SECTION 871(M) AND DELTA: WHEN SHOULD A DIVIDEND EQUIVALENT BE TREATED LIKE A DIVIDEND?

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If certain derivative exposures to U.S. stocks present an inappropriate opportunity to avoid U.S. withholding taxes with respect to “dividend equivalents,” what is the nature of those inappropriate derivatives? Is “delta” a useful tool for identifying them?

To begin, is it appropriate to “buy” a known dividend amount without withholding tax? You must pay for that dividend amount. That is, with or without withholding tax, nobody will give you the economics of a $1 future dividend for less than $1 (time value and tax effects aside). So have you “avoided” anything by taking “new” derivative exposure to known – or even highly expected – dividends? In this circumstance, if you suffer a withholding tax, you will lose money (unless you can credit the tax elsewhere); but avoiding the tax will not help you make any money – it’s a zero-sum game (minus transaction costs).

On this logic, you could avoid U.S. withholding tax only if you were already exposed to the underlying stock, and you could – cheaply – avoid an impending tax by switching the form of your exposure to one with no withholding tax. From this perspective, Congress’s focus on “crossing into and out of” total return swaps makes sense.

But the purpose of the dividend withholding tax is to make a $1 dividend worth less than $1 to a non-U.S. person (ignoring credits). Which means even if you don’t make any money via the avoidance, avoiding the tax avoids the intended economic loss that the withholding tax represents.

So perhaps, instead, avoidance occurs when the “short” party is the “tax owner” of, but is not itself effectively subjected to tax on, a dividend. For example, a securities dealer might hold

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stock, “swap” that stock to a non-U.S. person, mark both positions to market and be “flat” (tax-wise) except for the spread built into its pricing. In that event, if the dividend equivalents under the swap go untaxed, the dividends are effectively never taxed.

So asking if the counterparty holds the underlying stock makes sense as a policy matter. It also ensures we don’t treat as a dividend something that has no actual connection to the underlying stock. (Incidentally, it would eliminate issuer-issued instruments – convertible debt and warrants – from Section 871(m), as they should be. We already have rules that apply to those, which treat all investors consistently – as well as the issuer; Section 871(m) does not affect E&P.) But asking if the counterparty owns the underlying probably isn’t practical, especially considering that the counterparty might have lent the underlying to someone – which should change the result, policy-wise, because that stock presumably ends up in the hands of a “normal” taxpayer (after being sold short by its borrower), resulting in “proper” taxation of the relevant dividend.

Nonetheless, the “logic” of delta seems consistent with the goal of taxing the amount of dividends that the counterparty can be expected to “own” as a U.S. tax matter (a dealer in securities will generally hedge a short exposure by being long the delta at any given point). Why then tax only if delta was high when the long party entered into the transaction? Perhaps for the same reason the proposed regulation exempts indices (as defined): There are typically feasible alternative hedges for the counterparty when the delta is low (e.g., listed options) or when the underlier is an index (e.g., futures contracts, or listed options), so perhaps the thought is that it isn’t appropriate to assume that the counterparty will own any underlying stock(s). A more directly probative question than delta might be whether the counterparty could cheaply hedge otherwise than by holding (a substantially fixed amount of) the underlying.

One theme that threads through this is “cheapness.” With few exceptions, transaction costs for equity swaps are extremely low. There is typically little or no credit risk (at least from the counterparty’s perspective; the long party typically posts adequate collateral), and these
transactions are done on standardized documentation, so there’s essentially nothing to negotiate, and no basis to charge meaningful fees. And swaps can be priced to allow the long party seamless transition into and out of existing positions, so no “gap risk” (another form of transaction cost) is created. “Equity finance” is done on razor-thin margins. Indeed, many end users can buy and sell swaps electronically, as they can the underlying.

As delta gets lower than one, the derivative gets more expensive. True options cost money, because the counterparty is taking meaningful risk, for which it must be compensated. The more option-like the exposure, the higher the transaction costs (“risk premia”). If transaction costs exceed the value of the avoided tax, the transaction ceases to be explainable as tax avoidance. And the further out in time the potential (but increasingly uncertain, as dividend policies change) benefit, the less rational it will be to pay meaningful transaction costs for the prospect. So, for example, nobody will use either “structured notes” (generally, prepaid forwards with often complex economics) or combinations of low-delta positions (with unrelated, non-accommodating counterparties) to avoid U.S. withholding tax; it’s just too expensive.

Delta might be a proxy for whether the counterparty should be expected to own the underlying (potentially leaving dividends effectively untaxed), or whether expected avoidance value might be expected to exceed transaction costs. But it is in both cases a very rough proxy. And delta is an unwieldy and imprecise concept (indeed, one that simply can’t be applied coherently in not uncommon fact patterns, e.g., digital options), making its functionality debatable in any event.

One approach might be to establish a presumption that an instrument or group of instruments is subject to Section 871(m) if it reflects or includes on a net basis a high-delta exposure to dividend-paying U.S. stock, a presumption which could be rebutted by showing either material transaction costs or that the counterparty does not own the underlying in connection with the transaction on a given dividend date.