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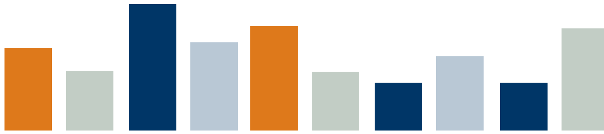

Investment Management Hot Topics

FATCA and Dividend Equivalent Withholding Developments

April 3, 2012

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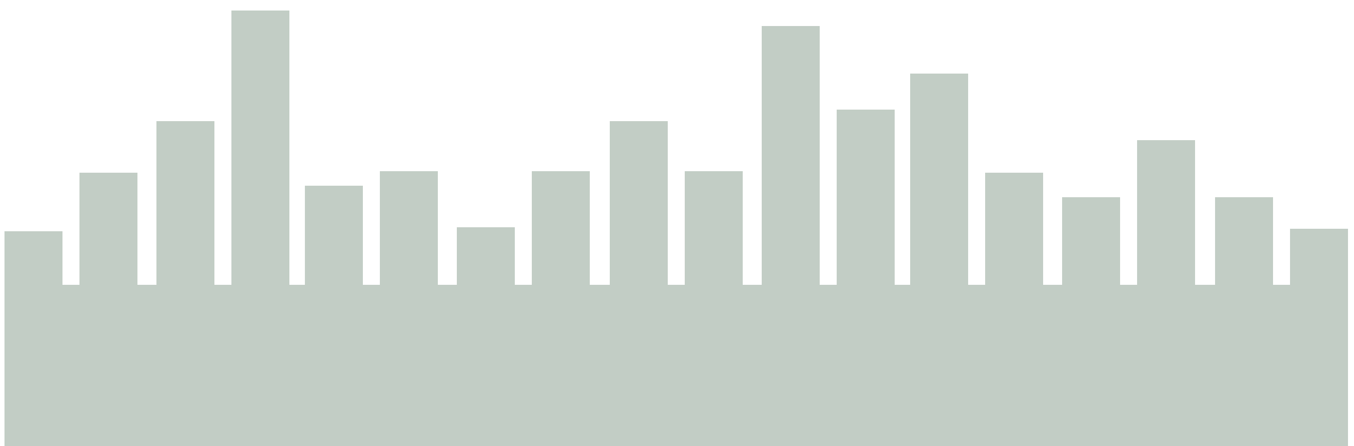
   ***SRZ Client Alert*, February 9, 2012**



1. About the Speakers

Philippe Benedict
919 Third Avenue
New York, NY 10022
+1 212.756.2124 | philippe.benedict@srz.com

Philippe Benedict, a partner at Schulte Roth & Zabel, focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments.

Philippe has been involved in many major transactions involving sales or spinoffs of investment fund managers. He recently advised Gresham Investment Management LLC in its sale of a 60 percent stake to Nuveen Investments and represented ABS Investment Management LLC in Evercore Partners Inc.'s $45 million purchase of a non-controlling stake in ABS. He also advised Secor Asset Management LP in regard to an investment by Babson Capital Management.

A frequent speaker at prominent industry events, Philippe was invited to present "How Will New Tax Changes Affect Hedge Funds in 2012?" at Bank of America Merrill Lynch's Deciphering the New Regulatory and Tax Environment event and discussed "Succession Planning" and "Tax Update 2012: FATCA and Other Issues" at SRZ's 21st Annual Private Investment Funds Seminar. He also co-authored "New Paradigm in Asset Manager M&A: Financial Institution Alliances with Hedge Fund Managers," which appeared in *The Hedge Fund Journal*.

Philippe attended New York University School of Law, where he was awarded an LL.M. in taxation and a J.D. While attending NYU for his J.D., he was the recipient of a Gruss Fellowship and served on the staff of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University.

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Dominique Padilla Gallego
919 Third Avenue
New York, NY 10022
+1 212.756.2332 | dominique.gallego@srz.com

Dominique Padilla Gallego, a partner at Schulte Roth & Zabel, focuses her practice on U.S. federal income tax matters relating to investment funds, financial products and structured finance transactions.

Dominique speaks at industry conferences and events, most recently presenting "Tax Update 2012: FATCA and Other Issues" at SRZ's 21st Annual Private Investment Funds Seminar and "Withholding on U.S. Equity Swaps Under the HIRE Act," at an American Bar Association's Section of Taxation Mid-Year Meeting. She is also a co-author of "On the CLO Horizon — Regulations Expected to Impact CLOs," a chapter in *The International Comparative Legal Guide to: Securitisation 2011*. In 2000, she received the prestigious AT&T Asia Pacific Leadership Award. She is a member of the New York State Bar Association, the American Bar Association and the Integrated Bar of the Philippines.

After obtaining her undergraduate degree in Economics, *summa cum laude*, from De La Salle University in Manila, Philippines, Dominique earned a J.D., *cum laude* and valedictorian, from Ateneo de Manila University in Manila, Philippines and an LL.M. in International Taxation from New York University School of Law.

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Daniel F. Hunter
919 Third Avenue
New York, NY 10022
+1 212.756.2201 | daniel.hunter@srz.com

Daniel F. Hunter, a partner at Schulte Roth & Zabel, concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid funds and private equity funds. He regularly advises funds that invest in distressed debt, asset-backed securities and bank loans with requirements including Treasury Forms and Form PF as well as questions related to the U.S. Commodity Futures Trading Commission. Dan also provides day-to-day regulatory, operational, M&A and restructuring advice to his fund clients, and advises funds regarding the receipt or allocation of seed capital. As part of his compliance practice, Dan advises clients on the Treasury Forms (TIC Forms), the CFTC rules and regulations, as well as the recently adopted Form PF.

