CLEARY GOTTLIEB

ALERT MEMORANDUM

December 19, 2013 clearygottlieb.com

New IRS Rules Would Impose U.S. Withholding Tax on Many Derivatives and Other Financial Transactions Linked to U.S. Stock

I. OVERVIEW

On December 5, 2013, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") published proposed regulations that would impose U.S. withholding tax on a wide range of financial instruments linked to stock issued by U.S. issuers, including most equity swaps and many other equity derivatives, and many mandatory convertible bonds and structured notes that provide for the delivery of, or payment by reference to, U.S. equities. The withholding tax also will apply to certain conventional convertible bonds acquired in the secondary market. As drafted, the rules appear to apply to certain kinds of U.S. equity-based deferred compensation, M&A and joint venture transactions involving the acquisition of a minority stake and certain types of insurance although it is not clear that all of those applications were intended.

The withholding tax would apply to payments and deemed payments by U.S. and non-U.S. payors on financial instruments held by nonresident aliens and legal entities organized outside the United States that are "long" the underlying stock, including individuals, hedge funds, activist shareholders, special purpose vehicles, and dealers trading for their own account, starting January 1, 2016. The rules generally would apply to equity swaps outstanding on that date, and would apply to other equity-linked instruments acquired on or after March 5, 2014, regardless of when they were issued or entered into.

More specifically, the proposed regulations generally would impose U.S. withholding tax under section 871(m) of the Internal Revenue Code of 1986 ("871(m) withholding tax") on post-1/1/16 "dividend equivalents" paid or deemed paid pursuant to a swap or other financial transaction linked to the stock of a U.S. issuer if the instrument has a delta of 0.70 or higher (i) when entered into, in the case of a swap, or (ii) when acquired, in the case of other equity-linked instruments.[1] If a financial transaction is within the scope of the rules, generally withholding tax would be imposed when the amount of a dividend equivalent is fixed (*i.e.*, when the dividend payment on the underlying stock is fixed) even if there is no payment on the financial instrument at that time, or no payment at all under the instrument specifically linked to dividends. (Issues related to how to fund the withholding tax are discussed in more detail below.) U.S. equity-linked transactions likely to be subject to withholding tax under these rules include, among others:

---

[1] Delta measures the sensitivity of the price of a derivative instrument to a change in price of the underlying stock (*e.g.*, the value of a 0.70-delta derivative increases by 70¢ for every $1 increase in the value of the underlying U.S. equity). It typically varies over the life of the trade and is used by dealers to dynamically hedge their derivative positions. Delta estimates may differ by dealer.

- total return swaps and price return swaps, other than certain equity index-linked swaps;
- many collars and options that are in-the-money when acquired;
- many exchange-traded options, if in-the-money when acquired, and single stock futures;
- mandatory convertible bonds acquired on or after March 5, 2014, if the issuer pays dividends during the life of the bond;
- convertible bonds acquired at a time on or after March 5, 2014 when the delta of the embedded call option is 0.70 or higher, if the issuer pays dividends during the life of the bond;
- non-principal-protected structured notes acquired on or after March 5, 2014, and other structured notes if interest payable on the notes is linked to U.S. equities, other than notes linked to certain equity indices; and
- possibly, equity-based compensation such as unvested restricted stock or restricted stock units acquired by non-U.S. employees of U.S. employers on or after March 5, 2014; transactions involving the acquisition of a minority interest in a U.S. company by a non-U.S. acquirer or JV partner; and insurance contracts with payouts linked to U.S. equities. It is not clear, however, that the government intended the regulations to apply to all of these.

The IRS and Treasury also issued final regulations that extend current law through the end of December 2015.[2] The proposed regulations described above replace regulations proposed in January 2012.[3] While the new proposed rules greatly improve on the prior iteration, and in our view are closer to what Congress intended, they also raise a number of difficult new and continuing issues. The government has indicated that it is interested in hearing comments from taxpayers on a number of specific topics, and we understand that some of the proposed rules are in the nature of discussion drafts open to change, so that we expect that the final rules will differ in some regards.

