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IRS and Treasury Department Publish Anticipated Guidance on "Dividend Equivalent" Payments Derived from Equity Swap Arrangements

January 27, 2012

Temporary and Proposed Regulations under Section 871(m) Issued January 19, 2012

On January 19, 2012, the U.S Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issued rules governing when equity swaps and similar transactions would result in imposition of U.S. withholding tax under Section 871(m) and related Sections of the Internal Revenue Code of 1986, as amended (the "Code").[1] These new rules include both temporary Treasury regulations (the "Temporary Regulations") and proposed Treasury regulations (the "Proposed Regulations" and, together with the Treasury Regulations, the "Regulations"),[2] and provide highly anticipated guidance related to determining the amount of U.S.-source "dividend equivalents" (thus potentially subject to U.S. tax), as well as U.S. withholding tax requirements related to payments which include dividend equivalents. Section 871(m) and these Regulations are part of the government's continuing focus on the perceived abusive use of equity swap arrangements and other derivatives and financial products to avoid U.S. withholding tax. However, while the Regulations provide some clarity with respect to the dividend equivalent rules, it is not clear whether certain aspects of the Regulations are administrable as drafted. As a result, the Regulations may limit taxpayers' ability to use some types of equity derivative arrangements at all, even for legitimate hedging purposes.

To discuss the Regulations with us, or the taxation of swap arrangements generally, please contact any of the Proskauer Tax Group lawyers listed on this client alert, or the Proskauer lawyer with whom you regularly consult on these matters.

Summary

Background

Section 871(m) was enacted on March 18, 2010,[3] in response to the government's concern that non-U.S. taxpayers (including offshore funds) might be using share lending arrangements, sale-repurchase agreements and notional principal contracts ("NPCs"), particularly equity swaps and similar derivative financial contracts,[4] to avoid U.S. withholding taxes. A typical arrangement involved an offshore fund selling an equity security before the dividend date and acquiring an economically equivalent long position under a swap on the same date. Payments made pursuant to these swap arrangements prior to the introduction of Section 871(m) arguably were sourced to the residence of the recipient, with the result that a payment made to a non-U.S. party pursuant to such an arrangement would not be subject to U.S. withholding tax, even if such withholding would have been required on a dividend paid on the underlying security.

In an attempt to address these potentially abusive structures, Section 871(m) treats amounts that are "dividend equivalents" as U.S.-source dividend income for purposes of the tax imposed on nonresident aliens and foreign corporations, as well as withholding tax, under the Code.[5] Effectively, this results in dividend equivalents being subject to U.S. tax, regardless of how they might have been treated under prior law.

The statute defines "dividend equivalent" payments to include any amounts contingent upon, or determined by reference to, the payment of a dividend from U.S. sources (this includes effectively all dividends paid by U.S. corporations), where such payments are made pursuant to securities lending or sale-repurchase transactions and "specified" NPCs ("SNPCs"), as well as any other payment determined by the Treasury to be "substantially similar" to such payments.[6]

The statutory definition of an SNPC, applicable to payments made September 14, 2010 through March 18, 2012 covers swaps (and other NPCs) where:

- the hedging party "crosses in" – i.e., on entering into the NPC, any "long" party transfers the underlying security to any "short" party (the "long" party is hedging a position held, the "short" party is pricing the hedge);
- the hedging party "crosses out" – i.e., on closing out the NPC, the short party transfers the underlying security to the long party;

- the swap's underlying security is not readily tradable on an established securities market; or
- the underlying security is posted as collateral on the NPC by the short party with the long party.

For payments made after March 18, 2012, the definition of SNPC expands to include *any* NPC, unless the Treasury determines the NPC "is of a type which does not have the potential for tax avoidance."[7]

Temporary and Proposed Regulations

Broadly stated, the Proposed Regulations elaborate on what constitutes an SNPC (i.e., a swap or other financial contract that is subject to these rules) and the Temporary Regulations delay the implementation of the definition in the Proposed Regulations until December 31, 2012 so that taxpayers and withholding agents will have time to modify their systems and other operating procedures.

