by the amount of the section 305 dividend arising from such change.

Although a transaction (for example, a change in conversion ratio of a convertible security) may give rise to both a dividend equivalent and a section 305 dividend, dividend equivalents and section 305 dividends have different characteristics. These final regulations do not alter any of the rules applicable to section 305 dividends. As noted in Part II.L. of this preamble, however, the changes made elsewhere in these final regulations should make section 871(m) inapplicable to most convertible debt instruments, including those that are convertible securities subject to section 305(c).

3. Due Bills

The 2013 proposed regulations reserve on the question of whether a due bill gives rise to a dividend equivalent and request comments regarding whether a payment made by a seller of stock to the purchaser pursuant to an agreement to deliver a pending U.S. source dividend after the record date (for example, a due bill) should be treated as a substantially similar payment.

One comment noted that a due bill may give rise to payments that appear to satisfy the criteria for a dividend equivalent. That comment expressed concern regarding the impact this treatment might have on the capital markets because of the relative frequency of due bills, as well as the administrative complexity of treating these payments as dividend equivalents. Another comment asserted that a due bill is not the economic equivalent of a dividend. Both comments requested that the regulations either address due bills under the anti-abuse rule or exclude them from the term dividend equivalent.

The final regulations provide that a dividend equivalent does not include a payment made pursuant to a due bill that arises from the actions of a securities exchange that apply to all transactions in the stock and when the relevant exchange has set an ex-dividend date that occurs after the record date. This rule is expected to apply in situations in which a securities exchange sets an ex-dividend date after the record date to accommodate a special dividend.

4. Employee Compensation

The 2013 proposed regulations do not specifically exclude payments of compensation for personal services of a nonresident alien individual from being treated as a dividend equivalent. Comments suggested that compensation arrangements should be excluded from dividend equivalent treatment because compensation is already subject to an existing tax withholding framework, compensatory transactions arise in a different context from other derivatives and do not have the potential to avoid U.S. withholding tax, and compensation should be subject to tax where the services are performed.

The Treasury Department and the IRS have determined that section 871(m) should not apply to compensation that is generally subject to withholding or has a specific exception therefrom. Accordingly, the final regulations provide that a dividend equivalent does not include the portion of equity-based compensation for personal services of a nonresident alien individual that is wages subject to withholding under section 3402, excluded from the definition of wages under § 31.3401(a)(6)–1, or exempt from withholding under § 1.1441–4(b). For example, when a restricted stock unit is paid as compensation and tax is collected by the employer at the time of payment through withholding, the payment will not also be a dividend equivalent subject to withholding. If the restricted stock unit results in the receipt of stock, however, dividends subsequently paid on that stock would be subject to withholding under section 871.

5. Certain Corporate Acquisitions

In response to comments, § 1.871–15(j) of the 2013 proposed regulations provides an exception to the definition of a section 871(m) transaction when a taxpayer enters into a transaction as part of a plan pursuant to which one or more persons (including the taxpayer) are obligated to acquire more than 50 percent of the entity issuing the underlying securities.

Comments requested that the acquisition threshold in this exception be lowered from 50 percent to 10 or 20 percent. Comments noted that corporate acquisitions generally would not provide an opportunity for avoiding dividend withholding. Further,

comments noted that the anti-abuse rule should be sufficient to address any abuse that could occur through such transactions. Comments acknowledged that when a target company pays a pre-closing dividend and the purchase price is reduced for the dividend, this may allow the purchaser to avoid a subsequent dividend. However, comments observed that this event should be viewed as a purchase price adjustment rather than a dividend equivalent.

The final regulations do not change the 50 percent threshold. Requiring that an acquisition (as part of a plan by one or more person) total more than 50 percent of a corporation is appropriate because it indicates that the primary intent of the acquirer is to obtain a controlling interest rather than just a substantial investment in the target company. In circumstances where a taxpayer enters into a transaction pursuant to which the taxpayer is obligated to acquire 50 percent or less of the entity issuing the underlying securities, and the transaction is a section 871(m) transaction, any party to the transaction that is a broker, dealer, or intermediary, a short party, or a withholding agent, must comply with any requirements in the final regulation to make appropriate determinations, and satisfy reporting and withholding obligations, as applicable.

D. Payment of a Dividend Equivalent

Section 871(m)(5) provides that a ''payment'' includes any gross amount that references a U.S. source dividend and that is used to compute any net amount transferred to or from the taxpayer. The 2013 proposed regulations provide that a dividend equivalent includes any amount that references an actual or estimated payment of a U.S. source dividend, whether the reference is explicit or implicit. Thus, in addition to amounts equal to actual payments of dividends and estimated dividends, a dividend equivalent includes any other contractual term of a section 871(m) transaction that is calculated based on an actual or estimated dividend. For example, when a long party enters into an NPC that provides for payments based on the appreciation in the value of an underlying security but that does not explicitly entitle the long party to receive payments based on regular dividends (a price return swap), the 2013 proposed regulations treat the price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining other terms of the NPC, such as in the payments that the long party is required to make to the short party or in setting the price of the underlying securities referenced in the price return swap.

Comments objected to the provisions in the 2013 proposed regulations that include estimated and implicit dividends in the definition of a dividend equivalent. These comments noted that an estimated dividend is reflected as a price reduction or as an amount that the foreign investor does not have to pay rather than an amount the foreign investor affirmatively receives for holding the derivative, which suggests that there is no ''payment'' of a dividend equivalent to the foreign investor. Comments also noted that, while estimated dividends may be implicitly incorporated into the pricing of a derivative, the price is ultimately determined by supply and demand in the market and the expected dividend is not always explicitly used in computing the amount paid.

The Treasury Department and the IRS have concluded that the economic benefit of a dividend is present in transactions that implicitly incorporate estimated dividends to virtually the same extent as transactions that pay or adjust for actual dividends. Thus, the final regulations retain the rules in the 2013 proposed regulations that include estimated and implicit dividends as dividend equivalents. *See* § 1.871–15(i)(2). More specifically, the final regulations provide that any gross amount that references the payment of a dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the regulations. The final regulations change the time that withholding is required on a payment of a dividend equivalent, as discussed in Part II.M of this preamble.

E. Amount of a Dividend Equivalent

1. *Calculation of Dividend Equivalent Amount*

Under the 2013 proposed regulations, the amount of a dividend equivalent for a specified NPC or specified ELI equals the per-share dividend amount with respect to the underlying security multiplied by the number of shares of the underlying security referenced in the contract (subject to adjustment), multiplied by the delta of the transaction with respect to the underlying security at the time when the amount of the dividend equivalent is determined. If a transaction provides for a payment based on an estimated or implicit estimated dividend, the actual dividend is used to calculate the amount of the dividend equivalent unless the short party identifies a reasonable estimated dividend amount in writing at the inception of the transaction. When a payment based on estimated dividends is supported by the required documentation, the per-share dividend amount used to compute the amount of a dividend equivalent is the lesser of the estimated dividend and the actual dividend.

Comments on the 2013 proposed regulations noted that recalculating the delta of a section 871(m) transaction each time the amount of a dividend equivalent is determined would add administrative complexity without necessarily improving accuracy. In the interest of simplicity, several comments recommended using the actual dividend amount rather than an amount adjusted for delta as the dividend equivalent amount. Other comments suggested using the delta at the time the transaction is issued or entered into for determining the dividend equivalent amount. For complex transactions for which the delta is indeterminate, comments suggested that withholding be based on the number of shares required by the short party to the transaction to hedge its initial position in the transaction.

The final regulations simplify the rules for determining the amount of a dividend equivalent in response to these comments. For a simple contract, the final regulations provide that the amount of the dividend equivalent for each underlying security equals the amount of the per-share dividend, multiplied by the number of shares referenced in the contract, multiplied by the applicable delta. In a change from the 2013 proposed regulations, the final regulations provide that this formula references the delta of the transaction at the time the simple contract is issued, rather than when the dividend is paid. For a complex contract, the amount of the dividend equivalent equals the amount of the per-share dividend multiplied by the number of shares that constitute the initial hedge of the complex contract (as that term is defined in § 1.871–15(a)(14)(ii) and discussed in Part III.A of this preamble).

Another simplifying rule applies to dividend equivalents paid with respect to baskets of more than 25 securities. If a section 871(m) transaction references a basket of more than 25 underlying securities, the short party is allowed to treat all of the dividends on the basket as paid on the last day of the calendar quarter.

2. *Specified NPCs and Specified ELIs With a Term of One Year or Less*

For a specified NPC or specified ELI with a term of one year or less when acquired, the 2013 proposed regulations provide that the amount of a dividend equivalent is determined when the long party disposes of the section 871(m) transaction. Therefore, a long party that acquires an option with a term of one year or less that is a specified ELI would not incur a withholding tax if the option lapses.

One comment noted that the rule providing that there is no dividend equivalent for options that have a term of one year or less and lapse unexercised is inappropriate in the case of written put options because put writers realize their maximum profit when puts lapse. Comments further noted that the one-year rule could have uneconomic consequences for options close to expiration and for options that are slightly in-the-money or slightly out-of-the-money because the delta could fluctuate materially in response to small changes in the price of the underlying stock.

Based on the comments received, the final regulations eliminate the special rule for contracts with terms of one year or less. Any benefit from the rule is outweighed by the complexity of creating systems to track contracts that differ only in term. Eliminating the special rule for contracts of one year or less means that a dividend equivalent amount must be determined for any option, including a short-term option, that is a specified ELI.

F. Qualified Indices

The 2013 proposed regulations revise rules provided in the 2012 proposed regulations pertaining to an exception for transactions that reference certain equity indices. Under the 2013 proposed regulations, a qualified index is any index that (1) references 25 or more underlying securities, (2) references only long positions in underlying securities, (3) contains no underlying security that represents more than 10 percent of the index's weighting, (4) rebalances based on objective rules at set intervals, (5) does not provide a dividend yield that is greater than 1.5 times the dividend yield of the S&P 500 Index, and (6) is referenced by futures or option contracts that trade on a national securities exchange or a domestic board of trade. In addition, the 2013 proposed regulations provide that a qualified index would become disqualified if a transaction references a qualified index and also references a short position in any component underlying security of the qualified index other than a short position with respect to the entire qualified index (such as a cap or a floor).

One comment recommended eliminating the exception for a qualified index. This comment noted that when a long party holds a total return swap referencing a basket of underlying securities, that swap is economically equivalent to multiple total return swaps that each reference a single underlying security. Similarly, when a long party holds a delta-one derivative that references an index, that derivative is economically equivalent to multiple delta-one derivatives each referencing a single component of the index; therefore, that long party is receiving the economic equivalent of all dividends paid with respect to each stock in the index. Thus, transactions that reference U.S. stock indices have no less potential for avoidance of gross basis withholding tax on dividends than transactions that reference single equities or that reference customized baskets of equities.

Another comment noted that the criteria in the 2013 proposed regulations provide a reasonable method for identifying legitimate indices that have not been designed to avoid withholding taxes. That comment noted that the rules would exclude most securities that are linked to an index and traded on U.S. stock exchanges from dividend taxation, while preventing customized indices from becoming a vehicle designed to evade U.S. dividend taxes.

The majority of comments, however, recommended that the scope of the index exception be expanded to include most of the indices that are represented by exchange traded funds. Several comments requested that the definition allow an index with fewer than 25 stocks to be a qualified index, noting that many sector indices have fewer than 25 names. Another comment suggested providing an exception to the requirement that an index be referenced by exchange-traded futures or options that would apply to indices that are sufficiently broad-based (for example, indices containing one hundred or more component securities). Comments also suggested eliminating the requirement that the stock of a single company cannot represent more than 10 percent of the index's weighting because some indices include component securities that grow rapidly. Several comments also noted that many indices would fail to satisfy the requirement that a qualified index rebalance based on objective rules at set intervals because many popular indices, including the S&P 500 Index, rebalance using a combination of objective and subjective factors.

Comments further requested that the permitted dividend yield be increased to 2.5 times the current dividend yield of the S&P 500 Index. The comments noted that an index may not satisfy the requirement based on 1.5 times the current dividend yield of the S&P 500 Index if the stocks in the index depreciated significantly relative to the general U.S. stock market. In addition, other indices would not qualify because some market sectors routinely pay dividends at a rate that is more than 1.5 times the average rate in the U.S. market.

Other comments suggested additional categories of indices that should be treated as qualified indices. Specifically, one comment recommended that any index that was published by a recognized independent index publisher should be a qualified index if the index is offered for license to third parties on similar terms and multiple third party industry participants actually license the index. The comments proposed defining a recognized independent index publisher as an organization that publishes indices that are created, calculated, and compiled by a group of employees that have no duties other than those related to the publication of the indices.

The rule in the 2013 proposed regulations that prevents taxpayers from using short positions to decrease their long position with respect to one or more components of an index was also noted by comments as too restrictive. Comments suggested permitting taxpayers to decrease risk with respect to a small percentage of the value of the stocks in the index without disqualifying the index. One comment suggested that an index should remain a qualified index unless the short position is used to establish a net long position in a narrow set of underlying securities for purposes of evading withholding.

The 2013 proposed regulations also included a safe harbor for global indices with 10 percent or less U.S. stocks. Comments recommended expanding this safe harbor because U.S. equities in a global index can comprise more than half of the index's weighting. The comments proposed increasing the threshold to allow U.S. stocks to represent 50 percent or more of the index. These comments also noted that global indices do not typically trade on U.S. securities or commodities exchanges and will not be qualified indices under the current provisions. Other comments suggested that the

regulations except from withholding all global indices that are not created to avoid withholding tax, with a presumption that widely-used benchmark indices are not designed to avoid tax.

The Treasury Department and the IRS believe that the approach taken in the 2013 proposed regulations for identifying qualified indices appropriately balances the competing concerns. Accordingly, the final regulations generally retain the criteria of the 2013 proposed regulations with modifications to clarify the intent and improve the functionality of the qualified index rule. *See* § 1.871–15(l)

The final regulations add a paragraph stating that the purpose of the qualified index rule is to provide a safe harbor for transactions on passive indices that reference a diverse basket of securities and that are widely used by numerous market participants. The index exception is not intended to apply to any index that is customized or reflects a trading strategy, is unavailable to other investors, or targets special dividends. The final regulations further provide that an index will not be treated as a qualified index if treating the index as a qualified index would be contrary to this purpose.

To make the rules easier to administer, the final regulations modify the time for determining whether an index satisfies the qualified index criteria. Specifically, the final regulations provide that the determination of whether an index is a qualified index is made on the first business day of each calendar year, and that determination applies for all potential section 871(m) transactions issued during that calendar year.