A sought-after speaker, Dan recently discussed "Legal, Regulatory & Tax" concerns at the Goldman Sachs Prime Brokerage Hedge Fund Conference and presented "Brazilian Investment Management 101: Opportunities and Challenges in Starting a Brazilian Investment Management Business" and "Form PF Workshop" at SRZ events. Additionally, he authored "Focus On: US Investors in LatAm," which was published in *LatAm Fund Manager*. He has been recognized in *The Legal 500 USA* in the Investment Fund Formation and Management Category.

Dan received his A.B., *cum laude* and with high honors in history, from the University of Michigan, and his J.D. from the University of Michigan Law School. While a law student at Michigan, he was articles editor of the *University of Michigan Journal of Law Reform*.

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Shlomo C. Twerski
919 Third Avenue
New York, NY 10022
+1 212.756.2510 | shlomo.twerski@srz.com

Shlomo C. Twerski, a partner at Schulte Roth & Zabel, focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. Shlomo provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Shlomo regularly speaks at industry conferences and events, and has recently addressed such topics as “Tax Update 2012: FATCA and Other Issues,” “The Return of CLOs: Changes That Matter to Managers and Investors” and “Running a Multi-Jurisdictional Adviser” for various SRZ seminars. He is a member of the Tax Section of the New York State Bar Association.

Shlomo earned his J.D. from Hofstra University School of Law, where he was an articles editor of the *Hofstra Law Review*.

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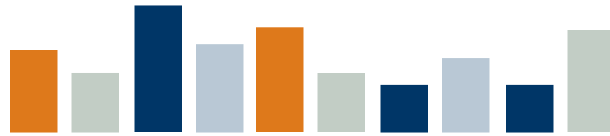
Schulte Roth & Zabel 

Investment Management Hot Topics

2. PowerPoint Presentation

Dividend Equivalent Payments

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Investment Management Hot Topics

Notes:

Dividend Equivalent Payments: Proposed Regulations

- Long party is in the market
- Underlying security is not regularly traded
- Short party posts underlying security as collateral (> 10% of notional)
- NPC term < 90 days
- Long party controls short party's hedge
- Notional amount of NPC is greater than:
  - **5% of total public float, or**
  - **20% of 30-day daily average trading volume**
- NPC entered into ON or AFTER special dividend announcement (but before ex-dividend date)

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Notes:

FATCA: Background and Basics

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The FATCA Effect

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FATCA: Withholdable, Passthru and Foreign Passthru Payments

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FATCA:
FFI Agreement

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FATCA: Intake Procedures for Investors

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FATCA: Confidentiality

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FATCA: Implementation and Certification

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Timeline: Phasing-in FATCA

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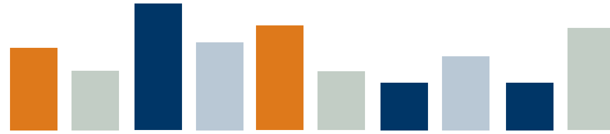
Schulte Roth & Zabel 

Investment Management Hot Topics

3. Outline

FATCA and Dividend Equivalent Withholding Developments

I. New Temporary and Proposed Tax Regulations on Dividend Equivalents

A. Temporary Regulations: Section 871(m) of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), expanded the definition of U.S.-source income subject to U.S. withholding tax to include "dividend equivalent payments," amounts (directly or indirectly) contingent upon, or determined by reference to, the payment of a U.S.-source dividend, and which are: (1) made on "specified notional principal contracts," (a "Specified NPC"); (2) made pursuant to a securities lending or repurchase agreement; or (3) any other payment that the Treasury Secretary determined to be substantially similar to a payment described in (1) or (2) above.

1. Currently, a notional principal contract (an "NPC") is a Specified NPC if it provides for one or more amount(s) that (directly or indirectly) may be contingent upon, or determined by reference to, a dividend from sources within the United States and:

(a) In connection with entering into such NPC, any long party to the NPC transfers the underlying security to any short party to the contract (i.e., "crossing in");

(b) In connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract (i.e., "crossing out");

(c) The underlying security is not readily tradable on an established securities market; or

(d) The underlying security is posted as collateral by any short party to the contract with any long party to the contract.

The temporary regulations extend the current definition of a Specified NPC through December 31, 2012. The proposed regulations clarify the meaning of "dividend equivalent," broaden the definition of a Specified NPC and confirm withholding agents' obligations with respect to dividend equivalents.

B. Changes Made by the Proposed Regulations:

1. The proposed regulations redefine "Specified NPC" for payments made after December 31, 2012, to include any NPC where:

(a) The long party is "in the market" with respect to the underlying U.S. security, generally meaning that the long party (or any related party): (1) sells or otherwise disposes of the underlying U.S. security on the same day, or days, that the parties price the NPC; (2) purchases or otherwise acquires the underlying security on the same day, or days, that the NPC terminates; or (3) purchases or disposes of the underlying U.S. security at a price that is set or calculated in a way that is substantially identical to, or determined by reference to, an amount used to price or terminate the NPC (e.g., a forward contract), in each case not considering whether a transaction was entered into "in connection with" the swap;

(b) The underlying U.S. security is not regularly traded; a security is regularly traded if it is: (1) listed on a qualified national securities exchange; and (2) traded for at least 15 trading days during the 30 trading days prior to the date on which the parties price the NPC, counting only those days in which the underlying U.S. securities are traded in quantities that exceed 10 percent of the 30-day average daily trading volume (this is in contrast with the current standard, which requires that the underlying U.S. security be readily tradable to not be a Specified NPC);

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(c) The short party posts the underlying U.S. security as collateral and the underlying security represents more than 10 percent of the collateral posted by the short party on any date that the NPC is outstanding (thus market value fluctuations may be an issue; this is in contrast to the current rule, which applies to a posting of any amount of the underlying security as collateral in connection with entering into a swap);

(d) The actual term of the NPC has fewer than 90 days, and will be reduced for any periods where the long party is a party to a transaction that offsets its position with respect to the NPC; also, it could encompass terminations outside the control of the long party (e.g., events of default or other credit events). This rule may cause investment funds who enter into NPCs as part of a high-frequency trading strategy to reconsider their investment strategies;

(e) The long party controls, contractually or by conduct, the short party's hedge or participates in an underlying equity control program;

(f) The notional principal amount of the NPC is greater than: (1) five percent of the total public float of the underlying security; or (2) 20 percent of the 30-day daily average trading volume of the underlying security. For each calculation, a taxpayer must aggregate the notional principal amounts of all NPCs for which it is the long party that reference the same underlying U.S. security (even if the swaps are not entered into by the same portfolio manager or trading group of a hedge fund or are entered into on different dates); or

(g) The NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

2. An NPC meeting any one of these seven factors is a Specified NPC, and a withholding agent is required to withhold on any dividend equivalents.