Concerns raised by market participants are likely to include the proposed application of the rules to transactions entered into long before the regulations take effect or, in some cases, before section 871(m) was enacted; the application of the rules to many transactions other than equity swaps; the effect on issuers and investors in convertible bonds; and liability, competitive

2 The final regulations generally adopt without change the proposed rules from 2012 providing that dividend equivalents paid to a taxpayer eligible for the benefits of a U.S. income tax treaty will be taxed at the reduced rates for dividends under the treaty, and that dividend equivalents will be exempt from 871(m) withholding tax in the case of foreign sovereign investors claiming the benefit of section 892.

3 For our discussion of the prior proposals, see Cleary Gottlieb Alert Memorandum, Proposed IRS Regulations Will Impose U.S. Withholding Tax on Dividend-Linked Amounts under Many Equity Swaps and Other Equity-Linked Transactions on U.S. Equities (February 1, 2012), available online at http://www.cgsh.com/proposed_irs_regulations_will_impose_us_withholding_tax_on_dividend-linked_amounts/.

and operational issues for banks and broker-dealers. Technical concerns include the imposition of 871(m) withholding tax when no payments are being made; the requirement to withhold different amounts at different times and/or for different customers, in the case of non-delta one transactions; the narrow scope of the exception for qualified indices; the "combination" rules requiring that multiple long transactions be taken into account; and the potential for cascading withholding tax where there are back-to-back transactions.

Part II below highlights the key consequences of the new regulations. Parts III and IV then provide more extensive discussion of a number of technical issues for participants in equity derivatives (p. 10) and convertible bonds (p. 13). This memorandum does not address every part of the proposed regulations and should not be viewed as advice on any particular transaction.

II. KEY CONSEQUENCES

Equity Derivatives

Equity swaps

- *Gross basis withholding; delayed effective date but no grandfathering.* Payments on equity swaps on U.S. equities would become subject to 871(m) withholding tax starting January 1, 2016, regardless of when the swap was entered into. The gross amount of a dividend equivalent would be subject to withholding when the dividend amount is fixed even if payment netting provisions cause the short party to receive rather than make a payment, or no gross amount in respect of the dividend is ever explicitly taken into account in calculating any future payment.

- *Index-linked swaps.* Swaps linked to an equity index would be exempt if the index trades through U.S. futures or exchange-listed options, does not have a high dividend yield, and satisfies certain other criteria for exemption.[4] Narrow-based and customized indices would not be exempt, so each component U.S. equity would be separately

---

4 The exception applies to a "qualified index," which means an index that: (a) references 25 or more component U.S. equities; (b) references only long positions in component U.S. equities; (c) contains no component U.S. equity representing more than 10% of the weighting of the underlying U.S. equities in the index; (d) is modified or rebalanced based only on objective rules at set intervals; (e) does not provide for a dividend yield that is greater than 1.5 times the current dividend yield of the S&P 500 Index for the month immediately preceding the date the non-U.S. investor acquires the transaction; and (f) is referenced by futures or option contracts that trade on a U.S. national securities exchange or a domestic board of trade designated as a contract market. A separate safe harbor would exempt any index if it is made up solely of long positions and the underlying U.S. equities comprise 10% or less of its weighting.

We understand that the IRS expected that the qualified index rules would mean that no withholding tax would be required for financial instruments linked to most broad-based standardized indices. For technical reasons – for example, that an index may be rebalanced periodically but may also be subject to other modifications at times that are not preset – the rules may need to be revised to achieve that result.

analyzed (and potentially withheld upon). Swaps based on a non-U.S. index could be subject to withholding if the index includes U.S. equities.

- *Price return swaps*. The proposed regulations would treat a price return swap where the dividend is factored into the pricing as if it "paid" estimated dividend amounts that would be subject to withholding tax. The expansion of the proposed regulations to price return swaps is unexpected.

- *Documentation*. Unless amended, standard ISDA swap documentation would require the short party to an equity swap to gross up for the new withholding tax, although that party may be entitled to terminate the swap early.