In response to comments, a number of changes also were made to specific aspects of the qualified index definition. First, the final regulations delete the modifier ''underlying'' with respect to ''securities,'' thereby allowing an index to qualify with fewer than 25 component underlying securities provided that the index contains a total of at least 25 component securities (in other words, a component security may include a security that does not give rise to U.S. source dividends). The index, however, will not qualify if it references five or fewer component underlying securities that together represent more than 40 percent of the weighting of the component securities in the index. Second, the final regulations increase the 10 percent limit for the maximum weighting of a single underlying security to 15 percent. Third, in response to concerns regarding the requirement that a qualified index rebalance based on objective rules, the final regulations do not require that an index be modified or rebalanced at set dates or intervals, and provide flexibility for how the rules governing the constitution of an index are applied. Instead, under the final regulations, an index that is periodically rebalanced by a board or committee that is allowed to exercise judgment in interpreting the rules governing the composition of the index will not be disqualified if the index is otherwise a qualified index.

The final regulations continue to require that an index be referenced by futures or options listed on a national securities exchange or board of trade to be a qualified index, which is consistent with the intent to provide a safe harbor only for non-customized and widely-available indices. The final regulations do, however, permit an index that trades on certain foreign exchanges to be a qualified index, provided that the referenced component underlying securities, in aggregate, comprise less than 50 percent of the weighting of the component securities in the index and the index otherwise meets the definition of a qualified index.

Similarly, the Treasury Department and the IRS have concluded that the proposed rule permitting no more than 1.5 times the current dividend yield of the S&P 500 Index is appropriate and have retained it in the final regulations. To reduce the number of required calculations, however, the final regulations provide that the annual yields of the tested index and of the S&P 500 Index are determined based on their annual yields for the immediately preceding calendar year, rather than requiring comparison of the annual yields for the month immediately preceding the date that the potential section 871(m) transaction is issued.

The Treasury Department and the IRS agree that de minimis short positions, whether as part of the index or entered into separately, should not disqualify an index. Accordingly, the final regulations permit a qualified index to reference one or more short positions (in addition to any short positions with respect to the entire qualified index, such as caps or floors, which were already permitted by the 2013 proposed regulations) that represent five percent or less, in the aggregate, of the value of the long positions in underlying securities in the qualified index.

G. Combined Transactions

The 2013 proposed regulations treat multiple transactions as a single transaction for purposes of determining if the transactions are a section 871(m) transaction when a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other. The 2013 proposed regulations apply only to combine transactions in which the taxpayer is the long party, and typically would not combine transactions when a taxpayer is the long party with respect to an underlying security in one transaction and the short party with respect to the same underlying security in another transaction. The 2013 proposed regulations provide that a broker-dealer must use ''reasonable diligence'' to determine whether a transaction is a section 871(m) transaction. Under the 2013 proposed regulations, a withholding agent was not required to withhold on a dividend equivalent paid pursuant to a transaction that is combined with one or more other transactions unless the withholding agent knew that the long party (or a related person) entered into the potential section 871(m) transactions in connection with each other.

The Treasury Department and the IRS requested comments regarding whether and how the rules for combining separate transactions should apply in other situations, such as when a taxpayer holds both long and short positions with respect to the same underlying security (for example, a call spread). Comments also were requested regarding whether and how the remaining transaction (or transactions) should be retested when a long party terminates one or more, but not all, of the transactions that make up a combined position.

Several comments recommended that the regulations not provide a specific combination rule and instead rely on an anti-abuse rule. One comment endorsed the proposed regulations as they applied to combinations of long calls and written puts (two options that can be used to closely approximate the economics of stock ownership) but recommended that transactions not be combined if the transactions replicate the same or similar risks with respect to additional shares (for example, two purchased calls on the same underlying securities).

Many comments observed that determining whether transactions were entered into ''in connection with'' each other would be difficult for a withholding agent and that the regulations should adopt a different standard or clarify the meaning of the phrase. Comments asked that the final regulations conform the standard for combined transactions to the narrower withholding standard that requires

''actual knowledge.'' Comments noted that the requirement in the 2013 proposed regulations for broker-dealers to use ''reasonable diligence'' to determine whether a transaction is a section 871(m) transaction could be interpreted to require broker-dealers to inquire whether transactions are entered into in connection with each other in order to determine whether they must be combined. These comments observed that this standard for combined transactions is impractical because broker-dealers are generally not in a position to discern the intent of their counterparties, even using ''reasonable diligence.''

Several comments recommended that a combination rule permit netting of long and short positions. Commenters observed that many standard option strategies involve multiple options positions, often combining positive and negative delta options. As a result, an approach that does not combine these positions would fail to reflect the economics of the transactions. Commenters suggested that when a taxpayer modifies an existing combined position that includes both long and short positions, the combined position should continue to be tested based on the net deltas of the component positions rather than test the delta for each position separately. None of the comments, however, proposed an administrable test that could be used to reliably combine long and short positions and net the resulting deltas.

The final regulations retain the general rules from the 2013 proposed regulations that define when transactions are combined. In response to questions about whether the rules were intended to combine transactions that had similar economic exposure, the final regulations add a requirement that the potential section 871(m) transactions, when combined, replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction. Thus, the purchase of two out-of-the-money call options would typically not be combined because each call option provides the taxpayer with exposure to appreciation, but not depreciation, on the referenced stock.

The Treasury Department and the IRS recognize the challenges that short parties could face in identifying transactions to be combined. The final regulations therefore provide brokers acting as short parties with two presumptions they can apply to determine their liability to withhold. First, a broker may presume that transactions are not entered into in connection with each other if the long party holds the transactions in separate accounts. Second, a broker may presume that transactions entered into two or more business days apart are not entered into in connection with each other. These presumptions are independent of each other. Thus, a broker acting as a short party is relieved of the obligation to withhold if either of the two presumptions is met. A broker cannot rely on the first presumption if it has actual knowledge that the long party created or used separate accounts to avoid section 871(m), however, and neither presumption applies if the broker has actual knowledge that transactions were entered into in connection with each other.

In addition, the final regulations provide that the Commissioner will presume that transactions that are properly reflected on separate trading books of the taxpayer are not entered into in connection with each other. The Commissioner will also presume that a long party did not enter into two or more transactions in connection with each other if the long party entered into the transactions two or more business days apart. These presumptions are rebuttable. The Commissioner may rebut the first presumption with facts and circumstances showing that separate trading books were created or used to avoid section 871(m), and may rebut either presumption with facts and circumstances showing that the transactions in question were entered into in connection with each other.

The Commissioner will also apply an affirmative presumption. The Commissioner will presume that transactions that are entered into fewer than two business days apart and reflected on the same trading book are entered into in connection with each other. In this case, the long party can rebut the presumption by presenting facts and circumstances showing that the transactions were not entered into in connection with each other. In applying the presumptions that are based on trades being separated by at least two business days, the regulations include a rule of convenience that generally allows parties to treat all of their transactions as entered into at 4:00 p.m.

The presumptions are not available to the long party. A long party therefore must treat two or more transactions as combined transactions if the transactions satisfy the requirements to be a combined transaction. The long parties affected by this rule consist primarily of securities traders, who are in a position to know their securities positions and trading strategies and to monitor their compliance with section 871(m).

The Treasury Department and the IRS will continue to evaluate the possibility of expanding the combination rules to accommodate netting of long and short positions in light of future developments in transactional reporting and recordkeeping. Additional comments regarding combined transactions are welcome.

H. Derivatives Referenced to Partnership Interests

The 2013 proposed regulations treat a transaction that references an interest in an entity that is not a C corporation for Federal tax purposes as referencing the allocable portion of any underlying securities and potential section 871(m) contracts held directly or indirectly by that entity. The 2013 proposed regulations provide an exception for a transaction that references an interest in an entity that is not a C corporation if the underlying securities and potential section 871(m) transactions allocable to that interest represent, in the aggregate, 10 percent or less of the value of the interest in the referenced entity at the time the transaction is entered into. Comments recommended changing the threshold for applying the look-through rule from 10 percent to 50 percent unless the taxpayer controls the entity. Comments also noted that taxpayers would have difficulty determining the assets owned by referenced entities.

The final regulations revise the rules to provide that section 871(m) applies to derivatives that reference a partnership interest only when the partnership is either a dealer or trader in securities, has significant investments in securities, or holds an interest in a lower-tier partnership that engages in those activities. The final regulations define a security by cross-reference to section 475(c). When the rule in the final regulations applies, a potential section 871(m) transaction that references a partnership interest is treated as referencing the allocable share of underlying securities and the potential section 871(m) transactions in the partnership directly or indirectly allocable to that partnership interest. Even when a partnership is not covered by this rule, the anti-abuse rule in § 1.871–15(o) may still apply, or the transaction may be recharacterized under the substance-over-form doctrine or other common law doctrine.

I. Anti-Abuse Rule

The 2013 proposed regulations provide that the Commissioner may treat any payment made with respect to a transaction as a dividend equivalent if

the taxpayer acquires the transaction with a principal purpose of avoiding the application of section 871(m). Comments generally agreed with the need for such a rule, and the final regulations retain this provision. *See* § 1.871–15(o).

In addition, the IRS may challenge the U.S. tax results claimed in connection with transactions that are designed to avoid the application of section 871(m) using all available statutory provisions and judicial doctrines (including the substance-over-form doctrine, the economic substance doctrine under section 7701(o), the step transaction doctrine, and tax ownership principles) as appropriate. For example, nothing in section 871(m) precludes the IRS from asserting that a contract labeled as an NPC or other equity derivative is in fact an ownership interest in an underlying security referenced in the contract.

J. Reporting Obligations

The 2013 proposed regulations provide rules for reporting and withholding. The preamble to the 2013 proposed regulations explains that most equity-linked transactions involve a financial institution acting as a broker, dealer, or intermediary and that the financial institution would be in the best position to report the tax consequences of a potential section 871(m) transaction. Accordingly, § 1.871–15(o) of the 2013 proposed regulations provides that when a broker or dealer is a party to a potential section 871(m) transaction the broker or dealer is required to determine whether the transaction is a section 871(m) transaction, and if so, the amounts of the dividend equivalents. If no broker or dealer is a party to a transaction or both parties are brokers or dealers, the short party is required to determine whether the transaction is a section 871(m) transaction and the amounts of the dividend equivalents. Determinations made by the broker, dealer, or short party are binding on the parties to the section 871(m) transaction unless a party to the transaction knows or has reason to know that the information is incorrect. Those determinations, however, are not binding on the IRS.

Comments expressed concern that the delta information necessary for an investor to determine whether a transaction is subject to section 871(m) may not be available on a timely basis, and requested that the regulations expand the categories of persons permitted to request information about the status and calculations associated with potential section 871(m) transactions. Comments recommended requiring the information to be provided on an issuer's Web site at or prior to the time that the transaction is issued and updated regularly. Investors could then rely on such information between update intervals.

In response to these comments, the final regulations make several changes to the reporting obligations in the 2013 proposed regulations. The final regulations revise the period for providing requested information from 14 calendar days to 10 business days from the date of the request. In addition, the final regulations replace the list of persons entitled to request information in the 2013 proposed regulations with a simpler provision that entitles ''any party to the transaction'' to request information. The final regulations define ''a party to the transaction'' to include any agent acting on behalf of a long party or short party to a potential section 871(m) transaction, or any person acting as an intermediary with respect to a potential section 871(m) transaction. This simplification responds to the requests to expand the scope of persons entitled to request information. Several other changes that were requested, however, such as posting information electronically, were already permitted by the 2013 proposed regulations. Like the 2013 proposed regulations, the final regulations permit parties to a transaction to obtain information on potential section 871(m) transactions in a variety of ways, including through electronic publication (such as a Web site).

Comments also noted that a short party to a listed option will not be able to provide the long party with a written estimate of dividends at inception because the short party does not have a contractual relationship with the long party. These comments requested that the broker be required to provide the written estimates. As in the 2013 proposed regulations, the final regulations do not require any party to a transaction to provide written estimates of dividends. The final regulations have taken these comments into account, however, by increasing a taxpayer's ability to obtain information from other parties to the transaction. The final regulations accomplish this by expanding the definition of a ''party to the transaction'' to include a broker and by clarifying that either a dealer or a middleman is a ''broker.'' Therefore, if written estimates of dividends are prepared when a transaction is issued, the long party should be able to obtain the information from another party to the transaction, whether the short party or a broker.

K. Recordkeeping Rules

The 2013 proposed regulations generally cross-reference the recordkeeping rules in § 1.6001–1 for how a taxpayer establishes whether a transaction is a section 871(m) transaction and whether a payment is a dividend equivalent. For clarity and to ensure that the IRS will have access to sufficient information to audit taxpayers and withholding agents that are parties to section 871(m) transactions, the final regulations provide more detailed recordkeeping rules. The final regulations provide that any person required to retain records must keep sufficient information to establish whether a transaction is a section 871(m) transaction and the amount of a dividend equivalent. To satisfy this requirement, a taxpayer must retain documentation and work papers supporting a delta calculation or substantial equivalence calculation (including the number of shares of the initial hedge) and written estimated dividends (if any). The records and documentation must be created substantially contemporaneously with the time the potential section 871(m) transaction is issued.

L. Contingent and Convertible Debt Instruments

1. Contingent Debt Instruments

Section 871(h)(1) generally provides that U.S. source portfolio interest received by a nonresident alien individual is not subject to the 30-percent U.S. tax imposed under section 871(a)(1). Section 871(h)(4)(A)(i), however, excludes certain contingent interest payments from the definition of portfolio interest. Section 871(h)(4)(A)(ii) grants the Secretary authority to impose tax on contingent interest other than the payments described in section 871(h)(4)(A)(i) when necessary or appropriate to prevent the avoidance of federal income tax.

Comments on the 2012 proposed regulations recommended narrowing the definition of a specified notional principal contract to clarify that the term does not include contingent or convertible debt. These comments suggested that section 871(m) should not override the portfolio interest exception. Section 871(h)(4)(A)(ii) expressly provides authority to the Secretary to treat interest as contingent interest if necessary or appropriate to prevent the avoidance of federal income tax. Consistent with this grant of authority, the 2013 proposed regulations provide that contingent interest will not qualify for the portfolio interest

exemption to the extent that the contingent interest payment is a dividend equivalent. The final regulations retain this exception to the portfolio interest exemption. There is no reason that an equity derivative that otherwise would be a specified NPC or a specified ELI should receive different treatment because it is embedded in a debt instrument. A debt instrument that provides for a contingent interest payment determined by reference to a U.S. source dividend payment that would otherwise be a section 871(m) transaction is a transaction that has the potential for tax avoidance, and it is appropriate for section 871(m) to apply. The effect of this rule, however, is expected to be minimal because the delta of the embedded derivative in a contingent debt or convertible debt instrument is tested only at the time it is issued.