3. Potential withholding agents, such as dealers and investment funds going short on an NPC, will likely seek to have counterparties make certain representations with respect to all seven factors and any related parties. Investment funds may seek to transact only with U.S. dealer counterparties or non-U.S. dealers, who will only act from their respective U.S. permanent establishments and provide an "ECI" representation, where no withholding is required. An investment fund may simply be unable to provide representations that negate the absence of the seven factors, not due to the presence of abusive facts but rather lack of control over facts that could make an NPC a Specified NPC.

C. Dividend Equivalents — Gross Amounts, Estimates and Substantially Similar Amounts: A payment of a dividend equivalent includes any gross amount that is used in computing any net amount that is transferred to or from a taxpayer under the terms of the contract. Thus, even if no net payment is made or the party entitled to the gross amount is required to make a net payment to the other party, the dividend equivalent is equal to that gross amount.

1. The proposed regulations specify that a payment is not a dividend equivalent if it is determined by reference to an estimate of an expected dividend, provided that there is no reference to, or adjustment for, the amount of any actual dividend.

2. The proposed regulations also define what is "substantially similar" to dividend equivalents paid pursuant to a securities lending agreement, repurchase agreement or Specified NPC. Substantially similar payments are: (1) gross-up amounts paid by a short party in satisfaction of the long party's tax liability with respect to a dividend equivalent; and (2) payments calculated by reference to a dividend from sources within the United States that are made pursuant to an equity-linked instrument other than an NPC, including a futures contract, forward contract, option or other contractual arrangement.

3. For equity-linked instruments (e.g., futures, forwards, options and other contractual arrangements), it appears that one of the seven factors needs to apply before withholding is required.

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D. Anti-Abuse Rule:

1. The proposed regulations also include an anti-abuse rule that permits the Treasury to treat payments made under a transaction or transactions as dividend equivalents if a taxpayer enters into such a transaction or transactions with a principal purpose of avoiding the withholding rules under Section 871(m) of the Code.

E. Withholding Agents' Responsibility When Outstanding NPCs Become Specified NPCs:

1. The proposed regulations amend several regulations clarifying that an NPC that is not a Specified NPC at the time it is entered into but becomes a Specified NPC during the term of the contract will be treated as though it had been a Specified NPC during the entire term of the contract. The withholding agent will be responsible for reporting and depositing the amount of tax required to be withheld or paid over on all amounts that are recharacterized as dividend equivalents on the next payment date following the NPC's characterization as a Specified NPC (including any termination date payment), even when the withholding agent does not know, or have reason to know, that the NPC has been recharacterized.

2. The Treasury also expressly stated that in addition to the statute and regulations, it will continue to apply general common law principles and judicial doctrines to determine whether an NPC or other equity derivative represents tax ownership in the referenced equity.

3. It may prove very difficult for withholding agents to fulfill their obligations and collect payment for tax, especially when they are the short party and they are not making a payment from which they could withhold. In the case of the short party who generally has no control over the assets in respect of an NPC, such short party should ensure that it has the right to be fully indemnified by the long party in respect of any circumstance giving rise to withholding under Section 871(m) of the Code. Some U.S. equity derivative counterparties might seek to withhold on all amounts that can be calculated in reference to a dividend in respect of any non-U.S. counterparty or they might seek to exclude any dividend-related economics from trades altogether.

F. Effective Date of Proposed Regulations:

1. The proposed regulations under Section 871(m) of the Code are generally effective on the date of publication in the Federal Register of the Treasury decision adopting such regulations as final regulations. Thus, payments made on or after the regulations are finalized may be subject to withholding, even if the contracts were entered into before the effective date. If the proposed regulations are not finalized prior to the expiration of the temporary regulations on December 31, 2012, in the absence of any additional guidance, dividend equivalent payments made thereafter on all NPCs will likely be subject to dividend withholding tax.

II. New Proposed Tax Regulations on FATCA Withholding and Reporting

A. Introduction: The Internal Revenue Service (the "IRS") released proposed regulations for sections 1471 through 1474 of the Code ("FATCA"). FATCA provides for certain information reporting and withholding rules in order to ensure that U.S. persons invested in foreign entities are reported to the IRS. Generally, FATCA requires withholding agents to withhold 30 percent on "withholdable payments" and "passthru payments" made to foreign financial institutions ("FFIs") or to certain non-financial foreign entities ("NFFEs"), unless certain information reporting requirements are met.

1. Withholdable payments are currently defined as payments of U.S. source fixed or determinable annual or periodic income ("FDAP income") and any gross proceeds from the sale or other disposition of any property that produces U.S. source interest or dividend income. Passthru payments are payments that are withholdable payments or foreign passthru payments. The IRS has reserved its definition of foreign passthru payments.

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2. Financial institutions, for FATCA purposes, include entities that are engaged primarily in the business of investing, reinvesting, or trading in securities, commodities, interests, and contracts. Therefore, investment funds would generally be treated as financial institutions under FATCA.