As further discussed below, the Proposed Regulations would treat NPCs (which includes most conventional swap arrangements as well as a variety of other financial derivatives involving notional reference pools)[8] as SNPCs, requiring the relevant payor to determine whether and in what amount any payment on the NPC consists of a dividend equivalent that is subject to withholding tax, if the NPC satisfies any one of seven tests: the "In the Market" test, the "Thinly Traded" test, the "Posted Collateral" test, the "Short-Term NPC" test, the "Hedging Control" test, the "Float or Volume" test or the "Special Dividend" test. The first three categories are refinements of the statutory definition of an SNPC, while the other four categories are new. The technical standards for these tests (described in greater detail in the *Discussion* section below) are intended to be objective in nature, are in some cases very broad, and in certain cases may not be determinable by one or either party at the time the swap is entered into.

The Proposed Regulations vastly expand the universe of financial instruments potentially subject to Section 871(m) to include futures, forwards, options or other contractual arrangements that reference securities paying U.S.-source dividends. The Proposed Regulations also provide much-needed guidance on baskets and indices used as underlying securities, generally providing objective standards that require looking through to the underlying security unless the basket or index consists solely of securities for which futures and options publicly trade and is not excessively concentrated (e.g., consisting of nine or fewer securities).

The Proposed Regulations further provide that a dividend equivalent will be treated as a dividend for most income tax treaty purposes and as income from investments in stocks for purposes of determining income of foreign governments. These rules provide needed clarity on the application of Section 871(m) in these situations.

Finally, the Proposed Regulations provide specific withholding procedures with respect to dividend equivalents where the payment occurs before the underlying contract becomes an SNPC – generally requiring that withholding be applied to the entire amount of the dividend equivalent under the SNPC, even where the dividend equivalent was paid before the underlying contract became an SNPC. This result may leave hedging parties with unpalatable choices in some cases, since this may require withholding in respect of a payment on a swap that has already been made.

Although the Regulations as promulgated are intended to create bright-line tests to guide affected taxpayers, the Regulations raise substantial questions of their own, including how swap counterparties will be able to draft effective representations, indemnity provisions and other contract terms (especially net-payment provisions) where the determination as to SNPC status is not known at the time of execution of the swap, as well as how to account for withholding tax that is uncertain at the outset and for which there is conceivably no payment made from which to withhold. As a result, all participants in the market for equity derivatives potentially subject to the Regulations need to carefully consider the effect of the Regulations on their swap activities, and may need to consider substantial revisions to existing documentation for equity swaps and related financial contracts. Further, hedging parties should consider carefully whether their expected economic benefits from an equity swap will be potentially compromised or eliminated by the Regulations, particularly where it is not clear if one or more of the tests might be triggered over the life of the swap.

Provisions Effective Immediately

Effective January 23, 2012, the Temporary Regulations also provide that the gross amount of any dividend equivalent used in computing any net amount owed under an SNPC will be treated as a dividend equivalent payment for withholding tax purposes; withholding is due on that gross amount, even if there is no net payment due from which the relevant party can withhold the appropriate amounts. This intentional result is to ensure that both parties to an equity swap are potentially liable for withholding tax, and is effective now.

Note on Existing Guidance

In Notice 2010-46, the IRS outlined a proposed documentation-based framework for withholding on substitute dividends in the case of a series of securities lending or sale-repurchase transactions, with the intention of preventing taxation of the same dividend multiple times.[9] The preamble to the Temporary Regulations stated that proposed regulations on matters covered by Notice 2010-46 remain forthcoming, and are not covered in these Regulations.

Discussion

Proposed Regulations

Definition of Dividend Equivalent. The Proposed Regulations set out in detail the treatment of dividend equivalents, beginning with a general rule (following the language of Section 871(m))[10] that defines dividend equivalent to mean any substitute dividend payment made pursuant to:

- a securities lending transaction;
- a sale-repurchase transaction;
- an SNPC or a substantially similar transaction that is contingent upon or determined by reference to the payment of a dividend[11] from sources within the United States, whether that payment is pursuant to a Statutory SNPC or a SNPC described in the Proposed Regulations; or
- any "substantially similar payment" as defined the Proposed Regulations.[12]

However, the Proposed Regulations include an exception to this general definition, excluding from the term any payment made pursuant to an SNPC (or any substantially similar payment), if such payment is contingent upon or determined by reference to an estimate of expected dividends and the estimate is not subsequently adjusted in any way for the amount of an actual dividend.[13] This exception would seem to have limited practical effect, since a payment that is based on estimated dividends but not adjusted for actual dividends (including an adjustment of a subsequent estimated amount) would not appear to be "contingent" in the conventional sense of the word.