2. Convertible Debt Instruments

Numerous comments requested that convertible debt instruments be excluded from the definition of an ELI. Comments suggested that certain characteristics typical of convertible debt would discourage foreign investors from using these instruments to avoid U.S. withholding tax. Comments pointed, for example, to high transaction costs and certain discontinuities between the economic performance of the convertible debt and that of the underlying stock, such as the downside protection and creditors' rights afforded by convertible debt. Comments noted that convertible bonds are important capital markets instruments used by U.S. corporations to raise capital at lower rates. Comments also speculated that treating such bonds as specified ELIs could adversely impact capital markets by decreasing demand, reducing liquidity, and increasing costs.

The final regulations do not provide an exception from section 871(m) for convertible debt. When the stock price significantly exceeds the conversion price, convertible debt becomes a surrogate for the stock into which the debt can be converted. Accordingly, a convertible debt obligation is a specified ELI if the delta of the embedded option at the time the convertible debt is originally issued is 0.80 or higher. Moreover, the fact that convertible debt ordinarily has been issued with a delta on the embedded option of less than 0.80 is expected to significantly reduce the effect of these regulations on the convertible debt market. In response to uncertainty expressed by some market participants, the final regulations clarify that the delta of the convertible feature is tested separately from the delta of the debt instrument in making section 871(m) calculations.

M. Amounts Subject to Withholding

Section 1.1441–2(d)(5) of the 2013 proposed regulations provides that a withholding agent is not obligated to withhold on a dividend equivalent until the later of: (1) When the amount of the dividend equivalent is determined and (2) when any of the following occurs: (a) Money or other property is paid pursuant to a section 871(m) transaction, (b) the withholding agent has custody or control of money or other property, or (c) there is an upfront payment or a prepayment of the purchase price.

Comments emphasized the burden of withholding on dividend equivalents absent actual payments, and noted that, in the absence of actual payment, continuous monitoring and withholding on each specified ELI over time is impractical. Certain comments suggested that a foreign broker only be required to withhold on dividend equivalents from ELIs when there is a final payment or a sale.

Comments also maintained that upfront payments should not be viewed as payments subject to withholding because such proceeds are received in exchange for issuing the instrument, are used by the issuer to purchase related hedging positions, and are not intended to be reserves for satisfying tax owed by the counterparty.

Some comments expressed concern regarding the practical difficulties in withholding from funds that the broker-dealer holds as collateral. Comments noted that the broker-dealer may not be legally entitled to use cash or property in one account to satisfy a withholding obligation in another account. In addition, foreign counterparties may hold different accounts through different affiliates of a broker-dealer. Comments indicated that it would be impractical to determine the existence of affiliate accounts and apply set-off rules on that basis.

After consideration of these comments, the Treasury Department and the IRS have concluded that the withholding agent's obligations should not arise until an actual payment is made or there is a final settlement of a transaction. Accordingly, the final regulations provide that a withholding agent is not obligated to withhold on a dividend equivalent until the later of when a payment is made with respect to a section 871(m) transaction or when the amount of a dividend equivalent is determined. A payment with respect to a section 871(m) transaction will generally occur when the long party receives or makes a payment, when there is a final settlement of the section 871(m) transaction, or when the long party sells or otherwise disposes of the section 871(m) transaction. For options and other contracts that typically require an upfront payment, the final regulations do not treat the premium or other upfront payment as a payment for withholding purposes. Thus, withholding on these section 871(m) transactions is not required until there is a final settlement (including, in the case of an option, a lapse) or the long party sells or otherwise disposes of the transaction. Consequently, if an option that is a section 871(m) transaction lapses, the short party is nonetheless required to withhold on any dividend equivalent associated with the option. Parties may need to modify contractual arrangements to ensure that there are sufficient funds available to satisfy withholding obligations.

III. Temporary and Proposed Regulations

A. Test for Contracts With Indeterminate Deltas

As noted in Part II of this preamble, many commenters stated that the delta test was workable for most equity derivatives but would be difficult or impossible to apply to more exotic equity derivatives. In particular, a contract that provides for payments based on a number of shares of stock that varies at different points, or that provides for a payment that does not vary with the price of the shares (often called ''digital'' options), have an indeterminate delta because the number of shares of the underlying security that determine the payout of the derivative cannot be known at the time the contract is entered into. Path-dependent contracts were also mentioned as problematic for the delta computation.

Indeterminate delta may, for example, occur in contracts commonly known as structured notes. Structured notes are financial instruments that combine aspects of debt with aspects of derivatives, such as equity options. As an example, in return for an upfront payment of a set amount, a structured note might provide the long party with leveraged upside return, meaning that the long party is entitled to receive a fixed percentage (for example, 200 percent) of any appreciation in the value of a referenced stock up to a capped amount (for example, 125 percent of the issue price) in addition to return of the upfront payment, while being exposed to 100 percent of any depreciation in the value of the referenced stock, with any such depreciation reducing the amount

of the upfront payment that is returned to the long party. In such a structured note, the holder would have two times the ''upside'' up to the cap but only one times exposure to the ''downside.'' The issuer of this kind of structured note cannot readily determine a delta for the note because it references a different number of shares at different payoff amounts. In other words, because delta is the ratio of the change in the fair market value of a contract to a small change in the fair market value of the property referenced by the contract, the value of the referenced property must be known to calculate delta. In the case of the structured note described in this paragraph, the number of shares of stock (and hence the value of the property) referenced by the contract will be different depending on whether the stock appreciates, and in such case whether the cap is reached, or whether the stock depreciates.

As explained in Part II.C.4 of this preamble, a contract with an indeterminate delta is not a simple contract, and therefore falls into the residual category as a complex contract. Because the delta test cannot accurately be applied to a complex contract, commenters had various suggestions for how to determine whether such a contract should be a section 871(m) transaction. One comment suggested that the delta should be calculated using the highest possible number of shares that could be referenced by the derivative at maturity. This comment further suggested that the regulations include a delta-specific anti-abuse rule to prevent issuers from manipulating the number of referenced shares to artificially reduce delta. Other comments suggested that the regulations should disaggregate a transaction into a series of components and then separately apply the delta test to each component. When multiple derivatives are embedded in a single instrument, a comment recommended that multiple pieces be aggregated into separate components (for example, aggregating all embedded calls and separately aggregating all embedded puts) using an ordering rule that would maximize the likelihood that the delta threshold would be met.

A majority of comments requested that some version of a ''proportionality'' test be applied to complex contracts or to contracts where the basic delta test is susceptible of manipulation. A proportionality test measures the likelihood that a contract's performance will track the performance of the referenced equity. That is, a proportionality test measures the same variability or economic equivalence that the delta test seeks to measure without needing to know the number of shares that the contract references at the outset. Like the delta test, a proportionality test is based on the principle that when the value of an NPC or ELI closely tracks the value of an underlying security, it is appropriate to treat the NPC or ELI as a surrogate for the underlying security.

To test whether a complex contract is a section 871(m) transaction, the temporary regulations adopt the ''substantial equivalence'' test. The substantial equivalence test is a version of a proportionality test that was advocated by many commenters, and it uses information easily accessible to most issuers of complex contracts. Generally, the substantial equivalence test measures the change in value of a complex contract when the price of the underlying security referenced by that contract is hypothetically increased by one standard deviation or decreased by one standard deviation (each, a ''testing price'') and compares that change to the change in value of the shares of the underlying security that would be held to hedge the complex contract at the time the contract is issued (the ''initial hedge'') at each testing price. The smaller the proportionate difference between the change in value of the complex contract and the change in value of its initial hedge at multiple testing prices, the more equivalence there is between the contract and the referenced underlying security. When this difference is equal to or less than the difference for a simple contract benchmark with a delta of 0.80 and its initial hedge, the complex contract is treated as substantially equivalent to the underlying security.

The Treasury Department and the IRS are aware that there may be NPCs or ELIs that even the substantial equivalence test may not adequately address. The temporary regulations provide that when the steps of the substantial equivalence test cannot be applied to a particular complex contract, a taxpayer must use the principles of the substantial equivalence test to reasonably determine whether the complex contract is a section 871(m) transaction with respect to each underlying security.

The Treasury Department and the IRS request comments regarding the substantial equivalence test described in the temporary regulations. In particular, comments are requested on whether the two testing points required for most transactions in the temporary regulations are adequate to ensure that the substantial equivalence test captures the appropriate types of transactions, and the administrability of the test and its application to complex contracts that reference multiple securities, including path-dependent instruments.

B. Withholding Requirements and QDDs

1. Background

Section 871(m)(1) generally treats a dividend equivalent as a dividend from sources within the United States without regard to the residence of the person paying the dividend equivalent. As a result, section 871(m) may apply to payments made by a foreign payor to a foreign payee. *See* Staff of J. Comm. on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the ''Hiring Incentives to Restore Employment Act,'' JCX–4–10, at 79 (Feb. 23, 2010) (explaining that section 871(m) may apply to a chain of dividend equivalents, including payments made by a foreign person pursuant to transactions described in Notice 97–66); *see also* Notice 97–66, 1997–2 C.B. 328, at § 5, Examples 3 and 4 (illustrating that a foreign person making a substitute dividend payment to another foreign person must withhold U.S. tax). Because Congress was concerned that this rule may result in over-withholding in some instances, Congress granted the Secretary authority in section 871(m)(6) to reduce tax on a chain of dividend equivalents, but only to the extent that the taxpayer can establish that tax has been paid with respect to another dividend equivalent in the chain, or is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in such chain. For purposes of section 871(m)(6), a dividend is treated as a dividend equivalent.

2. Comments on the 2013 Proposed Regulations

The 2013 proposed regulations address the role of financial intermediaries in a chain of dividend equivalents with a rule that provides that payments made to a ''qualified dealer'' are not treated as dividend equivalents if made pursuant to a transaction that is entered into by the qualified dealer in its capacity as a dealer in securities and the dealer is the long party. For purposes of this rule, a qualified dealer is any dealer that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized and that certifies to the short party that it is receiving the payment in its capacity as a dealer. The 2013 proposed regulations require the qualified dealer to certify as to its dealer status to a short party on a transaction-

by-transaction basis, and do not apply to dividends paid to a qualified dealer.

Comments requested that the qualified dealer exception in the 2013 proposed regulations be expanded, noting that it would be impractical for dealers to certify that each transaction was entered into in a dealer capacity (and not as a proprietary trade) and that the rule did not accommodate transactions entered into as a hedge of another transaction. Some comments suggested that the regulations exclude transactions entered into in the ordinary course of the dealer's business for hedging purposes. Other comments recommended expanding the exception to include affiliates of qualified dealers that issue certain potential section 871(m) transactions. Comments further recommended that an affiliate in these circumstances should not be required to certify that it is acting in its capacity as a dealer. Several comments requested that, in addition to expanding the definition of qualified dealer, the final regulations provide rules similar to the proposed regulatory framework described in Notice 2010–46 (discussed in more detail in section III.B.4 of this preamble).

3. Qualified Intermediaries Acting as Qualified Derivatives Dealers

The comments received on both the 2012 proposed regulations and the 2013 proposed regulations consistently expressed the desire for a comprehensive withholding and documentation regime tailored to derivatives dealers. Rather than create a new regime for section 871(m) transactions, the Treasury Department and the IRS determined that the most comprehensive and efficient way to respond to the requests in the comments is to expand the existing qualified intermediary (QI) regime to accommodate taxpayers acting as financial intermediaries on section 871(m) transactions. Generally, a QI is an eligible person that enters into a QI agreement with the IRS and that acts as a QI under such agreement. *See* Rev. Proc. 2014–39, 2014–29 I.R.B. 150. A QI agreement typically requires the QI to assume certain documentation and withholding responsibilities in exchange for simplified information reporting for its foreign account holders and the ability to not disclose proprietary account holder information to a withholding agent that may be a competitor. A QI may either assume primary withholding responsibilities or may provide withholding information to a withholding agent from which it receives a payment.

QIs that hold stocks and bonds for customers often receive payments subject to withholding on behalf of their foreign account holders as custodians rather than as beneficial owners. In contrast, a broker that enters into derivative contracts as a principal typically receives dividends and dividend equivalents as part of a chain of transactions in which the broker is a counterparty to both long and short positions.

The Treasury Department and the IRS intend to implement the particular requirements of withholding and reporting on dividend equivalents received and paid by brokers by amending the QI agreement to include new provisions that will permit an eligible QI to act as a qualified derivatives dealer (QDD). A QI that acts as a QDD will not be subject to withholding on dividends or payments that may be dividend equivalents made with respect to potential section 871(m) transactions that the QDD receives while acting in its capacity as a dealer.

In order to act as a QDD, a QI must meet four requirements. First, the QDD must furnish to withholding agents a QI withholding certificate affirming that the recipient is acting as a QDD for dividends and dividend equivalent payments associated with the withholding certificate. Second, the QDD must agree to assume primary withholding and reporting responsibilities on all payments associated with the withholding certificate that the QDD receives and makes as a dealer, and to determine whether payments it makes are dividend equivalents. Third, a QDD must agree to remain liable for tax on any dividends and dividend equivalents it receives unless the QDD is obligated to make an offsetting dividend equivalent payment as the short party on the same underlying securities. Finally, a QDD must comply with any compliance review procedures that are applicable to a QI acting as a QDD, as specified in the QI agreement.

The class of persons eligible to act as a QDD is narrower than the class of persons that are eligible to enter into a QI agreement. A QI will be allowed to act as a QDD if it is either (1) a securities dealer that is regulated as a dealer in the jurisdiction in which it was organized or operates, or (2) a bank that is regulated as a bank in the jurisdiction in which it was organized or operates (or a wholly-owned foreign affiliate of such a bank). To act as a QDD, a QI that is not a securities dealer also must issue potential section 871(m) transactions to customers and receive dividends or dividend equivalent payments incident to hedges of potential section 871(m) transactions that it issues. The latter category of QDDs is intended to allow banks and bank affiliates that issue equity-linked instruments on an occasional basis to still act as QDDs.

4. Notice 2010–46

Shortly after section 871(m) was enacted, the Treasury Department and the IRS published Notice 2010–46, 2010–24 I.R.B. 757. Notice 2010–46 addresses potential overwithholding in the context of securities lending and sale repurchase agreements. Notice 2010–46 provides a two-part solution to the problem of overwithholding on a chain of dividends and dividend equivalents. First, it provides an exception from withholding for payments to a qualified securities lender (QSL). Second, it provides a proposed framework to credit forward prior withholding on a chain of substitute dividends paid pursuant to a chain of securities loans or stock repurchase agreements. The QSL regime requires a person that agrees to act as a QSL to comply with certain withholding and documentation requirements. Notice 2010–46 and any QI agreement imposing QSL requirements will remain effective until final regulations implementing the QDD rules are published.