B. Non-U.S./Offshore Funds as FFIs: In order to avoid receiving payments subject to FATCA withholding, FFIs must enter into agreements with the IRS in which such FFIs ("participating FFIs") agree to implement due diligence and verification procedures for determining whether any of their account holders are U.S. persons or U.S. owned foreign entities, report certain information about such accounts to the IRS, and withhold on payments to accounts that fail to provide information or other FFIs that do not otherwise comply with FATCA.

1. Online registration for offshore funds seeking participating FFI status begins no later than January 1, 2013, and for funds who have entered into such agreements by June 30, 2013, such FFI Agreements will take effect on July 1, 2013.

C. U.S./Onshore Funds as Withholding Agents: Onshore funds are withholding agents for purposes of FATCA withholding in respect of foreign entities (e.g., investors and contractual counterparties) who do not comply with the applicable information reporting requirements. Just like offshore funds, onshore funds must establish procedures by which they can identify the U.S. or foreign status of their investors and counterparties to ascertain any potential withholding obligations. Onshore funds must withhold on payments to foreign payees that do not provide the information necessary to avoid such withholding and must file information returns on withholdable payments.

D. Compliance Procedures and Appointing a Responsible Officer:

1. Under the proposed regulations, participating FFIs must adopt written due diligence policies and procedures for identifying and documenting account holders, withholding and reporting as required under the FFI Agreement. Participating FFIs must periodically review their compliance with the FFI Agreement and must appoint a responsible officer who must certify to the IRS their compliance.

2. A responsible officer of the participating FFI must certify to the IRS within one year of the effective date of its FFI agreement that the participating FFI has reviewed all of its high-value accounts and, to the best of the responsible officer's knowledge, the participating FFI did not have any formal or informal practices or procedures in place from August 6, 2011, through the date of the certification to assist account holders in the avoidance of FATCA withholding and reporting. Additionally, such responsible officer of the participating FFI must certify to the IRS within two years of the FFI Agreement's effective date that it has completed the account identification procedures and documentation requirements for all financial accounts that are preexisting obligations or, if it has not obtained the documentation required to be obtained with respect to an account, that it treats such account in accordance with the requirements of its FFI agreement.

3. In the absence of direct guidance, in respect of offshore funds, it appears likely that an offshore fund's board of directors would appoint the investment manager as the responsible person for FATCA compliance and the investment manager would establish its internal FATCA compliance procedures, including appointing a responsible person to provide for the relevant certifications and disclosures.

E. The FFI Agreement: The proposed regulations include the general provisions intended to be included in the FFI Agreement. The IRS intends to circulate a draft model FFI Agreement in the Spring of 2012. The FFI Agreement will require the following provisions (among others):

1. Withholding: Participating FFIs must generally agree to act as withholding agents and must withhold 30 percent on passthru payments that are withholdable payments to recalcitrant account holders, nonparticipating FFIs and participating FFIs electing to have payments to them subject to withholding.

2. Identification and Documentation Procedures: Participating FFIs must perform due diligence for identifying and documenting account holders. Determining an account holder's status requires the collection of an account holder's valid withholding certificate (W-8 or W-9). Forms W-8IMY must include the intermediary's FFI-EIN (or QI/WP/WT-EIN).

   (a) Participating FFIs must retain originals or photocopies of the documentation needed to determine an account holder's status generally for six calendar years (subject to extension by the IRS) for preexisting accounts. The retention period for new accounts is unspecified.

3. Annual Reporting: Participating FFIs must annually report certain information to the IRS. Certain information to be reported is subject to a staggered phase-in schedule (as described below). The annual reporting form must be filed by March 31, but the IRS will grant an automatic 90-day extension (and a discretionary additional 90-day extension) if the participating FFI files Form 8809 requesting such extension.

   (a) For accounts held by specified U.S. persons:[1] Participating FFIs must report the name, address and TIN of each specified U.S. person account holder; the account number, and account balance or value; the payments made with respect to the account during the calendar year; and such information required to be reported on the IRS form for this reporting.

   (b) For accounts held by U.S.-owned NFFEs: Participating FFIs must report the name, address and TIN (if any) of the U.S. owned foreign entity; the name, address and TIN of each substantial U.S. owner[2] of such entity; the account number, and account balance or value; and the payments made with respect to the account during the calendar year.

   (c) For recalcitrant account holders: Participating FFIs must report separately the number of active accounts and aggregate values of accounts of recalcitrant account holders for each of: (1) those accounts with U.S. Indicia; and (2) those accounts without U.S. Indicia.

4. Foreign Law Waiver: When the law of the foreign jurisdiction in which the account is held prohibits (but for a waiver) the reporting required by the FFI Agreement, participating FFIs must either obtain a valid waiver from its U.S. account holders or close the account if they do not obtain a waiver within a reasonable amount of time.

5. Verification Procedures: As described above, participating FFIs must adopt written due diligence policies and procedures for identifying and documenting account holders and withholding, and reporting as required under the FFI Agreement. The IRS may audit (through an external auditor) a participating FFI to determine compliance, if disclosures in these periodic reports raise concerns for the IRS.

F. Validly Identifying and Documenting Account Holders:

1. A significant amount of FATCA groundwork for investment managers is to validly identify its fund investors and fund counterparties as individuals or entities and as U.S. or non-U.S. Investment managers can begin this identification process immediately, particularly with the helpful guidance in the proposed regulations which provide extensive guidance on the types of documentation for different types of accounts and account holders on which participating FFIs and withholding agents may rely as sufficient to determine the U.S. or foreign status of account holders. In general,

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[1] "Specified U.S. Person" means any U.S. person other than a publicly traded corporation; any corporation that is a member of the same expanded affiliated group as a publicly traded corporation; any 501(a) tax exempt organization or an individual retirement plan; the United States or any wholly-owned agency or instrumentality thereof; any state, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly-owned agency or instrumentality of any one or more of the foregoing; any bank; any REIT; any RIC or any entity registered with the SEC under the Investment Company Act of 1940; any common trust fund; any tax exempt trust under section 664(c) or described in section 4947(a)(1); a dealer in securities, commodities, or derivative financial instruments (including notional principal contracts, futures, forwards, and options) that is registered as such under the laws of the United States or any state; and a broker.