"*Payment*" *Based on Gross Payment, Not Net Payment.* The Proposed Regulations provide that a payment includes any gross amount that is used in computing any net amount that is transferred to or from the taxpayer under the terms of the contract, even if the taxpayer makes a net payment, or no payment is made because the net amount is zero.[14]

Substantially Similar Payments. Under the Proposed Regulations, payments will be considered substantially similar to substitute dividends paid pursuant to securities lending and sale-repurchase transactions and to payments made pursuant to SNPCs if they are:

- gross-up amounts paid for a beneficial owner's tax liability with respect to a dividend equivalent; or
- made pursuant to an equity-linked instrument that is contingent upon or determined by reference to a U.S.-source dividend.[15]

Anti-Abuse Rule. The Proposed Regulations provide that if a taxpayer enters into a transaction or transactions with a principal purpose of avoiding the application of these rules, payments made with respect to such transaction(s) may be treated as a dividend equivalent to the extent necessary to prevent such avoidance.[16]

Definition of an SNPC after December 31, 2012. The core of the Proposed Regulations is the expanded definition of an SNPC with respect to payments after December 31, 2012.[17] After that date, SNPCs will include all of the Statutory SNPCs, *plus* any SNPC that is an NPC which meets any one of the following seven tests – the standards for which are detailed and complex, but are generally intended to be objective in their application.[18]

1. "In The Market" Test:

If the long party is "in the market" with respect to the underlying security on the same day that either the parties price the NPC or the NPC terminates, the NPC is an SNPC.[19] The long party is "in the market" if

- it sells or otherwise disposes of the underlying security on the same day or days that the parties price the NPC,
- it purchases or otherwise acquires the underlying security on the same day or days that the NPC terminates; or
- it either purchases or disposes of the underlying security at a price that is set or calculated in such a way as to be substantially identical to or determined by reference to an amount used to price or terminate the NPC.[20]

The "In The Market" test is subject to a de minimis exception where the long party is otherwise "in the market" with respect to an amount of the underlying security that is less than 10% of the notional principal amount of the NPC.[21]

It is not clear how a party to a swap would determine whether a counterparty will be in the market on a termination date on the date a swap is entered into. Also, the related persons provision in the Proposed Regulations, discussed below, provides that any related person is considered a party to an NPC; this could make it difficult to be aware of compliance with the "In The Market" test.

2. The "Thinly Traded" Test:

If the underlying security is not "regularly traded on a qualified exchange," the NPC is an SNPC.[22] An underlying security is regularly traded if such security is:

- listed on one or more qualified exchanges at the time the NPC is priced; and
- the underlying security was traded in sufficient quantities on at least 15 trading days during the 30 trading days prior to the date the parties price the NPC.[23]

For purposes of the "Thinly Traded" test, a "qualified exchange" is a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities Exchange Act of 1934.[24]

3. The "Posted Collateral" Test:

If more than 10% of the total fair market value of all the short party's collateral posted on any date that the NPC is outstanding consists of the underlying security, the NPC is an SNPC.[25] Given that the value of the underlying security or other collateral might vary substantially in value over the life of the swap and, as proposed, no "cure" is possible, swap counterparties may have to set collateral limits well below the 10% limitation, or consider automatic termination if the underlying security crosses a threshold just short of the 10% threshold (e.g., 9.9%).

