IRS and Treasury Publish New Rules Regarding Payments of Synthetic Dividends

On January 23, 2012, the IRS and the Treasury Department published temporary and proposed regulations under Section 871(m) of the Internal Revenue Code. The regulations implement the tax and withholding regime applicable to U.S.-source "dividend equivalent" payments made to non-U.S. persons (including non-U.S. hedge funds, swap dealers, banks and others) pursuant to securities loans, sale-repurchase transactions (repos), certain notional principal contracts (NPCs) and certain other instruments.

Temporary Regulations

In general, the temporary regulations extend the rules currently in force to all dividend equivalent payments made after March 18, 2012, but prior to January 1, 2013. For a discussion of the existing Section 871(m) rules, please see an earlier Ropes & Gray Alert.

Proposed Regulations

The proposed regulations are expected to apply to payments made on or after January 1, 2013. They treat the following payments as dividend equivalent payments:

i. any payment that is contingent upon or determined by reference to the payment of a U.S.-source dividend and is paid pursuant to (a) a securities lending transaction, (b) a repo, or (c) a substantially similar transaction;

ii. any payment that is contingent upon or determined by reference to the payment of a U.S.-source dividend and is paid pursuant to a specified NPC (an SNPC); and

iii. any "substantially similar" payment (including a payment pursuant to certain "equity-linked instruments" (such as a futures or forward contract, an option, or other contractual arrangement) and any dividend equivalent tax gross up payment).

The definition of an SNPC would, if adopted, generally include NPCs described in any one of the following seven types of fact patterns:

i. The long party is "in the market" with respect to the underlying security. "In the market" means that the long party either (i) sells the security underlying the payment on the same day(s) as the parties price the NPC, (ii) purchases the underlying security on the same day(s) as the NPC terminates or (iii) either purchases or sells the underlying security at a price that is set or calculated so as to be substantially identical to or determined by reference to an amount used to price or terminate the NPC. A purchase or sale of less than 10% of the notional principal amount of the NPC will not result in the long party being in the market. Note that each tranche of an NPC is apparently tested separately.

ii. The underlying security is not regularly traded. "Regular" trading is present only if the security is listed on one or more qualified exchanges and is traded on at least 15 of the 30 trading days prior to pricing. "Trading," in turn, is present only on those days when the traded securities exceed 10% of the 30-day average daily trading volume. (OTC does not appear to count.)

iii. The short party posts the underlying security as collateral. This applies only if the amount of such collateral exceeds 10% of the total value of all collateral posted by the short party "on any date during the term of the NPC."

iv. The term of the NPC is fewer than 90 days (potentially, fewer than 91 days since the day the NPC is entered into does not count). The term ends if the contract is terminated or if the long party enters into an offsetting position (including with other persons).

v. The long party controls the short party's hedge.

vi. The notional principal amount of the underlying security is greater than 5% of the total public float of that class of security or greater than 20% of the 30-day average daily trading volume.

vii. The NPC is entered into on or after the announcement of a special (i.e., non-recurring) dividend and prior to the ex-dividend date.

Observations Regarding the Proposed Regulations

Although the proposed regulations are not effective until finalized, their current form presents a number of uncertainties and compliance concerns for recipients of such payments and for withholding agents.

1. ***Application to Existing Contracts.*** The proposed regulations apply to dividend equivalent payments made on or after January 1, 2013, regardless of when the parties entered into the underlying agreement (i.e., even if the parties entered into the contract prior to 2013). To address this, short parties may (as some have already done) attempt to carve out gross-ups with respect to any Section 871(m) tax or may attempt to treat the imposition of such tax as a termination event.

2. ***Retroactive Imposition of SNPC Status.*** The proposed regulations specifically contemplate that an NPC may become an SNPC sometime during or at the end of its term even if it was not an SNPC initially. (This could occur if any of the above seven fact patterns arise after the parties enter into the NPC.) Were that to happen, the proposed regulations are explicit that withholding would apply retroactively to all prior dividend equivalent payments (so long as they were deemed made in 2013 or later) on such NPC (even if no actual payment is due when such NPC becomes an SNPC or in the future). It would appear that escrow or similar arrangements may be necessary to guarantee compliance.