Collars and option transactions

- *Delayed effective date and limited grandfathering.* Payments on collars and in-the-money or long-dated long options on U.S. equities would become subject to U.S. withholding tax starting January 1, 2016, if they have a delta of 0.70 or greater when acquired by the taxpayer, if acquired on or after March 5, 2014. Since tax is not required to be withheld until 2016, the March 5, 2014 cut-off date would require taxpayers either to determine the delta of a transaction retroactively once the regulations are issued in final form, or to start keeping records of the initial delta even though the regulations will still be in proposed form in March 2014 and may be modified.

- *Withholding required even if no payment made.* The proposed regulations treat the use of dividends as an input in pricing or setting the terms of a transaction as if the transaction provided for the payment of an estimated dividend. This amount generally would be subject to withholding when the actual dividend amount is fixed, if the short party holds collateral or other assets of the long party, or the long party has made a prepayment – or, it appears, has paid a premium – to the short party.

- *Multiple related transactions.* The deltas of multiple long positions that are entered into "in connection with" one another by the same or a related party would be aggregated in applying the 0.70 test. It is not clear how related transactions must be to each other in order to come within this rule. Moreover, related short positions are not taken into account for this purpose. As a result, complex strategies involving long options and offsetting positions could be subject to withholding tax even if the trade as a whole has a low delta.

- *Short-term transactions*. While withholding tax generally applies at the time a dividend is fixed, and is determined by reference to the number of underlying shares multiplied by the delta at the time of the dividend, a special rule applies for transactions acquired within one year of maturity. In that case, delta is determined at maturity, exercise or other disposition, and withholding takes place at that time. As a result, no withholding is required if an option lapses, but withholding is required on an amount equal to dividends on the full number of shares if the option is exercised. Consequently, taxpayers will not know until maturity or earlier disposition whether withholding will be required, and if withholding is required it will be on an amount that is not likely to correspond to the dividend-related amount taken into account in pricing the option or making adjustments to it during its term.

Exchange-traded transactions (options and certain futures contracts)

- *No exclusion for exchange-traded transactions.* The proposed regulations make clear that they apply to exchange-traded transactions and that clearing organizations may have 871(m) withholding tax liability, starting January 1, 2016. Accordingly, while clearing organizations generally should be exempt from withholding tax for transactions through U.S. clearing members, they may be required to withhold tax with respect to transactions through non-U.S. clearing members. This would require clearing organizations to build withholding tax and reporting systems that, in our experience, do not exist. The implementation of a withholding tax system for entities that act in practice as conduits for payments between the commercial parties to a transaction also raises significant operational issues.

- *Index-linked futures and options may be subject to withholding tax.* As described above under *Equity Swaps*, while it appears that the IRS intended to exclude most index-linked futures and options from withholding tax, the rules as proposed appear to include many such transactions. It is possible that these rules will be modified to operate as intended.

- *Uncertainty as to whether withholding tax applies.* In practice, because many exchange-traded options are short-term, whether withholding tax would apply would be determined only at maturity or earlier disposition of the option (see *Short-term transactions* above). For options with a term of more than one year, however, there would be several additional layers of uncertainty with respect to the timing and amount of tax (see *Varying amount of tax*, below).

Capital Markets

Convertible bonds

- *Secondary market transactions.* The acquisition of a convertible bond by a non-U.S. person at a time on or after March 5, 2014 when the embedded option has a 0.70 delta, would trigger 871(m) withholding tax when the issuer pays post-1/1/16 dividends on its shares. As a result, identical bonds may be exempt from or subject to 871(m) withholding tax in the hands of different investors.

- *Varying amount of tax.* The amount of tax required to be withheld could differ on every dividend payment date, because it is determined by reference to the delta of the embedded option at that time. Different rules would apply to bonds acquired within one year of maturity (see *Short-term transactions* above). Moreover, because withholding tax would apply to a convertible bond only if it is *acquired* at a time when its delta is 0.70 or greater, identical bonds may be subject to withholding tax in the hands of some parties and not in the hands of others. In addition, the withholding tax status of a single bond may flip back and forth if it is traded when its delta is moving above and below 0.70.

- *Issuer obligations.* Issuers would be obligated to use reasonable diligence to determine whether a convertible bond was subject to these withholding tax rules, and the amount of any withholding tax on the bond when a dividend is paid, and to provide that information to investors or brokers upon request. In practice, issuers generally do not know when a convertible bond trades, and may not track delta. We understand that the IRS expects issuers to obtain sufficient information to make the required determinations. In practice, it seems likely that issuers will look to the underwriters of the bonds to assist them.