As stated above, Notice 2010–46 provided a proposed framework to credit forward prior withholding on a chain of substitute dividends paid pursuant to a chain of securities loans or stock repurchase agreements. The Treasury Department and the IRS will continue to consider whether a credit forward system for prior withholding would be appropriate in the context of a chain of dividend equivalents on NPCs or ELIs. While administrating the credit forward system described in Notice 2010–46, however, the IRS has had difficulty verifying that prior withholding in a chain of securities loans had in fact occurred in order to justify the crediting of prior withholding to a subsequent payment. The temporary regulations, therefore, reserve on the issue of a general credit forward system, and the Treasury Department and the IRS request comments on the need for such a system and how it could be implemented.

5. Implementation of the QDD Regime and Phase-out of the QSL Regime

All existing QI agreements expire on December 31, 2016. Prior to January 1, 2017, the Treasury Department and the IRS intend to publish an updated QI agreement and rules addressing the requirements for QDD status.

Procedures for entering into a QI agreement that permits a QI to act as a QDD are expected to be set out in this agreement. QDD status will be effective no sooner than January 1, 2017. Until these temporary regulations are finalized and appropriate provisions are incorporated into a new QI agreement, the provisions for QSLs and the credit-forward rules under Notice 2010–46 will continue to apply for dividend equivalents that are substitute dividend payments made pursuant to a securities lending or a sale-repurchase transaction.

Once fully implemented, the new QDD status under the QI regime will replace and expand the QSL regime described in Notice 2010–46. To continue to be eligible for the exception from withholding, entities that have been treated as QSLs will be required to enter into a QI agreement to satisfy and comply with the requirements for QDD treatment provided in the temporary regulations and in the updated QI Agreement. When these temporary regulations are finalized, the Treasury Department and the IRS expect the final regulations to supplant the proposed regulatory framework described in Notice 2010–46.

C. Certain Insurance Contracts

The 2013 proposed regulations do not specifically address whether payments made on life insurance or annuity contracts are dividend equivalents when the payments are directly or indirectly contingent upon or determined by reference to the payment of a dividend from sources within the United States. Comments noted that treating annuity contract payments as dividend equivalents could conflict with section 72, which provides that the holder of an annuity contract is taxed only when an amount is received from the annuity. Comments further noted that when a foreign person receives payments or withdrawals from an annuity contract issued by a domestic insurance company, the payment is FDAP subject to 30% withholding to the extent such payment or withdrawal constitutes gross income as determined in accordance with section 72. Similarly, withdrawals of income from a life insurance contract issued by a domestic insurance company are generally U.S. source FDAP subject to withholding. Commenters argued that the existing rules that apply to life insurance and annuity contracts obviate the need for withholding under section 871(m).

The Treasury Department and the IRS agree that the taxation of life insurance and annuity contracts issued by domestic insurance companies is adequately addressed under current law. Therefore, the temporary regulations provide that there is no dividend equivalent associated with a payment that a foreign person receives pursuant to the terms of an annuity, endowment, or life insurance contract issued by a domestic insurance company (including the foreign or U.S. possession branch of the domestic insurance company).

The Treasury Department and the IRS are considering how section 871(m) should apply to annuity, endowment, and life insurance contracts that reference U.S. equities and that are issued by foreign life insurance companies. Until further guidance is issued, the temporary regulations provide that these contracts do not include a dividend equivalent when issued by a foreign corporation that is predominately engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation. Similarly, the temporary regulations do not treat any portion of a payment received by a foreign life insurance company as a dividend equivalent when the payment is made according to the terms of an insurance contract, such as reinsurance, by a foreign corporation meeting the same requirements. The Treasury Department and the IRS are also evaluating how section 871(m) should apply to reinsurance contracts. Taxpayers are encouraged to send comments on how section 871(m) should apply to foreign life insurance companies and the contracts they issue.

IV. Effective/Applicability Date

The final and temporary regulations are generally effective on September 18, 2015. To ensure that brokers have adequate time to develop the systems needed to implement the regulations, however, the final and temporary regulations generally apply to transactions issued on or after January 1, 2017. In addition, with respect to transactions issued on or after January 1, 2016, and before January 1, 2017, that are section 871(m) transactions, the regulations also apply to any payment of a dividend equivalent made on or after January 1, 2018. The regulations do not change the applicability date of § 1.871–15(d)(1)(i) for specified NPCs described in that section.

The chapter 4 regulations provide a coordinating effective date for the treatment of dividend equivalents as withholdable payments for purposes of chapter 4 withholding. Section 1.1471–2(b)(2)(i)(A)(*2*) provides that grandfathered obligations under chapter 4 include any obligation that gives rise to a withholdable payment solely because the obligation gives rise to a dividend equivalent pursuant to section 871(m) and the regulations thereunder. This grandfather rule applies only to obligations that are executed on or before the date that is six months after the date on which obligations of its type are first treated as giving rise to dividend equivalents.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that few, if any, small entities will be affected by these regulations. The regulations will primarily affect multinational financial institutions, which tend to be larger businesses, and foreign entities. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are D. Peter Merkel and Karen Walny of the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS also participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.871–14(h) also issued under 26 U.S.C. 871(h) and 871(m). * * *

§§ 1.871–15 and 1.871–15T also issued under 26 U.S.C. 871(m). * * *

Par. 2. Section 1.871–14 is amended by:

■ 1. Redesignating paragraphs (h) and (i) as paragraphs (i) and (j), respectively.

■ 2. Adding new paragraphs (h) and (j)(3).

The additions read as follows:

§ 1.871–14 Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

* * * * *

(h) *Portfolio interest not to include certain contingent interest*—(1) *Dividend equivalents.* Contingent interest does not qualify as portfolio interest to the extent that the interest is a dividend equivalent within the meaning of section 871(m).

(2) *Amount of dividend equivalent that is not portfolio interest.* The amount that does not qualify as portfolio interest because it is a dividend equivalent equals the amount of the dividend equivalent determined pursuant to § 1.871–15(j). Unless otherwise excluded pursuant to section 871(h), any other interest paid on an obligation that is not a dividend equivalent may qualify as portfolio interest.

* * * * *

(j) * * *

(3) *Effective/applicability date.* The rules of paragraph (h) of this section apply beginning September 18, 2015.

■ **Par. 3.** Section 1.871–15 is amended by:

■ 1. Redesignating paragraphs (d)(1)(i) as (d)(1)(i)(A), (d)(1) introductory text as (d)(1)(i), (d)(1)(ii) as (d)(1)(i)(B), (d)(1)(iii) as (d)(1)(i)(C), and (d)(1)(iv) as (d)(1)(i)(D).

■ 2. Removing ''2016'' from newly redesignated paragraph (d)(1)(i) and adding ''2017'' in its place.

■ 3. Removing ''Specified NPCs before January 1, 2016'' from newly redesignated paragraph (d)(1)(i) and adding ''*In general''* in its place.

■ 4. Adding new paragraphs (d)(1) introductory text, (d)(1)(ii) and (d)(2).

■ 5. Redesignating paragraph (o) as paragraph (r)(2) and:

■ a. Revising the heading for newly redesignated paragraph (r)(2),

■ b. Removing the language ''This'' in paragraph (r)(2) and adding ''Paragraph (d)(1)(i) of this'' in its place, and

■ c. Adding new paragraphs (r)(1), (r)(3) and (q).

■ 7. Adding new paragraphs (a) through (c), and (e) through (p).

The additions and revisions read as follows:

§ 1.871–15 Treatment of dividend equivalents.

(a) *Definitions.* For purposes of this section, the following terms have the meanings described in this paragraph (a).

(1) *Broker.* A *broker* is a broker within the meaning provided in section 6045(c).

(2) *Dealer.* A *dealer* is a dealer in securities within the meaning of section 475(c)(1).

(3) *Dividend.* A *dividend* is a dividend as described in section 316.

(4) *Equity-linked instrument.* An *equity-linked instrument* (*ELI*) is a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, that references the value of one or more underlying securities. For example, a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one or more underlying securities is an ELI.

(5) *Initial hedge.* An *initial hedge* is the number of underlying security shares that a short party would need to fully hedge an NPC or ELI (whether the NPC or ELI is a complex contract or a simple contract benchmark (within the meaning of paragraph (h)(2) of this section), as appropriate) with respect to an underlying security at the time the NPC or ELI is issued, even if the short party does not in fact fully hedge the NPC or ELI.

(6) *Issue.* An NPC or ELI is treated as issued at inception, original issuance, or at the time of an issuance as a result of a deemed exchange pursuant to section 1001.

(7) *Notional principal contract.* A *notional principal contract* (*NPC*) is a notional principal contract as defined in § 1.446–3(c).

(8) *Option.* An *option* includes an option embedded in any debt instrument, forward contract, NPC, or other potential section 871(m) transaction.

(9) *Parties to the transaction*—(i) *Long party.* A *long party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be entitled to receive a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(ii) *Short party.* A *short party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be obligated to make a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(iii) *Party to the transaction.* A *party to the transaction* is any person that is a long party or a short party to a potential section 871(m) transaction, any agent acting on behalf of the long party or short party, or any person acting as an intermediary with respect to the potential section 871(m) transaction.

(iv) *Party to the transaction that is both a long party and a short party*—(A) *In general.* If a potential section 871(m) transaction references more than one underlying security, the long party and short party are determined separately with respect to each underlying security. A party to a potential section 871(m) transaction is both a long party and a short party when the party is entitled to a payment that references a dividend payment on an underlying security and the same party is obligated to make a payment that references a dividend payment on another underlying security pursuant to the potential section 871(m) transaction.

(B) *Example.* The following example illustrates the definitions in paragraph (a)(9) of this section:

Example. (i) Stock X and Stock Y are underlying securities. A and B enter into an NPC that entitles A to receive payments from B based on any appreciation in the value of Stock X and dividends paid on Stock X during the term of the contract and obligates A to make payments to B based on any depreciation in the value of Stock X during the term of the contract. In return, the NPC entitles B to receive payments from A based on any appreciation in the value of Stock Y and dividends paid on Stock Y during the term of the contract and obligates B to make payments to A based on any depreciation in the value of Stock Y during the term of the contract.

(ii) A is the long party with respect to Stock X, and the short party with respect to Stock Y. B is the long party with respect to Stock Y, and the short party with respect to Stock X.

(10) *Payment.* A *payment* has the meaning provided in paragraph (i) of this section.

(11) *Reference.* To *reference* means to be contingent upon or determined by reference to, directly or indirectly, whether in whole or in part.

(12) *Section 871(m) transaction and potential section 871(m) transaction.* A *section 871(m) transaction* is any securities lending or sale-repurchase transaction, specified NPC, or specified ELI. A *potential section 871(m) transaction* is any securities lending or sale-repurchase transaction, NPC, or ELI that references one or more underlying securities.

(13) *Securities lending or sale-repurchase transaction.* A *securities lending or sale-repurchase transaction* is any securities lending transaction, sale-repurchase transaction, or substantially similar transaction that references an underlying security. *Securities lending transaction* and *sale-repurchase transaction* have the same meaning as provided in § 1.861–3(a)(6).

(14) *Simple contracts and complex contracts*—(i) *Simple contract.* A *simple contract* is an NPC or ELI for which, with respect to each underlying security,

(A) 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 (as determined in paragraph (j)(3) of this section) of the underlying security, provided that the number of shares can be ascertained when the contract is issued, and (B) 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. 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. 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. A simple contract that is an NPC is a *simple NPC.* A simple contract that is an ELI is a *simple ELI.*

(ii) *Complex contract*—(A) *In general.* A *complex contract* is any NPC or ELI that is not a simple contract. A complex contract that is an NPC is a *complex NPC.* A complex contract that is an ELI is a *complex ELI.*

(B) Example. An ELI entitles the long party to a return equal to 200 percent of the appreciation on 100 shares of Stock X, and obligates the long party to pay an amount equal to the actual depreciation on 100 shares of Stock X. Because the ELI does not provide the long party with an amount that is calculated by reference to a single, fixed number of shares of Stock X on the maturity date that can be ascertained at issuance, it is not a simple ELI. More specifically, upon maturity the ELI will either entitle the long party to receive a payment that is, in substance, measured by reference to 200 shares of stock or obligate the long party to make a payment measured by reference to 100 shares of stock. The ELI is a complex ELI because it is not a simple ELI.

(15) *Underlying security.* An *underlying security* is any interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to § 1.861–3, where applicable taking into account paragraph (m) of this section. Except as provided in paragraph (l) of this section, if a potential section 871(m) transaction references an interest in more than one entity described in the preceding sentence or different interests in the same entity, each referenced interest is a separate underlying security for purposes of applying the rules of this section.

(b) *Source of a dividend equivalent.* A dividend equivalent is treated as a dividend from sources within the United States for purposes of sections 871(a), 881, 892, 894, and 4948(a), and chapters 3 and 4 of subtitle A of the Internal Revenue Code.

(c) *Dividend equivalent*—(1) *In general.* Except as provided in paragraph (2), *dividend equivalent* means—

(i) Any payment that references the payment of a dividend from an underlying security pursuant to a securities lending or sale-repurchase transaction;

(ii) Any payment that references the payment of a dividend from an underlying security pursuant to a specified NPC described in paragraph (d) of this section;

(iii) Any payment that references the payment of a dividend from an underlying security pursuant to a specified ELI described in paragraph (e) of this section; and

(iv) Any other substantially similar payment as described in paragraph (f) of this section.

(2) *Exceptions*—(i) *Not a dividend.* A payment that references a distribution with respect to an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to section 871 or section 881 if the long party owned the underlying security. For example, if an NPC references stock in a regulated investment company that pays a dividend that includes a capital gains dividend described in section 852(b)(3)(C) that would not be subject to tax under section 871 or section 881 if paid directly to the long party, then an NPC payment is not a dividend equivalent to the extent that it is determined by reference to the capital gains dividend.

(ii) *Section 305 coordination.* A dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction.

(iii) *Due bills.* A dividend equivalent does not include a payment made pursuant to a due bill arising from the actions of a securities exchange that apply to all transactions in the stock with respect to the dividend. For purposes of this section, a stock will be considered to trade with a due bill only when the relevant securities exchange has set an ex-dividend date with respect to a dividend that occurs after the record date.

(iv) *Certain payments pursuant to annuity, endowment, and life insurance contracts.* [Reserved]. For further guidance, see § 1.871–15T(c)(2)(iv).

(v) *Certain payments pursuant to employee compensation arrangements.* A dividend equivalent does not include the portion of equity-based compensation for personal services of a nonresident alien individual that is—

(A) Wages subject to withholding under section 3402 and the regulations under that section;

(B) Excluded from the definition of wages under § 31.3401(a)(6)–1; or

(C) Exempt from withholding under § 1.1441–4(b).

(d) *Specified NPCs*—(1) *Specified NPCs entered into before January 1, 2017*—(i) * * *.