[2] "Substantial U.S. Owners" means certain U.S. persons with at least a 10 percent ownership interest in the foreign entity.

participating FFIs and withholding agents may rely on documentary evidence that reasonably establishes a person's identity, unless they have reason to know that the information provided is incorrect or misleading.

2. In the absence of proper documentation, certain helpful presumptions apply in determining whether an account holder or payee is a U.S. or foreign person.

   (a) Account holders and payees are presumed to be entities, unless something indicates that they are individuals (such as the name of the account is that of an individual).

   (b) Payments are presumed made to U.S. persons, unless any of the following applies (in which case, payments are presumed made to foreign persons):

      (i) The withholding agent or participating FFI treats the payee as an entity and: (1) has actual knowledge that the EIN of the payee begins with "98;" (2) mails communications to the payee to an address in a foreign country; (3) knows the payee's telephone number to be outside the U.S., or (4) the payee's name indicates that it is a per se foreign corporation;

      (ii) The payee is a certain type of exempt recipient; or

      (iii) The payment is made outside of the U.S. with respect to an offshore obligation, and the withholding agent does not know or have reason to know that the payee is a U.S. person.

   (c) Foreign entities whose FATCA status is undetermined are presumed nonparticipating FFIs.

   (d) Payments are presumed made to an intermediary if documentation or facts and circumstances indicate that the person who receives the payment is a bank, broker, custodian, intermediary, or other agent, and the withholding agent has no knowledge that the person receives the payment for its own account. If the intermediary is treated as foreign, then the payments are presumed made to a foreign intermediary that is a nonparticipating FFI.

   (e) If a withholding agent or participating FFI, making a payment to joint payees, lacks valid documentation from each payee but all of the joint payees appear to be individuals, then the payment is presumed made to an unidentified U.S. person. If any joint payee does not appear, by its name and other information contained in the account file, to be an individual, then the entire payment will be treated as made to a nonparticipating FFI. However, if one of the joint payees provides a valid Form W-9, the payment is treated as made to that payee.

G. Documentation and Inspection of Specific Types of Accounts: Investment managers will generally be constrained by existing subscription agreements and fund documents in respect of existing investors and will have greater flexibility in requiring new investors to adhere to FATCA requirements.

1. Preexisting Individual Accounts:

   (a) If a participating FFI has previously determined that an individual account holder is a U.S. person for other withholding purposes, such account is treated as a U.S. account.

   (b) Individual accounts with a balance or value at or below $50,000 as of the date of the FFI Agreement are exempt from review, unless the participating FFI elects otherwise.

   (c) Accounts that are offshore obligations with a balance or value above $50,000 but not above $1,000,000 as of the date of the FFI Agreement are subject only to review of electronically searchable data for indicia of U.S. status. No further search is required unless U.S. Indicia are found through the electronic search.

   (d) Accounts exceeding $1,000,000 as of the date of the FFI Agreement or at the end of any subsequent calendar year are considered high value accounts and require documentation to determine their U.S. or foreign status. These accounts are subject to review of electronic and

non-electronic files for U.S. Indicia,[3] including inquiry into actual knowledge of any relationship manager associated with the account. Review of non-electronic files is limited to the current customer files and certain other documents, and is required only to the extent that the electronically searchable files lack sufficient information about the account holder. AML/KYC diligence alone is insufficient.

2. New Individual Accounts:

   (a) Participating FFIs must obtain a Form W-8 or W-9 from individual account holders. However, for an individual account that is an offshore obligation, a W-8 is unnecessary if the participating FFI obtains documentary evidence sufficient to determine the individual's foreign status (e.g., certificate of residence, valid ID issued by a foreign government).

   (b) Participating FFIs must inspect all documentation received from individual account holders (at opening the account and for other regulatory purposes) for U.S. Indicia. But, FFIs are not required to make significant changes to their account opening procedures unless U.S. Indicia are found.

   (c) If U.S. Indicia are found, participating FFIs must obtain follow-up information to confirm an account's foreign status:

      (i) If the individual is identified as a U.S. person, a valid Form W-9 and waiver of foreign law disclosure limitations;

      (ii) If the individual has a U.S. place of birth, a valid Form W-9 and waiver of foreign law disclosure limitations, or a Form W-8BEN and a non-U.S. passport or government issued ID evidencing citizenship in another country; accompanied by a Certificate of Loss of U.S. nationality, explanation of individual's renunciation of U.S. citizenship, or the reason for not obtaining U.S. citizenship at birth;

      (iii) If the individual has a U.S. (mailing) address or telephone number in the U.S., a valid Form W-9 and waiver of foreign law disclosure limitations, or a Form W-8BEN and a non-U.S. passport or government issued ID evidencing citizenship in another country;

      (iv) If the account has standing instructions to transfer funds to a U.S. maintained account, a valid Form W-9 and waiver of foreign law disclosure limitations, or a Form W-8BEN and government-issued documentation of foreign person status;

      (v) If the individual has granted a power of attorney or signatory authority to a U.S. person or a U.S. "in-care-of" or "hold mail" address, a valid Form W-9 and waiver of foreign law disclosure limitations, or a Form W-8 and government-issued documentation of foreign person status.

3. Preexisting Entity Accounts:

   (a) For entity accounts with balances at or below $250,000 as of the date of the FFI Agreement where no holder of the account has been documented previously by the FFI as a U.S. person, such accounts are exempt from review until any such account balance exceeds $1,000,000.

   (b) For entity accounts with balances exceeding $250,000 as of the date of the FFI Agreement, FFIs can generally rely on AML/KYC records and other existing account information to determine the entity's status.