- *Section 305 dividends.* For technical reasons, these rules generally will not apply to convertible bonds issued by issuers that do not pay dividends at the time of issuance. Separate, existing rules under section 305 apply to such bonds. Because sections 305 and 871(m) both provide for withholding liability in respect of deemed payments related to dividends, starting in 2016, issuers will be required to provide reporting to investors, or to the IRS, under both regimes. Although section 305 trumps in the case of a direct conflict between the two regimes, the regimes nonetheless provide for different measures of withholding tax, and have different reporting obligations, and need further attention in order to work in a coordinated fashion.

- *Effect on market*. These rules would apply to existing convertible bonds, starting January 1, 2016, if acquired as described above. It is not yet clear whether the 871(m) proposed regulations will have an effect on secondary trading of such bonds. Convertible arbitrage strategies and call spread transactions generally would not be affected, apart from the potentially significant impact on the convertible bonds themselves.

    - The proposed regulations do not explain why they apply to convertible bonds, which are significantly different from all of the other financial instruments subject to the rules: they are conventional capital market instruments that have been used for decades; they are typically issued by operating companies in order to raise financing, at rates lower than would apply to a conventional debt instrument, rather than by sophisticated financial institutions as part of an equity-linked customer business; they are issued at a time when the embedded option is out-of-the-money and purchased by investors who are making an economic bet, not a disguised investment in the underlying stock; and both Congress (in section 163(*l*)) and the IRS have recognized in the past that the tax rules for convertible bonds, while out of date, are not "broken." A fuller consideration of whether the proposed regulations should apply to convertible bonds appears to us to be warranted.

Mandatory convertible bonds

- Because mandatory convertible bonds typically have a delta in excess of 0.70, they would be subject to the new withholding tax in the hands of investors that acquire them on or after March 5, 2014. The discussion above under *Convertible bonds* generally applies to mandatory convertible bonds as well, except that 871(m) withholding tax typically will apply to actual dividend-linked payments on the bonds.

Structured notes

- Structured notes that do not have principal protection or that pay interest linked to U.S. equities would be subject to 871(m) withholding tax after January 1, 2016, if the note is acquired by a non-U.S. person on or after March 5, 2014 at a time when the embedded derivative on any underlying U.S. equity has a delta of at least 0.70. Because the delta test applies on an equity-by-equity basis, withholding could be required with respect to some underlying equities and not others. As described above under *Convertible bonds*, the amount of tax required to be withheld could vary from one dividend payment date to another.

- Notes linked to customized baskets or proprietary indices will not qualify for the qualified index exemption discussed under *Equity Swaps* above.

- For non-U.S. issuers that are not derivatives dealers – for example, a special purpose vehicle that is not treated as a dealer for U.S. tax purposes – there may be additional concerns. For example, if the issuer hedges its exposure on a note subject to the rules, 871(m) withholding tax may be imposed both on the hedge and on the note. In addition, in the case of a reverse convertible, the customer could be required to withhold tax on amounts deemed paid to the issuer.

Financial Institutions

Commercial issues

- *Delta disclosure.* A financial institution that is a short party to a transaction subject to 871(m) withholding tax would be required to disclose the delta of the transaction at the time of issuance and when dividends are paid, upon request by a counterparty or investor. This may raise issues as a competitive matter, and may expose the dealer to liability.

- *Potential cascading withholding tax.* Non-U.S. derivatives dealers that are long a potential 871(m) transaction would be exempt from 871(m) withholding tax if they are acting in their dealer capacity and certify as to compliance with the 871(m) rules. The exemption does not apply to proprietary transactions, or to entities not treated as dealers in derivatives or securities for tax purposes, in which case the withholding tax may apply more than once to the same transaction.

Withholding agent issues

- *Withhold on what?* The withholding agent would have a withholding obligation in the absence of an associated cash flow under many of the types of transactions discussed above. Withholding tax systems today operate primarily by withholding tax on actual payments. The new rules improve on the prior proposed regulations by eliminating retroactive determinations, but technical complications persist.