(ii) *Specified NPC status as of January 1, 2017.* An NPC that is treated as a specified NPC pursuant to paragraph (d)(1)(i) of this section will remain a specified NPC on or after January 1, 2017.

(2) *Specified NPCs on or after January 1, 2017*—(i) *Simple NPCs.* A simple NPC that has a delta of 0.8 or greater with respect to an underlying security when the NPC is issued is a specified NPC.

(ii) *Complex NPCs.* A complex NPC that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security when the NPC is issued is a specified NPC.

(e) *Specified ELIs*—(1) *Simple ELIs.* A simple ELI that has a delta of 0.8 or greater with respect to an underlying security when the ELI is issued is a specified ELI.

(2) *Complex ELIs.* A complex ELI that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security when the ELI is issued is a specified ELI.

(f) *Other substantially similar payments.* For purposes of this section, any payment made in satisfaction of a tax liability of the long party with respect to a dividend equivalent by a withholding agent is a dividend equivalent received by the long party. The amount of that dividend equivalent constitutes additional income to the

payee to the extent provided in § 1.1441–3(f)(1).

(g) *Delta*—(1) *In general.* Delta is the ratio of the change in the fair market value of an NPC or ELI to a small change in the fair market value of the number of shares of the underlying security (as determined under paragraph (j)(3) of this section) referenced by the NPC or ELI. If an NPC or ELI contains more than one reference to a single underlying security, all references to that underlying security are taken into account in determining the delta with respect to that underlying security. If an NPC or ELI references more than one underlying security or other property, the delta with respect to each underlying security must be determined without taking into account any other underlying security or property. The delta of an equity derivative that is embedded in a debt instrument or other derivative is determined without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. Thus, for example, the delta of an option embedded in a convertible note is determined without regard to the debt component of the convertible note. For purposes of this section, delta must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of this section.

(2) *Time for determining delta.* For purposes of applying the rules of this section, the delta of a potential section 871(m) transaction is determined only when the potential section 871(m) transaction is issued (as defined in paragraph (a)(6) of this section).

(3) *Simplified delta calculation for certain simple contracts that reference multiple underlying securities.* If an NPC or ELI references 10 or more underlying securities and the short party uses an exchange-traded security (for example, an exchange-traded fund) that references substantially all of the underlying securities (the hedge security) to hedge the NPC or ELI at the time it is issued, the delta of the NPC or ELI may be calculated by determining the ratio of the change in the fair market value of the simple contract to a small change in the fair market value of the hedge security. A delta determined under this paragraph (g)(3) must be used as the delta for each underlying security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(ii) of this section.

(4) *Examples.* The following examples illustrate the rules of this paragraph (g). For purposes of these examples, Stock X and Stock Y are common stock of domestic corporations X and Y. LP is the long party to the transaction.

Example 1. Delta calculation for an NPC. The terms of an NPC require LP to pay the short party an amount equal to all of the depreciation in the value of 100 shares of Stock X and an interest-rate based return. In return, the NPC requires the short party to pay LP an amount equal to all of the appreciation in the value of 100 shares of Stock X and any dividends paid by X on those shares. The value of the NPC will change by $1 for each $0.01 change in the price of a share of Stock X. When LP entered into the NPC, Stock X had a fair market value of $50 per share. The NPC therefore has a delta of 1.0 ($1.00/($0.01 × 100)).

Example 2. Delta calculation for an option. LP purchases a call option that references 100 shares of Stock Y. At the time LP purchases the call option, the value of the option is expected to change by $0.30 for a $0.01 change in the price of a share of Stock Y. When LP purchases the option, Stock Y has a fair market value of $100 per share. The call option has a delta of 0.3 ($0.30/($0.01 × 100)).

(h) *Substantial Equivalence.* [Reserved]. For further guidance, see § 1.871–15T(h).

(i) *Payment of a dividend equivalent*—(1) *Payments determined on gross basis.* For purposes of this section, a payment includes any gross amount that references the payment of a dividend and that is used in computing any net amount transferred to or from the long party even if the long party makes a net payment to the short party or no amount is paid because the net amount is zero.

(2) *Actual and estimated dividends*—(i) *In general.* A payment includes any amount that references an actual or estimated payment of dividends, whether the reference is explicit or implicit. If a potential section 871(m) transaction provides for a payment based on an estimated dividend that adjusts to account for the amount of an actual dividend paid, the payment is treated as referencing the actual dividend amount and not an estimated dividend amount.

(ii) *Implicit dividends.* A payment includes an actual or estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction, including interest rate, notional amount, purchase price, premium, upfront payment, strike price, or any other amount paid or received pursuant to the potential section 871(m) transaction.

(iii) *Actual dividend presumption.* A short party to a section 871(m) transaction is treated as paying a per-share dividend amount equal to the actual dividend amount unless the short party to the section 871(m) transaction identifies a reasonable estimated dividend amount in writing at the time the transaction is issued. For this purpose, a reasonable estimated dividend amount stated in an offering document or the documents governing the terms at the time the transaction is issued will establish the estimated dividend amount. To qualify as an estimated dividend amount, the written estimated dividend amount must separately state the amount estimated for each anticipated dividend or state a formula that allows each dividend to be determined. If an underlying security is not expected to pay a dividend, a reasonable estimate of the dividend amount may be zero.

(iv) *Additions to estimated payments.* If a section 871(m) transaction provides for any payment in addition to an estimated dividend and that additional payment is determined by reference to a dividend (for example, a special dividend), both the estimated dividend and the additional payment are used to determine the per-share dividend amount.

(3) *Dividends for certain baskets*—(i) *In general.* If a section 871(m) transaction references long positions in more than 25 underlying securities, the short party may treat the dividends with respect to the referenced underlying securities as paid at the end of the applicable calendar quarter to compute the per-share dividend amount.

(ii) *Publicly available dividend yield.* For purposes of paragraph (i)(3)(i) of this section, if a section 871(m) transaction references the same underlying securities as a security (for example, stock in an exchange-traded fund) or index for which there is a publicly available quarterly dividend yield, the publicly available dividend yield may be used to determine the per-share dividend amount for the section 871(m) transaction with any adjustment for special dividends.

(iii) *Dividend yield for a section 871(m) transaction using the simplified delta calculation.* When the delta of a section 871(m) transaction is determined under paragraph (g)(3) of this section, the per-share dividend amount for that section 871(m) transaction must be determined using the dividend yield for the exchange-traded security that fully hedges the section 871(m) transaction.

(4) *Examples.* The following examples illustrate the rules of this paragraph (i). For purposes of these examples, Stock X is common stock of Corporation X, a domestic corporation, that historically pays quarterly dividends on Stock X.

The parties anticipate that Corporation X will continue to pay quarterly dividends.

Example 1. Forward contract to purchase domestic stock. (i) When Stock X is trading at $50 per share, Foreign Investor enters into a forward contract to purchase 100 shares of Stock X in one year. Reasonable estimates of the quarterly dividend are specified in the transaction documents. The price in the forward contract is determined by multiplying the number of shares referenced in the contract by the current price of the shares and an interest rate, and subtracting the value of any dividends expected to be paid during the term of the contract. Assuming that the forward contract is priced using an interest rate of 4 percent and total estimated dividends with a future value of $1 per share during the term of the forward contract, the purchase price set in the forward contract is $5,100 (100 shares × $50 per share × 1.04 − ($1 × 100)).

(ii) Subject to paragraph (i)(2)(iv) of this section, the estimated dividend amount is the per-share dividend amount because the estimate is reasonable and specified in accordance with paragraph (i)(2)(iii) of this section. The estimated per-share dividend amount is a dividend equivalent for purposes of this section.

Example 2. Price return only swap contract. (i) Foreign Investor enters into a price return swap contract that entitles Foreign Investor to receive payments based on the appreciation in the value of 100 shares of Stock X and requires Foreign Investor to pay an amount based on LIBOR plus any depreciation in the value of Stock X. The swap contract neither explicitly entitles Foreign Investor to payments based on dividends paid on Stock X during the term of the contract nor references an estimated dividend amount. The LIBOR rate in the swap contract, however, is reduced to reflect expected annual dividends on Stock X.

(ii) Because the LIBOR leg of the swap contract is reduced to reflect estimated dividends and the estimated dividend amount is not specified, Foreign Investor is treated as receiving the actual dividend amount in accordance with paragraph (i)(2) of this section. The actual per-share dividend amounts are dividend equivalents for purposes of this section.

(j) *Amount of dividend equivalent*—(1) *Calculation of the amount of a dividend equivalent*—(i) *Securities lending or sale-repurchase transactions.* For a securities lending or sale-repurchase transaction, the amount of the dividend equivalent for each underlying security equals the amount of the actual per-share dividend paid on the underlying security multiplied by the number of shares of the underlying security.

(ii) *Simple contracts.* For a simple contract that is a section 871(m) transaction, the amount of the dividend equivalent for each underlying security equals:

(A) The per-share dividend amount (as determined under either paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The number of shares of the underlying security multiplied by;

(C) The delta of the section 871(m) transaction with respect to the underlying security.

(iii) *Complex contracts.* For a complex contract that is a section 871(m) transaction, the amount of the dividend equivalent for each underlying security equals:

(A) The per-share dividend amount (as determined under paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The initial hedge for the underlying security.

(iv) *Other substantially similar payments.* In addition to any amount determined pursuant to paragraph (j)(1)(i), (ii), or (iii), the amount of a dividend equivalent includes the amount of any payment described in paragraph (f) of this section.

(2) *Time for determining the amount of a dividend equivalent.* The amount of a dividend equivalent is determined on the earlier of the date that is the record date of the dividend and the day prior to the ex-dividend date with respect to the dividend. For example, if a specified NPC provides for a payment at settlement that takes into account an earlier dividend payment, the amount of the dividend equivalent is determined on the earlier of the record date or the day prior to the ex-dividend date for that dividend.

(3) *Number of shares.* The number of shares of an underlying security generally is the number of shares of the underlying security stated in the contract. If the transaction modifies that number by a factor or fraction or otherwise alters the amount of any payment, the number of shares is adjusted to take into account the factor, fraction, or other modification. For example, in a transaction in which the long party receives or makes payments based on 200 percent of the appreciation or depreciation (as applicable) of 100 shares of stock, the number of shares of the underlying security is 200 shares of the stock.

(k) *Limitation on the treatment of certain corporate acquisitions as section 871(m) transactions.* A potential section 871(m) transaction is not a section 871(m) transaction with respect to an underlying security if the transaction obligates the long party to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the long party) are obligated to acquire underlying securities representing more than 50 percent of the value of the entity issuing the underlying securities.

(l) *Rules relating to indices*—(1) *Purpose.* The purpose of this section is to provide a safe harbor for potential section 871(m) transactions that reference certain passive indices that are based on a diverse basket of publicly-traded securities and that are widely used by numerous market participants. Notwithstanding any other provision in this paragraph (l), an index is not a qualified index if treating the index as a qualified index would be contrary to the purpose described in this paragraph.

(2) *Qualified index not treated as an underlying security.* For purposes of this section, a qualified index is treated as a single security that is not an underlying security. The determination of whether an index referenced in a potential section 871(m) transaction is a qualified index is made at the time the transaction is issued based on whether the index is a qualified index on the first business day of the calendar year in which the transaction is issued.

(3) *Qualified index.* A *qualified index* means an index that—

(i) References 25 or more component securities (whether or not the security is an underlying security);

(ii) Except as provided in paragraph (l)(6)(ii) of this section, references only long positions in component securities;

(iii) References no component underlying security that represents more than 15 percent of the weighting of the component securities in the index;

(iv) References no five or fewer component underlying securities that together represent more than 40 percent of the weighting of the component securities in the index;

(v) Is modified or rebalanced only according to publicly stated, predefined criteria, which may require interpretation by the index provider or a board or committee responsible for maintaining the index;

(vi) Did not provide an annual dividend yield in the immediately preceding calendar year from component underlying securities that is greater than 1.5 times the annual dividend yield of the S&P 500 Index as reported for the immediately preceding calendar year; and

(vii) Is traded through futures contracts or option contracts (regardless of whether the contracts provide price only or total return exposure to the index or provide for dividend reinvestment in the index) on—

(A) A national securities exchange that is registered with the Securities and Exchange Commission or a domestic

board of trade designated as a contract market by the Commodity Futures Trading Commission; or

(B) A foreign exchange or board of trade that is a qualified board or exchange as determined by the Secretary pursuant to section 1256(g)(7)(C) or that has a staff no action letter from the CFTC permitting direct access from the United States that is effective on the applicable testing date, provided that the referenced component underlying securities, in the aggregate, comprise less than 50 percent of the weighting of the component securities in the index.

(4) *Safe harbor for certain indices that reference assets other than underlying securities.* Notwithstanding paragraph (l)(3) of this section, an index is a qualified index if the referenced component underlying securities in the aggregate comprise 10 percent or less of the weighting of the component securities in the index.

(5) *Weighting of component securities.* For purposes of this paragraph (l), the weighting of a component security of an index is the percentage of the index's value represented, or accounted for, by the component security.

(6) *Transactions that reference a qualified index and one or more component securities or indices*—(i) *In general.* When a potential section 871(m) transaction references a qualified index and one or more component securities or other indices, the qualified index remains a qualified index only if the potential section 871(m) transaction does not reference a short position in any referenced component security of the qualified index, other than a short position with respect to the entire qualified index (for example, a cap or floor) or a de minimis short position described in paragraph (l)(6)(ii) of this section. If, in connection with a potential section 871(m) transaction that references a qualified index, a taxpayer (or a related person within the meaning of section 267(b) or section 707(b)) enters into one or more transactions that reduce exposure to any referenced component security of the index, other than transactions that reduce exposure to the entire index, then the potential section 871(m) transaction is not treated as referencing a qualified index.

(ii) *Safe harbor for de minimis short positions.* Notwithstanding paragraphs (l)(3)(ii) and (l)(6)(i) of this section, an index may be a qualified index if the short position (whether part of the index or entered into separately by the taxpayer or related person within the meaning of section 267(b) or section 707(b)) reduces exposure to referenced component securities of a qualified index (excluding any short positions with respect to the entire qualified index) by five percent or less of the value of the long positions in component securities in the qualified index.

(7) *Transactions that indirectly reference a qualified index.* If a potential section 871(m) transaction references a security (for example, stock in an exchange-traded fund) that tracks a qualified index, the potential section 871(m) transaction will be treated as referencing a qualified index.

