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Client Alert

Tax Practice Group

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New "Dividend Equivalent" Withholding Regulations

New temporary and proposed Treasury regulations were issued on January 19, 2012 concerning withholding taxes imposed on certain "dividend equivalent" payments with respect to "specified notional principal contracts" (specified NPCs) and certain other transactions. The temporary regulations generally extend the current rules for dividend equivalent payments through the end of this year. The proposed regulations provide new rules which are currently scheduled to be effective for payments made on or after January 1, 2013. Because the effective date provision references payments, contracts entered into in 2012 would not be grandfathered if they extend into 2013.

Section 871(m)

Section 871(m) of the Internal Revenue Code (the Code) was added in 2010 to treat dividend equivalents as US source dividends for withholding tax purposes. A "dividend equivalent" for this purpose is 1) any substitute dividend made pursuant to a securities lending or a sale-repurchase (repo) transaction or any payment made under a specified NPC, if the substitute dividend or payment is contingent upon, or determined by reference to, the payment of a US source dividend, and 2) any other payment determined by the government to be substantially similar to the payments described in clause 1 above.

Under the statute, a notional principal contract is a "specified NPC" if one or more of four criteria are met: 1) any long party transfers the underlying security to any short party (a cross-in); 2) any short party transfers the underlying security to any long party (a cross-out); 3) the underlying security is not "readily tradable" on an established securities market; or 4) the underlying security is posted as collateral by any short party to a long party "in connection with entering into" the contract. In addition, the IRS is authorized to identify other contracts as specified NPCs.

The above statutory rules are effective from September 14, 2010 until March 18, 2012. Any notional principal contract after that date is treated as a specified NPC unless the government "determines that such contract is of a type which does not have the potential for tax avoidance."

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Temporary Regulations

The newly issued temporary regulations extend the effective date for the statutory four-factor definition of a specified NPC through the end of 2012. The extension is intended to provide taxpayers and withholding agents more time to comply with the more onerous withholding regime.

The temporary regulations also amend the regulations under Sections 863, 881 and 1441 to clarify the application of Section 871(m). Among other things, the temporary regulations clarify that the general rule for sourcing NPC payments (by reference to the residence of the payee) does not apply to a dividend equivalent payment, which is treated as US source income. Conforming changes are made to the Section 881 and 1441 regulations. These temporary regulations are effective as of January 23, 2012.

Proposed Regulations

The proposed regulations represent the government's attempt under the Section 871(m) mandate to identify swap contracts that do "not have the potential for tax avoidance." The proposed regulations raise numerous practical issues and administrability concerns.

Seven Deadly Sins

An NPC will be a specified NPC if it falls into one of seven categories outlined below. Some of these categories represent material departures from the statute. Clients are already referring to these categories as the "seven deadly sins" although some are less fatal than others in terms of their potential impact on the securities business.

1. In the Market – the long party (or a related person) is "in the market" on the day (or days in the case of tranches) on which the NPC is priced or terminated.

2. Thinly Traded – the security is not listed on a qualifying exchange or, if it is so listed, it was not traded on at least 15 trading days during the 30 trading days prior to the pricing date of the NPC.

3. Posting Security as Collateral – the short party posts the underlying security with the long party as collateral.

4. Short-Term – the NPC has an actual term of fewer than 90 days.

5. Hedging Control – the long party controls the short party's hedge either contractually or "by conduct" or if an "underlying equity control program" is used.

6. Material Volume – the notional principal amount of the underlying security in the NPC is greater than 5 percent of the total float or 20 percent of the 30-day average trading volume of that security.

7. Special Dividend – the NPC is entered into on or after the announcement of a "special dividend" and prior to the ex-dividend date.

The term "underlying security" means the security paying the US source dividend. If an NPC references more than one security or a "customized index," each reference security or component of the index is treated as an underlying security of a separate NPC. A customized index is a "narrow-based index" (which is defined based on the Securities Exchange Act of 1934 definition of such term) or any other index unless futures or options contracts referencing that index are traded on a qualified board or exchange. Because customized indices are not treated as a single underlying security, it could be inferred that a broad based index is a single underlying security but this is not explicitly clear from the regulatory language.

Application

The regulations treat an NPC as being a specified NPC from its inception if it becomes a specified NPC at any time during its term. This means that withholding would be required for payments made, or deemed made, on or after January 1, 2013 even if those payments relate to a period during which the NPC was not a specified NPC. The withholding tax for payments made during the period when the NPC was not a specified NPC must be paid over on the first payment date after the NPC becomes a specified NPC. The preamble indicates that the withholding agent (the short party under the NPC) must remit the tax even when the tax exceeds the remaining amounts payable under the NPC.