4. The "Short-Term NPC" Test:

If the NPC has a term of fewer than 90 days, taking into account situations in which a long party enters into offsetting positions, the NPC is an SNPC.[26]

5. The "Hedging Control" Test:

If the long party controls the short party's hedge contractually or by course of conduct, or through an "equity control program," the NPC is an SNPC.[27]

6. The "Float or Volume" Test:

An NPC is an SNPC if the notional principal amount of the NPC is:

- ???greater than 5% of the total public float of the underlying security; or
- ???greater than 20% of the 30-day average daily trading volume

in each case as determined at the close of business on the day before the first day of the term of the NPC).[28]

7. The "Special Dividend" Test:

If the NPC is entered into on or after the announcement of a "special dividend" on an underlying security (any non-recurring dividend payment that is in addition to a recurring dividend payment) and prior to the ex-dividend date, the NPC is an SNPC.[29] The Proposed Regulations do not define what constitutes a recurring dividend, and therefore it is not certain under what conditions a swap entered into between the date a dividend is declared and goes ex-dividend would not be an SNPC.

Once an SNPC, Forever an SNPC. The Proposed Regulations provide that if an NPC that is not an SNPC on the date the parties enter into the contract subsequently becomes an SNPC, it will be treated as if it had been an SNPC for the entire term of the contract.[30] The Proposed Regulations state further that, for purposes of the withholding tax rules, the withholding agent will be responsible for reporting and paying the total amount due with the IRS, even if the tax owed is greater than the next payment made under the SNPC.[31] There are a number of practical issues for swap counterparties raised by the combination of these two proposals (including the possibility that a party may find itself owed no additional payments under the terms of a swap and a withholding tax liability in excess of the remaining payments due to the counterparty, leaving the party liable for the tax having to seek indemnity payments from the counterparty).

Related Party Rules. The Proposed Regulations also provide that each related person is treated as a party to the contract, other than in the case of a hedging NPC between related dealers over a third party swap.[32]

Dividend Equivalents under Sections 892 and 894. With respect to NPCs entered into by foreign governments and their instrumentalities (e.g., sovereign wealth funds), the Proposed Regulations provide that dividend equivalents are treated as income from investments in stock for purposes of Section 892.[33] For treaty purposes, the Proposed Regulations provide that a reduced rate of withholding tax provided by an income tax treaty for dividends applies to a dividend equivalent.[34]

Definition of Underlying Security and Treatment of Indices and Baskets. The term "underlying security" means any security that pays a U.S.-source dividend,[35] including virtually any financial instrument that is linked to U.S.-source dividends, including options and futures. If an NPC references a basket of more than one security or a "customized index," each security or component of such customized index is treated as an underlying security in a separate NPC.[36] An index is treated as a "customized index" if it is (1) a "narrow-based index" (including, among others, an index of nine or fewer underlying securities) or (2) any other index unless futures contracts or options contracts referencing the index trade on a qualified board or exchange.[37]

Temporary Regulations

Transition and Implementing Rules. The Temporary Regulations limit the definition of an SNPC to the Statutory SNPCs for payments made after March 18, 2012 and before January 1, 2013.[38] The Temporary Regulations also amend certain other regulations to clarify the application of Section 871(m), particularly excluding dividend equivalent amounts from the general source rules governing source and character of NPC income, [39] and implementing rules under Section 881 making the Regulations applicable to foreign corporations that receive a dividend equivalent amount.[40]

Dividend Equivalents Generally Subject to Withholding Tax. The Temporary Regulations treat the payment of a dividend equivalent as subject to 30% withholding under Section 1441 unless a lower rate applies by treaty, and expand the definition of the term "payment" to include any gross amount that is used in computing the net amount transferred under the contract.[41] When a dividend equivalent is used to determine a net payment, the person entitled to the gross dividend equivalent is considered to have received a payment even if that person receives no payment because the net payment equals zero, or that person makes a net payment.[42]

Use of Estimated Dividend Amounts by Withholding Agents. In order to determine the amount subject to withholding as a dividend equivalent, a withholding agent may use a distributing corporation's estimate or other determination with respect to the underlying security, but the withholding agent will be liable for the amount by which the actual amount required to be withheld exceeds the amount withheld as well as applicable penalties and interest resulting from relying on such estimate or other determination.[43]

Who is the "Withholding Agent" on a Dividend Equivalent. Under the Temporary Regulations, each person that is a party to any contract or arrangement that provides for the payment of a dividend equivalent is treated as having control and custody of such payment and is therefore a withholding agent that is liable for the withholding tax due. [44] This means, effectively, that as of the effective date of the Temporary Regulations, both parties to a swap arrangement will be substantively liable for the entire amount of withholding tax due on a "dividend equivalent."

