

## 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;<sup>1</sup>
- 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.

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<sup>1</sup> 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.

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.

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.

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