Tax Alert
Treasury Issues Temporary and Proposed Regulations on Dividend Equivalent Payments

February 1, 2012

Summary
On January 19, 2012, the Treasury Department released temporary and proposed regulations under Section 871(m) of the Internal Revenue Code of 1986, as amended (the “Code”).1 Very generally, Section 871(m) imposes withholding tax on gross payments to non-U.S. persons that are contingent on, or determined by reference to, the payment of U.S. source dividends and made pursuant to certain types of equity swaps.2 Under the current rules, payments made pursuant to equity swaps are not subject to withholding tax if (i) the long party to the contract refrains from “crossing in” or “crossing out” of the contract3 and (ii) underlying shares are not posted as collateral by the short party to the contract with the long party to the contract.4

However, the current rules were set to change after March 18, 2012, after which the Section 871(m) regime would have applied to all swaps (other than those determined by the Treasury Department not to have the potential for abuse). In recent months, there was growing concern among practitioners that Treasury would not issue rules to prevent this result. Under the new rules, effective January 1, 2013, non-U.S. investors still would be able to invest in certain swaps without being subject to any withholding tax—but in more limited circumstances than under current law.5 The new rules also extend withholding under Section 871(m) to payments pursuant to a variety of equity-linked instruments other than swaps, including futures, forwards, options and other contractual arrangements.

In general, the new rules are more restrictive than the current rules, and non-U.S. investors may find it difficult, in practice, to avoid their application. The significant features of the new rules include—

• specific restrictions on the market activity of the long party (presumably attempting to preclude indirect crossing into and out of swap positions through market transactions)
• guidance on the meaning of the term “readily tradable”
• a 90-day un-hedged holding period rule
• limitations on the control a long party may have over the hedging activity of the short party

1 Except where otherwise specified, all section references in this client alert are to the Code.
2 Section 871(m) also authorizes Treasury to expand the rules to cover other types of equity linked contracts.
3 “Crossing in” means, in connection with entering into the contact, the long party may not transfer the underlying security to the short party; “crossing out” means, in connection with terminating the contract, the short party may not transfer the underlying security to the long party.
4 An additional requirement to avoid withholding under the current rules is that the reference property must be “readily tradable.”
5 As discussed in greater detail below, the proposed regulations describe the new rules that would be effective beginning January 1, 2013, and the temporary regulations extend the current rules through the end of 2012.
• limitations on size of the swap relative to the total float of the underlying security

• limitations relating to the use of swap contracts to avoid withholding with respect to special dividends.

The proposed regulations also include a taxpayer favorable exception clarifying that the term “dividend equivalent” (as applied to either swap or other derivative contracts) does not include any payment made pursuant to a specified swap if such payment is merely an estimate of expected dividends, provided such payment is not adjusted in any way for the amount of the actual dividend. This exception is relevant, for example, to single stock future contracts, which generally include a pricing component that is determined by reference to the amount of dividends anticipated to be paid on the underlying shares. Under the exception, this feature should not be treated as a dividend equivalent provided there is no true-up for the amount of dividends actually paid.

There are number of significant practical issues raised by the proposed regulations, including—

• Because many of the factors described in the proposed regulations depend on actions undertaken by the long party (including actions undertaken after the long party entered into the contract) and, thus, unknown to the short party, short parties will likely react, in practice, by imposing harsh contractual terms on non-U.S. long parties. To avoid this situation, many non-U.S. long parties may opt to invest through a domestic entity (e.g., a domestic partnership) that may act as its withholding agent.

• The scope of the proposed regulations is not entirely clear. In particular, it is not clear whether non-traditional swaps, including dividend swaps, would be covered. As a policy matter, dividend swaps do not raise the same potential for the type of abuse that Section 871(m) was meant to address, inasmuch as they are not really an economic substitute for ownership of the underlying security.

• In determining whether it meets the 90-day holding period rule, a non-U.S. investor would have to track whether it, or one of its affiliates, has entered into an offsetting position with respect to the long stock position. This could prove burdensome and, in some cases, impossible.

• The restrictions on market activity necessitate an investment tracking and coordination capability that may prove challenging for larger financial institutions.

Note that the Treasury Department is seeking comments on and continuing to review the proposed regulations, with the result that the proposed regulations may not be finalized in their current form. The features of the temporary and proposed regulations summarized above are discussed in greater detail below.