   - The proposed regulations impose the withholding tax obligation at the time when a dividend equivalent amount is fixed, which ordinarily is the record date. However, withholding agents will not actually receive a dividend until it is paid. As a result, even in a case in which the withholding is applied to an actual dividend payment, withholding will be required before withholding agents actually receive any dividends.

   - The time for withholding tax is deferred if neither party makes a payment, the short party does not hold collateral or other assets of the long party, and the long party has not made a prepayment to the short party. This rule is intended to protect withholding agents from paying tax out of their own pockets (although we question whether that goal is achieved when the only payment that the long party has made is a prepayment or option premium, since those payments are assets of the short party). The result, however, is that the withholding agent will have to track the deferred withholding tax for that particular investor and collect it at a later point.

- *Potential withholding agent liability.* The broker or dealer that is short (or long, if it is the only broker/dealer party to the trade) would be required to use reasonable diligence to determine whether the rules apply. Negligent determinations of delta could give rise to liability to clients (if too high) or to the IRS (if too low).

   - For combination trades consisting of multiple long positions, the dealer would be required to withhold only if it "knows" that the multiple trades are entered into in connection with each other. If the trade involves multiple desks, however, there may be no individual who has all of the requisite knowledge, even if the legal entity as a whole does have all of that knowledge. Moreover, in the case of an index trade with a related short position, the general "reasonable diligence" standard applies rather than the actual "knowledge" standard.

- *Significant complexity for withholding agents.* The amount of withholding tax imposed on a payment or deemed payment may vary from dividend to dividend, and may differ for different investors, since the transaction may be subject to 871(m) for some investors and not for others. A withholding agent would be required to record or calculate deltas on a trade-by-trade basis (and for an index or basket-linked instrument, on an underlying stock-by-stock basis) both when the instrument is acquired by a non-U.S. party and when a dividend is paid on the underlying U.S. equity. No existing withholding tax systems that we are aware of are configured for this level of complexity.

- *No grandfathering.* Building systems to cover swaps acquired years in the past, or equity-linked instruments acquired beginning March 5, 2014, will be a challenge. Market participants cannot create systems without having seen final regulations, and will be responsible for capturing delta information before they can realistically do so. Moreover, while we understand that the IRS intends to issue final regulations in 2014, even if they are issued in the first half of the year – which would be a highly accelerated timetable – dealers may not have sufficient time to build a system that is completely novel in several regards, including creating a capacity to withhold even though no payment is made.

General issues

- *Very broad scope; low delta threshold*. The proposed regulations treat all equity swaps as potentially abusive, without analysis of factors like the liquidity and other factors specifically provided for by the section 871(m) statutory language. The attempt to write factor-based rules in the previous proposed regulations, which were widely viewed as unadministrable, illustrates the reasons why the current proposed regulations take this approach. However, while the preamble to the regulations describes other transactions subject to the rules as ones with economic terms substantially similar to a payment on a securities loan or equity swap, the delta threshold of 0.70 is much lower than that standard would suggest. By contrast, the statutory "constructive sale" rules, which measure when a taxpayer is economically short – the direct inverse of the concern here – generally are understood to apply to transactions that have a delta in the 0.80+ or 0.85+ range. In practice, we suspect that many of the difficult technical issues we discuss would become much less significant as a practical matter if the delta threshold were raised to a level like 0.90, when an instrument functions much more like a surrogate for the underlying stock.

  The proposed regulations also would impose withholding tax on transactions where no party holds stock of a U.S. issuer, such as offsetting single stock futures contracts.

- *Equity compensation awards.* The new rules literally could be read to apply to equity compensation awards such as restricted stock units (RSUs) or unvested restricted stock granted by a non-U.S. subsidiary to non-U.S. employees. Our understanding is that this result was intended, although it does not appear that the consequences of such treatment have been fully explored.

