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IRS Releases Final and Proposed Regulations Regarding Dividend Equivalent Payments to Foreigners

As part of 2010 legislation, Congress enacted section 871(m) of the Internal Revenue Code, which provides that payments made to foreign persons under specified notional principal contracts ("Specified NPCs"), securities loans, sale-repurchase transactions ("repos"), and other substantially similar payments ("dividend equivalent payments") that are determined by reference to U.S. source dividends shall be treated as U.S. source dividend income subject to withholding. While withholding already applied to substitute dividends on securities loans and repos prior to the enactment of section 871(m), dividend withholding had not previously applied to equity swaps or other equity-linked instruments.

Under the statute, Specified NPCs include NPC transactions in which the reference security is:

1. transferred between the NPC counterparties;
2. posted as collateral by the short NPC counterparty; or
3. not "readily tradable" on an established securities market.

In addition, a Specified NPC includes any other NPC transaction that is identified by the Internal Revenue Service (the "IRS") as a Specified NPC. For payments after March 18, 2012, the statute provides that <u>any</u> NPC is a Specified NPC unless the IRS determines it does not have the potential for tax avoidance.

In 2012, the IRS released temporary and proposed Treasury regulations (the "Prior Regulations"). Under the Prior Regulations, as subsequently modified, the statutory definition of Specified NPCs continued to apply to payments made on Specified NPCs through the end of 2013. Thus, payments on NPCs that did not fall within the statutory definition of Specified NPC (and are not subject to withholding under common law principles) would remain exempt from withholding until January 1, 2014. For payments being made on or after January 1, 2014 (including payments on contracts entered into prior to that date), the Prior Regulations contained a seven-factor test for determining whether a notional principal contract was a Specified NPC. In addition, the Prior Regulations broadened the categories of dividend equivalent payments to include certain payments made pursuant to equity-linked instruments (including futures, forwards and options) ("ELIs") as U.S. source dividends. The Prior Regulations provided that, for the foregoing purposes, a payment determined by reference to an estimate of expected dividends would not be treated as a dividend equivalent payment if such payment was not determined by reference to, or adjusted by, the amount of an actual dividend.

On December 4, 2013, the IRS released final and new proposed Treasury regulations (the "Final Regulations" and "Proposed Regulations," respectively) that finalized certain of the Prior Regulations and revoked other portions of such regulations, proposing new regulations applicable to dividend equivalent payments. The Proposed Regulations represent a significant shift from many of the approaches set forth in the Prior Regulations and, if finalized, would substantially modify the IRS's approach to dividend equivalents going forward, potentially covering many more transactions. Although in certain respects the

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Proposed Regulations represent an improvement over the Prior Regulations, the Proposed Regulations are complex and may apply to a broad range of transactions that would not have been subject to section 871(m) under the Prior Regulations.

The Final Regulations extend the statutory definition for Specified NPCs for dividend equivalent payments to all payments made prior to January 1, 2016. For payments made after December 31, 2015, the Proposed Regulations provide that a dividend equivalent payment will include any payment that references the payment of a dividend from an underlying security pursuant to a securities loan, repo, Specified NPC, specified ELI ("Specified ELI") that is acquired after March 5, 2014, or any other substantially similar payment. The Proposed Regulations would apply to dividend equivalent payments made on or after January 1, 2016, even if the contracts were entered into before that date.