(m) *Rules relating to derivatives that reference partnerships*—(1) *In general.* When a potential section 871(m) transaction references a partnership interest, the assets of the partnership will be treated as referenced by the potential section 871(m) transaction only if the partnership carries on a trade or business of dealing or trading in securities, holds significant investments in securities (either of which is a covered partnership), or directly or indirectly holds an interest in a lower-tier partnership that is a covered partnership. For purposes of this section, if a covered partnership directly or indirectly holds assets that are underlying securities or potential section 871(m) transactions, any potential section 871(m) transaction that references an interest in the covered partnership is treated as referencing the shares of the underlying securities, including underlying securities of potential section 871(m) transactions, directly or indirectly allocable to that partnership interest. For purposes of this paragraph (m), a security is defined in section 475(c).

(2) *Significant investments in securities*—(i) *In general.* For purposes of this paragraph (m), a partnership holds significant investments in securities if either—

(A) 25 percent or more of the value of the partnership's assets consist of underlying securities or potential section 871(m) transactions; or

(B) The value of the underlying securities or potential section 871(m) transactions equals or exceeds $25 million.

(ii) *Determining the value of the partnership's assets.* For purposes of this paragraph (m)(2), the value of a partnership's assets is determined at the time the potential 871(m) transaction referencing that partnership interest is issued based on the value of the assets held by the partnership on the last day of the partnership's prior taxable year unless the long party or the short party has actual knowledge that a subsequent transaction has caused the partnership to cross either of the thresholds described in paragraph (m)(2)(i). The value of a partnership's assets is equal to their fair market value, except that the value of any NPC, futures contract, forward contract, option, and any similar financial instrument held by the partnership is deemed to be the value of the notional securities referenced by the transaction.

(n) *Combined transactions*—(1) *In general.* For purposes of determining whether a potential section 871(m) transaction is a section 871(m) transaction, two or more potential section 871(m) transactions are treated as a single transaction with respect to an underlying security when—

(i) A person (or a related person within the meaning of section 267(b) or section 707(b)) is the long party with respect to the underlying security for each potential section 871(m) transaction;

(ii) The potential section 871(m) transactions reference the same underlying security;

(iii) The potential section 871(m) transactions, when combined, replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction; and

(iv) The potential section 871(m) transactions are entered into in connection with each other (regardless of whether the transactions are entered into simultaneously or with the same counterparty).

(2) *Section 871(m) transactions.* If a potential section 871(m) transaction is a section 871(m) transaction, either by itself or as a result of a combination with one or more other potential section 871(m) transactions, it does not cease to be a section 871(m) transaction as a result of applying paragraph (n) of this section or disposing of one or more of the potential section 871(m) transaction with which it is combined.

(3) *Short party presumptions regarding combined transactions*—(i) *Transactions in separate accounts.* A short party that is a broker may presume that transactions are not entered into in connection with each other for purposes of paragraph (n)(1) of this section if a long party holds or reflects the transactions in separate accounts maintained by the short party, unless the short party has actual knowledge that the transactions held or reflected in separate accounts by the long party were entered into in connection with each other or that separate accounts were created or used to avoid section 871(m).

(ii) *Transactions separated by at least two business days.* A short party that is a broker may presume that transactions

entered into two or more business days apart are not entered into in connection with each other for purposes of paragraph (n)(1) of this section unless the short party has actual knowledge that the transactions were entered into in connection with each other.

(4) *Presumptions Commissioner will apply to long party*—(i) *Transactions in separate trading books.* The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party properly reflected those transactions on separate trading books. The Commissioner may rebut this presumption with facts and circumstances showing that transactions reflected on separate trading books were entered into in connection with each other or that separate trading books were created or used to avoid section 871(m).

(ii) *Transactions separated by at least two days.* The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party entered into the transactions two or more business days apart. The Commissioner may rebut this presumption with facts and circumstances showing that the transactions entered into two or more business days apart were entered into in connection with each other.

(iii) *Transactions separated by less than two days and reflected in the same trading book.* The Commissioner will presume that transactions that are entered into less than two business days apart and reflected on the same trading book are entered into in connection with each other. A long party can rebut this presumption with facts and circumstances showing that the transactions were not entered into in connection with each other.

(5) *Rules of application*—(i) *Two business days rule.* For the purpose of determining the number of business days between transactions, the short party may, and the Commissioner will, assume that all transactions are entered into at 4:00 p.m. on the date the transaction becomes effective in the jurisdiction of the long party.

(ii) *No long party presumptions.* Notwithstanding the presumptions described in paragraphs (n)(3) and (n)(4) of this section, the long party must treat two or more transactions as combined transactions if the transactions are described in paragraph (n)(1) of section.

(6) *Ordering rule for transactions entered into in connection with each other.* If a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), a short party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security. Thus, for example, if a taxpayer has sold one at-the-money put and purchased two at-the-money calls, each with respect to 100 shares of the same underlying security, the put and one call are combined. Similarly, a purchased call on 100 shares and a sold put on 200 shares of the same underlying security can be combined for 100 shares with 100 shares of the put remaining separate. The two calls are not combined because they do not provide the long party with economic exposure to depreciation in the underlying security. Similarly, if a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), but have not been combined by a short party, the long party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security.

(7) *More than one underlying security referenced.* If potential section 871(m) transactions reference more than one underlying security, paragraph (n)(1) of this section applies separately with respect to each underlying security.

(o) *Anti-abuse rule.* If a taxpayer (directly or through the use of a related person within the meaning of section 267(b) or section 707(b)) acquires (whether by entering into, purchasing, accepting by transfer, by exchange, or by conversion, or otherwise acquiring) or disposes of (whether by sale, offset, exercise, termination, expiration, maturity, or other means) a transaction or transactions with a principal purpose of avoiding the application of this section, the Commissioner may treat any payment (as described in paragraph (i) of this section) made with respect to that transaction or transactions as a dividend equivalent to the extent necessary to prevent the avoidance of this section. Therefore, notwithstanding any other provision of this section, the Commissioner may, for example, adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, change the maturity, adjust the timing of payments, treat a transaction that references a partnership interest as referencing the assets of the partnership, combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions, or otherwise depart from the rules of this section as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). When a withholding agent knows that the taxpayer acquired or disposed of a transaction or transactions with a principal purpose of avoiding the application of this section and the Commissioner treats a payment made with respect to any transaction as a dividend equivalent, the withholding agent may be liable for any tax pursuant to section 1461.

(p) *Information required to be reported regarding a potential section 871(m) transaction*—(1) *In general.* If a broker or dealer is a party to a potential section 871(m) transaction with a counterparty or customer that is not a broker or dealer, the broker or dealer is required to determine whether the potential section 871(m) transaction is a section 871(m) transaction. If both parties to a potential section 871(m) transaction are brokers or dealers, or neither party to a potential section 871(m) transaction is a broker or dealer, the short party must determine whether the potential section 871(m) transaction is a section 871(m) transaction. The party to the transaction that is required to determine whether a transaction is a section 871(m) transaction must also determine and report to the counterparty or customer the timing and amount of any dividend equivalent (as described in paragraphs (i) and (j) of this section). Except as otherwise provided in paragraph (n)(3) of this section, the party required to make the determinations described in this paragraph is required to exercise reasonable diligence to determine whether a transaction is a section 871(m) transaction, the amount of any dividend equivalents, and any other information necessary to apply the rules of this section. The information must be provided in the manner prescribed in paragraphs (p)(2) and (p)(3) of this section. The determinations required by paragraph (p) of this section are binding on the parties to the potential section 871(m) transaction and on any person who is a withholding agent with respect to the potential section 871(m) transaction unless the person knows or has reason to know that the information received is incorrect. The

determinations are not binding on the Commissioner.

(2) *Reporting requirements.* For rules regarding the reporting requirements of withholding agents with respect to dividend equivalents described in this section, see §§ 1.1461–1(b) and (c) and 1.1474–1(c) and (d).

(3) *Additional information available to a party to a potential section 871(m) transaction*—(i) *In general.* Upon request by any person described in paragraph (p)(3)(ii) of this section, the party required to report information pursuant to paragraph (p)(1) of this section must provide the requester with information regarding the amount of each dividend equivalent, the delta of the potential section 871(m) transaction, the amount of any tax withheld and deposited, the estimated dividend amount if specified in accordance with paragraph (i)(2)(iii) of this section, the identity of any transactions combined pursuant to paragraph (n) of this section, and any other information necessary to apply the rules of this section. The information requested must be provided within a reasonable time, not to exceed 10 business days, and communicated in one or more of the following ways:

(A) By telephone, and confirmed in writing;

(B) By written statement sent by first class mail to the address provided by the requesting party;

(C) By electronic publication available to all persons entitled to request information; or

(D) By any other method agreed to by the parties, and confirmed in writing.

(ii) *Persons entitled to request information.* Any party to the transaction described in paragraph (a)(9) of this section may request the information specified in paragraph (p) of this section with respect to a potential section 871(m) transaction from the party required by paragraph (p)(3)(i) of this section to provide the information.

(iii) *Reliance on information received.* A person described in paragraph (p)(1) or (p)(3)(ii) of this section that receives information described in paragraph (p)(1) or (p)(3)(i) of this section may rely on that information to provide information to any other person unless the recipient knows or has reason to know that the information received is incorrect. When the recipient knows or has reason to know that the information received is incorrect, the recipient must make a reasonable effort to determine and provide the information described in paragraph (p)(1) or (p)(3)(i) of this section to any person described in paragraph (p)(1) or (p)(3)(ii) of this section that requests information from the recipient.

(4) *Recordkeeping rules*—(i) *In general.* For rules regarding recordkeeping requirements sufficient to establish whether a transaction is a section 871(m) transaction and whether a payment is a dividend equivalent and the amount of gross income treated as a dividend equivalent, see § 1.6001–1.

(ii) *Records sufficient to establish whether a transaction is a section 871(m) transaction and any dividend equivalent amount.* Any person required to retain records must keep sufficient information to establish whether a transaction is a section 871(m) transaction and the amount of a dividend equivalent (if any), including documentation and work papers supporting the delta calculation or the substantial equivalence test (including the number of shares of the initial hedge), as applicable, and written estimated dividends (if any). The records and documentation must be created substantially contemporaneously. A record will be considered to have been created substantially contemporaneously if it was created within 10 business days of the date the potential section 871(m) transaction is issued.

(q) *Dividend and dividend equivalent payments to a qualified derivatives dealer.* [Reserved]. For further guidance, see § 1.871–15T(q).

(r) *Effective/applicability date*—(1) *In general.* This section applies to payments made on or after September 18, 2015 except as provided in paragraphs (r)(2) and (3) of this section.

(2) *Effective/applicability date for paragraph (d)(1)(i).* * * *

(3) *Effective/applicability date for paragraphs (d)(2) and (e).* Paragraphs (d)(2) and (e) apply to any payment made on or after January 1, 2017, with respect to any transaction issued on or after January 1, 2017, and to any payment made on or after January 1, 2018, with respect to any transaction issued on or after January 1, 2016, and before January 1, 2017.

■ **Par. 4.** Section 1.871–15T is added to read as follows:

§ 1.871–15T Treatment of dividend equivalents (temporary).

(a) through (b) [Reserved]. For further guidance, see § 1.871–15(a) through (b).

(c) [Reserved]. For further guidance, see § 1.871–15(c)(1) through (c)(2)(iii).

(iv) *Payments made pursuant to annuity, endowment, and life insurance contracts*—(A) *Insurance contracts issued by domestic insurance companies.* A payment made pursuant to a contract that is an annuity, endowment, or life insurance contract issued by a domestic corporation (including its foreign or U.S. possession branch) that is a life insurance company described in section 816(a) does not include a dividend equivalent if the payment is subject to tax under section 871(a) or section 881.

(B) *Insurance contracts issued by foreign insurance companies.* A payment does not include a dividend equivalent if it is made pursuant to a contract that is an annuity, endowment, or life insurance contract issued by a foreign corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

(C) *Insurance contracts held by foreign insurance companies.* A payment made pursuant to a policy of insurance (including a policy of reinsurance) does not include a dividend equivalent if it is made to a foreign corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

(v) [Reserved]. For further guidance, see § 1.871–15(c)(2)(v).

(d) through (g) [Reserved]. For further guidance, see § 1.871–15(d) through (g).

(h) *Substantial equivalence test*—(1) *In general.* The substantial equivalence test described in this paragraph (h) applies to determine whether a complex contract is a section 871(m) transaction. The substantial equivalence test assesses whether a complex contract substantially replicates the economic performance of the underlying security by comparing, at various testing prices for the underlying security, the differences between the expected changes in value of that complex contract and its initial hedge with the differences between the expected changes in value of a simple contract benchmark (as described in paragraph (h)(2) of this section) and its initial hedge. If the complex contract contains more than one reference to a single underlying security, all references to that underlying security are taken into account for purposes of applying the substantial equivalence test with respect to that underlying security. With respect to an equity derivative that is embedded in a debt instrument or other derivative, the substantial equivalence test is applied to the complex contract without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. The complex contract is a section 871(m) transaction with respect

to an underlying security if, for that underlying security, the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change in value of the simple contract benchmark and its initial hedge when the substantial equivalence test described in this paragraph (h) is calculated at the time the complex contract is issued. To the extent that the steps of the substantial equivalence test set out in this paragraph (h) cannot be applied to a particular complex contract, a taxpayer must use the principles of the substantial equivalence test to reasonably determine whether the complex contract is a section 871(m) transaction with respect to each underlying security. For purposes of this section, the test must be applied and the inputs must be determined in a commercially reasonable manner. If a taxpayer calculates any relevant input for non-tax business purposes, that input ordinarily is the input used for purposes of this section.

(2) *Simple contract benchmark.* The simple contract benchmark is a closely comparable simple contract that, at the time the complex contract is issued, has a delta of 0.8, references the applicable underlying security referenced by the complex contract, and has the same maturity as the complex contract with respect to the applicable underlying security. Depending on the complex contract, the simple contract benchmark might be, for example, a call option, a put option, or a collar.

(3) *Substantial equivalence.* A complex contract is a section 871(m) transaction with respect to an underlying security if the complex contract calculation described in paragraph (h)(4) of this section results in an amount that is equal to or less than the amount of the benchmark calculation described in paragraph (h)(5) of this section.

(4) *Complex contract calculation*—(i) *In general.* The complex contract calculation for each underlying security referenced by a potential section 871(m) transaction that is a complex contract is computed by:

(A) Determining the change in value (as described in paragraph (h)(4)(ii) of this section) of the complex contract with respect to the underlying security at each testing price (as described in paragraph (h)(4)(iii) of this section);

(B) Determining the change in value of the initial hedge for the complex contract at each testing price;

(C) Determining the absolute value of the difference between the change in value of the complex contract determined in paragraph (h)(4)(i)(A) of this section and the change in value of the initial hedge determined in paragraph (h)(4)(i)(B) of this section at each testing price;

(D) Determining the probability (as described in paragraph (h)(4)(iv) of this section) associated with each testing price;

(E) Multiplying the absolute value for each testing price determined in paragraph (h)(4)(i)(C) of this section by the corresponding probability for that testing price determined in paragraph (h)(4)(i)(D) of this section;

(F) Adding the product of each calculation determined in paragraph (h)(4)(i)(E) of this section; and

(G) Dividing the sum determined in paragraph (h)(4)(i)(F) of this section by the initial hedge for the complex contract.