   (c) For preexisting accounts of passive investment entities with account balances at or below

[3] "U.S. Indicia" include: identification of an account holder as a U.S. person; U.S. place of birth; U.S. address; U.S. telephone number; standing instructions to transfer funds to a U.S. maintained account; and power of attorney or signatory authority in a person with a U.S. address; or a U.S. "in-care-of" or "hold mail" address that is the sole address the FFI has identified for the account holder.

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$1,000,000 as of the date of the FFI Agreement, FFIs may generally rely on information collected for AML/KYC due diligence purposes.

(d) Participating FFIs must obtain information regarding all substantial U.S. owners or a certification that the entity does not have substantial U.S. owners.

4. New Entity Accounts:

(a) Participating FFIs must obtain a valid Form W-8 or W-9, or other suitable documentary evidence, for new entity accounts in order to identify the entity's status as a U.S. person, a participating FFI, a nonparticipating FFI, or an NFFE. If a passive NFFE, the documentation must also provide sufficient information needed to determine if the entity has any substantial U.S. owners.

H. Special Entities with Reduced Compliance Burdens:

1. Deemed-Compliant FFIs: Deemed-Compliant FFIs are treated as having entered into an FFI Agreement and thus have a reduced compliance burden. Deemed-Compliant FFIs include: (1) Registered Deemed-Compliant FFIs; (2) Certified Deemed-Compliant FFIs; and (3) owner-documented FFIs.

(a) Registered Deemed-Compliant FFIs must: (1) have its chief compliance officer or an equivalent person certify to the IRS that the FFI has satisfied all of the requirements for the type of Deemed-Compliant FFI status claimed by the FFI as of the date the FFI registers as a Deemed-Compliant FFI; (2) obtain from the IRS a confirmation of its registration as a Deemed-Compliant FFI and an FFI-EIN; (3) agree that if it chooses to publish a passthru payment percentage, it will do so in accordance with certain procedures; (4) renew its certification every three years; and (5) agree to notify the IRS if there is a change in circumstances which would make the FFI ineligible for the deemed-compliant status for which it registered. Registered Deemed-Compliant FFIs include the following FFIs:

(i) Qualified collective investment vehicles:

(1) Investment funds regulated by their country of organization and considered FFIs solely because they are engaged primarily in the business of investing, reinvesting, or trading in securities, commodities, interests and contracts;

(2) Each debtholder above $50,000, equityholder or other financial interest holder in the vehicles is a participating FFI, a registered Deemed-Compliant FFI, a person exempt from FATCA withholding, or a specified U.S. persons;[4] and

(3) If part of an expanded affiliated group, all other FFIs in the group must be either participating FFIs or registered Deemed-Compliant FFIs.

(ii) Certain restricted funds regulated as investment funds by their country of organization (which itself is FATF-compliant) where their distribution agreements prohibits sales of debt or equity to U.S. persons, nonparticipating FFIs or passive NFFEs with substantial U.S. owners;

(iii) Any FFI that is deemed compliant because of an agreement between the U.S. government and a foreign government.[5]

[4] See, *supra* footnote 1.

[5] Concurrent with the proposed regulations, the United States promulgated a joint statement with France, Germany, Italy, Spain, and the United Kingdom acknowledging a general commitment to combating tax evasion and cross-border knowledge sharing. Through such intergovernmental cooperation, the FATCA partner country would assume a portion of the reporting obligations, thereby relieving FFIs from entering into FFI Agreements. Instead the FFIs would report to their country's government and that foreign government would report to the IRS.

(b) Certified Deemed-Compliant FFIs include certain retirement funds and certain non-profit organizations;

(c) Owner-documented FFIs are deemed compliant only with respect to payments received by, or accounts held with, withholding agents that agree to undertake additional due diligence and reporting necessary to deem the owner-documented FFI compliant. Owner-documented FFIs are not deemed compliant when acting as intermediaries.

I. Phasing In FATCA — Important Effective Dates:

1. Information Reporting for Non-US/Offshore Funds that Are Participating FFIs:

(a) **Beginning in 2014 and 2015** (for calendar years **2013** and **2014**), participating FFIs are only required to report the name, address, TIN, account number and account balance of U.S. accounts.

(b) **Beginning in 2016** (for calendar year **2015**), in addition to the above information, participating FFIs must report income associated with U.S. accounts.

(c) **Beginning in 2017** (for calendar year **2016**), full reporting, including reporting on gross proceeds from broker transactions, takes effect.

2. Information Reporting for U.S. Financial Institutions/Withholding Agents/Onshore Funds:

(a) While U.S. financial institutions can voluntarily perform due diligence on their preexisting account holders currently, for accounts opened **after January, 1 2013**, U.S. financial institutions must perform due diligence to determine new account holders' U.S. or foreign status. Even though diligence does not need to be performed for preexisting accounts, if **after January 1, 2013**, a financial institution reviews a preexisting account holder's documentation, that financial institution must perform due diligence to determine the account holder's U.S. or foreign status.[6]

(b) **Beginning March 15, 2014**, U.S. financial institutions, as withholding agents, must report for the 2013 calendar year on the substantial U.S. owners of foreign entity account holders, the name of the NFFE that is owned by a substantial U.S. owner and the name of each substantial U.S. owner, each owner's TIN, mailing address, and any other information that the IRS form may require.

(c) **Beginning March 15, 2015**, U.S. financial institutions, as withholding agents, must also report information required on Form 1042 and 1042-S (U.S. source FDAP income) for the 2014 calendar year.

(d) **Beginning March 15, 2016**, Form 1042-S will also require U.S. financial institutions, as withholding agents, to report gross proceeds.

(e) The proposed regulations do not exempt items from reporting because they are also reported on a Schedule K-1.

3. Withholding by Participating FFIs:

(a) **Beginning on January 1, 2014**, participating FFIs must generally withhold on withholdable payments of U.S. source FDAP income paid to recalcitrant account holders or nonparticipating FFIs.