The regulations generally treat related persons (defined using the broad definitions of Sections 267(b) and 707(b)(1) of the Code) as parties to the NPC. This rule likely will have the effect of increasing the number of NPCs that will be classified as specified NPCs. This related-party rule creates numerous administrative difficulties since even completely independent activities of affiliates can be attributed to a party in determining whether a specified NPC exists. This rule could have particularly harsh results when combined with the look-back rule discussed above.

The regulations provide some minor relief from the application of the related party rule by declaring that an NPC entered into between two related dealers will not be a specified NPC if the NPC hedges risk associated with another NPC entered into with a third party. This exception only applies where the dealers entered into the NPCs in the ordinary course of their businesses as dealers in securities or commodities derivatives. This rule means that a foreign dealer can hedge its risk on a swap with its related US dealer without having a cascading withholding issue.

The regulations revolve around the definition of "dividend equivalents." A dividend equivalent includes any amount paid on a specified NPC that (directly or indirectly) is contingent on, or determined by reference to, a US-source dividend. Payments based on expected dividends are not dividend equivalents unless they are estimated or adjusted after the dividend is announced. The withholding amount on gross payments that are netted under a specified NPC is determined by treating the gross amounts as payments. Tax-gross ups of withholding on dividend equivalent amounts are also treated as dividend equivalents.

Equity-linked instruments can also be treated as specified NPCs. Section 871(m)(2)(C) allows the US Treasury to deem payments that are "substantially similar" to dividend equivalents as dividend equivalents in their own right. The proposed regulations define substantially similar payments to include any payment under an "equity-linked instrument" if the payment is contingent on or made by reference to a US-source dividend. An equity-linked instrument is any financial instrument that references one or more underlying securities to determine its value. This would include futures, forwards, options and other similar contractual arrangements. The regulations are unclear whether the instrument must provide a delta one exposure to the counterparty. An equity-linked instrument is treated as an NPC if it provides for any dividend equivalent payments.

The regulations are silent on cascading withholding issues. The preamble to the temporary regulations references IRS Notice 2010-46, which addresses cascading withholding for securities lending and sale-repurchase transactions. The preamble indicates that the US Treasury and the IRS anticipate issuing proposed regulations addressing the issues raised in Notice 2010-46.

The ISDA Master Agreement 2010 Hire Act Protocol excludes the dividend equivalent tax imposed by Section 871(m) from the definition of an "Indemnifiable Tax". Therefore, the short party is not required to gross-up for the tax. Also, the tax is treated as a withholding tax, which means that the tax becomes an additional amount payable by the long party under the swap.

Observations

The regulations are problematic in a number of respects:

- First, an NPC can be a specified NPC without being part of an abusive transaction.
- Second, an NPC can become a specified NPC without either party knowing the contract's status has changed.
- Third, the rules that treat an NPC as a specified NPC *ab initio* can produce particularly harsh results for non-abusive transactions.
- Fourth, the regulations do not provide a means for taxpayers to protect themselves against the above issues through counterparty representations or otherwise.

In the Market

This category applies if the long party to the NPC is "in the market" on certain dates with respect to the underlying security. The regulations expand the concept beyond the statutory language to cover taxpayers who transact in the underlying security even if the transaction has no connection with the NPC. A long party is in the market if it: (i) sells or otherwise disposes of the underlying security on the same day or days that the parties price the NPC; or (ii) purchases or otherwise acquires the underlying security on the same day or days that the NPC terminates. In addition, a long party is considered in the market if it either purchases or sells 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 the amount used to price or terminate the NPC.

The "in the market" category includes actions taken by related parties. Therefore, if a taxpayer enters into a swap (under which it is the long party) and, in a completely unrelated transaction, on the day the swap is entered into or terminated, an affiliate of the taxpayer engages in a transaction in the underlying security, the swap may become a specified NPC. The regulations have a de minimis exception (applicable where the amount of the underlying securities purchased or disposed of is less than 10 percent of the NPC's notional amount), but this may not adequately protect the parties to the swap.

This category has the potential for causing significant problems if the regulations are not materially changed before they are finalized. The regulatory definition can catch an NPC even if the short party does not acquire the underlying security. The "in the market" standard is much broader than the "cross in/cross out" standard enunciated in the statute. It also clearly has the potential to catch transactions that have no abusive element.

Funds with multiple portfolio managers may be particularly susceptible to these rules. One manager is unlikely to know that another manager is taking a synthetic or physical position in a particular equity. One manager's actions would unintentionally taint the transaction of another. The current "in connection with" standard, although subject to some uncertainty, is preferable to the proposed rules.