Background

In 2010, in response to perceived abuses in taxpayers’ use of swaps and other derivative transactions to avoid withholding tax on dividends, Congress added Section 871(m) to the Code. In general, Section 871(m) provides that any “dividend equivalent” is treated as U.S.-source income (and, hence, subject to withholding tax when paid to a foreign person) if it is determined by reference to the payment of an underlying dividend that would itself be U.S.-source.

A dividend equivalent is generally defined as—

• any substitute dividend pursuant to a securities lending or sale-repurchase transaction that is contingent on, or determined by reference to, the payment of an underlying U.S.-source dividend

• any payment pursuant to a “specified notional principal contract”6 that is contingent on, or determined by reference to, the payment of an underlying U.S.-source dividend

6 We have referred to SNPCs colloquially as specified swaps in the summary above.
any other payment that Treasury determines to be “substantially similar” to either of such types of payments.

The Code provides specific rules for defining “specified notional principal contracts” (SNPC), which, as originally enacted, were to be applicable for payments made before March 18, 2012. For payments after the expiration of this rule, the Code provides that a SNPC is any NPC unless Treasury determines that it is of a type that does not have the potential for tax avoidance. Thus, for this period, the definition is effectively left to regulations, subject to a presumption that a notional principal contract (NPC) is an SNPC.

**The Temporary Regulations**

The most significant feature of the temporary regulations is that they extend the statutory definition of SNPC (which would otherwise have applied only to payments before March 18, 2012) until December 31, 2012. However, it is important to note that the cutoff date applies to the date a particular payment is made; thus, payments made after December 31, 2012, will be subject to the presumption (and, if promulgated in final form, the rules set forth in the proposed regulations) even if they are pursuant to a contract entered into before 2013.

The preamble to the temporary regulations specifically reserves the right to apply otherwise-applicable judicial doctrines to challenge a transaction that is designed to avoid the application of the rules. Specifically, Treasury states that it may assert that a particular transaction is not an NPC (or other derivative) at all, but, instead, effectively transfers an ownership interest in the underlying security to the long party. Presumably, if the long party were so treated, the “dividend equivalents” would be treated as actual dividends and, hence, would be subject to withholding without regard to Section 871(m).

The temporary regulations are effective beginning January 23, 2012.

**The Proposed Regulations**

In addition to restating the temporary regulations in proposed form, the proposed regulations address several issues that are not addressed in the temporary regulations.

**Definition of SNPC for payments after 2012.** For payments after December 2012, the proposed regulations would identify seven factors, the presence of any one or more of which would cause an NPC to be an SNPC. The seven factors are as follows—

- An NPC is an SNPC if the long party is “in the market” with respect to the underlying security. The long party is treated as “in the market” if (i) it sells or disposes of the underlying security on the day the NPC is priced, (ii) it acquires the underlying security on the day the NPC terminates or (iii) it purchases or disposes of the underlying security at a price that is set or calculated to be substantially identical to (or determined by reference to) an amount used to price or terminate the NPC. However, this rule does not apply if the long party is “in the market” with respect to an amount of the underlying securities that is less than 10 percent of the notional principal amount of the NPC.

- An NPC is an SNPC if it is with respect to an underlying security that is not regularly traded. To be regularly traded, a security must generally be listed on an SEC-registered exchange on the date the NPC is priced, and it must be actually traded on at least 15 of the 30 trading days prior to the pricing date.

- An NPC is an SNPC if the short party posts the underlying security as collateral with the long party, provided such security represents more than 10 percent (by value) of the total collateral so posted on any day that the NPC is outstanding.

- An NPC is an SNPC if it has a term of less than 90 days.
• An NPC is an SNPC if (i) the long party controls the short party’s hedge (either contractually or by conduct) or (ii) the long party enters into the NPC using an “underlying equity control program.” Generally, an “underlying equity control program” is a system or procedure that permits a long party to acquire economic exposure to an underlying security and to determine the form of the transaction (i.e., an NPC) later.

• An NPC is an SNPC if the notional amount represents greater than 5 percent of the total public float or greater than 20 percent of the 30-day average trading volume (as of the business day before the first day of the term of the NPC) of the underlying security.

• An NPC is an SNPC if it is entered into after announcement of a special dividend and before the ex-dividend date.

Because some of these factors (in particular, the first) depend not on the terms of the contract, but on other actions undertaken by the long party, the short party (which is the party required to withhold) may have no way of determining whether the contract is an SNPC or not. Although representatives of the Treasury Department have been reported as having informally stated that withholding agents will not be held accountable for facts that they could not possibly know, the proposed regulations in their current form do not provide for certification procedures or any other mechanism on which a potential withholding can rely to ensure that it is not making a payment with respect to an SNPC.

