New U.S. Tax Regulations under Section 871(m), Effective January 1, 2017 for Non-US Clients

Overview of the 871(m) Rules

On September 17, 2015 and on January 24, 2017, the U.S. Treasury published final regulations under section 871(m) of the United States Internal Revenue Code (the "871(m) Rules"), which came into effect on January 1, 2017 and applies to investments in relevant products issued or entered into on or after this date. The 871(m) Rules were enacted because the U.S. Congress believed that certain financial products were being used by non-U.S. investors to avoid paying tax on U.S.-source dividend income. The 871(m) Rules generally impose a withholding tax of 30% (or a lower rate if a U.S. tax treaty applies) on any investor that is neither a U.S. citizen nor a U.S. tax resident (each, a "Non-U.S. Client") with respect to "dividend equivalent amounts"[1] received or deemed received by the Non-U.S. Client under certain derivative contracts or equity linked instruments that reference U.S. equities (such U.S. equities, including U.S. equities referenced or held by certain indices or partnerships, each a "U.S. Underlier"). In general, the 871(m) Rules apply when the relevant contract or instrument with respect to a U.S. Underlier is "delta-one" at the time that it is issued, entered into or significantly modified. Delta measures how closely a derivative instrument tracks a U.S. Underlier and is equal to the ratio of the change in the value of the derivative instrument that occurs if the U.S. Underlier increases or decreases in value by a small amount (e.g., $1).[2] Certain instruments whose delta cannot be easily calculated will be deemed "complex" under the 871(m) Rules. In general, the 871(m) Rules do not apply to complex contracts entered into before January 1, 2018. For instruments issued on or after January 1, 2018, withholding will be required when the delta of the relevant instrument is 0.8 or higher at the time of issuance. For complex contracts entered into on or after January 1, 2018, a substantial equivalency test is applied to the instrument and the results of this test will determine whether an instrument is in or out of scope for the 871(m) Rules.

The obligation to withhold tax under the 871(m) Rules applies to all financial institutions globally, including those that are located outside of the U.S. and do not have any U.S. presence. Examples of products impacted by this regulation include, but are not limited to, swaps, options, futures, forwards, structured notes, convertible debt, and warrants that reference U.S. Underliers.

1) What products are exempt from the 871(m) Rules?

U.S. withholding tax under the 871(m) Rules is not imposed on U.S. citizens or U.S. tax resident investors, and does not apply to transactions that have no U.S. Underliers or to products issued or entered into prior to January 1, 2017, unless there is a significant modification to the terms of the product on or after January 1, 2017. Thus, products issued before 2017, but purchased in a secondary market on or after January 1, 2017, are generally exempt.

In addition, the 871(m) Rules do not apply if:

i. **The delta of the product is less than the applicable delta threshold:** where the delta of an instrument is less than "delta-one" for transactions entered into on or after January 1, 2017 and 0.8 for transactions entered into on or after January 1, 2018 at the time of "issuance"[3], the derivative is generally out of scope, subject to the "Combination Rule" discussed in section 4(i) below. The relevant delta is generally determined on the earlier of the date that the product is priced and the date when the product is issued or entered into and any changes in the delta during the term of the product do not have any effect on the initial determination of whether the product is subject to the 871(m) Rules or on how the dividend equivalent amounts are calculated, except that a significant modification to the terms of the product may be considered a re-issuance of the modified product, in exchange for the unmodified product, such that delta may have to be measured again as of the time of the significant modification.

ii. **Any distribution on the referenced U.S. Underlier that would not otherwise be subject to U.S. dividend withholding tax:** for example, there is no requirement to withhold on a dividend equivalent payment with respect to a distribution treated as a capital gain or return of capital.

iii. **The product references a "qualified index"**

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An exemption for products referencing qualified indices is meant to exclude products that are linked to broad-based, diversified indices widely used by numerous market participants where the index's return attributed to dividends on U.S. equities is relatively insignificant. However, the definition of a qualified index is very technical and may be difficult to meet.

a. There is a 7-part test that an index must satisfy in order for it to be a "qualified index":

i. The index must be comprised of 25 or more securities;
ii. No one component can be greater than 15% of the index;
iii. Five or fewer components cannot be more than 40% of the index;
iv. The index generally only references long positions – additionally, if a Non-U.S. Client (or any of its affiliates) takes a short position of greater than 5% against any component of an index during the life of a transaction that references the index, the index will not be a qualified index with respect to that transaction;
v. Publicly stated, predefined criteria must be used to modify or rebalance the index;
vi. The dividend yield in the prior calendar year for the index must be less than or equal to 1.5x the annual dividend yield for the S&P 500 for that year; and
vii. The index must have futures or options contracts traded on either (i) a U.S. Exchange or (ii) a qualified foreign exchange AND U.S. Securities are less than 50% of the weighting of the index.
viii. A qualified index includes indices where the underlying U.S. equity securities comprise 10% or less of the weighting of the component securities in the index provided the indices are widely used by numerous market participants.

