THE MOST RECENT PROPOSED REGULATIONS UNDER SECTION 871(M): THE PERFECT IS THE ENEMY OF THE GOOD

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While the recent proposed regulations under section 871(m) raise many technical issues, three features of the proposed regime are perhaps most controversial: (1) The use of a “delta” threshold of 0.7 to identify those derivatives that should be subject to section 871(m), (2) requiring that delta threshold be tested whenever a party acquires a long position not merely at original issuance and (3) requiring withholding on estimated dividend amounts (i.e., even if the derivative does not provide for payments linked directly or indirectly to actual dividend payments). These three features of the regulation, particularly in combination, may cause the regulations to capture a broader class of transactions than Congress perhaps intended.

The prior proposed regulations focused on identifying “abusive” indicia common to transactions used to avoid dividend withholding. The new proposed regulations largely abandon the attempt to identify factual indicia common to abusive transactions (like “crossing in” or out, where the stock is transferred by an actual owner to the short derivative counterparty pre-dividend and reacquired thereafter). Instead, they effectively treat withholding as appropriate where the economic effect of a derivative transaction is reasonably equivalent to ownership of the underlying stock. The proposed regulations adopt a test based on “delta,” which generally reflects the correlation between changes in the value of the derivative and changes in the value of the underlying U.S. stock.

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Using this “bright line” test to identify positions that economically resemble stock ownership has the advantage of being more objective than a test based on factual indicia of abuse and therefore is potentially more easily administered. Derivatives dealers typically compute delta to establish an appropriate hedge of their positions and therefore should be in a position to provide this information to counterparties. To prevent easy avoidance of the rules, it is sensible that positions economically very similar to stock ownership should be caught even if the correlation is less than perfect (i.e., delta is less than 1). Nevertheless, although selecting an appropriate bright line threshold is necessarily somewhat arbitrary, most market participants view a derivative with a 0.7 delta as substantially different economically from a “delta one” transaction which is closely equivalent economically to stock ownership.

The delta test is difficult to apply to derivatives with more complex economics than a simple total return swap referencing an equity security. It may be unclear how many shares of stock should be considered in the denominator of the delta test (and this may be determinative in some cases). For example, assume the swap requires the counterparty to pay any depreciation in the value of 100 shares of reference stock in exchange for the appreciation in 200 shares of stock in excess of a threshold that is substantially higher than the current share price. Should changes in the value of the derivative be compared to changes in value of 100 shares or changes in the value of 200 shares? Presumably the position should be disaggregated in some way to test delta but the regulations do not provide guidance on how to do this.

More fundamentally, delta is an imperfect proxy for dividend equivalence (which is the focus of the statutory provision). A position may be closely correlated with changes in the stock’s value but relatively insensitive to changes in the actual dividend return, or vice versa. Thus, the test may be too broad in some cases but too narrow in others. For example, a taxpayer
could in theory enter into a combination of positions that effectively pays it amounts linked to the actual dividend return on a specified number of a U.S. company’s shares for some period but does not provide for any returns related to changes in the stock’s value. The delta of such a position could be lower than 0.7 even though the transaction effectively passes through the dividend. Because delta is an imperfect proxy, the regulation drafters therefore need to include “anti-abuse” rules that can override the objective delta test, although this may undermine the advantages of having a bright line rule.

The proposed regulations compound these difficulties by testing the delta not only at issuance but whenever a party acquires its long position. This heightens the possibility that that the rules will catch derivatives that were not entered into to avoid dividend withholding. For example, a typical convertible bond typically would be issued with a strike price that is out of the money and would not meet the delta test at issuance. However, if the stock later has substantially appreciated above the strike price, the delta may later exceed 0.7 and a secondary market purchaser after that date may have acquired an instrument subject to 871(m) withholding. Further, dealers may not recalculate delta with sufficient regularity to provide the necessary information and, in cases where the derivative takes the form of a traded instrument (like a structured note), the dealer may not even be aware the derivative instrument has changed hands. More generally, applying section 871(m) withholding to instruments that reference the issuer’s own equity like convertible bonds may conflict with other provisions of the Code, like section 305, which may also impute dividends on such instruments in certain (sometimes inconsistent) circumstances.

A third controversial aspect of the new proposed regulations is to adopt withholding on estimated dividends. The new proposed regulations expressly treat an instrument as subject to
withholding if it meets the delta test even if it provides for no actual payments linked to dividends (on the theory that expected dividends must necessarily have been priced into the contract). It is questionable whether such an adjustment in the pricing based on an anticipated dividend (which may not in fact correspond to any actual dividend adjustment) is in any sense the payment of a dividend equivalent amount for income tax purposes.

The regulatory drafters deserve sympathy, however. Coming up with administrable rules that do not impede at least some transactions that are not motivated by avoidance of dividend withholding is an impossible challenge. However, changes to the three features of the current proposed regulations above-- for example, increasing the delta threshold to 0.8, and limiting substantially situations in which delta is tested post-issuance and withholding is applied to estimated dividends-- will probably be necessary to make the rules workable.