(b) **Beginning on January 1, 2015**, participating FFIs must also generally withhold on withholdable payments of gross proceeds from the sale of property that produces U.S. source interest or dividend income paid to recalcitrant account holders or nonparticipating FFIs.

[6] Diligence must be performed for accounts opened on or after January 1, 2013, because for such accounts the proposed regulations treat withholding agents as having reason to know that an account holder's status is unreliable if any information contained in its account opening or other files contradicts the account holder's claimed U.S. or foreign status.

4. Withholding by U.S. Funds:

   (a) **Beginning on January 1, 2014**, U.S. persons, as withholding agents, must generally withhold on withholdable payments of U.S. source FDAP income paid to nonparticipating FFIs.

   (b) **Beginning on January 1, 2015**, U.S. persons, as withholding agents, must also generally withhold on withholdable payments of gross proceeds from the sale of property that produces U.S. source interest and dividend income paid to nonparticipating FFIs.

5. Special Withholding and Reporting on Passthru Payments:

   (a) **Beginning on January 1, 2014**, participating FFIs will be required to withhold only on passthru payments that are withholdable payments, as opposed to foreign passthru payments. Participating FFIs, however, must report annually on Form 1042-S the aggregate amount of foreign passthru payments to each nonparticipating FFI for the 2015 and 2016 calendar years (to be reported by March 15 of the following year).

   (b) Withholding on foreign passthru payments will not begin earlier than **January 1, 2017**, and the IRS will provide for this in future guidance.

6. Grandfathered Obligations:

   (a) Obligations outstanding on **January 1, 2013** are grandfathered. Payments on and gross proceeds from the disposition of such grandfathered obligations are not subject to FATCA withholding. An obligation is "outstanding on January 1, 2013" if, for a debt obligation, the issue date precedes January 1, 2013, or, for all other obligations, the binding agreement was executed before January 1, 2013. Note that any material modification of an outstanding obligation causes the obligation to be treated as newly issued/executed as of the modification date. Any material modification after January 1, 2013 will result in the loss of an obligation's grandfathered status.

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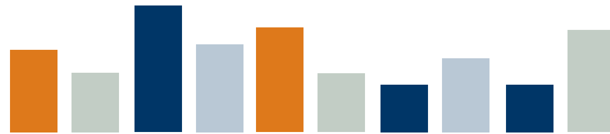

Investment Management Hot Topics

4. New Temporary and Proposed Tax Regulations on Dividend Equivalents

SRZ Client Alert, February 9, 2012

Alert

New Temporary and Proposed Tax Regulations on Dividend Equivalents

February 9, 2012

Section 871(m) of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), was enacted to expand the definition of U.S.-source income subject to U.S. withholding tax to include "dividend equivalent payments," which are amounts that (directly or indirectly) are contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and which are: (1) made on "specified notional principal contracts," (a "Specified NPC"); (2) made pursuant to a securities lending or repurchase agreement; or (3) any other payment that the Treasury Secretary determined to be substantially similar to a payment described in (1) or (2) above.

Currently, a notional principal contract (an "NPC") is a Specified NPC if it provides for one or more amount(s) that (directly or indirectly) may be contingent upon, or determined by reference to, a dividend from sources within the United States and:

- In connection with entering into such NPC, any long party to the NPC transfers the underlying security to any short party to the contract (i.e., "crossing in");
- In connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract (i.e., "crossing out");
- The underlying security is not readily tradable on an established securities market; or
- The underlying security is posted as collateral by any short party to the contract with any long party to the contract.

The temporary regulations extend the current definition of a Specified NPC through Dec. 31, 2012. The proposed regulations clarify the meaning of "dividend equivalent," broaden the definition of a Specified NPC and confirm withholding agents' obligations with respect to dividend equivalents.

Proposed Regulations

Specified NPC: The proposed regulations redefine what is a Specified NPC in respect of payments made after Dec. 31, 2012, to include any NPC where:

- The long party is "in the market" with respect to the underlying U.S. security, generally meaning that the long party (or any related party): (1) sells or otherwise disposes of the underlying U.S. security on the same day, or days, that the parties price the NPC; (2) purchases or otherwise acquires the underlying security on the same day, or days, that the NPC terminates; or (3) purchases or disposes of the underlying U.S. security at a price that is set or calculated in a way that is substantially identical

to, or determined by reference to, an amount used to price or terminate the NPC (e.g., a forward contract), in each case not considering whether a transaction was entered into "in connection with" the swap;

  - The removal of the "in connection with" standard will likely be an issue for multi-strategy hedge funds with more than one portfolio manager, where one manager executes an NPC giving it long exposure to a U.S. equity, while on the same day, but in an unrelated transaction, another manager sells or otherwise disposes of the same U.S. equity. Such transaction would be unintentional and seemingly not in line with the goal of targeting abusive transactions seeking to avoid dividend withholding tax;
  - Unlike the current cross-in/cross-out standard, this new rule does not require that the short party acquire the underlying security from, or sell the underlying security to, the long party. In fact, a long party can be "in the market" even where the short party never holds the underlying physical position;
  - The long party will not be deemed to be "in the market" for purposes of Section 871(m) of the Code with respect to an underlying U.S. security if the amount of the underlying security disposed of at the time at which the NPC is priced, or the amount of the underlying security acquired at the time at which the NPC is terminated, is less than 10 percent of the notional principal amount of the NPC;