b. The qualified index exemption is also available for exchange traded funds that "track" a qualified index. For example, the SPDR S&P 500 ETF trust, ticker SPY, is exempt as it tracks a qualified index.
c. For the first year an index is listed, the determination of whether it is qualified is made on the first business day it is listed. In subsequent years, the determination of whether an index is qualified is made on the first day of the calendar year and will apply to all derivatives issued during that calendar year. Accordingly, it is possible that an index will be a qualified index with respect to transactions entered into during a particular year but not for one or more other years.

You must confirm with Citi whether it will treat any particular index as a qualified index.

2) When will withholding occur under the 871(m) Rules?

Under the 871(m) Rules, a withholding agent has the option of withholding on: (i) on the dividend payment date for the U.S. Underlier or (ii) the later of the date that the amount of the "dividend equivalent" is determined or the date that "payment" occurs on the derivative. The dividend equivalent amount generally is determined when dividends are paid on the U.S. Underlier and generally is equal to the dividend (or, in certain cases, the estimated dividend) per share multiplied by the number of shares referenced by the product, multiplied by the delta of the product that was determined at the time of issuance. Pershing has informed Citi that it will withhold on the date that the dividend is paid on the U.S. Underlier.

Under the 871(m) Rules, withholding tax can be due, even if no cash or property is delivered to a Non-U.S. Client or the Non-U.S. Client has a net payment obligation to its counterparty. For example, if a Non-U.S. Client purchases a call option on a U.S. equity at or above the applicable delta threshold, it will be in scope for withholding. If the option expires worthless and is not exercised, withholding will still be required at expiration on the dividend equivalent amounts calculated during the term of the option.

3) Are there any scenarios where a product that meets one of the exemptions described above could still be subject to the 871(m) Rules?

There are two additional rules that must be considered when determining whether a product is subject to the 871(m) Rules.

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i. Combination rule

If a Non-U.S. Client and/or its affiliates enter into multiple transactions in connection with each other, those transactions may be combined, in whole or in part, and treated as a single transaction subject to the 871(m) rules if the combined transaction replicates the economics of a single product that would have been subject to 871(m).

Citi generally must combine transactions for purposes of withholding U.S. tax if Citi knows that the Non-U.S. Client (or its affiliates) entered into transactions "in connection with" each other. Therefore, Citi will combine trades entered into on or after January 1, 2017 if the transactions are priced, marketed or sold together or there is actual knowledge that transactions are entered into in connection with each other. For trades entered into on or after January 1, 2018, absent actual knowledge, Citi will also apply certain presumption rules to treat certain transactions as not made in connection with one another. The application of these presumption rules beginning in 2018 will not change the designation of any transaction entered into in 2017 for purposes of the combination rule; only a reissuance requiring a retesting of the delta of a transaction would cause its designation to change.

ii. Anti-abuse rule

The 871(m) Rules also have an anti-abuse rule, which states that if a taxpayer acquires, structures or disposes of a transaction or transactions with a principal purpose of avoiding the application of the 871(m) Rules, the IRS may treat the transaction as subject to the 871(m) Rules. Withholding agents will be required to create internal policies to address this rule, which may include ongoing surveillance in trading behavior of clients for potential 871(m) Rules avoidance.

4) Where can I get further information?

Please contact your usual Citi representative if you have questions on how 871(m) will affect any investment decision that you make with us.

[1] A "dividend equivalent" is roughly the economic benefit of a dividend paid to stockholders of a U.S. equity that is included in the pricing of a derivative contract or equity linked instrument on that U.S. equity. For example, where a total return swap references a U.S. equity security that pays a dividend, the payment to the investor of an amount equal to that dividend is the classic example of a dividend equivalent. The IRS has determined that derivative contracts and equity linked instruments may provide the economic benefit of dividends, and therefore, include "dividend equivalents" for the long party either explicitly or implicitly. For example, a "dividend equivalent" also includes the value of any estimated dividend that results in a discount to the price that the investor paid for a call option, even if no cash payment is made to the investor at the time the dividend is paid, and even if the option expires worthless. (See section 3)

[2] E.g., if the derivative contract increases in value by $0.85 when the value of the underlying stock increases by $1, the delta of the contract is 0.85.

[3] For over the counter derivatives and listed derivatives contracts, issuance generally means the time of trade execution. For all other instruments issuance generally means the date all material economic terms are agreed.

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