Expiration Date and Effective Date Provisions of the Regulations

Each provision of the Temporary Regulations will expire on January 16, 2015, unless finalized or otherwise extended. The Proposed Regulations are effective as of the date they are published as final regulations; however, it is clear from the text of the preamble to the Proposed Regulations that it is expected that the Proposed Regulations will be finalized, so that their provisions will apply to notional principal contracts on or after January 1, 2013.

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[1] All section references hereafter are to the Code, unless otherwise stated.

[2] The Temporary Regulations are included in T.D. 9572, and the Proposed Regulations are included in REG-120282-10, both dated January 19, 2012.

[3] *See* § 541 of the Hiring Incentives to Restore Employment Act, P.L. 111-147.

[4] Many equity swaps are included within the definition of notional principal contracts ("NPCs") for U.S. federal income tax purposes; however, the mere fact that a contract is entered into pursuant to a swap arrangement (for example, pursuant to the terms of an ISDA Master Agreement) is not entirely conclusive as to whether or not the contract is a NPC for U.S. federal income tax purposes. The definition of an NPC is set forth at Treas. Regs. § 1.446-3; in 2011, the IRS and Treasury released regulations substantially revising the definition of an NPC (*See* Prop. Reg. Sec. 1.446-3, 76 F.R. 57684 (Sep. 16, 2011)). The preamble to the Regulations specifically preserves the possibility that the IRS may assert that "a contract labeled as an NPC or other equity derivative is in fact an ownership interest in the equity referenced in the contract."

[5] Section 871(m)(1), referring specifically to Sections 871(a), 881 and 4948(a), as well as Chapters 3 and 4 of the Code.

[6] Section 871(m)(2).

[7] Section 871(m)(3).

[8] For U.S. federal income tax purposes, many (but not all) swap arrangements are treated as NPCs. See the *Background* section and related endnotes for a further discussion of the importance of this distinction.

[9] 2010-24 I.R.B. 757 (May 20, 2010) provided updated guidance concerning certain issues relating to securities lending and sale-repurchase transactions. A discussion of the issues raised by Notice 2010-46 and its context is beyond the scope of this Client Alert.

[10] Prop. Regs. Sec. 1.871-15(a).

[11] For purposes of Section 871(m), it is irrelevant whether the payment is directly or indirectly contingent on the amount of a dividend. Additionally, a dividend for purposes of Section 871(m) includes payments made pursuant to a redemption of stock that give rise to a dividend under Section 301.

[12] Prop. Regs. §. 1.871-15(b)(1).

[13] Prop. Regs. Sec. 1.871-15(b)(2). Under the Proposed Regulations, on or after the earliest date on which the corporation declares, announces, or agrees to the amount or payment of a dividend, an expected dividend is no longer an estimate for this purpose. *See* Prop. Regs. Sec. 1.871-15(b)(2)(ii).

[14] Prop. Reg. Sec. 1.871-15(c).

[15] Prop. Reg. Sec. 1.871-15(d)(1). The preamble to the Proposed Regulations says that the Treasury Department and the IRS "will continue to monitor equity-linked transactions, and may identify in separate guidance other payments that are substantially similar to a substitute dividend payment or a payment made pursuant to an SNPC." REG-120282-10.

[16] Prop. Regs. Sec. 1.871-15(e).

[17] *See* Prop. Regs. Sec. 1.871-16(a).

[18] Prop. Regs. Sec. 1.871-16(c).

[19] Prop. Reg. Sec. 1.871-16(c)(1).

[20] Prop. Reg. Sec. 1.871-16(c)(1)(i).

[21] Prop. Reg. Sec. 1.871-16(c)(1)(ii).

[22] Prop. Reg. Sec. 1.871-16(c)(2). The term "regularly traded" is defined differently for different purposes under the Code. According to the preamble to the Proposed Regulations, the Treasury Department and the IRS believe that "readily tradable on an established securities market," as used in Section 871(m), is "intended to ensure that the underlying securities trade in sufficient volume to provide ample liquidity in the position." REG-120282-10.