- The underlying U.S. security is not regularly traded; a security is regularly traded if it is: (1) listed on a qualified national securities exchange; and (2) traded for at least 15 trading days during the 30 trading days prior to the date on which the parties price the NPC, counting only those days in which the underlying U.S. securities are traded in quantities that exceed 10 percent of the 30-day average daily trading volume (this is in contrast with the current standard, which requires that the underlying U.S. security be *readily* tradable to not be a Specified NPC);
- The short party posts the underlying U.S. security as collateral *and the underlying security represents more than 10 percent of the collateral posted by the short party* on any date that the NPC is outstanding (thus market value fluctuations may be an issue; this is in contrast to the current rule, which applies to a posting of any amount of the underlying security as collateral in connection with entering into a swap);
- The *actual* term of the NPC has fewer than 90 days, and will be reduced for any periods where the long party is a party to a transaction that offsets its position with respect to the NPC; also, it could encompass terminations outside the control of the long party (e.g., events of default or other credit events). This rule may cause investment funds who enter into NPCs as part of a high-frequency trading strategy to reconsider their investment strategies;
- The long party controls, contractually or by conduct, the short party's hedge or participates in an underlying equity control program;[1]
- The notional principal amount of the NPC is greater than: (1) five percent of the total public float of the underlying security; or (2) 20 percent of the 30-day daily average trading volume of the underlying security. For each calculation, a taxpayer must aggregate the notional principal amounts of all NPCs for which it is the long party that reference the same underlying U.S. security (even if the swaps are not entered into by the same portfolio manager or trading group of a hedge fund or are entered into on different dates); or
- The NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

If an NPC meets any one of these seven factors, it is a Specified NPC and a withholding agent is required to withhold on any dividend equivalents. In analyzing the seven factors, related persons (under Section 267(b) or Section 707(b)(1) of the Code) to the parties of an NPC are also considered parties to the NPC.

[1] An underlying equity control program means any system or procedure that permits: (1) a long party to an NPC to direct how a short party hedges its risk under such NPC; or (2) a long party to acquire, or cause the short party to acquire, an underlying security in a transaction with a short party and to instruct the short party to execute such acquisition in the form of an NPC after acquiring such underlying security.

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Potential withholding agents such as dealers and investment funds going short on an NPC will likely seek to have counterparties make certain representations with respect to all seven factors and any related parties. Investment funds may seek to transact only with U.S. dealer counterparties or non-U.S. dealers, who will only act from their respective U.S. permanent establishments and provide an "ECI" representation, where no withholding is required. An investment fund may simply be unable to provide representations that negate the absence of the seven factors, not due to the presence of abusive facts but rather lack of control over facts that could make an NPC a Specific NPC.

Dividend Equivalents — Gross Amounts, Estimates and Substantially Similar Amounts: A payment of a dividend equivalent includes any gross amount that is used in computing any net amount that is transferred to or from a taxpayer under the terms of the contract. Thus, even if no net payment is made or the party entitled to the gross amount is required to make a net payment to the other party, the dividend equivalent is equal to that gross amount.

The proposed regulations specify that a payment is not a dividend equivalent if it is determined by reference to an estimate of an expected (i.e., not yet announced, declared or agreed) dividend, provided that there is no reference to, or adjustment for, the amount of any actual dividend.

The proposed regulations also define what is "substantially similar" to dividend equivalents paid pursuant to a securities lending agreement, repurchase agreement or Specified NPC. Substantially similar payments are: (1) gross-up amounts paid by a short party in satisfaction of the long party's tax liability with respect to a dividend equivalent; and (2) payments calculated by reference to a dividend from sources within the United States that are made pursuant to an equity-linked instrument other than an NPC, including a futures contract, forward contract, option or other contractual arrangement. It is unclear whether the proposed regulations will apply to a final payment made in 2013 that varies based on the amount of underlying dividends paid in 2012.

For equity-linked instruments (e.g., futures, forwards, options and other contractual arrangements), it appears that one of the seven factors needs to apply before withholding is required.

The proposed regulations also include an anti-abuse rule that permits the Treasury to treat payments made under a transaction or transactions as dividend equivalents if a taxpayer enters into such a transaction or transactions with a principal purpose of avoiding the withholding rules under Section 871(m) of the Code.

Withholding Agents' Responsibility When Outstanding NPCs Become Specified NPCs: The proposed regulations amend several regulations clarifying that an NPC that is not a Specified NPC at the time it is entered into but becomes a Specified NPC during the term of the contract will be treated as though it had been a Specified NPC during the entire term of the contract. The withholding agent will be responsible for reporting and depositing the amount of tax required to be withheld or paid over on all amounts that are recharacterized as dividend equivalents on the next payment date following the NPC's characterization as a Specified NPC (including any termination date payment), even when the withholding agent does not know, or have reason to know, that the NPC has been recharacterized.

The Treasury also expressly stated that in addition to the statute and regulations, it will continue to apply general common law principles and judicial doctrines to determine whether an NPC or other equity derivative represents tax ownership in the referenced equity.

It may prove very difficult for withholding agents to fulfill their obligations and collect payment for tax, especially when they are the short party and they are not making a payment from which they could withhold. For an investment fund who is on the short side, a practical issue is how to enforce any required withholding given that dealer counterparties typically control the cash flows in connection with a transaction. In the case of the short party who generally has no control over the assets in respect of an NPC, such short party should ensure that it has the right to be fully indemnified by the long party in respect of any circumstance giving rise to withholding under Section 871(m) of the Code. Some U.S. equity derivative counterparties might seek to withhold on all amounts that can be calculated in reference to a dividend in respect of any non-U.S. counterparty or they might seek to exclude any dividend-related economics from trades altogether.

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The proposed regulations under Section 871(m) of the Code are generally effective on the date of publication in the Federal Register of the Treasury decision adopting such regulations as final regulations. Thus, payments made on or after the regulations are finalized may be subject to withholding, even if the contracts were entered into before the effective date. If the proposed regulations are not finalized prior to the expiration of the temporary regulations on Dec. 31, 2012, in the absence of any additional guidance, dividend equivalent payments made thereafter on all NPCs will likely be subject to dividend withholding tax.

If you have any questions concerning this *Alert*, please contact your tax attorney at Schulte Roth & Zabel.

New York
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC
Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com

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Schulte Roth & Zabel

Schulte Roth & Zabel LLP
New York
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Schulte Roth & Zabel LLP
Washington, DC
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

Schulte Roth & Zabel International LLP
London
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com