- *Other unexpected applications?* The proposed regulations attempt to eliminate M&A transactions involving the purchase of stock from their scope, through a rule that treats a transaction in which one or more persons are obligated to acquire more than 50% of the value of a U.S. company as outside the scope of the rules. This exception would not apply, however, to the purchase of a minority interest in a U.S. company by a non-U.S. buyer, and could conceivably apply to an option to buy out an existing JV partner or to a commitment by a new investor in a U.S.-organized JV. The carve-out also does not make clear whether a contract with significant closing conditions, for example antitrust clearance, qualifies as a contract where the long party is "obligated" to purchase the stock, although that presumably is the intent. It is possible that the 50% threshold was intended to invite comment by taxpayers on how to structure a more comprehensive carve-out for M&A or JV transactions.

  - It is possible that other types of transactions not obviously intended to be covered would also be subject to the rules, for example whole life insurance or variable annuities.

- *Anti-abuse rule.* An anti-abuse rule would authorize the IRS to depart from the rules if it determines that a transaction is structured with "a principal purpose" of avoiding them. There are no examples illustrating this rule. Accordingly, taxpayers will not be able to rely on the bright-line delta threshold in all cases.

III. EQUITY DERIVATIVES

"Estimated dividend" rules. A principal reason why the proposed 871(m) regulations are so sweeping in their scope is that they treat "estimated" dividends, or dividends taken into account in the pricing or terms of a transaction, as if they were actual dividend-linked payments. Since the financial models for pricing equity derivatives include dividends as an input, this rule brings virtually any equity derivative that is not explicitly excluded within the scope of the rules, unlike the prior proposed regulations. The use of estimated dividends as a trigger for subjecting a transaction to 871(m) withholding tax leads to a number of difficult practical and conceptual issues:

- Withholding tax will be imposed even though no payment directly reflecting dividends may be made in the course of a transaction.

- The delta actually realized on dividend-payment days during the term of the option may differ from the day 1 delta, so withholding may be imposed on dividend-equivalent amounts that are greater or less than the dividend-related amount priced into the option.

- Similarly, the simplified rules for short-term options ensure that the withholding tax will be imposed on an amount that differs from the dividend-related amount priced into the option on day 1, although the operational benefits of this simplicity may outweigh the economic distortion.

- Once a transaction is bad, it's bad for good, in the hands of that holder but not later acquirers. If a transaction meets the delta threshold when acquired by a long party, it will always be subject to withholding on dividend equivalents in the hands of that party even if the delta later declines close to zero, presumably on the theory that a high delta on acquisition indicates that the transaction was effectively purchased by the non-U.S. person as a proxy for directly holding the U.S. stock. A new acquirer would not, however, be subject to the withholding tax. This asymmetry may give the taxpayer an incentive to dispose of the transaction and later reacquire it. While the transaction is potentially subject to the anti-abuse rule, as a policy matter it seems difficult to justify treating two investors holding a transaction with a below-0.70 delta in different ways or to prevent the disadvantaged investor from using self-help.

Index swaps, futures, and options are exempt in only limited cases. An index-linked instrument must be delta-tested on an underlying U.S. equity-by-equity basis unless the index is a "qualified index."[5] The new rules would narrow the definition of a qualified index as

5 For the proposed definition, see note 4 above.

compared to the prior proposed regulations. They would generally restrict the exemption to exchange-traded stock indices. Otherwise, determining whether the rules apply would require an analysis of the U.S. equity components and makeup of the index at the time the non-U.S. investor acquires the contract, as well as information about the non-U.S. investor's trading strategy:

- The index must be traded through U.S. futures or exchange-traded options. It is not sufficient, therefore, for the notes linked to the index to be listed, or for the index to be used as a benchmark for mutual funds or asset managers.

- The index must reference at least 25 component U.S. equities. Consequently, many sector-specific indices will not qualify.

    - While a safe harbor rule provides that an index with less than 10% U.S. equities in the aggregate is a qualified index, if the U.S. equity component exceeds that 10% threshold, no individual U.S. equity can exceed 10% of the aggregate U.S. equities position.[6]

- An index with a dividend yield in excess of 1.5x the current dividend yield of the S&P 500 index in the month prior to acquisition of the transaction would be disqualified. An index thus may be qualified for one month but not the next month under this rule.