(ii) *Determining the change in value.* The change in value of a complex contract is the difference between the value of the complex contract with respect to the underlying security at the time the complex contract is issued and the value of the complex contract with respect to the underlying security if the price of the underlying security were equal to the testing price at the time the complex contract is issued. The change in value of the initial hedge of a complex contract with respect to the underlying security is the difference between the value of the initial hedge at the time the complex contract is issued and the value of the initial hedge if the price of the underlying security were equal to the testing price at the time the complex contract is issued.

(iii) *Testing price.* The testing prices must include the prices of the underlying security if the price of the underlying security at the time the complex contract is issued were alternatively increased by one standard deviation and decreased by one standard deviation, each of which is a separate testing price. In circumstances where using only two testing prices is reasonably likely to provide an inaccurate measure of substantial equivalence, a taxpayer must use additional testing prices as necessary to determine whether a complex contract satisfies the substantial equivalence test. If additional testing prices are used for the substantial equivalence test, the probabilities as described in paragraph (h)(4)(iv) of this section must be adjusted accordingly.

(iv) *Probability.* For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of an increase by one standard deviation is the measure of the likelihood that the price of the underlying security will increase by any amount from its price at the time the complex contract is issued. For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of a decrease by one standard deviation is the measure of the likelihood that the price of the underlying security will decrease by any amount from its price at the time the complex contract is issued.

(5) *Benchmark calculation.* The benchmark calculation with respect to each underlying security referenced by the potential section 871(m) transaction is determined by using the computation methodology described in paragraph (h)(4) of this section with respect to a simple contract benchmark for the underlying security.

(6) *Substantial equivalence calculation for certain complex contracts that reference multiple underlying securities.* If a complex contract references 10 or more underlying securities and the short party uses an exchange-traded security (for example, an exchange-traded fund) that references substantially all of the underlying securities (the hedge security) to hedge the complex contract at the time it is issued, the substantial equivalence calculations for the complex contract may be calculated by treating the hedge security as the underlying security. When the hedge security is used for the substantial equivalence calculation pursuant to this paragraph (h)(6), the initial hedge is the number of shares of the hedge security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(iii) of this section.

(7) *Example.* The following example illustrates the rules of paragraph (h) of this section. For purposes of this example, Stock X is common stock of domestic corporation X. FI is the financial institution that structures the transaction described in the example, and is the short party to the transaction. Investor is a nonresident alien individual.

Example. Complex contract that is not substantially equivalent. (i) FI issues an investment contract (the Contract) that has a stated maturity of one year, and Investor purchases the Contract from FI at issuance for $10,000. At maturity, the Contract entitles Investor to a return of $10,000 (i) plus 200 percent of any appreciation in Stock X above $100 per share, capped at $110, on 100 shares or (ii) minus 100 percent of any depreciation in Stock X below $90 on 100 shares. At the time FI issues the Contract, the price of Stock X is $100 per share. Thus, for example, Investor will receive $11,000 if the price of Stock X is $105 per share at maturity of the Contract, but Investor will receive $9,000 if the price of Stock X is $80 per share when the Contract matures. At issuance, FI

acquires 64 shares of Stock X to fully hedge the Contract issued to Investor.

(ii) The Contract references an underlying security and is not an NPC, so it is classified as an ELI under paragraph (a)(4) of this section. At issuance, the Contract does not provide for an amount paid at maturity that is calculated by reference to a single, fixed number of shares of Stock X. When the Contract matures, the amount paid is effectively calculated based on either 200 shares of Stock X (if the price of Stock X has appreciated up to $110) or 100 shares of Stock X (if the price of Stock X has declined below $90). Consequently, the Contract is a complex contract described in paragraph (a)(14) of this section.

(iii) Because it is a complex ELI, FI applies the substantial equivalence test described in paragraph (h) of this section to determine whether the Contract is a specified ELI. FI determines that the price of Stock X would be $120 if the price of Stock X were increased by one standard deviation, and $79 if the price of Stock X were decreased by one standard deviation. Based on these results, FI next determines the change in value of the Contract to be $2,000 at the testing price that represents an increase by one standard deviation ($12,000 testing price minus $10,000 issue price) and a negative $1,100 at the testing price that represents a decrease by one standard deviation ($10,000 issue price minus $8,900 testing price). FI performs the same calculations for the 64 shares of Stock X that constitute the initial hedge, determining that the change in value of the initial hedge is $1,280 at the testing price that represents an increase by one standard deviation ($6,400 at issuance compared to $7,680 at the testing price) and negative $1,344 at the testing price that represents a decrease by one standard deviation ($6,400 at issuance compared to $5,056 at the testing price).

(iv) FI then determines the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents an increase by one standard deviation and a decrease by one standard deviation. Increased by one standard deviation, the absolute value of the difference is $720 ($2,000 − $1,280); decreased by one standard deviation, the absolute value of the difference is $244 (negative $1,100 minus negative $1,344). FI determines that there is a 52% chance that the price of Stock X will have increased in value when the Contract matures and a 48% chance that the price of Stock X will have decreased in value at that time. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents an increase by one standard deviation by 52%, which equals $374.40. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents a decrease by one standard deviation by 48%, which equals $117.12. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the transaction calculation is 7.68 ((374.40 plus 117.12) divided by 64).

(v) FI then performs the same calculation with respect to the simple contract benchmark, which is a one-year call option that references one share of Stock X, settles on the same date as the Contract, and has a delta of 0.8. The one-year call option has a strike price of $79 and has a cost (the purchase premium) of $22. The initial hedge for the one-year call option is 0.8 shares of Stock X.

(vi) FI first determines that the change in value of the simple contract benchmark is $19.05 if the testing price is increased by one standard deviation ($22.00 at issuance to $41.05 at the testing price) and negative $20.95 if the testing price is decreased by one standard deviation ($22.00 at issuance to $1.05 at the testing price). Second, FI determines that the change in value of the initial hedge is $16.00 at the testing price that represents an increase by one standard deviation ($80 at issuance to $96 at the testing price) and negative $16.80 at the testing price that represents a decrease by one standard deviation ($80.00 at issuance to $63.20 at the testing price).

(vii) FI determines the absolute value of the difference between the change in value of the initial hedge and the one-year call option at the testing price that represents an increase by one standard deviation is $3.05 ($16.00 minus $19.05). FI next determines the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation is $4.15 (negative $16.80 minus negative $20.95). FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents an increase by one standard deviation by 52%, which equals $1.586. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation by 48%, which equals $1.992. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the benchmark calculation is 4.473 ((1.586 plus 1.992) divided by .8).

(viii) FI concludes that the Contract is not a section 871(m) transaction because the transaction calculation of 7.68 exceeds the benchmark calculation of 4.473.

(i) through (p) [Reserved]. For further guidance, see § 1.871–15(i) through (p).

(q) *Dividend and dividend equivalent payments to a qualified derivatives dealer*—(1) *In general.* Except as otherwise provided in this paragraph (q), a qualified derivatives dealer described in § 1.1441–1(e)(6) that receives a dividend or the payment of a dividend equivalent (within the meaning of paragraph (i) of this section) in its dealer capacity will not be liable for tax under section 871 or section 881 provided that the qualified derivatives dealer complies with its obligations under the qualified intermediary agreement described in §§ 1.1441–1(e)(5) and 1.1441–1(e)(6). If a qualified derivatives dealer receives a dividend or dividend equivalent payment on or determined by reference to an underlying security and the offsetting dividend equivalent payment the qualified derivatives dealer is contractually obligated to make on the same underlying security is less than the dividend and dividend equivalent amount received (including when the qualified derivatives dealer is not contractually obligated to make an offsetting dividend equivalent payment), the qualified derivatives dealer is liable for tax under section 871 or section 881 for the difference. For purposes of this paragraph (q), a dividend or dividend equivalent is not treated as received by a qualified derivatives dealer acting in its dealer capacity if the dividend or dividend equivalent is received by the qualified derivatives dealer acting as a proprietary trader. Transactions properly reflected in a qualified derivatives dealer's dealer book are presumed to be held by a dealer in its dealer capacity for purposes of this paragraph (q).

(2) *Examples.* The following examples illustrate the rules of this paragraph (q):

Example 1. Forward contract entered into by a foreign dealer. (i) *Facts.* FB is a foreign bank that is a qualified intermediary that acts as a qualified derivatives dealer. On April 1, Year 1, FB enters into a cash settled forward contract initiated by a foreign customer (Customer) that entitles Customer to receive from FB all of the appreciation and dividends on 100 shares of Stock X, and obligates Customer to pay FB any depreciation on 100 shares of Stock X, at the end of three years. FB hedges the forward contract by entering into a total return swap contract with a domestic broker (U.S. Broker) and maintains the swap contract as a hedge for the duration of the forward contract. The swap contract entitles FB to receive an amount equal to all of the dividends on 100 shares of Stock X and obligates FB to pay an amount referenced to a floating interest rate each quarter, and also entitles FB to receive from or pay to U.S. Broker, as the case may be, the difference between the value of 100 shares of Stock X at the inception of the swap and the value of 100 shares of Stock X at the end of 3 years. FB provides valid documentation to U.S. Broker that FB will receive payments under the swap contract in its capacity as a qualified derivatives dealer, and FB contemporaneously enters both the swap contract with U.S. Broker and the forward contract with Customer on its dealer books. Stock X pays a quarterly dividend of $0.25 per share.

(ii) *Application of rules.* FB is a long party on a delta one contract (the total return swap) and a short party on a delta one contract (the forward contract with Customer). U.S. Broker is not obligated to withhold on the dividend equivalent payments to FB on the swap contract that are referenced to Stock X dividends, however, because U.S. Broker has

received valid documentation that it may rely upon to treat the payment as made to FB acting as a qualified derivatives dealer. Similarly, FB is not obligated to pay tax on the payments it receives from U.S. Broker referenced to Stock X dividends because at the time it received the payments FB was contractually obligated to make fully offsetting dividend equivalent payments as the short party with respect to 100 shares of Stock X to Customer. FB is required to withhold on dividend equivalent payments to Customer on the forward contract in accordance with § 1.1441–2(e)(8).

Example 2. At-the-money option contract entered into by a foreign dealer. (i) *Facts.* The facts are the same as Example 1, but customer purchases from FB an at-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.5 and FB hedges the call option by purchasing 50 shares of Stock X, which are held in an account with U.S. Broker, who also acts as paying agent.

(ii) *Application of rules.* FB is a long party on 50 shares of Stock X and a short party on an option. Because the option has a delta of less than 0.8 on the date it was issued, it is not a section 871(m) transaction. U.S. Broker is not obligated to withhold on the Stock X dividends paid to FB because U.S. Broker has received valid documentation that it may rely upon to treat the dividends as paid to FB acting as a qualified derivatives dealer. FB is liable for tax under section 871 or section 881 on the Stock X dividends it receives from U.S. Broker, however, because at the time it received the dividends FB was not contractually obligated to make an offsetting dividend equivalent payment to Customer. FB is not required to make an offsetting dividend equivalent payment to Customer because the option has a delta of 0.5; therefore, it is not a section 871(m) transaction.

Example 3. In-the-money option contract entered into by a foreign dealer. (i) *Facts.* The facts are the same as Example 2, but Customer purchases from FB an in-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.8 and FB hedges the call option by purchasing 80 shares of Stock X, which are held in an account with U.S. Broker, who also acts as paying agent. The price of Stock X declines substantially and the option lapses unexercised.

(ii) *Application of rules.* FB is a long party on 80 shares of Stock X and a short party on an option. Because the option has a delta of 0.8 on the date it was issued, it is a section 871(m) transaction. U.S. Broker is not obligated to withhold on the Stock X dividends paid to FB because U.S. Broker has received valid documentation that it may rely upon to treat the dividends as paid to FB acting as a qualified derivatives dealer. Similarly, FB is not obligated to pay tax on the Stock X dividends it receives from U.S. Broker to the extent that FB is contractually obligated to make offsetting dividend equivalent payments as the short party to Customer. FB is required to withhold on dividend equivalent payments to Customer on the option contract in accordance with § 1.1441–2(e)(8). FB is also liable for tax under section 871 or section 881 on Stock X dividends, if any, that exceed the dividend equivalent payment to Customer.

(r)(1) through (3) [Reserved]. For further guidance, see § 1.871–15(r)(1) through (3).

(4) *Effective/applicability date.* This section applies to payments made on or after January 1, 2017.

(s) *Expiration date.* This section expires September 17, 2018.

■ **Par. 5.** Section 1.1441–1 is amended by:

■ 1. Redesignating paragraph (b)(4)(xxi) as (b)(4)(xxiv).

■ 2. Adding paragraphs (b)(4)(xxi) through (xxiii).

■ 3. Adding new paragraphs (e)(3)(ii)(E) and (6).

■ 4. Adding new paragraph (f)(4).

The additions read as follows:

§ 1.1441–1 Requirement for the deduction and withholding of tax on payments to foreign persons.

(b) * * *

(4) * * *

(xxi) Amounts paid with respect to a notional principal contract described in § 1.871–15(a)(7), an equity-linked instrument described in § 1.871–15(a)(4), or a securities lending or sale-repurchase transaction described in § 1.871–15(a)(13) are exempt from withholding under section 1441(a) as dividend equivalents under section 871(m) if the transaction is not a section 871(m) transaction within the meaning of § 1.871–15(a)(12), if the transaction is subject to the exception described in § 1.871–15(k), or if the payment is not a dividend equivalent pursuant to § 1.871–15(c)(2). However, the amounts may be subject to withholding under section 1441(a) if they are subject to tax under any section other than section 871(m). For purposes of this withholding exemption, it is not necessary for the payee to provide documentation establishing that a notional principal contract or equity-linked instrument has a delta (as described in § 1.871–15(g)) that is less than 0.80 or does not have substantial equivalence (as defined in § 1.871–15(h)) with the underlying security. For purposes of the withholding exemption regarding corporate acquisitions described in § 1.871–15(k), the exemption only applies if the long party furnishes, under penalties of perjury, a written statement to the withholding agent certifying that it satisfies the requirements of § 1.871–15(k).