The "in the market" category raises a fundamental issue regarding how the regulations will be applied. The regulations do not provide parties with a safe harbor or other mechanism for avoiding withholding and penalties for non-withholding even though the category is impossible to police in many situations. For example, the regulations could have provided that the short party's withholding obligation is relieved if it receives a representation from the long party that it is not, and will not be, in the market on the pricing/termination dates. There is no way for the short party to have this knowledge. However, it is also possible that most financial institutions could not give this representation as the long party because they could not be certain that an affiliate, or even another part of the institution, was in the market under the expansive definition. A financial institution could not reasonably be expected, for example, to generally prohibit the purchase of a particular underlying security by itself or any affiliates on the day an NPC terminates.

Thinly Traded

The underlying security is considered thinly traded if it is not regularly traded on a qualified exchange. Regular trading generally requires that the security be listed on a national securities exchange and traded in a quantity exceeding 10 percent of the 30-day average daily trading volume during at least 15 of the 30 trading days immediately preceding the day that the NPC is priced. This will require an analysis of each underlying security to determine whether or not it is thinly traded. This category should be contrasted with the statutory rule that only requires that the underlying security be "readily tradable" in order to avoid treatment as a thinly traded security.

Posting Security as Collateral

This category applies if the short party posts the underlying security as collateral with the long party. A *de minimis* exception applies if the pledged amount is no more than 10 percent of the total fair market value of all collateral posted by the short party on any date that the NPC is outstanding. The de minimis exception provides relief in cases where a short party posts a pool of securities as collateral and the pool includes a relatively small amount of the underlying security. Because the test is based on fair market value, market fluctuations could cause a swap to inadvertently become a specified NPC.

Short-Term

An NPC is "short-term" if it has an actual term of less than 90 days. The term of the NPC is deemed terminated where the long party is a party to a transaction that offsets its position with respect to the NPC. No guidance is provided as to what standard should be used in making this determination. Nor is there any means for a short party to know that the long party has offset its position. Given the treatment of related parties as a party to the NPC, it is possible that the long party itself may not be aware that the NPC has terminated early. As with the "in the market" category, representations from the long party would not relieve the short party of its withholding obligations.

The short-term category has another major flaw. It does not carve out terminations occurring due to matters beyond the control of the parties. For example, if any one of the standard termination provisions in an ISDA Master Agreement applies, such as a credit event, an NPC would become a specified NPC if the termination causes the NPC to have a term of less than 90 days. We expect this issue will be addressed in final regulations.

Hedging Control

This category applies if the long party controls the short party's hedge. Control can occur if the long party determines the short party's acquisition of the underlying security or directs the short party to sell its hedge to a particular purchaser at a specified price and date. The long party's control can arise either contractually or "by conduct."

An NPC is also a specified NPC if the long party uses an "underlying equity control program." This refers to an arrangement that allows the long party to direct how the short party hedges its risk, or to cause the short party to acquire the underlying security before entering into the NPC. However, an "underlying equity control program" does not include an electronic trading platform that allows customers to electronically place an order to enter into an NPC with a dealer, if the dealer controls the decision of whether and how it will hedge its position.

Material Volume

This category applies if the notional principal amount of the NPC is greater than: five percent of the total public float of the underlying security or 20 percent of the 30-day average daily trading volume of the underlying security. All NPCs of a long party (and its affiliates) that reference the same underlying security are aggregated for purposes of this test. Because this is not limited to NPCs having the same start date, taxpayers will need to monitor their aggregate position on a daily basis. Although the total position seems large, the 20 percent rule could be triggered unintentionally. The aggregation rule makes a trigger far more likely. As with other categories, representations from the long party will not relieve the short party of its withholding obligations.

Special Dividend

An NPC falls into the "special dividend" category if it is entered into on or after the announcement of a special dividend and prior to the ex-dividend date. The announcement is treated as occurring on the earliest date on which the corporation declares, announces or agrees to the amount or payment of the dividend. The term "special dividend" means a "nonrecurring payment to shareholders of corporate assets that is in addition to a recurring dividend payment". A special dividend can arise even if paid in conjunction with a recurring dividend.

If an NPC is a specified NPC by reason of being in the special dividend category, all dividend equivalent amounts (rather than just the special dividend component) are subject to withholding.

Summary

The regulations can hopefully be viewed as an opening offer by the government. Several of the anti-abuse rules show a desire to cover any conceivable transaction that the government considers to have the potential for abuse. Compromises in the name of administrability appear to be few. As drafted, some of the rules are impossible for taxpayers to police. We expect significant comments on several aspects of the regulations by practitioners and affected taxpayers with a view toward achieving a workable compromise.

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