- The index must be modified or rebalanced according to predefined objective rules at set dates or intervals. While it is clear that broad-based indices such as the S&P 500, the Russell 3000, the Dow Jones Industrial Average, and the NASDAQ 100 are intended to be treated as qualified indices, they may not satisfy this criterion as currently worded.

- If a taxpayer or transaction shorts a component of the qualified index (*e.g.*, so as to back out and isolate exposure to one or more U.S. equities), the index is disqualified and any long position in a U.S. equity must be tested under the rules applicable to individual stocks. Similarly, the index itself cannot involve a short position in any U.S. equity.

The aggregation rules are likely to be difficult to apply. Long positions acquired "in connection with" each other by a non-U.S. investor or related party are aggregated in evaluating whether the transaction crosses the delta threshold. The deltas of each component contract would need to be re-evaluated if a contract is added after a lapse of time (however long after the initial position was taken). As written, the rules raise several issues:

---

6 For example, if the index includes one U.S. equity comprising 5% of the index and other U.S. equities aggregating another 10% of the index, the index will not be qualified since the first U.S. equity represents 1/3 (= 5/15) of the total U.S. equity component of the index.

- Each long component must be evaluated (a) on a stand-alone basis, and (b) together with other long positions, in order to determine whether the delta threshold is crossed. Short positions generally are not taken into account for this purpose (*i.e.* negative deltas are not added to positive deltas in evaluating the 0.70 threshold).
  - As a result, pieces of exotic option strategies involving deep in-the-money or long-dated options or short option positions could be subject to withholding even if their aggregate payoff profile does not look anything like a directly held position in a U.S. equity.
  - The proposed rules do not have a safe harbor permitting a trader to identify a series of related trades as a single section 871(m) transaction in a certificate to the withholding agent. It is not clear whether a transaction documented as a single trade with a low delta would be exempt from 871(m) withholding tax, since an embedded option is treated as a separate potential 871(m) transaction.
- An example in the rules may create a presumption that simultaneous trades are entered into in connection with each other. For simultaneous or staggered trades, different withholding agents may adopt their own rubrics to evaluate when they "know" trades should be combined, with various levels of conservatism. Non-U.S. investors would need to communicate with their prime broker or other withholding agent to understand these policies.

Activist shareholders executing delta-one derivatives strategies would be subject to withholding. An offshore hedge fund or other non-U.S. investor taking a delta-one or high delta derivatives position (*e.g.*, through deep in-the-money options, reciprocal puts and calls, or total return swaps) in a company's stock in order to avoid triggering securities law reporting requirements or Hart-Scott-Rodino requirements would generally be subject to dividend equivalent withholding under the proposed rules. It would not matter if the transaction involves mismatched expiration dates, exercise styles, settlement styles or strike prices, if as a whole the strategy's exposure exceeds the delta threshold.

Lack of grandfathering will pose problems given existing documentation. As described above, existing swaps are not grandfathered, and other equity-linked instruments are grandfathered only in the hands of long parties that acquired them prior to March 5, 2014.

- The short party may be required to pay a gross-up under current market standard terms for swaps and other equity derivatives. If so, the short party may seek to terminate the transaction due to a change in tax law. Market-standard documentation is written in terms of withholding on "payments," however, and it is not clear how it will apply to withholding tax that is imposed in the absence of an actual contemporaneous payment.

IV. CONVERTIBLE BONDS

Convertible bonds will be subject to two inconsistent sets of rules relating to dividends. Under current market practice, the conversion ratio of a convertible bond is typically adjusted if the issuer increases its dividend, pays a special dividend, or starts to pay dividends, during the term of the bond. Under current law, section 305 generally treats the embedded option underlying a convertible bond as if it were stock in respect of which dividends may be deemed to be paid. Accordingly, an adjustment of this kind gives rise to a deemed dividend equal to the value of the adjustment, which ordinarily is determined by reference to dividends on the total number of shares into which the bond can be converted. Absent an adjustment, current law does not impute a dividend. By contrast, under the proposed 871(m) regulations, if the issuer is dividend-paying when the convertible bond is issued, 871(m) withholding tax may apply to the imputed dividend amount if purchased by a secondary market investor when the embedded option has a delta of 0.70 or greater.