[23] Prop. Reg. Sec. 1.871-16(c)(2)(i)(A). The Proposed Regulations include a special IPO rule where regularly traded means being traded during at least 15 trading days on one or more qualified exchanges during the 30 trading days subsequent to the IPO. Prop. Reg. Sec. 1.871-16(c)(2)(i)(B). A security is considered traded only on days when the trading quantities exceed 10% of the 30-day average daily trading volume. Prop. Reg. Sec. 1.871-16(c)(2)(i)(C). A qualified exchange means a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established pursuant to Section 11A of the Securities Exchange Act of 1934.

[24] Prop. Reg. Sec. 1.871-16(c)(2)(ii). This definition is similar to the definition used to determine if stock of a passive foreign investment company (PFIC) is marketable under Section 1296 and Treas. Reg. § 1.1296-2(a)(1).

[25] Prop. Reg. Sec. 1.871-16(c)(3).

[26] Prop. Reg. Sec. 1.871-16(c)(4). The date the NPC is terminated is counted, but the date the NPC is entered into is not. An NPC is considered terminated on the date that a long party enters into an offsetting position with respect to the underlying security, within the meaning of Treas. Regs. § 1.246-5(b)(3).

[27] Prop. Reg. Sec. 1.871-16(c)(5). An "equity control program" is a program where the long party effectively directs the short party how to hedge, but does not include electronic platforms maintained by a dealer to allow customers to place swap orders that allow the dealer to make its own hedge determinations. Prop. Regs. Sec. 1.871-16(f)(2).

[28] Prop. Reg. Sec. 1.871-16(c)(6).

[29] Prop. Reg. Sec. 1.871-16(c)(7). A special dividend can include a nonrecurring amount that is paid in connection with a recurring dividend.

[30] Prop. Reg. Sec. 1.871-16(d).

[31] Prop. Reg. Sec. 1.1441-3(h)(2). The preamble to the Proposed Regulations states that the mechanism by which a withholding agent collects the amount due from the taxpayer is left to the discretion of the withholding agent and the taxpayer, and goes on to say that the withholding agent must deposit the total amount due even if it cannot collect the amount from the counterparty. REG-120282-10.

[32] Prop. Reg. Sec. 1.871-16(e). For these purposes, the "related person" definitions found in Sections 267(b) or 707(b)(1) are used. The preamble to the Proposed Regulations states that this provision is intended to prevent taxpayers from avoiding these rules through related parties, while avoiding excessive withholding tax on transactions commonly employed by dealers to transfer risk from one entity to another within their affiliated group. REG-120282-10.

[33] Prop. Reg. Sec. 1.892-3(a)(6).

[34] Prop. Reg. Secs. 1.894-1(c)(2), 1.1441-6(h).

[35] Prop. Reg. Sec. 1.871-16(f)(1).

[36] *Id*. *See* preamble to Prop. Regs. Sec. 1.871-16. REG-120282-10.

[37] Prop. Reg. Sec. 1.871-16(f)(3). The definition of "narrow-based index" is generally based on the definition of that term in the Securities Exchange Act of 1934, Section 3(a)(55)(B). REG-120282-10.

[38] Temp. Treas. Reg. § 1.871-16T(b).

[39] Temp. Treas. Reg. § 1.863-7T(a)(1).

[40] Temp. Treas. Reg. § 1.881-2T(a)(3).

[41] Temp. Treas. Reg. § 1.1441-2T(b)(6). The Temporary Regulations also provide that a withholding agent that makes a payment attributable to an SNPC that is not treated as effectively connected with the conduct of a trade or business in the United States shall be obligated to withhold on the portion of such payment that is a dividend equivalent. Temp. Treas. Reg. § 1.1441-4T(a)(3)(iii).

[42] Temp. Treas. Reg. § 1.1441-2T(e)(7).

[43] Temp. Treas. Reg. § 1.1441-3T(h)(2)(i).

[44] Temp. Treas. Reg. § 1.1441-7T(a)(2).

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