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Delay of Withholding Tax on Equity-Linked Instruments Pleases Practitioners.

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Responding to taxpayer concerns about uncertainty surrounding the proposed section 871(m) specified ELI rules (REG-120282-10), Treasury issued Notice 2014-14, 2014-13 IRB 1 , that amends prop. reg. section 1.871-15(e) to limit the specified ELI definition to ELIs issued on or 90 days after the date of the final regs' publication.

Erika W. Nijenhuis of Cleary Gottlieb Steen & Hamilton LLP approved of the extension, telling Tax Analysts, "It will remove a cloud of uncertainty from convertible bonds, structured notes, and options issued or traded prior to issuance of the final regulations, just as that cloud was about to descend on the market."

Jeffrey D. Hochberg of Sullivan Cromwell agreed, saying, "The Treasury Department and IRS should be commended for their willingness to take into account the real-world practical problems that the securities industry was facing under the section 871(m) proposed regulations."

Before Notice 2014-14, payments on specified ELIs would be subject to withholding on payments on or after January 1, 2016, for all specified ELIs acquired by the long party beginning March 5, 2014.

Opportunity to Improve

Hochberg hopes the extra time will allow Treasury and the IRS to address some issues taxpayers have with the proposed regulations, including structuring a withholding regime that works for complex instruments and clarifying delta computations.

David P. Hariton of Sullivan & Cromwell said, "The securities industry is very appreciative of the grandfathering relief, and we hope to engage in a constructive dialogue with Treasury and the IRS on a going-forward basis to help them implement the proposed regulations in the most efficacious manner."

The proposed regulations, issued December 4, 2013, adopted a delta test to determine whether section 871(m) dividend equivalent withholding requirements apply to ELIs. Some examples of ELIs are convertible bonds and options. The proposed regulations scrapped prior regulations that established a seven-factor test for determining whether the section 871(m) withholding tax would apply.

An issue that must be addressed is with delta computation in the case of a structured note that includes synthetic leverage or other complex terms, Hochberg said. If the March 4 notice were not released, issuers would have had to issue instruments and report delta to holders without knowing how to compute it on these complex instruments, he said.

Perhaps most importantly, the regulators can reduce some of the uncertainty regarding how withholding would apply to structured notes under the proposed regulations, Hochberg said. Under the proposed regulations, an issuer of an ELI might be required to make withholding payments to the IRS when the underlying pays dividends, even though payments under the note may not be made until maturity, Hochberg said.

“This could result in the issuer bearing the cost of the tax because it would have no payment upon which to withhold, particularly if the foreign holder transfers the note to a U.S. holder before any payment is made on the note,” Hochberg said.

“There was a significant amount of concern that without an extension of the grandfather date, issuers might be reluctant to issue structured notes because of this [factor], which in turn could impair a major capital funding source of financial institutions,” Hochberg said, adding that structured notes also represent a significant amount of the capital markets.

“The extension of the grandfather date will allow [the IRS] to address these unresolved issues before the new withholding regime is in effect, and will give the securities industry the necessary time to build the necessary systems to implement this new withholding regime,” Hochberg said.

by William R. Davis