A coordination rule provides that if both section 305 and 871(m) could apply, section 305 trumps. The section 305 and 871(m) rules are otherwise not coordinated, and consequently apply in significantly different ways. For example, assume that an issuer is paying a $1/share dividend when a convertible bond is issued with typical provisions providing that a bond holder is compensated through a favorable adjustment to the conversion ratio in an amount determined by reference to any increase in the dividend of the underlying stock over the bond's term. Assume further that during the term of the bond the issuer increases its dividend to $1.20/share. Assuming that the bond is convertible into 100 shares and on a particular dividend payment date the delta of the embedded option is 0.75, under current law and the proposed regulations:

- *The basis and timing for determining the 305 dividend and 871(m) dividend equivalent amounts are different.* Non-U.S. investors who purchased the bond after the delta threshold was reached will be subject to withholding tax based on (i) a section 305 dividend equal to $0.20 x 100, the number of underlying shares (which corresponds to the economic terms of the convertible bond), plus (ii) an 871(m) dividend equivalent amount equal to $1 x 75 shares. The 75 share number is a function of the delta multiplied by the number of underlying shares and will be different on each dividend payment date as the delta fluctuates. The timing of these two amounts also will differ (the adjustment date for the 305 dividend, and the record date for the dividend equivalent).

- *The rules for reporting the 305 dividend and the 871(m) dividend equivalent are inconsistent and do not ensure that the information is available prior to a dividend payment date.* The issuer of the convertible bond will be required (a) starting in 2016 (under new "cost basis reporting" rules) to report the section 305 dividend either (i) by providing information to the IRS, generally within 45 days of the dividend payment, and by providing it to investors and/or brokers by January 15 of the next calendar year, or (ii) by posting the information on its website, and (b) to report information about the 871(m) dividend (i) in an annual information form filed with the IRS, and (ii) upon request by an investor or nominee. Additional issues relating to these reporting obligations are discussed below.

The 871(m) reporting requirements may create significant liability issues for both issuers and withholding agents. As discussed earlier, the proposed regulations require issuers to use reasonable diligence to determine whether a convertible bond is subject to 871(m) withholding tax, which will depend on (a) the delta of the embedded option and (b) when the bond is purchased in the secondary market. Issuers also must provide information about the amount of a dividend equivalent, which also will depend on delta determinations. Issuers do not ordinarily have information about when their convertible bonds trade, and we expect that most issuers do not track the delta of the embedded option.

Consequently, in order to make these determinations, an issuer may request trading and delta information from the underwriter of the bond, which ordinarily would make a market in the bond and so would have some – but not complete – information about trading and would be able to determine the delta of the embedded option. However, financial institutions may be reluctant to provide information that they consider proprietary or to provide information that will be used by a third party to determine tax obligations, for liability reasons. The liability issue may be particularly fraught because the issuer may be liable for any withholding tax not collected by a withholding agent or broker if the information provided by the issuer to withholding agents is not correct.

Withholding agents also may have special concerns, because they are permitted to rely upon the information provided by the issuer only if they do not know or have reason to know that the information is incorrect. If an affiliate, or another department, of the same legal entity that is the withholding agent has the relevant trading and delta information, that information may be imputed to the tax compliance function of a broker holding convertible bonds for customers. As a result, issuers and withholding agents each may have full liability for the withholding tax, without meaningful ability for either of them to rely on the other.

Another complication is that hedge funds constitute a significant part of the investor market for convertible bonds. A hedge fund investor may independently determine the delta of the embedded conversion option, for its own trading purposes. An investor of this kind may disagree with the determinations made by the issuer, and conceivably could seek refunds of any withholding tax on that basis. And if a dealer acquires a convertible bond for its own account as a hedge, the responsibility for making 871(m) determinations and providing reporting would shift to the dealer with respect to those bonds.

* * *

If you have any questions, please feel free to contact Erika W. Nijenhuis (+1 212 225 2980), William L. McRae (+1 212 225 2188) or Doug Borisky (+1 212 225 2332). You may also contact our other U.S. partners and counsel listed under “Tax” located in the “Practices” section of our website at http://www.clearygottlieb.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road
Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099