(xxii) Certain payments to qualified derivatives dealers (as described in paragraph (e)(6) of this section). For purposes of this withholding exemption, the qualified derivatives dealer must furnish to the withholding agent the documentation described in paragraph (e)(3)(ii) of this section. A withholding agent that makes a payment of a dividend or a divided equivalent to a qualified intermediary that is acting as a qualified derivatives dealer is not required to withhold on the payment if the withholding agent can reliably associate the payment with a valid qualified intermediary withholding certificate as described in paragraph (e)(3)(ii) of this section, including the certification described in paragraph (e)(3)(ii)(E).

(xxiii) Amounts paid with respect to a potential section 871(m) transaction that is only a section 871(m) transaction as a result of applying § 1.871–15(n) to treat certain transactions as combined transactions, if the withholding agent is able to rely on one or more of the presumptions provided in § 1.871–15(n)(3)(i) or (ii) (applying those paragraphs whether or not the withholding agent is a short party by substituting ''withholding agent'' for ''short party''), and the withholding agent does not otherwise have actual knowledge that the long party (or a related person within the meaning of section 267(b) or section 707(b)) entered into the potential section 871(m) transaction in connection with any other potential section 871(m) transactions. The ability of one or more withholding agents to rely on the presumptions provided in section 1.871–15(n)(3) does not affect the withholding tax obligations or liability of any party to the transaction that cannot rely on the presumptions. Notwithstanding the withholding exemption provided to the withholding agent in this paragraph (b)(4)(xxii), the long party may still be liable for tax on dividend equivalent amounts with respect to such combined transactions under section 871(m).

(e)(3)(ii)(E) [Reserved]. For further guidance, see § 1.1441–1T(e)(3)(ii)(E).

(6) *Qualified derivatives dealers.* [Reserved]. For further guidance, see § 1.1441–1T(e)(6).

(f) * * *

(4) *Effective/applicability date.* Paragraphs (b)(4)(xxi) through (b)(4)(xxiii) of this section, and paragraphs (e)(3)(ii)(E) and (e)(6) of this section apply to payments made on or after September 18, 2015.

■ **Par. 6.** Section 1.1441–1T is amended by:

■ 1. Redesignating paragraph (e)(3)(ii)(E) as paragraph (e)(3)(ii)(F).

■ 2. Adding new paragraphs (e)(3)(ii)(E) and (e)(6).

■ 3. Revising paragraph (e)(5)(i).

■ 4. Amending paragraph (f)(3) by removing ''This section'' and adding in its place ''Except for paragraphs (e)(3)(ii)(E) and (e)(6), this section'' and adding a third sentence.
■ 5. Amending paragraph (g) by removing ''The applicability'' and adding in its place ''Except for paragraphs (e)(3)(ii)(E) and (e)(6), the applicability'' and adding a third sentence.

§ 1.1441–1T Requirement for the deduction and withholding of tax on payments to foreign persons (temporary).

(e) * * *
(3) * * *
(ii) * * *

(E) In the case of dividends or dividend equivalents received by a qualified intermediary acting as a qualified derivatives dealer, a certification that the qualified intermediary meets the requirements to act as a qualified derivatives dealer as further described in paragraph (e)(6) of this section and that the qualified derivatives dealer assumes primary withholding and reporting responsibilities under chapters 3, 4, and 61, and section 3406 with respect to any dividend equivalent payments;

(5) *Qualified intermediaries*—(i) *In general.* A qualified intermediary, as defined in paragraph (e)(5)(ii) of this section, may furnish a qualified intermediary withholding certificate to a withholding agent. The withholding certificate provides certifications on behalf of other persons for the purpose of claiming and verifying reduced rates of withholding under section 1441 or 1442 and for the purpose of reporting and withholding under other provisions of the Internal Revenue Code, such as the provisions under chapter 61 and section 3406 (and the regulations under those provisions). Furnishing such a certificate is in lieu of transmitting to a withholding agent withholding certificates or other appropriate documentation for the persons for whom the qualified intermediary receives the payment, including interest holders in a qualified intermediary that is fiscally transparent under the regulations under section 894. Although the qualified intermediary is required to obtain withholding certificates or other appropriate documentation from beneficial owners, payees, or interest holders pursuant to its agreement with the IRS, it is generally not required to attach such documentation to the intermediary withholding certificate. Notwithstanding the preceding sentence, a qualified intermediary must provide a withholding agent with the Forms W–9, or disclose the names, addresses, and taxpayer identifying numbers, if known, of those U.S. non-exempt recipients for whom the qualified intermediary receives reportable amounts (within the meaning of paragraph (e)(3)(vi) of this section) to the extent required in the qualified intermediary's agreement with the IRS. When a qualified intermediary is acting as a qualified derivatives dealer, the withholding certificate entitles a withholding agent to make payments of dividend equivalents and dividends to the qualified derivatives dealer free of withholding. Paragraph (e)(6) of this section contains detailed rules prescribing the circumstances in which a qualified intermediary can act as a qualified derivatives dealer. A person may claim qualified intermediary status before an agreement is executed with the IRS if it has applied for such status and the IRS authorizes such status on an interim basis under such procedures as the IRS may prescribe.

(6) *Qualified derivatives dealers*—(i) *In general.* To act as a qualified derivatives dealer under a qualified intermediary agreement, a qualified intermediary must be an eligible entity as described in paragraph (e)(6)(ii) of this section and, in accordance with the qualified intermediary agreement, must—

(A) Furnish to a withholding agent a qualified intermediary withholding certificate (described in paragraph (e)(3)(ii) of this section) that indicates that the qualified intermediary is a qualified derivatives dealer with respect to the applicable dividends and dividend equivalent payments;

(B) Agree to assume the primary withholding and reporting responsibilities, including the documentation provisions under chapters 3, 4, and 61, and section 3406, the regulations under those provisions, and other withholding provisions of the Internal Revenue Code, on all dividends and dividend equivalents that it receives and makes in its dealer capacity. For this purpose, a qualified derivatives dealer is required to obtain a withholding certificate or other appropriate documentation from each counterparty to whom the qualified derivatives dealer pays a dividend equivalent. The qualified derivatives dealer is also required to determine whether a payment it makes to a counterparty is, in whole or in part, a dividend equivalent;

(C) Agree to remain liable for tax under section 871 and section 881 on any dividend or payment of a dividend equivalent (within the meaning of § 1.871–15(i)) it receives in its dealer capacity to the extent that the offsetting dividend equivalent payment on an underlying security the qualified derivatives dealer is contractually obligated to make is less than the dividend and dividend equivalent amount the qualified derivatives dealers received on or with respect to the same underlying security (including when the qualified derivatives dealer is not contractually obligated to make an offsetting dividend equivalent payment); and

(D) Comply with the compliance review procedures applicable to a qualified intermediary that acts as a qualified derivatives dealer under a qualified intermediary agreement, which will specify the time and manner in which a qualified derivatives dealer must:

(*1*) Certify to the IRS that it has complied with the obligations to act as a qualified derivatives dealer (including its performance of a periodic review applicable to a qualified derivatives dealer);

(*2*) Report to the IRS the dividend equivalent payments that it made and the dividends and dividend equivalent amounts received in determining offsetting payments (as described in § 1.871–15(q)(1)); and

(*3*) Respond to inquiries from the IRS about obligations it has assumed as a qualified derivatives dealer in a timely manner.

(ii) *Definition of eligible entity.* An eligible entity is a qualified intermediary that is—

(A) A dealer in securities subject to regulatory supervision as a dealer by a governmental authority in the jurisdiction in which it was organized or operates; or

(B) A bank subject to regulatory supervision as a bank by a governmental authority in the jurisdiction in which it was organized or operates or an entity that is wholly-owned by a bank subject to regulatory supervision as a bank by a governmental authority in the jurisdiction in which it was organized or operates and that—

(*1*) Issues potential section 871(m) transactions to customers; and

(*2)* Receives dividends with respect to stock or dividend equivalent payments pursuant to potential section 871(m) transactions that hedge potential section 871(m) transactions that it issued.

(iii) *Crediting prior withholding to a subsequent dividend equivalent payment.* [Reserved].

(f)(3) * * * Paragraphs (e)(3)(ii)(E) and (e)(6) apply beginning September 18, 2015.

(g) * * * Paragraphs (e)(3)(ii)(E) and (e)(6) of this section expire September 17, 2018.

■ **Par. 7.** Section 1.1441–2 is amended by adding paragraph (e)(8) and adding a sentence to the end of paragraph (f) to read as follows:

§ 1.1441–2 Amounts subject to withholding.

* * * * *

(e) * * *

(8) *Payments of dividend equivalents*—(i) *In general.* A payment of a dividend equivalent is not considered to be made until the later of when—

(A) The amount of a dividend equivalent is determined as provided in § 1.871–15(j)(2), and

(B) A payment occurs with respect to the section 871(m) transaction.

(ii) *Payment.* For purposes of paragraph (e)(8) of this section, a payment occurs with respect to a section 871(m) transaction when—

(A) Money or other property is paid to or by the long party;

(B) In the case of a section 871(m) transaction described in § 1.871–15(i)(3), a payment is treated as being made at the end of the applicable calendar quarter; or

(C) The long party sells, exchanges, transfers, or otherwise disposes of the section 871(m) transaction (including by settlement, offset, termination, expiration, lapse, or maturity).

(iii) *Premiums and other upfront payments.* When a long party pays a premium or other upfront payment to the short party at the time a section 871(m) transaction is issued, the premium or other upfront payment is not treated as a payment for purposes of paragraph (e)(8)(ii)(A) of this section.

* * * * *

(f) * * * Paragraph (e)(8) of this section applies to payments made on or after September 18, 2015.

■ **Par. 8.** Section 1.1441–3 is amended by:

■ 1. Adding a second sentence to paragraph (h)(1).

■ 2. Redesignating paragraph (h)(2) as (h)(3) and revising newly redesignated paragraph (h)(3).

■ 3. Adding new paragraph (h)(2).

The additions and revisions read as follows:

§ 1.1441–3 Determination of amounts to be withheld.

* * * * *

(h) * * *

(1) * * * Withholding is required on the amount of the dividend equivalent calculated under § 1.871–15(j).

(2) *Reliance by withholding agent on reasonable determinations.* For purposes of determining whether a payment is a dividend equivalent and the timing and amount of a dividend equivalent under section 871(m), a withholding agent may rely on the information received from the party to the transaction that is required (as provided in § 1.871–15(p)) to make those determinations, unless the withholding agent knows or has reason to know that the information is incorrect. When a withholding agent fails to withhold the required amount because the party described in § 1.871–15(p) fails to reasonably determine or timely provide information regarding whether a transaction is a section 871(m) transaction, the timing and amount of any dividend equivalent, or any other information required to be provided pursuant to § 1.871–15(p), and the withholding agent relied, absent actual knowledge to the contrary, on that party's determination or did not timely receive required information, then the failure to withhold is imputed to the party required to make the determinations described in § 1.871–15(p). In that case, the IRS may collect any underwithheld amount from the party to the transaction that was required to make the determinations described in § 1.871–15(p) or timely provide the information and subject that party to applicable interest and penalties as if the party were a withholding agent with respect to the payment of the dividend equivalent made pursuant to the section 871(m) transaction.

(3) *Effective/applicability date.* Except for the first sentence of paragraph (h)(1), this paragraph (h) applies to payments made on or after September 18, 2015. The first sentence of paragraph (h)(1) of this section, applies to payments made on or after January 23, 2012.

* * * * *

■ **Par. 9.** Section 1.1441–7 is amended by:

■ 1. Adding *Example 7* to paragraph (a)(3).

■ 2. Adding a second sentence to paragraph (a)(4).

The additions read as follows:

§ 1.1441–7 General provisions relating to withholding agents.

(a) * * *

(3) * * *

Example 7. CO is a domestic clearing organization. CO serves as a central counterparty clearing and settlement service provider for derivatives exchanges in the United States. CB is a broker organized in Country X, a foreign country, and a clearing member of CO. CB is a nonqualified intermediary, as defined in § 1.1441–1(c)(14). FC is a foreign corporation that has an investment account with CB. FC instructs CB to purchase a call option that is a specified ELI (as described in § 1.871–15(e)). CB effects the trade for FC on the exchange. The exchange matches FC's order with an order for a written call option with the same terms. The exchange then sends the matched trade to CO, which clears the trade. CB and the clearing member representing the call option seller settle the trade with CO. Upon receiving the matched trade, the option contracts are novated and CO becomes the counterparty to CB and the counterparty to the clearing member representing the call option seller. To the extent that there is a dividend equivalent with respect to the call option, both CO and CB are withholding agents as described in paragraph (a)(1) of this section.

(4) * * * *Example 7* of paragraph (a)(3) of this section applies to payments made on or after September 18, 2015.

* * * * *

■ **Par. 10.** Section 1.1461–1 is amended by:

■ 1. Redesignating paragraphs (c)(2)(i)(N) as (c)(2)(i)(O) and (c)(2)(i)(M) as (c)(2)(i)(N).

■ 2. Adding paragraph (c)(2)(i)(M).

■ 3. Redesignating paragraph (c)(2)(ii)(K) as (c)(2)(ii)(L) and redesignating paragraph (c)(2)(ii)(J) as (c)(2)(ii)(K)

■ 4. Adding paragraph (c)(2)(ii)(J).

§ 1.1461–1 Payments and returns of tax withheld.

* * * * *

(c) * * *

(2) * * *

(i) * * *

(M) Any dividend or any payment that references the payment of a dividend from an underlying security pursuant to a securities lending or sale-repurchase transaction paid to a qualified derivatives dealer even when the withholding agent is not required to withhold on the payment pursuant to § 1.1441–1(b)(4)(xxi), (xxii), or (xxiii);

* * * * *

(ii) * * *

(J) Except as provided in § 1.1461–1(c)(2)(i)(M), any payment to a qualified derivatives dealer when the withholding agent is not required to withhold on the payment pursuant to § 1.1441–1(b)(4)(xxi), (xxii), or (xxiii);

* * * * *

■ **Par. 11.** Section 1.1473–1 is amended by:

■ 1. Adding new paragraph (a)(4)(viii).

■ 2. Adding a sentence to the end of paragraph (f).

The additions read as follows:

§ 1.1473–1 Section 1473 definitions.

(a) * * *

(4) * * *

(viii) *Certain dividend equivalents.* Amounts paid with respect to a notional principal contract described in § 1.871–

15(a)(7), an equity-linked instrument described in § 1.871–15(a)(4), or a securities lending or sale-repurchase transaction described in § 1.871–15(a)(13) that are exempt from withholding under section 1441(a) as dividend equivalents under section 871(m) if the transaction is not a section 871(m) transaction within the meaning of § 1.871–15(a)(12), if the transaction is subject to the exception described in § 1.871–15(k), or to the extent the payment is not a dividend equivalent pursuant to § 1.871–15(c)(2).

* * * * *

(f) * * * Paragraph (a)(4)(viii) of this section applies to payments made on or after September 18, 2015.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: July 20, 2015.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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