The practical difficulties faced by a withholding agent are further exacerbated by the fact that the proposed regulations provide that, where an NPC is not an SNPC at its inception but becomes an SNPC during its term, at the time of the first payment after it becomes an SNPC, the payor must withhold with respect to all dividend equivalents up to that time, including dividend equivalents that were paid before the contract became an SNPC. When combined with the rule (set forth in the Code and confirmed by the proposed regulations) that withholding is required with respect to the gross amount of a dividend equivalent (even where, under the contract, the actual payment due to the long party may be offset against a payment due to the short party), the very real possibility exists that the amount required to be withheld may exceed the amount of the payment being made.

Stock Indices as Underlying Securities. Section 871(m)(4)(C) provides that “any index or fixed basket of securities shall be treated as a single security,” presumably for purposes of determining whether the NPC is an SNPC. Thus, for example, if the long party to an NPC on a broad-based index sells one or more of the underlying components on the same date the NPC is priced, such sales would presumably not cause the long party to be treated as “in the market” with respect to the underlying security because the underlying security would be the index itself and not each of the components. Notwithstanding this statutory rule, proposed regulations would provide a different rule for a so-called “customized index,” whereby “each security or component [of a] customized index is treated as an underlying security in a separate NPC.” A customized index is a narrow-based index or any index if futures contracts or option contracts do not trade on a qualified board or exchange.7 While not entirely clear, the proposed regulations do not seem to change the result that broad-based indices are treated as single stocks.

Definition of “dividend equivalent.” The proposed regulations would clarify that, in order to be a “dividend equivalent,” a payment must be contingent on, or determined by reference to, payments of actual dividends on the underlying security. In particular, payments calculated by reference to dividends that are expected to be paid are not dividend equivalents, provided that (i) the contract is entered into (and the payments fixed) before an actual dividend has been announced and (ii) the contract does not provide for any adjustment to reflect the actual amount of dividends paid.

The proposed regulations also clarify that dividend equivalents would be treated as dividends for treaty purposes and for purposes of Section 892, which exempts from U.S. taxation payments to foreign governments and international

7 A narrow-based index includes any index that meets one of the following four tests: (i) the index has nine or fewer components, (ii) a component of the index comprises more than 30 percent of the index’s weighting, (iii) the five highest weighted components in the aggregate are more than 60 percent of the index’s weighting or (iv) the lowest weighted components comprising, in the aggregate, 25 percent of the index’s weighting have an aggregated dollar value of average daily trading volume of less than $50 million (this last test also has certain other exceptions).
organizations. The preamble to the proposed regulations provides that taxpayers may rely on the Section 892 rule prior to finalization, but does not seem to allow any similar reliance with respect to the treaty rule.

“Substantially Similar” payments. As noted above, payments that are substantially similar to those in connection with securities lending transactions and SNPCs can be dividend equivalents subject to withholding. The proposed regulations would identify two categories of “substantially similar” payments:

- Payments to reimburse a long party for tax with respect to a dividend equivalent (i.e., a tax gross-up) are themselves treated as dividend equivalents.

- Any payment pursuant to an “equity-linked instrument” that is contingent on, or determined by, reference to a dividend is treated as a dividend equivalent. An “equity-linked instrument” is any financial instrument (or combination of financial instruments), including a futures contract, forward contract, option or other contractual arrangement, that references one or more underlying securities to determine its value. On its face, this definition seems quite broad, and it remains to be seen just how broadly it will be interpreted. For example, arguably, this could be read to cover a derivative that exposes the holder to the dividends paid on an underlying security, but does not otherwise expose the holder to the economics of that security. However, it would make little sense to treat such an instrument (which gives less exposure to the economics of the underlying security than a total return swap) as giving rise to dividend equivalents unless there was also a factor present such that, were it an NPC, it would be an SNPC.

Significantly, it appears that “substantially similar” payments arising with respect to an “equity linked instrument” would only be subject to withholding under the proposed regulations if the equity linked instrument included one or more of the features which would cause a notional principal contract to be a “specified notional principal contract.” However, this is not entirely clear because another provision of the proposed regulations suggests that a substantially similar” payment arising with respect to an “equity linked instrument” is per se a dividend equivalent. Final regulations may clarify this point.

Comments and Hearing

The Treasury Department has requested comments on the proposed regulations and has scheduled a hearing for April 27, 2012. In light of the uncertainties and practical issues raised by the proposed regulations as currently drafted, this provides an opportunity to request changes that may alleviate these problems.