Post-2015, the Proposed Regulations replace the seven-factor test of the Prior Regulations with a new single-factor test that focuses on an instrument's "delta." The change to a single-factor, delta-based test means that section 871(m) could apply to virtually any cross-border financial instrument and will impose new requirements for parties to determine the appropriate delta for any such instrument that may be outstanding (including those that have already been issued). In particular, after December 15, 2013, the Proposed Regulations would cause an NPC or ELI to be a Specified NPC or Specified ELI if its fair market value correlation (*i.e.*, its delta) to the underlying reference security is 0.70 or greater at the time the long party to the transaction acquires the NPC or ELI. Thus, to the extent the ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of the underlying reference security is determined to be 0.70 or greater on the date of acquisition by the long party (and not just at the time of origination), such NPC or ELI will be subject to the rules of section 871(m). The Proposed Regulations set forth rules for determining an instrument's delta, requiring taxpayers to determine delta in a commercially reasonable manner and including rules intended to prevent taxpayers from circumventing the application of section 871(m) by reducing delta without altering the underlying economics of a transaction. As a result of these changes, any equity-linked swap or derivative will now be subject to dividend withholding if it tracks the economics of the underlying security too closely, even if it would not be a transfer of the underlying security under general tax principles. Effectively, the Proposed Regulations are treating total return swaps, and potentially other equity derivatives, like repos or securities loans, with a bright line drawn at a 0.70 delta to divide those contracts that are "abusive" and those that are not.

In addition to modifying the types of instruments to which section 871(m) will apply, the Proposed Regulations also significantly expand the types of payments that will constitute dividend equivalent payments. In particular, dividend equivalent payments will not only include those payments that explicitly reference actual dividends, but also those payments that implicitly reference dividends or, in a shift from the Prior Regulations, that reference estimated dividends. Similar to the Prior Regulations, substantially similar payments will also include amounts paid in satisfaction of a tax liability with respect to dividend equivalent payments.

A payment implicitly references dividends if a payment is implicitly taken into account in computing one or more of the terms of the contract, such as the interest rate, notional amount, purchase price, premium, upfront payment, strike price, or any other amount paid or received pursuant to the contract. In addition, the Proposed Regulations provide that unless the short party to a transaction identifies a reasonable estimated dividend amount in writing at the inception of the transaction, the long party will be treated as receiving an amount equal to the actual dividends paid on the underlying stock. Accordingly, if the terms of a derivative implicitly reference an estimated dividend, the long party to the transaction will be treated as having received an actual dividend, which may be far in excess of the

implicit estimate. To illustrate this concept, the Proposed Regulations include an example in which a foreign investor enters into a total return swap pursuant to which it will receive any appreciation in the value of stock of X corporation in exchange for paying a LIBOR-based floating amount and any depreciation in the value of the stock. The example provides that if the LIBOR-based amount is reduced to reflect estimated annual dividends on the stock of X (which can be retained by the short party), the investor will be treated as receiving the actual dividend amount (even though the reduction in the LIBOR amount was based on estimated dividends).

The Proposed Regulations also include various anti-abuse provisions, including provisions to treat multiple transactions referencing the same underlying security as a single transaction for purposes of determining whether a transaction is subject to section 871(m) and rules providing that payments made pursuant to transactions entered into with a principal purpose of avoiding section 871(m) may be treated as dividend equivalent payments. The preamble to the Proposed Regulations also makes clear that the IRS intends to continue to apply common law principles in instances not specifically covered by the Proposed Regulations to cause payments to be subject to U.S. withholding tax (by, for example, asserting that a transaction that is in form an NPC is in substance the beneficial ownership of the referenced underlying security).

The Proposed Regulations contain several exceptions for transactions and/or instruments that the IRS deems to have limited potential for tax avoidance. The first exception applies to dealers that: (1) are the long party in a transaction, (2) are subject to regulatory supervision in their jurisdiction of organization or creation, and (3) provide certain written certification to the short party to the transaction. Notably, this exception would not apply to dealers that are trading for their own account. In addition to this dealer exception, derivatives referencing certain "qualified indices" would be exempt from section 871(m). The definition of qualified index was revised in the Proposed Regulations to include any index that: (1) references 25 or more component underlying securities, (2) references only long positions on such securities, (3) contains no component security representing more than 10 percent of the index's weighting, (4) is modified or rebalanced only according to certain predefined objective rules, (5) that does not provide a high dividend yield, and (6) is referenced by futures or options contracts that trade on a national securities exchange or board of trade. Although the determination of whether an index satisfies these requirements is made at the time of acquisition, an index will not constitute a qualified index if the transaction also references a short position in a specific referenced component of the qualified index, or if, at a later date, the taxpayer otherwise enters into one or more transactions that reduce exposure to underlying reference components of the index (with exceptions for transactions that reduce exposure to the entire index). Finally, the Proposed Regulations contain an exemption for certain transactions obligating a long party to acquire ownership of an underlying security in an issuer as part of a plan pursuant to which one or more persons (including the long party) will acquire underlying securities representing more than 50 percent of the issuing entity's value.