3. ***Calculations Based on Gross Amounts.*** Consistent with the statutory language of Section 871(m), the proposed regulations reiterate that a dividend equivalent payment may be deemed to be made even if no net payment is made to the long party (or, indeed, if the payment is being made to the short party), if the gross amount of such payment is used in computing the net payable amount.

4. ***Expansion of Crossing-in and -out Rules.*** For purposes of determining whether a crossing-in or -out transaction is of a type subject to withholding, the current rules generally look to whether the relevant securities are transferred "in connection with" the NPC between the long party and the short party. However, the proposed regulations would change the test to whether the long party is "in the market" with respect to a security. This expanded standard looks to *all the trades* of the taxpayer even if the trades are with other counterparties and even if they are otherwise "unconnected" with entering

or exiting an NPC. (This is of particular concern given the breadth of the aggregation rules – see 5. below.)

5. ***Broad Aggregation Rules.*** To determine whether an NPC is an SNPC, a taxpayer, generally, must aggregate all of the trades of its related parties, and must do so with *all* counterparties. Accordingly, the long party will need to be in a position to monitor (see also the issues described below in 8.) not only its own separate trading desks and counterparties (as noted above in 4.) but also the activities of separate but related entities (including, apparently, even if such entities are U.S. persons or otherwise subject to U.S. net-basis taxation) to determine whether any of the seven fact patterns enumerated above arises (e.g., to determine whether the long party is "in the market," whether it is exceeding the volume-limitation tests through unrelated trades, or whether it is entering into "offsetting trades" such that an NPC is deemed terminated within the 90 day period). This may be an extremely difficult task for the long party and an impossible one for the short party serving as the withholding agent. Any attempt to avoid the seven fact patterns would require monitoring of the relevant persons' positions throughout the life (at least) of the NPC.

6. ***Withholding Agent Liability.*** The proposed regulations do not provide withholding agents with any safe-harbors that would allow such agents to rely on representations/ certificates issued by their counterparties in order to avoid liability for not having withheld. However, some IRS representatives have informally acknowledged that the IRS will not view the regulations as imposing a "strict liability" standard on a withholding agent and that receiving certain representations may be sufficient to relieve the agent of its withholding obligations without incurring a liability to the government.[1]

7. ***Application to Other Instruments.*** The proposed regulations expand the application of tax and withholding to instruments other than swaps, repos and securities loans. In particular, they include "equity-linked instruments." It is not clear whether the tax liability as to such instruments (futures, forwards, options, etc.), is incurred once such an instrument is deemed to be "equity-linked" (similar to a repo or securities loan) or only if it would also be an SNPC (i.e., like a swap) (although we believe the latter is correct). Also, the definition of an "equity-linked" investment includes "other contractual arrangement[s]." The scope of this language is not clear. For example, it appears to cover many exchange-traded notes, spread bet/differences transactions and, perhaps, equity-linked debt instruments in general. (If so, it appears that withholding could arise even if the actual payment on the debt instrument would otherwise – e.g., in some cases where interest is linked to dividends on publicly traded stocks – qualify as portfolio interest.)

   Further, it is worth noting that a "payment" under an equity-linked instrument may occur and, therefore, a tax and withholding obligation may arise, even if no actual payment is being made at such time (e.g., when an exercise price is adjusted on an option or convertible security to reflect a dividend or in notional reinvestments) or, indeed, will ever be made.[2] Such a mechanism appears consistent with the September 2011 proposed regulations that vastly expanded what is covered by the definition of an NPC (e.g., covering non-financial underlying indices and certain bullet swaps). Those proposed regulations also expand the definition of a "payment" to include the date of the "fixing" of an amount actually payable (or taken into account) at a later time.

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[1] We note that, in the absence of withholding, the non-U.S. taxpayer is required to nonetheless pay the tax (and file a return).

[2] Although current law may already impose a tax (and withholding) obligation with respect to some of such adjustments (e.g., under Section 305 of the Internal Revenue Code), the proposed regulations broaden the rules.

8. ***Determination of the Underlying Security.*** If an NPC references more than one security or a "customized" index, then each security or component of the customized index is treated as a separate underlying security in a separate NPC. In addition, a customized index includes not only a "narrow-based" index but also *any other index* unless futures or option contracts on such index are traded on a qualified board or exchange. Therefore, parties to NPCs that reference baskets of securities or indices will need to ensure that their compliance programs can evaluate correctly whether an NPC must be "split up" and, if so, are able to do so. The application of this rule with the rules aggregating positions of other desks and related parties appears daunting. Moreover, at least as per the statute, even a non-customized index may be viewed as an underlying security requiring separate testing as to that index. An NPC on such an index may be subject to these rules if, for example, it has a term of less than 90 days.