In addition to the foregoing, the Proposed Regulations also contain numerous other features. For example, the Proposed Regulations contain provisions to treat transactions referencing interests in flow-through entities as referencing the allocable portion of underlying securities or 871(m) transactions held, directly or indirectly, by such entity. Moreover, if a transaction is treated as referencing an underlying security held by a flow-through entity as a result of the application of this rule, the transaction is deemed to reference the payment of any dividends on those underlying securities and to have a dividend equivalent equal to the allocable portion of the dividend or dividend equivalent received by the flow-through entity. These "look-through" rules will not apply to the extent the underlying

securities and 871(m) transactions held, directly or indirectly, by the flow-through entity represent, in the aggregate, 10 percent or less of the value of the interest in the flow-through entity referenced by transaction and there is no plan or intention for acquisitions or dispositions that would cause this 10 percent threshold to be exceeded.

The Proposed Regulations also contain provisions that make clear that contingent interest will not qualify for the "portfolio interest exemption" to the extent such interest constitutes a "dividend equivalent payment." This particular modification highlights the difficulties that will be presented to non-U.S. acquirors of ELIs post-issuance, as an acquiror will be obligated to determine the delta of, *e.g.*, a convertible security at the time of acquisition to determine whether a portion of the interest paid on such security may be subject to withholding going forward. Further, issuers of convertible securities will need to consider such provisions in allocating withholding tax risk under the indenture to such instruments, particularly if such instruments provide for dividend adjustments.

In addition, the Proposed Regulations impose new information reporting and withholding requirements on parties that enter into transactions potentially subject to section 871(m). Importantly, these rules will require either the broker or dealer (or if both or neither party is a broker or dealer, the short party) in a transaction to determine whether the transaction is subject to section 871(m). The Proposed Regulations provide that a withholding agent will not be liable for under-withholding if it reasonably relies on information received from the party obligated to determine whether the transaction is subject to section 871(m). In addition, even though multiple transactions may be combined to be treated as a single transaction, a withholding agent will not be held liable for withholding unless it knows that the long party (or a related party) entered into such transactions in connection with one another.

Finally, the Proposed Regulations include provisions detailing how withholding is to apply where no money or property is being paid by the short party to the long party to the transaction. In particular, the Proposed Regulations provide that withholding is not required until the later of: (1) the time that the dividend equivalent is determined, or (2) the time at which the withholding agent is deemed to have control over money or other property of the long party. Such deemed control occurs when money or other property is paid to or from the long party, the withholding agent has custody or control over money or other property of the long party after the dividend equivalent is determined, or where an upfront payment or prepayment of purchase price has occurred.

While the continued delay of the application of a broad definition of Specified NPC certainly represents a welcome extension, several aspects of the Proposed Regulations are uncertain and, in general, the Proposed Regulations will present practical difficulties for counterparties entering into swaps and other equity-linked derivatives, particularly given that the economics of many derivatives are extremely complicated. Given that the Proposed Regulations would apply to financial instruments outstanding prior to January 1, 2016, the parties to many common swaps and other transactions will need to begin considering how withholding risk should be allocated in the future. Further, neither the Final Regulations nor the Proposed Regulations address all of the potential scenarios for over-withholding where a chain of dividend equivalent payments exists (current relief from over-withholding (Notice 2010-46) only covers securities loans and repos).