9. ***Unclear Triggers.*** It appears that under the statutory language of Section 871(m) a contract that references a U.S.-source dividend *in part* to determine any portion of the payments under the contract (presumably this would be an NPC) will be considered as providing for dividend equivalent payments that may not be limited to the portion of the payment that is, in fact, contingent upon or determined by reference to a U.S. source dividend. The proposed regulations do not specifically address this issue.

10. ***Extent of Offsets in the 90-Day Test.*** In analyzing whether a position offsets an NPC (for purposes of the 90 day test), the proposed regulations import the definition of "position" from a different section of existing regulations but appear to shy away from also importing the standard of "substantially similar or related property" (SSRP) provided for by the same regulations. It is not clear whether the drafters intended the definition of "offsetting position" for purposes of Section 871(m) to be broader than a "position in an SSRP".

11. ***Application to Redemption Payments.*** The proposed regulations explicitly apply to contracts that provide for dividend equivalent payments if the "dividend" is actually a redemption payment but is treated as a dividend pursuant to tax rules. Although this treatment is consistent with the treatment of such redemption payments outside of Section 871(m), the administrative challenge for counterparties is, if anything, greater than for a corporation redeeming its shareholders; some of whom are non-U.S. persons. Note also that the effect of such a redemption may differ as between different actual shareholders, raising issues as to the proper treatment of a "notional" shareholder. The analysis is further obscured by the fact that Section 871(m), by its terms, does not treat dividend equivalent payments as actual dividends for purposes of the redemption rules.

12. ***Treaty Reliance and Section 892.*** The proposed regulations treat dividend equivalent payments as dividends for purposes of U.S. income tax treaties and as income from investments in stocks, with respect to foreign governments and international institutions, for purposes of Section 892 of the Internal Revenue Code. However, while the regulations state that the Section 892 rule may be immediately relied upon, they provide no corresponding relief for the treaty rule. Consequently, it would appear that until the proposed regulations are finalized, dividend equivalent payments may be "other income" for treaty purposes.

13. ***Collateral Test Safe-Harbor.*** The "collateral" test safe-harbor relies on the underlying securities not collateralizing the short party's obligation in excess of 10% of the total fair market value of all collateral posted at any time during the term of the NPC. In order to rely on this safe-harbor it will

be necessary to monitor (continuously?) the relative fair market values of the securities posted as collateral (although certain IRS representatives have informally acknowledged that fluctuations in value of the underlying collateral should not cause an NPC to become an SNPC) and, potentially, do so by taking into account other contracts and related party activities.

14. ***Cascading Dividend Payments.*** Perhaps unsurprisingly given the genesis of Section 871(m), the proposed regulations do not provide regulatory relief from cascading dividend payments (i.e., where an amount already has been withheld from a dividend payment but the contract references the same dividend payment – a thorny issue in foreign-to-foreign transactions). The preamble to the temporary regulations states that the IRS anticipates offering a future regulatory solution. It is likely that a solution, if offered, would follow the proposed rules of Notice 2010-46, which provides that dividends on securities loans and repos (*though not NPCs* – raising issues for non-U.S. dealers) will not be subject to withholding in the first instance if paid to a "qualified securities lender" (if such dealer is obligated to make an offsetting substitute payment) and that tax already paid may be "credited forward" (if documentation requirements are met) to prevent aggregate withholding exceeding the maximum applicable rate.

15. ***Extensive Anti-Abuse Authority.*** The proposed regulations (and their preamble) reserve the IRS' right to challenge transactions not explicitly described in the regulations (though that may be a very limited set) whether through a rule covering transactions "substantially similar" to repos and securities loans, the regulations' general anti-abuse rule or "applicable judicial doctrines" as referenced in the preamble (e.g., by deeming a long party to a contract to be an owner of the underlying security and the short party merely an agent, nominees or another "accommodation" party).

Taxpayers who wish to comment on the proposed regulations have until April 6 to do so.

For more information regarding the temporary and proposed regulations, please contact a member of Ropes & Gray's tax practice group or your regular Ropes & Gray attorney.

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